

## DigitalOcean

# New CEO sets a customer first agenda; F24 a year of investment

Reiterate Rating: UNDERPERFORM | PO: 25.00 USD | Price: 35.85 USD

## Beat 4Q, Focused on profitable growth

DOCN reported F4Q23 revenue of \$180.9mn (+11% y/y), EPS of \$0.44 and adj. EBITDA of \$73mn beating the high end of prior guidance in each metric. The company noted some stabilization in 4Q and subsequent improvement in the core Digital Ocean platform in Jan and Feb. There was marginal improvement in Churn, contraction and expansion which is encouraging. NDR came in roughly flat at 96% (slightly better without rounding). Mgmt. expects NDR to improve in F2H2024. We reiterate our Underperform rating as we expect a slow re-acceleration in growth with investments in 2024, which is the correct strategy, but will also limit margin upside in 2024.

## FY24 double digit rev growth; EBITDA, FCF margins down

Mgmt guided F24 rev of \$765mn (midpoint) or just over 10% (5% core growth, 2-3% growth from Cloudways and 3% growth from Paperspace) with no change in the macro demand environment. Adj EBITDA margin guidance for FY24 of 37-38% compares to 40% in FY23. Adj FCF margin guidance for FY24 of 19-21% compares to 22.5% in FY23. The company expects some margin compression given the investments for future growth. New CEO Paddy Srinivasan outlined both Product innovation targeted towards developers and investing in features such as security and resiliency. Incremental investments in Paperspace could drive about \$50mn in incremental spend on infrastructure that could marginally pressure FCF and gross margins in the near term.

## Pace of customer growth slow in 4Q but ARR trends better

Growth in Builders and Scalars decelerated to 8% y/y and q/q trends in Builders and Learners slowed to 1% and 2% respectively in F4Q23. However, spending metrics were better leading to incremental ARR of \$17mn (\$18mn organic in Q3). The board authorized \$140mn in share repurchases through 2025, which we expect will be ongoing. The company expects to exit 2024 at just over 3x net leverage ratio and targets 2.5-3x net leverage over time.

## Adjusting estimates; PO stays at \$25

Our F24E rev/EPS moves to \$765mn/\$1.61 from \$751mn/\$1.66. Our PO stays at \$25 on 22x (unchanged) 2025E EV/FCF. We roll-over to C25 based valuation.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	0.88	1.52	1.61	1.95	2.32
GAAP EPS	(0.01)	0.43	0.74	1.08	1.45
EPS Change (YoY)	158.8%	72.7%	5.9%	21.1%	19.0%
Consensus EPS (Bloomberg)			1.62	1.89	2.33
DPS	0	0	0	0	0
Valuation (Dec)					
P/E	40.7x	23.6x	22.3x	18.4x	15.5x
GAAP P/E	NM	83.4x	48.4x	33.2x	24.7x
EV / EBITDA*	21.7x	15.5x	15.3x	12.8x	10.9x
Free Cash Flow Yield*	2.3%	3.4%	3.4%	4.8%	5.5%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 6.

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Refer to important disclosures on page 7 to 9. Analyst Certification on page 5. Price Objective Basis/Risk on page 5.

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### Equity

#### Key Changes

(US\$)	Previous	Current
2024E Rev (m)	750.7	765.3
2025E Rev (m)	857.5	874.2
2026E Rev (m)	NA	999.2
2024E EPS	1.66	1.61
2025E EPS	1.99	1.95
2026E EPS	NA	2.32

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### Stock Data

Price	35.85 USD
Price Objective	25.00 USD
Date Established	8-Sep-2023
Investment Opinion	C-3-9
52-Week Range	19.39 USD - 51.69 USD
Mkt Val (mn) / Shares Out (mn)	3,255 USD / 90.8
Free Float	60.4%
Average Daily Value (mn)	38.97 USD
BofA Ticker / Exchange	DOCN / NYS
Bloomberg / Reuters	DOCN US / DOCN.N
ROE (2024E)	NA
Net Dbt to Eqty (Dec-2023A)	NA
ESGMeter <sup>TM</sup>	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

# iQprofile<sup>SM</sup> DigitalOcean

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	5.0%	10.1%	12.8%	13.7%	14.2%
Return on Equity	33.0%	NM	NM	NM	140.2%
Operating Margin	17.7%	25.8%	26.6%	28.2%	-4.9%
Free Cash Flow	75	110	111	158	179

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	1.9x	1.5x	1.8x	1.6x	1.5x
Asset Replacement Ratio	1.2x	1.1x	1.5x	1.3x	1.4x
Tax Rate	NM	17.7%	15.0%	15.0%	15.0%
Net Debt-to-Equity Ratio	NM	NM	NM	NM	215.0%
Interest Cover	12.1x	20.0x	20.8x	22.1x	22.9x

## Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	576	693	765	874	999
% Change	34.5%	20.2%	10.5%	14.2%	14.3%
Gross Profit	366	422	456	525	600
% Change	41.3%	15.2%	8.0%	15.1%	14.3%
EBITDA	199	278	282	338	396
% Change	48.2%	39.8%	1.5%	19.9%	17.2%
Net Interest & Other Income	2	15	(10)	(11)	(13)
<b>Net Income (Adjusted)</b>	<b>104</b>	<b>159</b>	<b>165</b>	<b>200</b>	<b>238</b>
<b>% Change</b>	<b>167.7%</b>	<b>53.3%</b>	<b>3.4%</b>	<b>21.4%</b>	<b>19.0%</b>

## Free Cash Flow Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	104	160	165	200	237
Depreciation & Amortization	102	118	118	126	134
Change in Working Capital	(14)	(22)	8	(7)	(18)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	3	(20)	0	0	9
Capital Expenditure	(120)	(125)	(181)	(162)	(185)
<b>Free Cash Flow</b>	<b>75</b>	<b>110</b>	<b>111</b>	<b>158</b>	<b>179</b>
<b>% Change</b>	<b>212.0%</b>	<b>47.0%</b>	<b>0.4%</b>	<b>42.6%</b>	<b>13.3%</b>
Share / Issue Repurchase	(9)	22	0	0	0
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	0	(2)	0	0	0

## Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	864	412	522	680	858
Trade Receivables	54	62	59	67	77
Other Current Assets	28	29	29	29	29
Property, Plant & Equipment	273	305	360	387	427
Other Non-Current Assets	594	649	656	665	675
<b>Total Assets</b>	<b>1,813</b>	<b>1,457</b>	<b>1,627</b>	<b>1,828</b>	<b>2,066</b>
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	164	193	197	199	200
Long-Term Debt	1,470	1,478	1,478	1,478	1,478
Other Non-Current Liabilities	130	104	104	104	104
<b>Total Liabilities</b>	<b>1,765</b>	<b>1,775</b>	<b>1,779</b>	<b>1,781</b>	<b>1,782</b>
<b>Total Equity</b>	<b>51</b>	<b>(314)</b>	<b>(150)</b>	<b>51</b>	<b>288</b>
<b>Total Equity &amp; Liabilities</b>	<b>1,816</b>	<b>1,461</b>	<b>1,629</b>	<b>1,832</b>	<b>2,070</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 6.

## Company Sector

IT Hardware

## Company Description

DigitalOcean is a cloud services company offering infrastructure and platform tools to SMBs, start-ups and developers. The majority of revenues comprises "Droplets" or virtual servers, and DOCN has expanded its product offering since launching Droplets in 2012. Historically DOCN has relied on an efficient self-service model to drive growth, as customers are organically drawn to DOCN's website given extensive learning material. About 69% of 2021 revenues were generated outside the U.S.

## Investment Rationale

Our Underperform rating is based on increased risk associated with both the company's strategy and growth. The CEO transition drives headwinds in the trajectory of the business, with the CFO also relatively new to the company. Also, data from our analytics team suggests that website traffic to the DigitalOcean domain has materially slowed since the beginning of 2023

## Stock Data

Average Daily Volume 1,087,146

## Quarterly Earnings Estimates

	2023	2024
Q1	0.28A	0.38E
Q2	0.44A	0.38E
Q3	0.42A	0.42E
Q4	0.44A	0.44E

## Abbreviations

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NDR: Net Dollar Retention Rate

n-t: near term

FCF: Free Cash Flow

ARR: Annual Recurring Revenue



# Model

## Exhibit 1: DOCN Income Statement

We model F24 rev at \$765mn.

(\$ in millions except EPS)

(\$ in millions except EPS)	F2023E				F2024E				F2025E											
	1Q23A	2Q23A	3Q23A	4Q23A	1Q24E	2Q24E	3Q24E	4Q24E	1Q25E	2Q25E	3Q25E	4Q25E	FY2021	FY2022	FY2023E	FY2024E	FY2025E			
Sales	165	170	177	181	182	184	196	203	209	208	223	234	429	576	693	765	874			
Cost of Sales (excl SBC)	69	65	66	71	75	75	78	81	83	83	89	94	169	210	271	310	350			
Gross Profit (excl SBC)	96	105	111	110	108	108	118	122	125	125	134	140	259	366	422	456	525			
Adj GP S (ex-Depr)	123	129	135	134	134	134	144	148	153	153	162	168	341	460	521	559	636			
R&D (excl SBC)	27	21	22	22	22	22	23	23	22	22	23	25	92	105	92	90	92			
S&M (excl SBC)	12	10	12	13	13	14	15	16	16	16	17	18	42	67	48	58	68			
G&A (excl SBC)	26	25	26	26	25	25	27	28	28	28	30	32	74	93	103	104	119			
Operating Earnings (excl SBC)	31	49	51	48	47	48	53	55	59	59	63	66	50	102	179	203	246			
Interest Expense	(2)	(2)	(2)	(2)	(2)	(2)	(3)	(3)	(3)	(3)	(3)	(3)	(4)	(8)	(9)	(10)	(11)			
Other Income	7	8	4	5	0	0	0	0	0	0	0	0	(5)	11	24	0	0			
Pretax Earnings (EBT)	36	54	53	51	45	45	51	53	56	56	60	63	41	104	194	194	235			
Taxes	8	9	9	9	7	7	8	8	8	8	9	9	2	0	34	29	35			
Rate	21%	17%	17%	17%	15%	15%	15%	15%	15%	15%	15%	15%	5%	(0%)	18%	15%	15%			
Min Int	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0			
Net Income Cont Ops (Non Gaap)	29	46	44	44	38	38	43	45	48	48	51	54	39	104	160	165	200			
Fully Diluted EPS (Non Gaap)	\$0.28	\$0.44	\$0.42	\$0.44	\$0.38	\$0.38	\$0.42	\$0.44	\$0.47	\$0.46	\$0.50	\$0.52	\$0.34	\$0.88	\$1.52	\$1.61	\$1.95			
Avg Shares-Basic (Fully Diluted Post-IPO)	96	96	103	92	92	92	92	92	92	92	92	92	106	103	97	92	92			
Avg Shares-Total Diluted Shares Outstanding	111	105	103	100	101	102	102	102	102	102	102	102	114	118	105	102	102			
Basic and Diluted GAAP EPS	(\$0.37)	\$0.01	\$0.19	\$0.17	\$0.16	\$0.16	\$0.20	\$0.22	\$0.25	\$0.25	\$0.28	\$0.31	(\$0.20)	(\$0.01)	\$0.43	\$0.74	\$1.08			
Adjusted EBITDA (excl SBC)	56	72	76	73	67	67	73	75	85	80	85	88	134	199	278	282	338			
Margin %	34%	43%	43%	41%	37%	37%	37%	37%	41%	39%	38%	37%	31%	34%	40%	37%	39%			
As % of Revenue																				
Cost of Sales	42%	38%	37%	39%	41%	41%	40%	40%	40%	40%	40%	40%	40%	36%	39%	40%	40%			
Gross Profit	58%	62%	63%	61%	59%	59%	60%	60%	60%	60%	60%	60%	60%	64%	61%	60%	60%			
Adjusted Gross Profit	74%	76%	76%	74%	73%	73%	73%	73%	73%	73%	73%	72%	80%	80%	75%	73%	73%			
R&D	16%	12%	13%	12%	12%	12%	12%	12%	11%	11%	11%	11%	22%	18%	13%	12%	11%			
S&M	7%	6%	7%	7%	7%	8%	8%	8%	8%	8%	8%	8%	10%	12%	7%	8%	8%			
G&A	16%	14%	15%	15%	14%	14%	14%	14%	14%	14%	14%	14%	17%	16%	15%	14%	14%			
Operating Earnings	19%	29%	29%	27%	26%	26%	27%	27%	28%	28%	28%	28%	12%	18%	26%	27%	28%			
Interest Expense	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)	(1%)			
Other Income	4%	4%	2%	3%	3%	3%	3%	3%	3%	3%	3%	3%	-1%	2%	3%	0%	0%			
Pretax Earnings	22%	32%	30%	28%	25%	25%	26%	26%	27%	27%	27%	27%	10%	18%	28%	25%	27%			
Minority Interest	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%			
Net Income	17%	27%	25%	24%	21%	21%	22%	22%	23%	23%	23%	23%	9%	18%	23%	22%	23%			
Year-Over-Year Growth																				
Sales	30%	27%	16%	11%	10%	8%	11%	12%	14%	13%	14%	15%	35%	34%	20%	10%	14%			
Cost of Sales	49%	39%	22%	12%	8%	16%	19%	15%	12%	11%	14%	15%	17%	24%	29%	14%	13%			
Gross Profit	18%	20%	13%	10%	12%	3%	6%	11%	16%	15%	14%	15%	49%	41%	15%	8%	15%			
R&D	-4%	-19%	1%	-22%	-15%	2%	2%	5%	-2%	1%	4%	5%	37%	13%	-12%	-2%	2%			
S&M	(22%)	(27%)	(26%)	(37%)	7%	36%	30%	20%	22%	13%	14%	15%	34%	57%	-29%	23%	16%			
G&A	8%	2%	28%	9%	-5%	1%	1%	5%	14%	13%	14%	15%	21%	26%	11%	1%	14%			
Operating Earnings	128%	119%	28%	84%	52%	(2%)	5%	14%	25%	23%	18%	19%	269%	102%	76%	14%	21%			
Other Income	792%	260%	22%	10%	(100%)	(100%)	(100%)	(100%)	N/A	N/A	N/A	N/A	(59%)	(294%)	124%	(100%)	NA			
Pretax Earnings	193%	143%	28%	79%	24%	(17%)	(3%)	3%	25%	24%	18%	20%	(412%)	153%	86%	(0%)	22%			
Minority Interest	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	NA	NA	NA	NA	NA			
Net Income	206%	98%	2%	38%	33%	(17%)	(1%)	2%	25%	24%	18%	20%	(378%)	165%	53%	3%	22%			

Source: Company reports, BofA Global Research estimates

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## Price objective basis & risk

### DigitalOcean (DOCN)

Our \$25 PO is based on 22x C2025E EV/FCF. We focus on FCF given the company is driving toward higher FCF faster rather than purely revenue growth. Our multiple of 25x is based on low double-digits topline growth with improving FCF margins given DOCN has an attractive lifetime value/customer acquisition cost (LTV/CAC) profile.

Upside risk factors: macro improving faster than expected, FCF better than expected, unexpected acquisitions that drive growth. Downside risks to achieving our PO are CEO transition takes longer than expected, DigitalOcean is unable to scale (implying customers move to AWS/Google/Azure as they grow), self-serve acquisition model proves less effective, the company is unable to reach profitability, larger cloud companies release offerings catered to SMBs/start-ups/developers (similar to Amazon Lightsail) and shift to multi-cloud creates low barriers to entry.

## Analyst Certification

I, Wamsi Mohan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - IT Hardware and Technology Supply Chain Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Amphenol	APH	APH US	Wamsi Mohan
	Apple Inc.	AAPL	AAPL US	Wamsi Mohan
	Corning Inc.	GLW	GLW US	Wamsi Mohan
	Dell Technologies Inc.	DELL	DELL US	Wamsi Mohan
	Flex Ltd.	FLEX	FLEX US	Ruplu Bhattacharya
	HP Inc.	HPQ	HPQ US	Wamsi Mohan
	International Business Machines Corp.	IBM	IBM US	Wamsi Mohan
	Jabil Inc.	JBL	JBL US	Ruplu Bhattacharya
	Nutanix Inc	NTNX	NTNX US	Wamsi Mohan
	Roku, Inc.	ROKU	ROKU US	Ruplu Bhattacharya
	Seagate Technology	STX	STX US	Wamsi Mohan
	TD Synnex Corp	SNX	SNX US	Ruplu Bhattacharya
	TE Connectivity Ltd.	TEL	TEL US	Wamsi Mohan
	Western Digital Corporation	WDC	WDC US	Wamsi Mohan
<b>NEUTRAL</b>				
	Arrow Electronics Inc.	ARW	ARW US	Ruplu Bhattacharya
	Avnet Inc.	AVT	AVT US	Ruplu Bhattacharya
	CDW Corp	CDW	CDW US	Ruplu Bhattacharya
	Concentrix Corporation	CNXC	CNXC US	Ruplu Bhattacharya
	Hewlett-Packard Enterprise	HPE	HPE US	Wamsi Mohan
	Pure Storage	PSTG	PSTG US	Wamsi Mohan
	Sensata Technologies Holdings Plc	ST	ST US	Wamsi Mohan
	Teradata Corporation	TDC	TDC US	Wamsi Mohan
<b>UNDERPERFORM</b>				
	DigitalOcean	DOCN	DOCN US	Wamsi Mohan
	NetApp Inc.	NTAP	NTAP US	Wamsi Mohan
	Sanmina Corporation	SANM	SANM US	Ruplu Bhattacharya
	Vishay Intertechnology, Inc.	VSH	VSH US	Ruplu Bhattacharya
<b>RSTR</b>				
	Super Micro Computer Inc.	SMCI	SMCI US	Ruplu Bhattacharya



## iQmethod<sup>SM</sup> Measures Definitions

### Business Performance

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

### Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

### Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

### Numerator

$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) \times (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

### Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

### Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

$\text{EV} = \text{Current Share Price} \times \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} +$

Other LT Liabilities

Enterprise Value

### Denominator

$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill}$

Amortization

Shareholders' Equity

Sales

N/A

N/A

### Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

### Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

$\text{Market Cap} = \text{Current Share Price} \times \text{Current Basic Shares}$

Sales

Basic EBIT + Depreciation + Amortization

iQmethod<sup>SM</sup> is the set of BofA Global Research standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

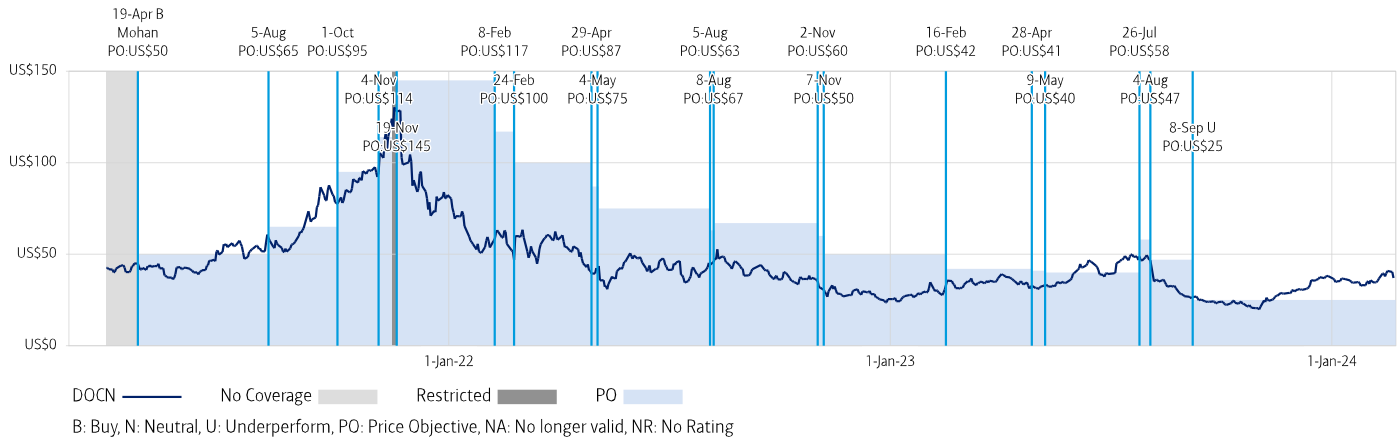
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# Disclosures

## Important Disclosures

### DigitalOcean (DOCN) Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

### Equity Investment Rating Distribution: Technology Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	215	53.09%	Buy	111	51.63%
Hold	97	23.95%	Hold	45	46.39%
Sell	93	22.96%	Sell	24	25.81%

### Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster <sup>R2</sup>
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

<sup>R2</sup> Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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