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Fastly, Inc. (FSLY)

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. At this time, I would like to welcome everyone to the Fastly Second Quarter 2022 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 conference over to Vern Essi, Investor Relations at Fastly. Please go ahead.

Vernon P. Essi

Vice President-Investor Relations, Fastly, Inc.

Thank you and welcome everyone to our second quarter 2022 earnings conference call. We have Fastly's Lead Independent Director, David Hornik; our CEO, Joshua Bixby; and our CFO, Ron Kisling, with us today.

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, strategy, long-term growth, and overall future prospects. These statements are subject to known and unknown risks, uncertainties and assumptions that could cause actual results to differ materially from those projected or implied during the call.

For further information regarding risk factors for our business, please refer to our most recent Quarterly Report 10-Q filed with the SEC and our second quarter 2022 earnings release and supplement for a discussion of the factors that could cause our results to differ. Please refer, in particular, to the sections entitled Risk Factors. We encourage you to read these documents.

Also note that the forward-looking statements on this call are based on information available to us as of today's date. We undertake no obligation to update any forward-looking statements, except as required by law.

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

Before we begin our prepared comments, please note that we will be attending two conferences in the third quarter, KeyBanc Technology Leadership Forum in Colorado on August 9 and Citi's 2022 Global Technology Conference in New York on September 7.

With that, I will turn the call over to David for his comments regarding today's announcement of our new CEO, Todd Nightingale. David?

David M. Hornik

Lead Independent Director, Fastly, Inc.

Thanks, Vern. Hi, everyone, and thank you for joining us today. As you may have seen from the press release we issued this afternoon, I'm thrilled to share that after a broad and extensive search to identify the company's next leader, Todd Nightingale has been appointed our next Chief Executive Officer of Fastly. Fastly's large enterprise customer base, robust product road map, and unrivaled customer satisfaction gives us confidence about Fastly's future and the significant opportunities ahead.

As we search for the company's next leader, the board was committed to finding a candidate that could help build upon Fastly's strong foundation and lead it into the next stage of growth. The board is confident that Todd's customer-oriented leadership style and extensive background helping customers transform their infrastructure and digitize their businesses will greatly benefit Fastly and position the company for future success.

Hailing from Cisco, where he currently serves as Executive Vice President and General Manager of Enterprise Networking and Cloud, Todd is a proven and passionate technology leader. Todd understands that now, more than ever, enterprises need innovative solutions that enable them to deliver globally performant secure and reliable applications to their customers. He will officially join us as CEO on September 1 and Joshua will remain with the company for a period of time to ensure a smooth and successful transition.

Please note that at this time, we won't be addressing any questions regarding Todd's appointment during today's Q&A, but we'll plan to share more information after his starting.

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

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thank you, David. Hi, everyone, and thanks for joining us today. Today, I will talk about the quarter and then we'll invite Ron to provide some more color on this quarter's results. Then we will take some questions, which, as David indicated, we ask that you focus on the results and the outlook.

In the second quarter 2022, we reported revenue of \$102.5 million, representing flat sequential growth and 21% growth year-over-year. These results exceeded the top end of our guidance range of \$99 million to \$102 million and represent another record revenue quarter. Our customer retention and growth engine remains strong. Our LTM NRR was 117% and our DBNER was 120% in the second quarter. Our average enterprise customer spend was \$730,000, representing a 1% quarter-over-quarter increase.

Our total customer count in the second quarter was 2,894, of which 471 were enterprise customers. Our total customer count increased by 14 in Q2, down from 76 in Q1. Our total customer count was impacted by higher churn at the low end of our customer base, which we believe was impacted by the uncertain macro environment impacting smaller customers and the dynamics we have described before in which small customers opt for our more robust developer-friendly trials. We continue to focus on landing new enterprise and large customers.

For example, in the second quarter the average monthly revenue run rate of the new customers we added to the platform was 85% higher than those that churned. In terms of developer traction, we added over 100,000 developers to our platform across Glitch and our Compute@Edge platform, and we're pleased to see so many new developers experimenting with us.

It is encouraging to see our enterprise customer count increase by 14 compared to 12 in the first quarter. This increase in enterprise customers validates our efforts in sales and marketing to retain and expand our customers' revenue, particularly focused on larger customers. This was the case with two Fortune 500 customers, one a leading CRM company with world-class enterprise customers and the other a global digital payments juggernaut. Both customers expanded their use of Fastly across multiple product lines in the second quarter.

You may have seen the announcement last week that Fastly is now an official global sponsor of the Mercedes-AMG Petronas Formula One Team. This long-term partnership reflects our shared commitment to experiences that are fast, safe and leading edge, both on the track and on the Internet. You will be hearing more about this growing relationship on the track and on our platform in the coming quarters.

As we discussed in detail last quarter, one of the key initiatives we've undertaken in 2022 is the deployment of our new architecture for key metro regions. As previously discussed, we believe we will achieve material gross margin leverage by doubling down our efforts on server efficiency with this new architecture which is coupled to our proprietary software development.

As discussed previously, we have been running duplicate sites which is a gross margin headwind. However, our gross margin in the second quarter was further adversely impacted primarily by onetime cost true-ups and other smaller items. Ron will provide more details in his section, as well as our strategic initiatives at reducing supply chain risks and carrying costs on our infrastructure CapEx.

Our gross margin declines are an area of focus and we remain committed to taking the necessary steps to see this improve. Like last quarter, the pricing dynamics in the business have not materially changed and have not been a major contributor to our recent decline. The team at Fastly remains united in our common mission, which is to fuel the next modern digital experience by providing developers with a programmable, secure, and reliable edge cloud network that they adopt as their own. Central to this common mission is the key role developers play in our journey, and the new and expanding power of distributed edge compute and security. As they use our

trusted platform, they become more interested in its features and that keeps them engaged and retained as customers as they scale.

To reinforce this effort, we acquired Glitch, announced on the heels of our Q1 results, a platform of 1.8 million developers, bringing together two of the world's best ecosystems for application development into a single, seamless developer experience to deliver globally performant, secure and reliable applications at scale. Now developers can innovate, create and share full stack web apps without having to run the infrastructure or manage tools themselves. We're very excited about Glitch as it provides a giant leap forward in our developer relations efforts.

We're also building partner momentum to broaden and deepen our developer reach. As you may have seen last week, we announced a reseller partnership with HUMAN to resell their industry-leading bot detection to help security and fraud teams keep cyber criminals out of their online applications and services. Using superior detection methods, hacker intelligence, and collective protection across the web, HUMAN detects and defeats bot attacks and fraud with unmatched scale, speed, and precision.

Now customers can get all the benefits of Fastly's Next-Gen WAF, the first and only unified WAF solution with HUMAN's exceptional bot protection management capabilities. In the coming quarters, we will continue to expand our roster of partners to expand the scope and reach of our platform.

Moving on to our product highlights for the second quarter. Our delivery products which are part of our network services portfolio, continued to receive strong market validation. Fastly was recognized as a customer choice in the 2022 Gartner Peer Insights Voice of the Customer Global CDN. Fastly received the highest customer rating of 4.8 out of 5 stars and the highest customer willingness to recommend at 97%. We earned recognition due to our network size and scale, developer focus, web security, and customer support.

Positive customer sentiment continues to lead to significant upsells with our largest customers. For example, in the second quarter, a leading social media platform with over 50 million daily active users chose to expand our relationship with additional products after undertaking a competitive RFP process. We continue to accelerate Fastly's product delivery. In the second quarter, we had 14 releases in total compared to 11 releases in the first quarter. Observability has been a top priority in 2022 and we announced general availability of both Origin Inspector and Domain Inspector, which both can be self-enabled straight from the Fastly UI.

For companies using a single origin, multi-cloud or multi-CDN architecture, Origin Inspector unlocks end-to-end visibility of Internet traffic traveling from the Origin to the Fastly edge cloud. Domain Inspector allows our customers to effortlessly monitor traffic for a single, fully qualified domain name or multiple domains assigned to a Fastly service.

On the security front, we had several new developments. Fastly's Next-Gen WAF edge deployment is now in general availability. Given the rise of new threats in late 2021 and into early 2022, such as Log4j and SpringShell, we added new APIs for de-provisioning, improved origin syncing and now support the percentage ramp-up feature to control the amount of traffic through the edge security service.

Our delivery customers are easily migrating to our expanded security offering. In the second quarter, an online discovery platform serving over 300 billion content recommendations monthly extended its Fastly edge delivery needs with the Next-Gen WAF product. Along with Fastly's Next-Gen WAF, we added CVE signals, allowing virtual patching functionality to be configured through a web interface.

We introduced Fastly Security Labs, a new program that empowers customers to be the first to test new detection and security features directly to the security product team, bolstering the quality of our Next-Gen WAF. We also added features to our Image Optimizer and we add JavaScript SDK to Compute@Edge-supported languages.

Compute@Edge continues to be critical in winning new business. For example, a Japanese e-commerce marketplace chose Fastly specifically because of our JavaScript support in a competitive deal for Compute@Edge that did not include delivery. Our continued strong execution on the product and engineering front is very exciting and our significant increase in release velocity reinforces our commitment to developers and platform builders.

Underpinning all of our technology is our lightning fast network. We continue to remain consistently faster than our peers in the US and Europe, even surpassing some of our toughest critics and customers' expectations. This performance advantage validates our unique architecture, and we are continuing to invest in this development to fuel growth. Performance paired with security is one of the most critical decision-making metrics for our customers. That is why we are excited and proud to be part of Apple's new iCloud private relay service that's designed to protect users' privacy on the Internet. And we're also collaborating with Apple, Google and others to develop and standardize the technology behind private access tokens to provide secure anonymity to end users.

I'll close out by saying that working closely with world-class customers like Apple is further validation of Fastly's technology and platform solution, and we look forward to further opportunities to collaborate with industry leaders.

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

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

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

Total revenue for the second quarter increased 21% year-over-year to \$102.5 million, exceeding the top end of our guidance of \$99 million to \$102 million. In the second quarter, revenue from Signal Sciences products was 13% of revenue, a 56% year-over-year increase or 41% increase after purchase price adjustments related to deferred revenue are reflected. While we are not immune to the macroeconomic trends, we are seeing healthy traffic expansion from our enterprise customers. And given our relatively smaller market share, we are benefiting from share gains in an otherwise challenging environment.

Our Dollar-Based Net Expansion Rate, or DBNER, was 120%, up slightly from 118% in Q1. And our trailing 12-month net retention rate was 117%, up slightly from 115% in the prior quarter. We continue to experience very low churn of less than 1% and our customer retention dynamics remain strong.

As Joshua stated, we had 2,894 customers at the end of Q2, of which 471 were classified as enterprise, those customers with an excess of \$100,000 of revenue over the previous 12 months. Enterprise customers accounted for 88% of total revenue on a trailing 12-month basis, down slightly from their 89% contribution in Q1 and increased their average spend to \$730,000 from \$722,000 in the previous quarter, demonstrating our continued ability to expand our business within our largest customers and our strong customer retention. Our top 10 customers comprised 34% of our total revenues in the second quarter of 2022, in line with their contribution in the first quarter of 2022.

Before I begin a detailed discussion of our financial performance, let me step back and take a moment to discuss the changes taking place within Fastly's financial organization. As we've discussed since I joined Fastly one year ago, we've been in the process of transforming our financial team, our operations and the management of our balance sheet. This has resulted in several changes that we believe will not only strengthen Fastly's financial position longer term but also improve Fastly's competitive positioning and its transparency to the investor community. Let me briefly discuss these improvements.

First, we used our strong cash balance to repurchase approximately \$235 million of the principal amount of our convertible debt at a 25% discount to its principal value, resulting in a \$54 million gain on this repurchase.

Secondly, we made advanced payments for capital hardware of \$29.3 million to suppliers on purchase commitments we had made in early 2021 to reduce our exposure to supply chain constraints. These advanced payments will reduce carrying cost by over \$1 million over the next 12 months, depending on our deployment schedule of the committed equipment.

Third, we have improved our capacity planning process with better forecasting and cross-functional reviews to better align capacity investments with expected traffic levels. We believe this will result in improved gross margins in the medium to long term.

In addition, we now expect our cash CapEx for 2022, which includes purchases of PP&E and capitalized internal-use software and excludes advanced payments for PP&E and repayments of finance leases, to decline to a range of 10% to 12% from our previously expected range of 12% to 14%.

Fourth, we have improved our controls around cost of revenues and made adjustments to our accounting for free developer and charitable organization accounts and recorded a onetime Q1 true-up to our cost of revenues of approximately 160 basis points in the second quarter.

And lastly, for the second half, we have put in place additional controls around hiring and non-head count spending. As we previously shared, our expenses in 2022 were weighted to the first half of the year, and with these adjustments, we expect second half operating expenses to decline as compared to the first half.

In addition as we improved our cost controls, we experienced some onetime true-up of costs in the second quarter, primarily in sales and marketing. I will now turn to the rest of our financial results for the second quarter.

Our gross margin was 50.4% for the second quarter compared to 52.6% in the first quarter of 2022. This gross margin is below the flattish sequential level we anticipated during our last quarterly earnings call. This is primarily due to a onetime true-up to our cost of revenue I discussed above, as well as other smaller onetime items that had they not occurred would have led to an approximate decline of only 50 basis points sequentially.

We realize the optics of this gross margin trend are unfavorable, and I want to confirm that we did not see any meaningful decrease in our pricing in Q2 compared to the first quarter. And our prior discussion on our network investments in the next-generation architecture remains intact, and we expect gross margin improvement in the second half. We continue to expect gross margin to increase meaningfully for the remainder of 2022 towards the low to mid-50s.

Operating expenses were \$78.6 million in the second quarter, up 18% over Q2 2021 due to increased head count across the organization, higher-than-expected salary increases, an acceleration in T&E expenses, increased investment in product and go-to-market activities and, as I previously mentioned, certain onetime expense items.

We experienced several onetime expense items in Q2, primarily in sales and marketing that we do not expect to repeat in the second half of 2022. A little over half of the quarter-to-quarter increase in OpEx was due to onetime expense items in the quarter.

While we now anticipate operating expenses for 2022 to be higher than we planned at the beginning of the year, as we previously stated, we still expect expenses to be lower in the second half as compared to the first half. Our operating loss for the quarter was \$26.9 million and our net loss was \$28 million or a \$0.23 loss per basic and diluted share, compared to an operating loss of \$17.6 million, a net loss of \$17.4 million and a \$0.15 loss per basic and diluted share in Q2 2021.

Turning to the balance sheet. We ended the quarter with approximately \$767 million in cash, cash equivalents, marketable securities and investments, including those classified as long term. During the quarter, we repurchased \$235 million in aggregate principal amount of our convertible debt for \$176.4 million or \$0.75 on the dollar before related fees and transaction costs, reducing our debt balance to \$703 million from \$934 million. We will continue to use our balance sheet strategically to capitalize on low-risk opportunities that arise in the capital markets during these volatile periods.

Our free cash flow reflects the impact of the advanced payments on capital equipment commitments of \$29.3 million, capital expenditures of \$15 million, which include cash purchases of capital equipment, capitalized internal-use software, and payments on finance leases in the quarter, resulting in the decrease in free cash flow to negative \$61 million. Our cash capital expenditures were 11% of revenue in the second quarter, and our capital expenditures include capitalized software. This, along with our foundational technology, drives efficiency and leverage in our network which is a competitive differentiator.

We previously shared that we made commitments for future equipment needs in early 2021 in response to supply chain challenges. As I discussed previously, as part of these commitments, we made advanced payments of \$29.3 million in the second quarter, and we will be making additional advanced payments of approximately \$16 million over the next three quarters to secure availability of this equipment and reduce ongoing carrying cost fees from these vendors.

We expect to take delivery of equipment covered by these commitments and deploy it over the remainder of 2022 and 2023. These payments will favorably impact our gross margin by reducing carrying costs, and we do not incur any operating costs, including depreciation, until we deploy this equipment.

And despite our transition to our next-generation network architecture and acceleration of some investments due to supply chain constraints, as I previously discussed, with the benefits from our improved capacity planning processes, we now expect our cash capital expenditures in 2022 to decline to a range of 10% to 12% of revenue from our previously expected range of 12% to 14%.

I will now turn to discuss the outlook for the third quarter and full-year 2022. 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 2022 outlook reflects our continued ability to deliver strong top line growth via improved customer acquisition and expansion within our enterprise customers, driven in part by new and enhanced products. Our revenue guidance is based on the visibility that we have today. And given our usage-based business model, we expect to gain additional visibility to our annual guidance as the year progresses.

Historically, our first and second quarter revenues are generally flat, with revenues increasing in the second half of the year. As a result, for the third quarter we expect revenue in the range of \$102 million to \$105 million, representing 19% annual growth at the midpoint. We expect a non-GAAP operating loss of \$21.5 million to \$18.5 million and a non-GAAP loss per share of \$0.18 to \$0.15.

For the full-year 2022, we are increasing our prior revenue guidance by \$10 million to a range of \$415 million to \$425 million, representing 19% annual growth at the midpoint. We expect a non-GAAP operating loss of \$78 million to \$72 million and a non-GAAP net loss of \$0.68 to \$0.63 per share, reflecting the impact from lower gross margins and higher expenses I discussed previously. And to reiterate, we anticipate gross margins to improve in the second half of 2022.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Frank Louthan with Raymond James. Your line is open.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you. So just to be clear on the gross margins, if you – adding back the charge you took, it would have been more like 46.5%, is that correct? And then, I missed what you said the back half would be, and does this mean that the upgrade you're doing there is finished and the back half is sort of the full benefit of that, or can we still expect gross margins to ramp going into 2023? Thank you.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah, Frank. This is Ron. A couple of things, on gross margin. If you back out kind of the onetime activities or adjustments, as we said, we would have been about 50 basis points below where we had sort of guided, which was flat. So that would work out on a non-GAAP basis to be around 52% gross margins in the quarter, ignoring the onetime cost. As for the technology migration at our largest sites, that is on track and is one of the drivers in the second half for improved gross margins, as we are decommissioning the redundant sites that we put in place as we made this technology migration.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Q

Okay. Great. Thank you. And can you walk us through the acquisition and just how you expect that to boost your other offerings in the space? Thanks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. Hey, Frank. It's Joshua here. I think as we've said all along, as a platform for platform builders and as an organization that really supports developers, that journey doesn't just start when you are ready as an enterprise to

adopt the technology. We've known for the lifetime of our business that that journey starts when you start experimenting. When you have a problem at 2:00 in the morning that you can't sleep and you're trying to solve, the developers will wake up and they'll try to solve problems.

And so, for us the Glitch acquisition is incredibly important because it continues that journey, actually drives that journey earlier into the developer lifecycle. Glitch is a tool that, as we said, is used by 1 million plus developers who are out there solving problems. And really what Compute@Edge is designed for is to solve problems for these people who build platforms and who are delivering platforms. So we see it as being very important on the sales journey, and not only that developer moment of inspiration, but that carries through the entire enterprise cycle.

So, we believe it's going to serve two main purposes, obviously on the revenue side. But the other thing, when you get so many people experimenting with the tools, you actually start to find new use cases, and the innovation of the community starts to become part of that innovation cycle. And one of the things that you've seen from the business over the last few quarters and really highlighted this quarter is we are delivering – there's 14 important releases. We are accelerating. We are getting faster. And I'm really proud of the team for doing that. And when we look at a community of millions of people experimenting, that only accelerates that. So I think it really helps in both areas of the business. It's very exciting.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

All right, great. Thank you very much.

Q

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Frank.

A

Operator: Your next question comes from the line of Fatima Boolani with Citigroup. Your line is open.

Hey. Good afternoon, guys. This is Mark on for Fatima. Thanks for taking our questions. So it sounds like strong expectations for the balance of the year, but can you give us a sense of the puts and takes and maybe key driver of guidance for second half that you guys are seeing that gives you confidence for the robust outlook on the top line for the back half, especially in the current environment? Thanks.

Q

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Yeah. It's Joshua here. I think that as we talked about and when you look at the enterprise number for the quarter, what we're seeing is our largest customers and those that are growing into that scale are more optimistic, are in the middle of these transformations, have large budgets. And so, we are definitely seeing that side of the market. The market we really focus on continuing to grow. And I think when you look at the guidance for the year and the quarter and the next quarter, what you see is it's really off the back of those large customers.

A

So we acknowledged that there's uncertainty across the entire customer base, but we are definitely seeing, within our larger, more established customers, we're seeing more their ability to plan further out and their – and the

projects that they're working on are central to their digital transformation. What we've seen historically in all of these times of economic upheaval is that people do invest in digital transformation. They do invest in the channels that are working, and they invest in ways to innovate. Right now, those channels are on the Internet, and the innovation is directly related to where the edge cloud provides so much value. Performance matters, security matters, and it matters even more in uncertain times.

So I think it's very much related to the momentum in the largest customers. That's really why we've been able to raise guidance and we continue to see strength in the business. But by no means is it clear path sailing here. We absolutely see that there is uncertainty ahead of us.

Q

Okay, great. Thanks for that. And then maybe just moving on to the security business, thank you for the high-level details, but maybe can we get an update on the momentum, anything quantifiable would be much appreciated, whether it's year-over-year sequential growth on your assets there. And then just given your 1% increase on the average enterprise customer spend, when can we maybe see some more apparent ramp there on the security business, maybe adoption from the customers. Thanks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. So on the customer spend side, I think that that's a number that you have to look at over a longer period of time. There's puts and takes to that. I think overall we're going to continue to see that go up because, as you say, as our customers start to and continue to adopt the security offering, but also the compute offerings as well as other offerings. So what we continue to see, and I mentioned that with a few Fortune 500 customers who have broadly adopted across the portfolio and increased their usage. That's a pattern that we're seeing, and that will take some time to flow through.

I think overall in the security business, Ron hit on the SigSci specific numbers, but if you go zoom out a little bit and look more broadly, what you'll see is that momentum is broad. We continue to innovate in that product line. We talked about the introduction of our Security Labs product. We talked about some of the private relay work that we're doing. I mean, security is very much top of mind for our customers, and we continue to see wide adoption.

One of the encouraging elements for me is how often the next-generation WAF platform is being leveraged into our largest accounts across all of our business units. So from media through to high tech through to technology, we are seeing that absolutely be adopted even in areas where initially when we when we acquired Signal Sciences, we weren't sure how broad that adoption would be. So we have been pleasantly surprised, and you can see that from the growth in that particular product offering.

Q

Perfect. Thank you, guys, so much.

Operator: Your next question comes from the line of Rudy Kessinger with D.A. Davidson. Your line is open.

Rudy Grayson Kessinger

Analyst, D.A. Davidson & Co.



Great, guys. Thank you for taking my questions. I joined a little bit late, so I apologize if you addressed this in your prepared remarks. But when I look at the guide for the year, you're taking rev up \$10 million. You're taking the operating loss guide down by \$10 million.

What are the puts and takes? I know you're still saying gross margins will ramp in the second half. But if I look at that \$10 million op loss reduction, how much of that is attributed to the Glitch, attributed to a lower gross margin outlook, increased OpEx spend on product or sales elsewhere? Just could you break it down for me?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.



Sure, Ron, you want to take that one?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.



Certainly. So a couple of drivers here. I think, first, we did see Q2 operating expenses come in higher than we had planned at the beginning of the year. Some of that was driven by increased head count across the organization, which was a contributor to that increased head count across the organization. We saw higher-than-expected salary increases, acceleration of T&E, and an increased investment in product and go-to-market activities in the first half, as well as certain onetime expense items.

So when you look at the impact on the first half, we now look for anticipated operating expenses for the year as a whole will be higher than we planned at the beginning of the year, although we still expect to see expenses down in the second half from the first half as we put in place a lot of controls around our spending and hiring levels.

But largely due to that increase in spending from those drivers is why we took up the operating loss ranges for the year of taking into account recognition of the increase in revenue. And from a gross margin perspective, while we still expect to see accretion in the second half, Q2 gross margins were lower than we had anticipated at the beginning of the quarter.

Rudy Grayson Kessinger

Analyst, D.A. Davidson & Co.



Got it. And then jumping to the gross margins, I mean, understanding there's a 160-basis-point impact in Q2, so really only down 50 points sequentially. But if I take a step back and compare the gross margins to, say, Q1 of 2020 pre-COVID, you're at 57.6% on a non-GAAP basis. And if I assume Signal Sciences is still about 80% gross margins, that would basically say that the rest of your business is running at about 46% gross margins, down about 12% from where you were pre-COVID. Understanding you got some boost later in 2020 on gross margins, but I guess just with the 12% kind of reduction in the rest of the business, what else is at play here besides the migration of some of your sites and the upgrades going on there and some pull forwards on CapEx? I have to imagine there's got to be some pricing pressure, a mix shift in your business. What else is driving the gross margin compression?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.



Yeah, I mean, the big drivers, and we talked about this through 2021, was an increase in our investments in our network infrastructure, both just in terms of investments in overall capacity as well as expansion internationally.

And particularly with new international sites, when you initially deploy them, you're running at less than sort of full capacity, so those tend to be also a drag on gross margin. So a lot of that was driven by the investments we made in the network over the last, say, year or 18 months.

Prospectively, as we look at the network, one, because of the investments we've made and, two, as we continue to improve our forecasting, we're able to align investments much more tightly with expected traffic. And so over time, we would expect capacity and traffic to come much more in line and drive improved gross margins as that sort of invest ahead of traffic is behind us.

Rudy Grayson Kessinger

Analyst, D.A. Davidson & Co.

Q

Okay, fair enough. Thanks for taking my questions.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Thanks, Rudy.

Operator: Your next question comes from the line of Jim Fish with Piper Sandler. Your line is open.

Quinton Gabrielli

Analyst, Piper Sandler & Co.

Q

Hey, guys. This is Quinton on for Jim Fish. Thanks for taking our questions. Maybe just first, enterprise revenue growth seemed to dip slightly compared to Q1 despite similar enterprise additions as last quarter. Are you seeing enterprise customers maybe slowed down on spend a little bit or take longer to decide on net new spending, or was there something else impacting the mix of commercial versus enterprise this quarter like some of your smaller enterprises maybe moving into the higher end of the commercial bucket?

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Ron, you want to take that?

Ronald Wayne Kising

Chief Financial Officer, Fastly, Inc.

A

Sure. So I guess you had a couple of different dynamics around enterprise customers. I think when you look at it over kind of the medium term, continue to point to, one, strong business with our enterprise customers. While on a trailing 12-month basis, it was down slightly at 1%, 88% of total revenues from 89%, we did see an increase in new enterprise customers this quarter of 14 compared to 12 in the last quarter and the average spend across our enterprise customers increased from \$722,000 to \$730,000.

So we're seeing continued increase in terms of expansion within our enterprise customers, and seeing some growth in new enterprise customers is clearly a focus to take that growth in enterprise customers and look at how we accelerate that through the work that we're doing in marketing in terms of brand awareness and leads and the development of the sales organization to accelerate that.

Quinton Gabrielli

Analyst, Piper Sandler & Co.

Q

Okay. That's helpful. And then maybe the last question from us is we've heard from recent reports how the gaming vertical specifically has continued to slow, especially as we move through the summer. To what extent is this slowdown, along with slowing results from other verticals like streaming or e-commerce, baked into the rate outlook provided? Are we assuming things continue to improve in the back half of the year, or are current trends embedded into this guide? Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Ron?

A

Ronald Wayne Kising

Chief Financial Officer, Fastly, Inc.

Yeah. So if we looked at guidance in the second half, I'd say we looked at a couple of things. We looked at the macro environment and certainly have taken into account what we believe the trends are across the key verticals that we play in, as well as we looked at what is the specific traffic that we expect to gain from our customers. We do a very detailed review of our customers in terms of what their plans are. And as I said, we've seen good expansion within those customers.

And based on discussions with those customers, we built out what we think are our traffic levels, our traffic shares are likely to be. And so it really is looking at our business, our traffic levels with our specific customers with recognition that the – it's a challenging environment. And I think the – as we sort of said on the call, we continue to see rate expansion. We continue to see new customers in a challenging environment. And given our relative market share, that does give us some ability to sort of, if you will, mute some of the macro drivers.

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

Charles Erlikh

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

Hey, guys. This is Charlie Erlikh on from Baird. Thanks for taking the question. I just want to ask about maybe – asking another way the revenue guidance as it pertains to the growth algorithm. Are you seeing any sort of shift in growth contribution from maybe new bookings or new customers added to the platform versus growth from existing customers, or has it been pretty consistent? Because we've heard from others that maybe existing customers are growing faster than new customer growth relative to past periods.

Q

Ronald Wayne Kising

Chief Financial Officer, Fastly, Inc.

I think what we saw in the second quarter was really driven by growth within existing customers. It was a combination of traffic as well as gaining new types of traffic and new types of business with those customers. So the expansion is really around both delivery and the types of services within those customers. We continue to see new customers.

Enterprise customers did increase in the quarter. We added to our total customer base. But our core dynamic, if you look at our business, is typically customers that we add in the current year contribute 5% to maybe 7% of our revenue, because our customers do typically ramp and contribute and expand over time. And I would say that pattern that we've seen in the past is intact.

A

Charles Erlikh

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

Q

Okay. That makes sense. Also, I just wanted to ask if there was any changes in trends between like April versus May versus June and now that July is behind us. Was there any change in the trend between those months or was it pretty consistent throughout?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

I think what we saw, and this kind of mirrors kind of what you see from our revenue traffic. We started to see traffic trend up as we got towards the end of the quarter. I think that's fairly consistent with our overall pattern. Q1 and 2Q tend to be relatively flat. We started to see increased revenues in Q3 and further acceleration in Q4. And so, traffic ramped as you moved through the quarter with higher traffic in June going into the summer months where we see the higher levels of traffic.

Charles Erlikh

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

Q

Got you. All right. Thanks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Thanks, Charlie.

Operator: Your next question comes from the line of Philip Rigby with RBC Capital Markets. Your line is open.

Philip Rigby

Analyst, RBC Capital Markets LLC

Q

Hey. Great. Thanks for taking the question. Want to start with a follow-up on guidance. If I look at your guidance, it seems to imply a bit of a deceleration in 4Q. Is that just pertaining to the uncertainty that you talked about, or are there other factors or assumptions in play there?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. I'd say, it's primarily tied to kind of the uncertainty. I mean, we've taken a strong view that we're a usage-based business that creates some volatility. And so, as we build our guidance, we take that into account. And certainly, as to the earlier question, we take into account kind of the macro trends that we're seeing as well as the trends we're seeing kind of on a micro basis within our own customer base.

Philip Rigby

Analyst, RBC Capital Markets LLC

Q

Got it. Thanks. And then you've mentioned increased salaries for employees. But I'm curious, if I look at where the stock is performing relative to some of the RSU issuances, would be curious to hear your thoughts on stock-based comp for existing employees. Any changes in philosophy or strategies you're thinking of taking there? Yeah, any insight would be great. Thank you.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. No real change in philosophy. I think retaining employees has been really critical, particularly in this competitive environment. And I think we've used a combination of things. We talked a little bit about salary increases in the first half being a little higher than we anticipated; and we've used a combination of equity and salary to be competitive.

I anticipate, just as you look at kind of the changes in the macro economy and the hiring environment, I expect the competitiveness in the hiring environment to become less competitive rather than more competitive, as we kind of see the rest of the year based on where you're seeing kind of the economy and overall hiring statistics, which will certainly impact the level of competitiveness in the hiring environment.

Operator: Your next question comes from the line of Jeff Van Rhee with Craig-Hallum Capital. Your line is open.

Q

Hey. This is [ph] Daniel (00:47:59) on for Jeff Van Rhee. Just a quick question on developers and the traction there in Glitch. Just if you could give us any additional color, walk us through – you said 100,000 incremental developers on the platform. Just any sort of sense of the scale of that relative to developers currently using Fastly, or just any other metrics or color you have around developer momentum. Thanks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, absolutely. When we acquired the platform, it was around 1.8 million. So you add 100,000 in the quarter, you get a sense for sort of how that's scaling. One of the things that Glitch has done exceptionally well has been very intelligent about how it scales its community. So instead of sort of opening the doors and encouraging everyone to come, they've been very thoughtful.

This is a team that comes out of building some of the best developer-led products that the world has ever seen so they understand how that works. And one of the things that they've learned is that in order to build an exceptional developer community, you need to have exceptional features and you need to be listening to your community early and iterating. So they follow that model. So what we are seeing is a very consistent growth path. That's what we saw very consistently over their history and that's what we'll continue to see.

Compared to Fastly's history, these numbers are huge. I mean, if you look at what we were doing before Glitch, it was a fraction of this. And that's what was so exciting about this deal for us is it just absolutely turbocharges our ability to get developers.

One of the things that was also very important was that 60% are in that range of their developers really were enterprise developers. And so that also is a very important metric for us in terms of thinking about where the targets are because we want all developers to use Fastly and we particularly want those that work in enterprises to use us.

Q

Thanks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Thank you.

Operator: Your next question comes from the line of Tom Blakey with KeyBanc. Your line is open.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Thanks for taking the question. My question – well, I have a couple. I have a follow-up for Ron here. But my first question was on Compute@Edge and developers as well. Like we're at a couple of million or almost a couple of million developers now. How is Fastly thinking about incentivizing these developers to work on Compute@Edge? I'm sure not all of them are well-versed in that, just incentives therein.

And also maybe as an illustration, Joshua, like maybe what is that Japanese win? Like what are they working on and what is kind of economic opportunity alongside the app development platform? That's my first question.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Sure. Yeah. That's a great question. I think you're absolutely right. The edge is an area that is that novel and new for a lot of developers. So, it really starts with bringing – making sure those tools are available and giving people the financial leeway in order to experiment.

So we talked about a program, a very successful program that we launched in Q4 and carried through to Q1 and we're still looking at ways where we can take this idea of taking the financial risk out of it in order for people to experiment. And the reason that's beneficial to take the financial risk out is because, and it comes back to that question about use cases, is because it brings so much value.

So we see customers dramatically reducing their central cloud bills. We see customers dramatically improving the performance of their applications. We see customers like some of the examples we've stated earlier where the sites are becoming significantly more personalized without playing off this consistent theme of I could make it personalized, but it's going to make it slow.

What Compute@Edge brings is the ability to not be making that tradeoff. And those are the kinds of things that we're seeing. But it absolutely starts with – it starts with this idea of experimentation and taking the risk out of it.

And so that's really what we see, and we see a lot of use cases which speak to bringing together the unique capabilities of Fastly and – which really come back to this idea of performance and scale and security. That's what central to all of this.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Good [indiscernible] (00:52:24) sounds like you are. And then for Ron on the gross margin. Sorry, Ron. But on the last call, we talked about mid-50s for the year in 2022. Now, it's kind of low to mid. There's a lot of one-timers in here. That's kind of a question, I suppose.

But in engaging what the percentage of maybe one-timers in the second half going into the second half of 2022, what are you building Fastly for structurally in terms of what gross margins can be sustainable long term 2023 and beyond? I think that'll be helpful for everyone...

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Yeah. So I think that's a good question. And I think what I would look to and I think as referenced earlier, if you kind of look back to kind of the margins we saw sort of in 2021, I think there's an opportunity to get back to those margins as we get some of these onetime things behind us, with the effort we put in place to better align our capacity investments with traffic on a go-forward basis. And then I think from there, then you can see additional accretion over time as we add – as security grows as a share of that, as we add more Compute@Edge.

But I think as a – what I would say maybe a medium-term guideline would be to see kind of where we were in 2021 and that's attainable just by getting beyond some of this technology transition that we talked about last quarter and managing capacity in line with traffic and bringing those two closer in line.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. That's great. So thanks for the clarity, Ron. Just as a clarification, last question from me, that 10% to 12% CapEx comment, impressive. Does that include advance – that can't include the advance payments in PP&E in 2022, does it, and...

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

No. Correct, this does not exclude the advance payments. When we take delivery of that and actually deploy it, we will include that in our cash CapEx. So that's – when we actually take title of the equipment is when we start depreciating it.

So, as we take deliveries out of that, that will be reflected in our cash CapEx. We will take some deliveries from some of those commitments in the second half. And so the deliveries against those purchase commitments are reflected in that outlook of 10% to 12% cash CapEx.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

That's interesting and maybe it's part of the upgrades that you're making to the network. Could you state now that you expect that range to kind of be consistent for at least the foreseeable future, like 20 – in the out years?

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

I mean, I think generally, I think as you look – absence any sort of other major sort of...

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

Right.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

...changes to the product, generally I see that as the level. I mean, ultimately, I think we're getting more efficient in terms of our capital deployment across the network and that would be kind of a good sort of medium-term guide.

Thomas Blakey

Analyst, KeyBanc Capital Markets, Inc.

Q

All right. Very good. Thanks, guys.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Thank you.

Ronald Wayne Kisling

Chief Financial Officer, Fastly, Inc.

A

Thank you.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

A

Thanks, Tom.

Operator: There are no further questions at this time. I'd like to turn the call back to our CEO, Joshua Bixby, for closing remarks.

Joshua Bixby

Chief Executive Officer & Director, Fastly, Inc.

Thank you. Before we sign off, I want to thank our employees, customers, partners and investors. We remain as committed as ever to fueling and securing digital experiences. And moving forward, we remain focused on execution, bringing lasting growth to our business and delivering value to our shareholders. I will remain in my role until Todd joins, and I look forward to supporting him. I want to reassure you that positioning Fastly for long-term success is my number one goal throughout this process. Thank you.

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

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