

Cloudflare, Inc. (NYSE:NET)

Cloudflare, Inc. (NYSE:NET) is an American technology company focusing primary on content-delivery-network (CDN) services.

A simple comparison of Cloudflare with other companies providing CDN services does not at first produce many useful valuation multiples/ratios due to Cloudflare's current and long-standing trend of negative net income, EBIT, and EBITDA. These consistently negative figures prompted further investigation; it was found that the majority of Cloudflare's operating expenses are SG&A (260.8m in LTM ending 3-31-20), with a significant but much smaller portion in R&D (\$106.4m in the same period). The latter is not particularly concerning, as R&D expenses can easily translate into future growth for the company, but the former does give pause. Of selling, general, & administrative expenses in the LTM ending 3-31-20, Cloudflare reported no advertising expenses, \$175.4m in selling and marketing, and \$85.4 in general and administrative expenses.

Though it is not unusual for young technology companies to be highly valued despite negative earnings, it is worth noting that a handful of Cloudflare's competitors have demonstrated positive net income, EBIT, and EBITDA over the same periods in which Cloudflare returned only a net loss. These companies demonstrate that Cloudflare's hefty expenses cannot be solely blamed on the nature of its CDN services but must also be partially due to a faulty business model or poor decisions by management.

It is possible that if Cloudflare successfully expands its market share, as its management predicts, its need for such high SG&A expenditures will decrease. That said, given the company's several years of net loss, it would be hard to imagine that this prediction is not accounted for—if not overestimated—in the market's current valuation of the company. This latter point is especially likely given its mid-to-large market cap (above \$10b) and the fact that the majority of its shares (51%) are held by institutions, both of which suggest a low likelihood that easily-predictable future developments for the company are not already priced in.

It is altogether possible that the market's current trend of heavily overvaluing technology companies continues in the near future, but we are not sufficiently confident that this trend will continue over the several-year horizon that would be required for Cloudflare to establish the market dominance for which it aims—assuming that it is successful in that goal.

As such, we are not at this time taking a position on Cloudflare.

---Wasim Rahaman

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