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DigitalOcean Holdings, Inc. (DOCN)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Rob and I will be your conference operator today. At this time, I would like to welcome everyone to the DigitalOcean Fourth 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.

Rob Bradley, Vice President of Investor Relations, you may begin your conference.

Rob Bradley
Vice President-Investor Relations, DigitalOcean Holdings, Inc.

Thanks, Rob, and thank you, and welcome, everybody, to DigitalOcean's Q4 2022 earnings call. Joining me today is Yancey Spruill, our Chief Executive Officer; and Matt Steinfort, our Chief Financial Officer.

Before we begin, I want to cover our Safe Harbor statement. During this conference call, we will be making forward-looking statements, including our financial outlook for the first quarter and full year as well as statements about our goals, business outlook, industry trends, market opportunities and expectations for future financial performance. All of these statements are subject to risks, uncertainties and assumptions. You can review more information about these in the Risk Factors section of our filings with the SEC. We remind everyone that our actual results may differ and we undertake no obligation to revise or update any forward-looking statements.

Finally, we'll be discussing our non-GAAP financial measures on our call. And reconciliations between our GAAP and non-GAAP financial results can be found in our earnings press release, which was issued earlier this morning and in our Investor Presentation, which can be found on our website.

With that, let me turn the call over to our CEO, Yancey Spruill. Yancey?

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

Thanks, Rob. Good morning and thank you for joining us. I'd like to welcome Matt Steinfort who joined as our CFO in early January, and he's integrating nicely with our team. And as you'll see shortly, he's coming up to speed quickly.

I'd like to start with a recap of 2022, then share our initial thoughts on growth and profitability for 2023, including detailing our key initiatives for the year. I'll then turn it over to Matt to provide more color on our results and on our financial outlook for 2023 and share more about our capital allocation strategy.

To say the very least, 2022 was an odd year. While the first quarter was strong, by early Q2 we saw an emerging dynamic where both new customer acquisition and expansion in our cohort of customers began to slow. Despite executing initiatives throughout the year to boost growth, we saw continued slower growth in our existing customer cohorts and new customer acquisition, and that has continued into 2023.

The three key headwinds that drove this slowing growth were: first, a general softness across our existing customers in terms of slower expansion and more volatile new customer additions, particularly among smaller customers. Expansion decelerated 400 basis points across the year. Importantly, churn largely remained in line with prior periods. We've consistently heard from our customers through formal surveys that despite their businesses having slowed, they continue to see us as a critical part of their business operations and that they aren't looking to move from DigitalOcean.

Second, the collapse of Bitcoin's valuation and its impact on our customers in blockchain, which represented 5% of total revenue at the peak in Q2 but declined to 1.5% as we exited the year. And finally, fallout from the war in Ukraine, as customers in Russia and Ukraine combined represented nearly 3.5% of total revenue at the peak in Q1 of last year, but declined to less than 2% as we exited 2022.

We see the consumption-based revenue model as a strength of our business long term, particularly in driving customer loyalty because of the flexibility it offers them in good times and challenging times like these when their volumes decline. Having said that, our model does enable more volatility with existing and new customers in times of deceleration, a pattern we have experienced beginning in 2022.

Yet, despite these headwinds, we delivered strong revenue growth with significant increases in operating and free cash flow margins. These improvements were the results of our pulling multiple levers, including introducing new product capabilities, raising prices for the first time in our history, prioritizing investments, and expanding our product set with the highly strategic acquisition of Cloudways.

For the year, we delivered $576 million in revenue, which represented 34% year-over-year growth. We're also able to make meaningful progress on our profitability and cash flow profile during the year. To get ahead of the softening macro environment, in Q2 2022, we began to rein in spending by narrowing our investments to those that we expected would have the largest impact on growth, managing the business to higher free cash flow while weathering the uncertainty. Those decisions paid off as we both increased improved free cash flow margins throughout the year and positioned ourselves to see the growth from those reprioritized investments in 2023.

We delivered adjusted EBITDA margins of [indiscernible] (05:44) which were up 200 basis points year-over-year. And additionally, non-GAAP operating margins were 18%, up 600 basis points year-over-year. We also made continued progress managing our capital spending footprint as we delivered CapEx of 21% of revenue, down 400 basis points from 2021, while balancing investments across the shorter and longer term. An example of longer-term capital investments was the launch of the Sydney data center in Q4 of last year. We are already seeing strong revenue traction in Sydney and that will be a meaningful boost to 2023 growth.

As a result of the strong revenue growth, improving margins and leverage on capital, free cash flow increased 217% year-over-year to $78 million or 13% margins, a 700 basis point improvement from 2021 and a major step towards our longer-term margin target. With a solid fourth quarter and full year 2022 performance behind us, in light of the challenging macro conditions, we have reassessed our near-term revenue growth and margin targets.

Since our 2021 IPO, we shared targets of delivering $1 billion in revenue and 20% plus free cash flow margins in 2024. While growth was 30% or better, we were comfortable ramping to a 20% or better free cash flow margin target over a number of years. Given the lower growth environment, we are accelerating free cash flow margins to our longer-term target range this year and at the same time we are pushing out the $1 billion revenue target by one year to 2025.

In response to the softer growth environment, yesterday, we announced the difficult decision to reduce our team as part of a broader initiative to right-size our cost base. The actions we have taken better align our cost footprint to the current and expected growth reality and will enable us to deliver a compelling balanced growth and profitability profile regardless of the economic climate, as we continue to pursue our goals of scaling this business.

As we contemplated these difficult decisions, we reviewed all aspects of our business with a goal to improve focus, efficiency and operating velocity. From this review, the actions we are taking will help us simplify our structure and also will rebalance our talent to more closely align with our global customer base. While the overall impact to the broader DigitalOcean team, a net decrease in our head count of 11% makes the decisions difficult, they result in a more nimble organization, enabling a much stronger operating profile now, while also freeing up investment capacity for targeted growth initiatives as we move forward.

As a team, we have relied on a return on invested capital framework to determine how we allocate resources. That's an important context for why we have emphasized our balanced orientation to deliver strong growth with consistently ramping free cash flow. Our strategy's ultimate goal is to drive compelling returns, as we believe it's the ultimate North Star measure of the performance of every business in any sector, in any economic environment.

To be crystal clear, growth is core to our strategy and we continue to invest to drive rapid and durable top line growth. What we are clarifying today is our approach will be to continuously improve the returns on invested capital in the context of balancing our investments in revenue and free cash flow growth.

Now, I'd like to turn our attention to 2023. We believe we are still in the early innings of realizing DigitalOcean's potential in a large global and highly diversified market serving small and medium-sized businesses. Increasingly, we are focusing more and more effort towards SMBs that collectively spend more than $98 billion annually on cloud infrastructure. Our growth investments this year are primarily focused on three key areas: product enhancements, sales initiatives and Cloudways synergies. Together, these initiatives will expand our wallet share with our customers, enhance our go-to-market motion and build our customer engagement muscle.

Attracting the right SMB customers to our platform and enabling them to purchase more products from us will drive increased consumption and result in higher net dollar retention and average revenue per customer. In a few minutes, Matt is going to share his fresh perspective in regard to the details of the drivers of our revenue growth. As we've disclosed previously, our revenue is predominantly coming from a small percentage of our total customers. Those customers typically start very small and after spending some time learning and testing ideas, many of them ramp usage on our platform. Once they launch an application that gains traction, they move into a phase where they're building and scaling a business.

We use the $50 per month threshold as a marker for when customers transition from learning and testing to building and scaling. In Q4, 86% of our total revenue was derived from customers that are spending more than $50 a month despite those customers representing just 21% of our total customers. Importantly, revenue from $50 per month customers grew 39% last year despite the overall economic weakness. And these trends of much higher customer and revenue growth with better unit economics from our larger customers have been a consistent pattern for a number of years. When we speak to investments in product development and go-to-market, our focus is on attracting, retaining and growing these larger customers.

A portion of the targeted incremental growth areas in 2023 will come from the roadmap of enhancements that we will introduce over the course of this year. Today, I'll highlight one of our key investments, augmenting our storage capabilities. As outlined last year, we are prioritizing building out our storage capabilities, which is a significant growth opportunity for us. We generate roughly 10% of our revenue from existing storage products and we are targeting to increase that proportion of total revenue by as much as 2x with the investments we are making. This represents a significant ARPU growth opportunity with existing customers, as customers who use our storage today spend roughly 25 times more than customers who don't. But we have storage products today, they are mainly focused on serving a narrow set of use cases and the needs of smaller businesses within our customer universe. The investments we are making are designed to extend our capabilities to serve a larger set of existing SMBs, that is to say builders and scalers as well as become more attractive for new customers to migrate their cloud workloads. By adding capabilities to our storage footprint, we will enable an increasing number of use cases as well as larger scale use cases.

The SnapShooter acquisition announced earlier this year is part of this broader effort to enhance our storage offerings. On the sales front, we are investing in a direct sales effort. While we have a low cost and efficient self-serve motion, which has been the key to achieving our current $659 million ARR business, direct sales will help unlock the immense potential of our installed base as we continue to scale in the years ahead. As mentioned earlier, we have more than 140,000 builders and scalers that are spending more than $50 per month with us. Across last year we added to our team to engage deeper with our existing cohorts through our inside sales motion.

An additional focus of our sales efforts is bringing new customers to our platform, principally through build-out of our partner channel effort, Partner Pod. There are hundreds of thousands of digital agencies in managed services and hosting providers around the world, and delivering a tailored value proposition to them would be an important growth driver as we make it easy for these channel partners to deliver their customers to us.

Finally, we see significant growth potential from our recent Cloudways acquisition. Cloudways has outperformed our expectation in the short time since we acquired them despite the weaker macro environment. The highly strategic acquisition broadened our product suite from the core DigitalOcean do-it-yourself cloud model to include a managed cloud service experience for the many SMB customers who want more help initiating and upgrading their cloud infrastructure. Cloudways' managed approach gives us a deeper understanding of SMB customers and their usage of cloud infrastructure. We are taking these learnings and applying them to our broader business, which will enable our combined business to better match customer wants with the capabilities on our platform.

As an example, the early returns on the deal, we've been able to accelerate Cloudways new customer acquisition by more than 15% for $50 and up customers. This validates one of the core premises of the transaction that many customers who sign up for DigitalOcean would benefit from and would be willing to pay for a managed hosting experience. We are actively working on evolving the DigitalOcean customer onboarding process to better optimize the customer starting point. The goal here is to better identify those customers who are running or intend to run a business in the cloud. The earlier we are able to identify them, the better we are able to engage and serve them, and there is a significantly higher customer lifetime value when we do, and that's going to be the focus for us.

In summary, despite a difficult environment in 2022, we strengthened our business through organic and inorganic initiatives and delivered strong financial results. We continue to be well-positioned to capture share in the $98 billion market for developers and SMBs cloud infrastructure. We are focused on realizing this exciting long-term growth opportunity and through our actions have committed to doing so while also delivering compelling returns on invested capital regardless of the economic climate.

I'd now like to turn the call over to Matt who will provide details on our financial results and our outlook for this year. Welcome aboard, Matt.

W. Matthew Steinfort

Chief Financial Officer, DigitalOcean Holdings, Inc.

Thanks, Yancey. Good morning, everyone, and thank you for joining us today on our Q4 2022 earnings call. I'm very excited to be here and to participate on my first earnings call as DigitalOcean's Chief Financial Officer. By just recently joining the company earlier this year, I have already witnessed in our fourth quarter and full year results one of the key reasons why DigitalOcean was so appealing to me in the first place. I consider myself very fortunate to have joined an organization that's delivering very healthy top line growth, has a strong capital structure, and is generating meaningful and growing free cash flow on both an absolute and a per share basis.

Another appeal for me was the company's strong competitive differentiation and large addressable market, with ample room to grow and to improve return on invested capital. I see a tremendous opportunity ahead for DigitalOcean as it is positioned both to grow along with the large addressable cloud market and to capture additional market share. We have a great brand and platform that is specifically tailored to the SMB market. The company's focus on simplicity, excellent price to value and strong customer satisfaction has enabled it to carve out a leadership position in this attractive and growing segment of the market outside the focus of the large hyperscalers.

Third important factor for me joining, on top of the strong financials and compelling competitive position, was the quality of the management team at DigitalOcean. I had previously worked with Yancey at Zayo Group, which at the time was a publicly traded multi-billion dollar revenue communications infrastructure company, where I was the CFO and he was the lead director, and where together we successfully executed a $14.5 billion take private of the company. From that experience, I have a tremendous amount of respect for Yancey and I've grown to respect the executive team that he's assembled, and I'm very excited to join that team and to work alongside him again.

To give you a little context for the experience base that I bring to DigitalOcean, I have a diverse background. I was the CFO of a large public company. I was the co-founder and CEO of a Software-as-a-Service company and I've held a variety of consulting and strategy leadership roles. I'm excited to be here and I'm committed to bringing my full experience to bear to help us achieve our long-term revenue, profit and cash flow goals.

Before I review the financials, I'd like to share an important observation that I hadn't truly appreciated from the outside and I don't believe the market has fully internalized either. The insight comes from within the incredible customer dynamic that DigitalOcean enjoys that has helped propel the company's impressive track record of growth to-date and it will be the engine that drives us forward as we achieve our long-term objectives.

From my early conversations with Yancey, I appreciated the efficiency of DigitalOcean's primarily self-serve go-to-market model. I was impressed that the company could spend so little on sales and marketing and yet attract so many customers through its self-serve funnel. Generating more than 10 million unique visitors each month and building a vast customer base numbering 677,000 at year-and was pretty remarkable.

What I hadn't appreciated fully, though, was the durability of the resulting customer growth model. DigitalOcean is a compelling cloud platform where developers and small business can come to test and experiment as they work on their ideas and their ambitions. While the total number of customers at any point is impressive and meaningful, focusing on that statistic by itself masks the elegance and the strength of the DigitalOcean model.

Our customers start their lifecycle simply as testers of our platform, spending up a single droplet, exploring our platform, trying things out for a couple months. Thousands of these testers come to our platform each month through our direct marketing and promotional investments. And a regular portion of these testers get traction and become true ongoing customers, sticking on our platform and continuing business with us for longer than three months. While not all of our testers go on to become long-term customers, the cost of acquisition is so low that it's worth the investment to give them exposure to our platform as they may come back to us down the road to test out a new idea or business.

Once a customer has gone beyond the tester phase, they become our learners, spending less than $50 per month as they continue to work on their ideas. There are hundreds of thousands of these learners on the DigitalOcean platform, 468,000 as of December of 2022. While these learners have modest spend individually, they are relatively stable as a group with 20% year-over-year revenue growth and with modest churn. The average learner has been on our DigitalOcean platform for 48 months. And this is where the insight comes in that this large group of learners who are the stated target audience when the company was founded is the feeder for, but not the driver of the value and growth at DigitalOcean.

From this large and stable pool of learners, a regular stream of customers each week and each month and each year find success with their ideas, and their businesses begin to grow. And with their growth comes larger demand for cloud infrastructure and more spend with DigitalOcean. As these customers grow to become builders who spend between $50 and $500 per month, and then scalers who spend over $500 per month, they become stickier and stickier with faster revenue growth, lower churn and more product attachment as they scale. Collectively, these builders and scalers represent only 21% of our customer base, but drive 86% of our revenue and as customer tiers grew revenue 30% and 45%, respectively, in 2022.

Importantly, while the rate of growth of the overall number of customers has slowed down over the past several years, the graduation rate of learners to builders and scalers has steadily accelerated on both percentage and absolute terms, fueling DigitalOcean's growth. As a result, there are 321% more builders today, generating 320% more revenue; and 423% more scalers today, generating 472% more revenue, despite our learner pool having only 140% of the customers and 181% of the revenue it had five years ago. These larger customers are the primary focus of the growth investments Yancey shared. Our investments will help maintain our large and healthy pool of learners, while nurturing our existing customers to support them as they grow into the higher spending cohort.

We will also continue to work to migrate similarly mature and growing SMB customers directly on to DigitalOcean from other cloud providers. These investment initiatives, whether enhancing our storage offering or expanding our direct sales effort, are very focused on expanding our ability to serve this growing base of customers, as their cloud infrastructure requirements expand with their business. Given the importance of the customer growth model, we will begin disclosing customer accounts, ARR and revenue growth rates at this more granular level and will no longer be focused so much on total customer count in our regular disclosures.

I'd like to now shift my comments to our financial performance in 2022 after which I will provide more context for our expanded share repurchase program and our 2023 financial outlook. As Yancey indicated, 2022 was a very unique year. The company was able to deliver strong results despite a number of macro headwinds. It delivered 30% plus top line growth, with meaningful improvements in both profitability and cash flow, while completing a highly accretive acquisition of one of our largest customers.

Beginning with the top line, we delivered $576 million of revenue in 2022, which was up 34% year-over-year. We ended the year with $659 million in ARR, which was also an increase of 34% year-over-year. Through improved procurement processes and better server utilization, GAAP gross margins increased to 63%, up 300 basis points from 2021. Through disciplined operating expense management, we saw a substantial increase in non-GAAP operating income delivering 18% in 2022, up from 12% in the prior year.

Adjusted EBITDA improved to 34% from 32% as we prioritized and focused our growth investments in light of the anticipated ongoing top line pressures. Capital efficiency also improved with capital expenditures as a percentage of revenue coming down from 36% back in 2020 and 25% in 2021 to 21% in 2022. This improved capital efficiency has been deliberate and we have confidence that we will continue to drive further efficiency improvements even as we invest to grow revenue. As evidence of our continued commitment to growth investments, we expanded our geographic reach into another attractive market by opening a new data center in Sydney, an investment that has already begun to contribute to growth in 2023.

As Yancey mentioned, free cash flow and free cash flow per share are our North Star metrics. And this is true now more than ever in this challenging economic. We have made great progress on these critical metrics. And as Yancey and the team have often said, we're just getting started. Free cash flow in 2022 was $78 million, which was 13% of revenue, a 217% increase from prior year. On the back of the strong performance in 2022 and our announced cost reduction initiatives, we have confidence in our plans to pull forward our longer-term free cash flow target and exit 2023 with free cash flow margins in the high 20s.

One of the other key priorities in my first month at the company has been to determine the most appropriate capital structure for the company. Based on this work, I'm excited to share more detail around the capital allocation strategy that we announced today. Given the reality of the near-term macroeconomic environment in conjunction with the maturation of our business model, we are conservatively bracing ourselves for the potential that our growth rates will be in the low to mid-20s in the years ahead. In light of this growth profile, we are taking immediate actions that will both boost our margins in 2023 and position us to generate annual free cash flow margins of 30% plus in the coming years.

Our continued revenue growth and increasing cash flow margins combined with our sizable cash balance will result in our building significant cash in the coming years. We will use this cash to both fund ongoing investments in our product and platform and pursue additional accretive M&A. But even after those investments, we are projecting to have material excess cash given our strong cash flow generation. Our plan is to return a meaningful portion of this excess cash through a regular share repurchase program. We believe an ongoing buyback program creates a compelling investor thesis for DigitalOcean when combined with our focus on driving operational excellence and profitable growth, and together will drive total shareholder return.

In support of this capital allocation strategy, I'm pleased to share that our board approved an expanded share repurchase program that allows us to repurchase up to $500 million of our stock in 2023. We are committing to purchasing a minimum of $230 million in 2023 and we are authorized to repurchase up to another $270 million based on market conditions and our relative investment alternatives at the time. We expect to keep an ongoing repurchase program in place beyond 2023 and anticipate additional repurchases in 2024 above the 125% of the free cash flow generated today. We are excited about this capital allocation framework as it will substantially accelerate free cash flow and earnings per share while both allowing us to invest in our business and enabling us to remain within our long-term target leverage range of 2.5 to 3 times net leverage to adjusted EBITDA.

To close my commentary, I'll provide our outlook for the first quarter and the full year 2023. But before I do, I'd like to share some context for how we thought about guidance in light of the uncertainty and headwinds facing the software market at large. Given the various macro uncertainties, our annual guidance range will be a bit wider than we have historically provided, which we believe is appropriate in this environment. The low end of our range represents our current run in the business trajectory, adjusted downwards somewhat to reflect a continued challenged growth environment. The high end of the range assumes we see solid incremental traction throughout 2023 from our key growth initiatives that Yancey explained earlier.

I'd also like to highlight that beginning with this earnings call, we will be guiding to and reporting adjusted EBITDA as our core profitability metric. This will closely align our external guidance to one of our key internal metrics as we measure the business internally using this metric and we believe it appropriately demonstrates the performance of the business.

In terms of specific guidance, for Q1 2023, we expect revenue to be in the range of $163 million to $165 million. For the first quarter, we expect adjusted EBITDA margins to be in the range of 31% to 32% and non-GAAP earnings per share to be $0.28 to $0.29. With the announced cost reduction actions implemented and behind us by the second half of the year, we expect that we will exit the year with adjusted EBITDA margins in the low to mid 40s.

For the full year, we expect revenue to be in the range of $700 million to $720 million. We expect adjusted EBITDA margins to be in the range of 38% to 39% and non-GAAP earnings per share to be $1.65 to $1.69. In 2023, free cash flow will increase as a result of our improved profit margin and lower capital expenditures, driving 21% to 22% free cash flow margin for the full year, excluding the one-time costs associated with our workforce reduction and transaction costs. Like adjusted EBITDA, free cash flow will ramp throughout the year, and we expect free cash flow margin to approach 30% by the fourth quarter.

That concludes my remarks, and I'll now turn it over to the operator to begin our Q&A session.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from a line of Jim Breen from William Blair. Your line is open.

James Breen
Analyst, William Blair & Co. LLC

Q

Hi. Thanks for taking the question. Just on the revenue generation side – on the revenue growth side, can you just talk about some of the more specific things you're seeing that's sort of cautious sort of push out the revenue guide for 2024? And then just on the buyback, how confident are you in the free cash flow generation in case there are opportunities for M&A and using that cash? Thanks.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Well, in terms of the growth outlook, given what we're seeing currently and the outlook that we set for this year, we decided to push out the expectations for a $1 billion. Again, that $1 billion target was organic and inorganic. But just to be cautious and based on the realities of what we're looking at, that's the basis for pushing out the outlook by a year. It's also the rationale for accelerating the margins. As I said in the script, we see the two is related. And frankly, if you look at how we looked at the view of growing north of 30% through 2024 to get to that first $1 billion and ramping the free cash flow margin versus our current outlook with the acceleration of margins, we're actually going to generate more free cash flow in the next couple years than we would have under a higher growth scenario. So, we're very comfortable with the outlook and the margin mix, and it's very important that you all understand that's exactly how we think about it.

In terms of – I'll comment on the free cash flow confidence. The way we look at it is we've prioritized our organic investment and making sure that over the next several years we are taking care of building out our platform products, et cetera. We've allocated a reasonable amount of – a meaningful amount of capital for M&A – accretive M&A. And I think the M&A we've done over the last year or two, whether it's the Cloudways in the $350 million range or a smaller single product company emerging from a seed stage is the framework for us from an M&A standpoint. So we've allocated reasonable amount of capital for that. And we project at these higher margins have a pretty significant amount of excess free cash flow and returning a portion of that – a meaningful portion of that to investors. So it's a very balanced approach. It's focusing on growth, it's focusing on optimizing operations for free cash flow margin, it's focusing on allocating capital to inorganic initiatives, and it's focusing on returning capital to shareholders.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. Thanks.

Operator: Your next question comes from the line of Gabriela Borges from Goldman Sachs. Your line is open.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good morning. Thank you. Yancey and Matt, I want to ask you about cyclical versus structural. I think we can appreciate all your commentary on the macro for 2023, your commentary on low to mid 20s growth rates. Has anything changed structurally about your ability to grow over 30% organically long term? [indiscernible] (34:50) when you say low to mid 20s, is that a longer-term structural growth rate or is that a cyclical target based on what you're seeing today as well?

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

It is not a long-term target. It's very specific to our guidance for this year and the realities of what we're facing this year. And again, it's an organic growth rate for this year. There isn't a change other than what we discussed earlier. Nothing changed competitively that we've seen. We continue to drive – as I mentioned, there's more volatility with smaller customers in terms of their growth. And I think that's a big aspect of the lower aggregate growth. And then our larger customers, as I mentioned, we stay very close to them. We're investing in more [ph] talent and (35:44) process to engage with even deeper numbers of those cohorts, and they're very consistent. In our formal surveys, which we've conducted, and in our anecdotal regular daily conversations with them, they're undergoing the same thing everybody is undergoing in the tech market, which is – there are growth challenges, they're in optimization mode, et cetera, and that's led to us – and we're helping them with that. And frankly, we offer a compelling value proposition given the capabilities and the price point, value is really high.

So I think we're having great conversations. So there's no real change other than everybody is just seeing a lower growth environment, and we're working through that with our customers. But as Matt laid out, the larger customers, once they break through on our platform, they're growing incredibly healthy, three-handle, almost four-handle for the even larger customers. And so, I think them doing that on our platform speaks to the value proposition in this environment and the fact that our cost proposition is so compelling.

So, no change. Smaller customers are more volatile, but as you see, we still have a large enough pool, we're still adding enough, and the pool is sufficiently large that we're still accelerating graduation on our platform. So we feel very good about where we are. And I think, as things moderate, one thing I'm really excited about with this newer cash flow profile, when things do re-accelerate, if they do, if they don't, we obviously have compelling margins now, we're going to position for even greater operating leverage in the future. So we feel good about where we are. It's definitely a challenge, a different environment than we thought a year or two ago. But I think our economic model is proving very compelling in the midst of all the uncertainty.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. The follow-up I have is on [indiscernible] (37:50) priorities. We've all thought of DigitalOcean as being pretty disciplined and thoughtful about your investing base. And so, give us a sense, where did you find incremental efficiencies on the workforce reduction and the pace of investment in your direct sales force? Are you planning to accelerate the pace of investment in direct sales? Thank you.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. Well, we have invested and accelerated even as we exited the year on the sales side. As we've spoken to previously, we have a narrower set of incremental growth initiatives, really around enhancing our foundation around storage. We have a number of other new products that are either about to launch or they're in beta now or will, as we approach the middle part of the year. We've funded those through reprioritization in the first half of last year as we slimmed down priorities, as I mentioned earlier. So, on that side of the business, we feel like we've raised the bar on growth initiatives. The hurdle rate is higher and that's how we slimmed down the priorities.

In terms of the operating structure, where we found efficiencies, it's really around setting this business up. We've gotten to $650 million, $660 million of run rate. And like most businesses, what got you there, is it going to get you to $1 billion or $2 billion in revenue over time. And so, we took this opportunity to kind of rethink how we work, simplify our organizational structure, importantly, globalize our business and we've seen incredible success moving talent around the world, and that's part of the activity. And then there was a number of other things that aren't even on the people side. They're actually contributing more of the efficiencies this year and going forward, just evaluating where we're spending our money, what do we need, what do we not need. And frankly, I think it's what everybody in the tech ecosystem is doing right now. And you add all those up and that's a meaningful contributor to the boost in our free cash flow and operating metrics that you'll see this year.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

Thank you for the detail.

Operator: Your next question comes from the line of Tim Horan from Oppenheimer. Your line is open.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Well, thanks, guys, Focusing on revenue, it seems like you're looking for a pretty big ramp for the second half of the year because you're like 1% sequential in the first quarter. And we kind of need more like 5% sequential for the next three quarters to hit the low end of the guidance. Are you planning on any price increases or are these new products going to drive that? Just talk about how we're going to see that acceleration. Thanks.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

The low end of the guidance reflects nothing different from how we're executing now, and the upper end reflects incremental initiatives we've talked about contributing. Whether it's – there is some monetization actions, there wouldn't be explicit price increases. But as bundling packaging are in the mix, which will have the net effect of pricing leverage, storage capabilities coming online middle of the year. And it's some of the near-term initiatives we have as well as our incremental investments in sales, our partner capability, our inside sales capability. So, those are contributing near term. We have our Sydney data center, which I mentioned came online in Q4, is ramping very nicely. So it's a host of things, many of which were in flight as we entered this year, already in-market and some near to coming in the market and others coming in Q2, Q3. And you add all those up and that's how you get to the upper end of the range.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Got it. But to be clear, I mean, annualizing the first quarter, you're kind of at more – well below the low end of the guidance. So there's a bunch of things that are hitting that. It's just a timing issue, they are more hitting in the second, third quarter that kind of drives the revenue growth, to be clear.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

The low end of the guidance reflects nothing really changing incrementally from those – contributing from those initiatives. The upper end of the guidance reflects more contribution from those initiatives. The middle is a balance of the two and we'll see ramping. It's important, though, a number of those initiatives are in flight. So they'll be generally available as we – over the next few weeks – exit this quarter, as we get into Q2. So, it's plenty of time for this year for those to contribute. Some of those are modernization, pricing, packaging, bundling options, et cetera. And so, you will see a ramp through the year, and our guidance reflects our cautious outlook in the aggregate towards reflecting some of the macro uncertainties that we're facing.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thank you.

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

James E. Fish
Analyst, Piper Sandler & Co.

Q

Hey guys. Thanks for the questions. Wanted to touch upon actually the last one here. With the investment behind the direct sales force, but kind of a pullback in spending in other areas of the business, just can you talk about how you're setting quotas and what you're expecting for quota-carrying capacity ramp? And what gives you kind of this confidence in this change from a self-serve model to a more direct-led model that this direct-led model will actually result in an uptick of adoption, given how we think about the typical size of your installed base and how they consume DigitalOcean? And in other areas of tech we've seen others try to move from kind of self-serve to direct not go well. Really my question is what gives you confidence this direct sales force shift will result in incremental uptick here.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Well, there's two points I would make. First of all, let me clarify what investment sales means which you said earlier. When it's inside sales, so we have, as you point out, a large cohort of customers. We've seen significant success over the past few years, adding inside salespeople, expanding the number of people who we assign to accounts, and they're working directly with those accounts to optimize them on the platform. That's led to ARPU acceleration, multi-product adoption, better use of the cloud, and we've helped our customers scale. So we've seen a lot of success there. In fact, we added pretty meaningfully in Q4 to that team so that we can go even deeper. Many thousands – 10-plus thousands of customers that we're actually talking to now versus sort of low single-digit thousands this time last year. So, that's a very important distinction. It's really the enhanced support, customer success, inside sales motion, we've already demonstrated that model very successfully.

And then our partner channel, as I mentioned, there's a host of digital agencies, hundreds of thousands of them around the world, managed hosting providers. As an example, Cloudways is one of them. And we've formalized and tailored an offering to them and we've seen that stood that up and as we got through last year and we expect that to see meaningful traction. We already have lots of agencies on the platform, organically through organic self-serve even. And we're looking to enhance that through bigger efforts through this Partner Pod capability.

So, those are, I would say they – and for this year, they wouldn't be bigger than the amount of revenue we generate from self-serve, but they've been very complementary and ramping very rapidly. Ours is always going to be a business, as Matt eloquently laid out, the pool of customers that test and – come to DigitalOcean and test and learn is massive and that we're always going to build the ecosystem around that because that ecosystem is driving so much of our growth through the graduation from sub $50 to greater than $50 and then greater than $500 customers.

James E. Fish
Analyst, Piper Sandler & Co.

Q

If I could follow up on that, I mean, how, Yancey, do you guys plan to balance having your own internal agency here with Cloudways versus kind of these external digital agency partners as it could potentially create friction? And then when do you expect that storage percentage to actually double? Is it a 2023 thing or is it kind of more of a 2024, 2025 goal? Thanks.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. On the second, we haven't set a target for the date, we just want to make meaningful progress. And I think as we add features and functionalities over the – and it's important we're making progress. We substantially increased the response times, cycles per second of storage in Q4. We obviously added SnapShooter from the acquisition earlier this quarter. We'll have more features and functionality coming online. So, the 2x is a longer-term target. That's how we benchmark against other folks in cloud. We haven't put a date on it. We just want to be making progress. And as we make progress and accelerate that, that's going to be a significant boost to our growth rate.

On the first one, there's just no channel conflict. Again, this is a $100 billion market for SMB cloud developer and developer cloud. It's a big market. We did a lot of diligence when we looked at Cloudways around whether there would be channel conflict. We've seen no churn on our platform from companies who do similar things to Cloudways since the acquisition. There's no concern on our end about that. After a significant amount of diligence on this theme and topic before signing the transaction and then, obviously, we've owned the company now for five months just has not been an issue.

Operator: Your next question comes from the line of Michael Turits from KeyBanc Capital Markets. Your line is open.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey good morning. This is Eric Heath on for Michael. Yancey, you talked about it seems Cloudways being more resilient than core DigitalOcean. Is there anything different about Cloudways, whether the customer base, value prop that makes it a bit more of a resilient business? And then a quick follow-up.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Eric, it's a question we ask all the time. I don't know that we have a resolution on that. And so, I don't want to speculate on that right now. But there's no question that the business has been quite resilient. They do have a higher percentage of those $50 and up customers than we do. We're mid-teens for legacy DO and Cloudways is in the mid-20s. So I think that's an aspect of it. And as I said in the script, we're taking a lot of learnings and applying them to the whole company. So, really excited to make a large acquisition like that, for us, our largest in the middle of 2022, a year of a ton of uncertainty and to have it play out as it's playing out, we're really excited about where we are and the prospects ahead.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. And then just quickly on that, I mean, part of the thesis I think of bringing Cloudways was to kind of reduce that churn that you kind of often see with those customers in the first 90 days or one years. Is there any progress you're seeing on that front, number one? And then number two, just curious if you're seeing any progress or opportunities to cross-sell Cloudways to kind of that broader DigitalOcean base?

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. So we've been very focused in this first several months on the customers who come to DigitalOcean who aren't best suited for a do-it-yourself model and managed was a better opportunity for them. We've changed a lot of our onboarding flow. And I mentioned more than 15% boost in net new customer acquisitions from Cloudways in the first few months. That's a big reason. So we are effectively capturing more value than a year ago, two years ago we might have been missing out on or having churn because we just weren't the best match.

The market size for managed is at least as big as sort of our core model. So that's really exciting to have a thesis for an M&A transaction and then months into it are already confirming that. So we feel good about that. We are working on other cross-sell motions that just have been later in priority and are starting to kick in now and look forward to updating our investors as we move through the year on that theme. But again, very excited about the progress to-date and even more excited about what's to come.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thanks, Yancey.

Operator: Your next question comes from the line of Wamsi Mohan from Bank of America. Your line is open.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. Good morning. Yancey, nice to see the profitability pull in. But I was wondering if you could comment on the cost actions you're taking. At full run rate, that should be driving 800 bps of EBITDA improvement and you're guiding 400 to 500 basis points of EBITDA expansion in 2023. As you look forward, are you converting the incremental dollar of revenue at the same, better or worse operating leverage ex these cost initiatives or restructuring plan that you're taking? And what's the long-term growth profile for expenses?

W. Matthew Steinfort
Chief Financial Officer, DigitalOcean Holdings, Inc.

A

So, Wamsi, it's Matt. Nice to talk to you again. If you look at the total run rate impact of the cost savings that we're projecting, it's $60 million a year on an annual basis, $35 million of which is non-head count-related, $25 million is head count related. And as Yancey said, we've seen the opportunity to reprioritize some of the investments that we're making in the business to focus on the higher growth and higher return initiatives. And that's what's enabled us to drive those costs out. Again, we're also taking advantage of the globalization of our company and moving our resource base to more closely match the kind of the revenue base of the company, which is about 70% international.

So we think there's a lot of opportunity for us to continue to optimize that while still making very, very effective and strong investments that have good return on invested capital. So, we see incremental operating leverage. Part of the challenge for this year is it's – the costs are going to come in over the course of the year and it's going to take a while for those cost effects to manifest themselves in our margins. And so, that's why, in my remarks, I tried to guide a little bit towards how we think that we're going to exit the year. And we think, again, from a EBITDA margin standpoint, we should be exiting the year in the low to mid-40s from an EBITDA margin, and from a free cash flow, we should be approaching the 30% by the end of this year, and we expect to see further margin improvement going forward.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. If I could just add one point to that. If you think about we take a step back what does it mean for Matt to say we'll exit this year at 30% free cash flow margins. It was just three years ago we had negative 25% free cash flow margin. So you're talking about 55% increase in three years as the business has gone from about $240 million of revenue to $650 million or a little over $700 million in revenue. So, we're talking about free cash flow conversion well over $0.50 on every incremental revenue dollar. I just want to make sure we're clear, we're very focused on incremental leverage in the business and we've already delivered it. And I think you're going to see a substantial improvement in that this year even in a lower growth environment.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay. Thank you. And as a follow-up – appreciate the details on the learners and builders, scalers that you gave. What is driving the improvement from learners to builders graduation rates in 2022? How much of that was a push versus pull effort and how are you expecting that to trend in 2023? Thank you.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

So, great question. I think as we've added more products over the last few years, managed databases, managed Kubernetes, enhanced our marketplace, our serverless portfolio, we've enhanced our infrastructure compute network and storage solutions, we've added more capability to the platform. And so, what that's enabled us to do, and this is why storage is so important, these investments, as companies grow, their needs for cloud evolve. And if you look at us three to five years ago with a similar product set, we couldn't capture as much share of wallet as their cloud spend grew. We are now able to, over the past few years through our investments, capturing more share of wallet, pushing out, for example, the time a company may go multi-cloud and certainly capturing more of the applications they're needing as they grow their businesses.

I think that's a principle sort of from the product side. And then as I talked about earlier, our investment in inside sales and enhancing our customer service value proposition has helped facilitate that by making customers more aware, building a really good muscle and working closely with customers. So, it's the combine of the product strategy and then our go-to-market strategy, which has been driving that acceleration in ARPU.

W. Matthew Steinfort
Chief Financial Officer, DigitalOcean Holdings, Inc.

A

And just one thing to add, and we included this data in the earnings presentation supplement. But if you look back all the way to 2018, part of the power of this model and the elegance of this model is how consistent and improving the graduation rate has been and how consistently we've been adding builders and adding scalers. You look back over the last five years that it's just up into the right. You can't even see a blip during the – or any impact during the pandemic. You don't see really any changes other than the recent acquisition of Cloudways and the pricing action of July. It's an incredibly durable model.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: And your final question comes from the line of Vinod Srinivasaraghavan from Barclays. Your line is open.

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Hi. Thanks for taking my question here. Just want to follow up on the last one. You mentioned exiting the year approaching 30% for free cash flow margins. Is it also fair to say you'll exit the year at or approaching the Rule of 50?

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yes.

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Great. And then want to talk about early adoption of Cloudways as well for your different customer cohorts. Can you maybe kind of break down customer spending $50 to $500 versus those who are spending over $500, are you seeing any different behavior with the drop in [ph] churns (57:37) so far?

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

So, are you speaking just specifically to Cloudways?

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Yeah. Just with Cloudways. Is it more just broad-based adoption among your base or are you saying, let's say, your largest customers or your smaller ones adopting more than others?

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Adopting Cloudways?

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Yes.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Well, as I mentioned earlier, you're seeing a boost in the $50 and up, especially when considering that 15% or better boost to net new customers, a significant percentage of those are $50 and up customers in terms of the synergies we referred to. I don't have the data whether it's the $500 or not. But again, a core aspect of the piece is people who want a managed service absolutely are going to run a business. And so, they have aspirations to grow rapidly. And it's a great time, as they're looking to set up their cloud infrastructure to ask them do you want to do-it-yourself or do you want a managed experience, which by the way is roughly 2x the price to go managed and they frequently will choose the managed. And so, we see that as a compelling essentially a product extension really from the entire DigitalOcean platform. So we'd expect it to skew higher ARPU over time and to drive higher ARPU, just reflecting Cloudways is roughly a quarter of their customers who are on $50 and up versus the legacy DO was about 15%. So, it's going to certainly improve the mix of builders and scalers on our platform.

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Thanks and congrats again.

Operator: And this concludes our question-and-answer session. I will turn the call back over to Yancey for some closing remarks.

Yancey L. Spruill
Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

Thank you for joining us this morning. I hope it's obvious – we are incredibly excited about the progress we've made in transforming our company, DigitalOcean into a durable high-growth business and a free cash flow machine in good times and in bad. We look forward to continuing the conversation in the coming weeks and months ahead as we work hard to realize this limitless potential of our business. Have a great rest of the day.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect.