

Cloudflare

4Q First Take: Clean beat, but in-line guidance sends more muted CY24 message

Maintain Rating: UNDERPERFORM | PO: 52.00 USD | Price: 90.31 USD

4Q beat, but in-line CY24 revenue guidance disappoints

Cloudflare finished the year strong, beating 4Q estimates across the board. Revenues of \$363mn (+32% YoY) were +3% above Street estimates and management's guide supported by increased sales productivity, higher pipeline conversion rates and improved linearity. Gross margin expanded modestly by +100bps to 79%, while operating margin saw more significant expansion of +475bps to 11%, mostly driven by topline outperformance. However, the company guided CY24 revenues in-line with Street's 27% growth, despite historically guiding above Street estimates. While management cites continued macro pressure and skittish IT buying as the source of the conservatism, we believe company specific challenges such as quickly commoditizing web security and SASE markets could further challenge topline growth.

SASE shines as the 4Q darling, AI story still further out

Cloudflare's 4Q outperformance was largely driven by strength in SASE and Zero Trust solutions. Earlier in the year, we expressed concerns that Cloudflare's SASE solutions were not as technologically robust compared to competitor solutions. However, the company highlighted multiple large figure SASE and Zero Trust deals, most notably a \$33mn Zero Trust contract with the Department of Commerce, implying material product enhancements over the last two quarters. While we like Cloudflare's software defined approach to edge AI, is likely still too early to be a meaningful revenue contributor in CY24, and we continue to believe AI will not materially impact revenues until CY25 earliest.

How to think about the stock from here

Cloudflare, which already trades at a premium of 18x EV/Sales compared to other high growth SaaS peers who trade at 16x, traded up +25% after hours on the 4Q print, after rising +8% intraday pre-earnings release. However, we flag that the entire positive performance of the year is from today's trading session. The stock underperformed the NASDAQ, high growth software peers, and cybersecurity peers YTD. We caution that the reaction to the 3% revenue beat and in-line FY guidance could be overstated, and note that SASE is quickly commoditizing and in our view there was no new catalyst to the growth trajectory in the print.

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Stock Data

| | |
|---------------------------------|-----------------------|
| Price | 90.31 USD |
| Price Objective | 52.00 USD |
| Date Established | 7-Sep-2023 |
| Investment Opinion | C-3-9 |
| 52-Week Range | 39.90 USD - 91.08 USD |
| Mrkt Val (mn) / Shares Out (mn) | 26,723 USD / 295.9 |
| Free Float | 93.1% |
| Average Daily Value (mn) | 256.82 USD |
| BofA Ticker / Exchange | NET / ASE |
| Bloomberg / Reuters | NET US / NET.N |
| ROE (2023E) | 9.9% |
| Net Dbt to Eqty (Dec-2022A) | 195.7% |
| ESGMeter™ | Medium |

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Financial highlights

Exhibit 1: Actual versus estimated results

Cloudflare printed a clean 4Q beat versus estimates

| | 4Q22 | 1Q23 | 2Q23 | 3Q23 | 4Q23 | 3Q23E | QoQ | YoY | Delta |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|---------------|----------|---------|---------|
| Total Revenues | 274.7 | 290.2 | 308.5 | 335.6 | 362.5 | 328.5 | 8.0% | 32.0% | 33.9 |
| QoQ | 8.2% | 5.6% | 6.3% | 8.8% | 8.0% | 6.5% | | | |
| YoY | 41.9% | 36.8% | 31.5% | 32.2% | 32.0% | 29.4% | | | |
| Total Cost of Sales | 62.2 | 64.3 | 68.8 | 71.4 | 76.5 | 73.4 | 7.1% | 22.9% | 3.1 |
| Gross Profit | 212.5 | 225.9 | 239.7 | 264.2 | 286.0 | 255.2 | 8.3% | 34.6% | 30.8 |
| Sales and Marketing | 113.6 | 120.6 | 125.4 | 129.0 | 145.2 | 134.7 | 12.6% | 27.9% | 10.5 |
| Research & Development | 49.4 | 51.3 | 53.0 | 54.2 | 59.5 | 56.8 | 9.6% | 20.3% | 2.7 |
| General and Admin | 33.3 | 34.6 | 41.0 | 38.5 | 41.5 | 43.1 | 7.9% | 24.8% | -1.6 |
| Total Operating Expenses | 196.3 | 206.5 | 219.4 | 221.7 | 246.2 | 234.7 | 11.1% | 25.4% | 11.5 |
| Operating Income | 16.2 | 19.4 | 20.3 | 42.5 | 39.8 | 20.5 | -6.4% | 145.1% | 19.3 |
| Interest income (expense) | 8.32 | 13.49 | 16.54 | 17.95 | 20.19 | 19.02 | 12.5% | 142.6% | |
| Other Income | -0.9 | 0.4 | 2.1 | -1.3 | -1.8 | -1.8 | nmf | nmf | 0.0 |
| Pretax Income | 23.3 | 31.0 | 35.1 | 60.5 | 57.8 | 37.8 | -4.5% | 148.7% | 20.1 |
| Income Tax Expense | 2.3 | 3.9 | 1.4 | 5.3 | 5.3 | 0.4 | 0.0% | 133.6% | 4.9 |
| Net Income | 21.0 | 27.2 | 33.7 | 55.3 | 52.6 | 37.4 | -4.9% | 150.3% | 15.2 |
| Proforma EPS | 0.06 | 0.08 | 0.10 | 0.16 | 0.15 | \$0.12 | -4.9% | 133.6% | 0.03 |
| Diluted Share count | 328.3 | 330.4 | 322.3 | 351.7 | 351.7 | 322.9 | 0.0% | 7.1% | 28.8 |
| Consolidated Gross Margin | 77.4% | 77.8% | 77.7% | 78.7% | 78.9% | 77.7% | 17 bps | 154 bps | 123 bps |
| Operating Margin | 5.9% | 6.7% | 6.6% | 12.7% | 11.0% | 6.2% | -168 bps | 507 bps | 474 bps |
| Net Margin | 7.6% | 9.4% | 10.9% | 16.5% | 14.5% | 11.4% | -196 bps | 685 bps | 312 bps |

Source: BofA Global Research estimates, company report

BofA GLOBAL RESEARCH

Price objective basis & risk

Cloudflare (NET)

Our \$52 PO is based on roughly 10x Cy24 EV/Sales. The company has traded historically at a premium of 30-40% to high growth SaaS peers. However, we believe the company should trade in line with peers given its growth and margin profile but potential ST and LT headwinds to growth.

Upside risks to our price objective are: 1) accelerated adoption of new security and edge compute products, 2) increase in enterprise customers and the number of products they purchase.

Downside risks to our price objective are: slower adoption of security & edge compute products, product convergence leading to a shrinking market with larger competitors, accelerated commoditization in Cloudflare's core markets.

Analyst Certification

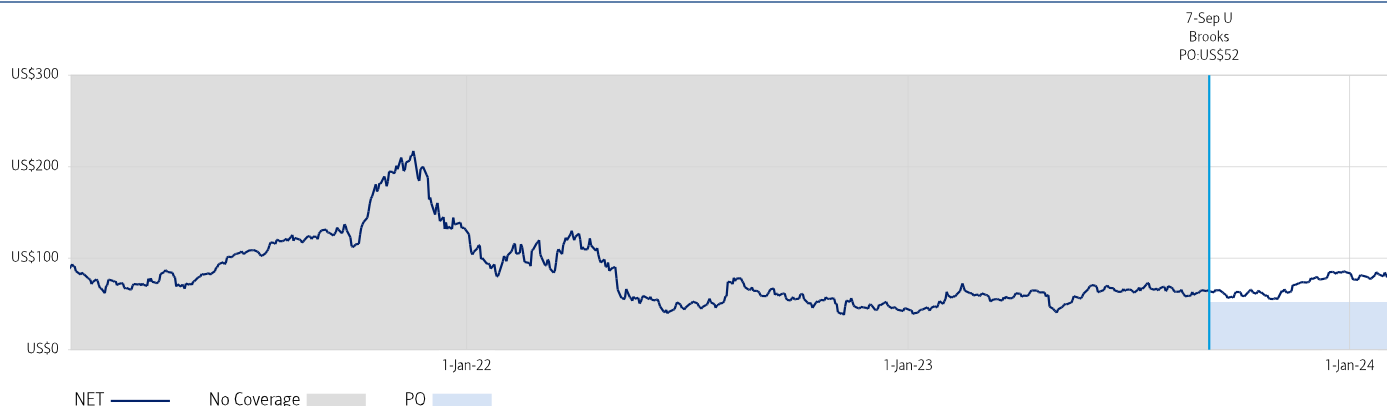
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Cloudflare (NET) Price Chart



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