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DigitalOcean Holdings, Inc. (DOCN)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome, everyone, to the DigitalOcean Second Quarter 2022 Earnings Conference Call. Please note today's conference is being recorded. 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]

At this time, I will turn the call over to Rob Bradley, Vice President of Investor Relations.

Rob Bradley

Vice President-Investor Relations, DigitalOcean Holdings, Inc.

Thank you. And welcome, everyone, to DigitalOcean's second quarter 2022 earnings call. Joining me today is Yancey Spruill, our Chief Executive Officer; and Bill Sorenson, our Chief Financial Officer.

Before we begin, I want to cover our Safe Harbor statement. During this call, we will be making forward-looking statements, including our financial outlook for the third quarter and full year, as well as statements about goals and business outlook, industry trends, market opportunities and expectations for future financial performance and similar items.

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.

Also, we will be discussing non-GAAP financial measures on our call. And reconciliations between our GAAP and our non-GAAP financial results can be found in our earnings press release, which was issued earlier this afternoon and in the investor presentation on our IR website.

With that, I'd now like to turn the call over to our CEO, Yancey Spruill. Yancey?

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

Thanks, Rob. Good afternoon and thank you for joining us today. I am pleased to review a quarter that had its share of challenges where nonetheless we demonstrated our ability to deliver against our financial targets despite the macro headwinds we are all facing. Our performance, alongside our improved financial outlook for the balance of the year, highlights that we are positioning DigitalOcean for strong revenue growth, coupled with rapidly scaling free cash flow, despite operating within uncertain an uncertain and challenging economic environment.

The durability and resiliency of our business is prominently on display right now. The simplicity of our business, including our consumption revenue model, allows our customers to automatically align strength or weakness in their business to what they pay us. For the market segment we serve, we believe that this is a critical strength as it supports our early stage business customers through good times and bad with the highly transparent economic model that builds loyalty with them. A validation of that premise is that despite a challenging environment, churn last quarter remained at similar levels to prior recent quarters.

The global nature of our customers and the diversity of the industries we serve, while not fully immunizing us from macroeconomic trends, does make us less vulnerable to a material change in our business since we aren't dependent on one type of industry, one set of large customers, or a particular region of the world. The key growth drivers in our business are being somewhat offset by macro weakness, which has resulted in a reduced expansion spend rate on our platform, particularly in Europe and Asia, and principally for customers operating in the blockchain vertical. That is to say, in aggregate, customers continue to grow in our platform, but in certain regions and use cases, they're growing more slowly than we have seen in prior quarters.

The traction we are seeing in Q3 gives us confidence to project at least 30% revenue growth for Q3 and maintain our revenue outlook for the year and given actions we have taken to drive efficiency in our spend, we are increasing our outlook for Q3 operating margins and both operating margins and free cash flow for the full year. To be clear, the approach to our forecast update today, we are being cautious setting near-term expectations, reflecting uncertainties not within our control.

Revenue in the quarter was $133.9 million, up 29% year-over-year. We came in at the midpoint of our Q2 revenue guide, while significantly outperforming on operating income and free cash flow. Our focus on simplicity, community, support, and open source software that is value priced are enabling our customers to grind through this tough environment and for us to do so with operating leverage.

ARR was up 28% year-over-year and ended the quarter at $544 million as we added $20 million in net new ARR in the three months ended June 30. Q2 had a 100 basis point growth headwind for Q2 last year from the launch of our Premium Droplet and the expected impact from Russia-Ukraine also represented another 100 basis point headwind to our Q2 growth rate. The balance of the sequential slower ARR growth is due to lower net expansion.

Another point to make is that we bill our customers and they pay us in US dollars. Although we don't have a direct way to tie FX impacts to our revenue, we can't ignore the likely headwind on our customers' businesses due to the significant strengthening of the US dollar in the first half of 2022. We added nearly 3,000 high spend customers that are spending more than $50 per month. In total, they now number just over 105,000 and generate 85% of total revenue, which is up 300 basis points from a year ago. Importantly, revenue from this cohort of customers grew 34% year-over-year, continuing to pull up our overall growth rate. Despite the weaker environment in the quarter, revenue from these customers is growing significantly faster than GDP in the markets in which we operate.

As we moved through Q2, we managed our business prudently. We slimmed our spending to focus on a critical few initiatives that we expect to have the greatest impact on growth, delivered on operational improvements that drove efficiencies and put our procurement engine into full gear, driving further leverage in core areas of third-party spend. These focus areas will pay dividends well beyond the near-term economic challenges, driving operating leverage as we continue our progress to 20% or better free cash flow margins as we achieve our first billion dollars of revenue.

The result of our managing spend were strong operating margins of 17% of revenue. We also demonstrated the powerful cash generation capabilities of the company in the quarter with free cash flow that was 10% of revenue. Given this period of uncertainty, we will be very cautious in adding new spend and we'll prioritize delivering strong margins and free cash flow until we have better clarity about the growth outlook. The key takeaway from our Q2 results is that in a challenging environment, we delivered a solid top line and continued accelerating margins and free cash flow.

One last thing about Q2. We have now bought approximately 15.5 million shares back since our March 2021 IPO. Make no mistake, we are principally focused on investing to drive revenue growth while generating meaningful free cash flow leverage. However, we are also focused on doing so with an efficient balance sheet that provides flexibility to achieve our long-term strategic goals while also honoring our deep commitment for driving value for our shareholders. Driving significant leverage to earnings and free cash flow while maximizing shareholder value are highly compatible goals, and this is how we will always run this business.

As we shared at our Investor Day in June, we have a number of growth initiatives that help us achieve our higher revenue outlook for 2022 despite the macroeconomic challenges. I'd like to share some insights into each of them now. Beginning with the pricing changes that we announced in May and that went into effect last month, we are already seeing meaningful impact today in Q3. A few early indicators of the impact of our recent changes to pricing. First, since the announcement and since July 1, the effective date for new pricing, we have been – we have seen dramatically lower churn than we accounted for in our base case, and net new customer acquisition has been unaffected. Second, downgrades to our $4 droplet remain modest and much less than anticipated, with roughly half of new $4 droplets being used in complement with the new $6 droplets. Finally, our large customer usage has remained in line with historical averages, with the exception of the prior mention of blockchain customers.

I'm excited about these pricing changes. They have created a new dialog with our customers in the broader market that clarifies our value proposition. That is to say we offer a highly performing cloud computing platform with simplicity, community, support, a commitment to open source software as core differentiators enabling a great customer experience. And our [ph] service (00:10:13) remains value price when factoring what you get versus what it costs. Our platform is tailor-made to serve a $70 billion SMB and developer cloud market.

Next, we continue to see strong results from our sales investments. As we mentioned in May, Q1, we exceeded our plan nicely and we're pleased to see that trend continue in the second quarter with average ARPU and Q2 deals just below $20,000, which is up approximately 50% year-over-year. Obviously, this is highly accretive to our total company ARPU. And with the continued progress we are making in Q2, we prioritize additional investment to continue to drive growth acceleration through our sales channels. We remain confident that accelerating growth from our sales channels is on track as it represented 5% of total revenue in Q2, up from just over 3% of revenue in the first quarter.

Finally, we continue to make investments to drive our top of funnel customer acquisition. In June, we acquired the website JournalDev. This developer-rich resource has tutorial context for Java and Python, along with other web development frameworks. Content from JournalDev will soon be found on our community site, where millions of learners visit monthly to find quality content from a source they trust. We're thrilled to expand the breadth of our content offering to help even more developers benefit and continue building a community that leads to highly efficient customer acquisition.

I want to make a critical point regarding the efficiency of our go-to-market model. Let's look at the payback period for customer acquisition. Using Q1 2022 non-GAAP sales and marketing expense of $15.7 million and net new ARR in Q2 of $20.5 million, combined with improving gross margins to 65% of revenue, we are paying back our customer acquisition costs in just – in less than six months. And that's happening while we are ramping spend to build our sales capabilities. This efficiency is paramount in our ability to sustain our revenue growth target and drive margins higher over the course of not just this year, but for years to come.

The next area of growth is our investments in product. DigitalOcean Functions was launched in May and represents our new serverless offer. As we shared previously, serverless is a high-growth adjacency that is well suited alongside our IaaS and PaaS suite and a capability that has been a top request of our customers.

Customers have been adopting Functions' capabilities at an encouraging rate. And through the second quarter, we saw a strong traction as more than 3,300 customer accounts are using Functions, which collectively have more than 20 million activations, that is how many times the [ph] function is invoked. (00:13:12) We are pleased with the adoption and feedback so far and Functions should help us deliver against our second half targets, while propelling greater customer acquisition, ARPU growth, and net expansion within NDR.

Over the past few years through investments [ph] in PaaS (00:13:31) capabilities, this portion of our business now represents 18% of total revenue. We have a number of additional product initiatives that we expect to launch over the next year that will enhance the value of our platform, giving our customers more applications they can run with us. This removes friction in their process as they can have a more seamless experience building and managing their applications. This has been a significant source of ARPU growth we've seen in recent years. And we expect that to continue as we scale to our first $1 billion of revenue in 2024.

In summary, I'm proud of our team and the commitment to serving our customers to help them weather the storm in Q2. We're able to deliver strong financial results despite many headwinds. And that's a testament to the strength and resilience of our business and a powerful demonstration of the durability of our value proposition within the $70 billion segment of the cloud market we serve. We're excited about the path forward from here and have a number of growth levers that we are pulling to deliver growth sustainably -sustainable 30% or better for the second half and full year, while also delivering significant margin and free cash flow leverage.

Today, we announced that our CFO, Bill Sorenson, will be retiring in 12 months. I wanted to express my highest gratitude for Bill who came out of retirement to take the CFO role at DigitalOcean. He has been an incredible partner to me and our leadership team as we've refashioned our company to be a high growth and free cash flowing company.

We are well capitalized with over $1.2 billion in liquidity. We have transitioned from a privately held to publicly traded shareholder base. And we are now set up for the next phase of profitable growth on our march to our first $1 billion in revenue and beyond. Bill has built a team and served as a coach and mentor to many, including me.

I also want to express thanks to Bill for working proactively with me on this plan such that we can have a smooth transition to a new CFO, the hiring process for which begins now. As leaders of organizations for the long-haul, orderly transitions are a critical role and aspect of our job, and I'm proud we are demonstrating this now.

With that, I'd like to now turn the call over to Bill, our Chief Financial Officer, who will provide details on our financial results in Q2 and our updated outlook for Q3 and the full year.

William G. Sorenson

Chief Financial Officer, DigitalOcean Holdings, Inc.

Thank you, Yancey, and thanks for those kind words. Hello, everybody and good afternoon. Thanks for joining us today to review our second quarter result. As Yancey mentioned, Q2 was not without its challenges. But for DigitalOcean, it clearly illustrated the operational leverage inherent in the business, the potential for material cash generation, and the opportunity for further acceleration in our revenue growth.

While we met our revenue guidance targets in uncertain markets, DigitalOcean was able to soundly beat all of its key financial operating metrics for gross margin, non-GAAP op income, free cash flow and earnings per share. Yancey covered many of the key operational highlights in the quarter and the growth investments we're making. I'd like to focus on how we were able to drive improvements in our profitability and cash flow before providing our outlook for the rest of the year and taking your questions.

In the second quarter, revenue grew by 29% at the midpoint of our guidance. Excluding those countries directly involved in the Ukraine conflict would have led to a slight improvement in growth rates. And while North America held up with growth rates similar to last year at around 30%, we saw slower growth in Europe and Asia versus what we have seen in the previous several quarters.

Looking under the hood, we see the dollar churn in these regions remained stable, but it is the expansion rate of our customers that has slowed. So customers are [ph] steady (00:17:33) and still growing nicely on our platform, but adjusting their spend level somewhat as they are cautious in managing their businesses as well. And even with these trends, ARPU is still growing greater than 20%.

Net dollar retention in Q2 declined to 112%, which compares to 113% in the year ago period and was down from 117% in Q1. Our NDR was impacted by several factors, slowing expansion in our customers that I just referenced, the conflict in Eastern Europe, and the impact of a new product launch in Q2 of 2021, which created a tough compare to last year's quarterly results.

Q2 2022 marked the anniversary of our first quarter with premium Droplet revenue, which, as you may recall, is a high performance offering that we introduced early in 2021. This advanced chip product enjoyed strong adoption last year and contributed to both NDR and ARPU growth from Q2 last year right through Q1 of this year. Additionally, we have begun to see declines in revenue from blockchain customers around the world from their previous highs. I'll reiterate Yancey's remarks by mentioning that our expectation is for these metrics to improve in the second half of this year based on the growth initiatives that he detailed in our new pricing model, our expanded sales capabilities, and the growth in our funnel.

As we began Q2, we tempered our guidance and outlook for that quarter as economic headwinds were clearly blowing, and the war in Eastern Europe was disrupting not only the combatants but other countries as well. Given that outcome, management reviewed all of our ongoing investments with a focus on our most critical investment growth areas. That prioritization helped us exceed both our non-GAAP operating income and free cash flow targets. As we've repeatedly discussed, we continue to see leverage opportunities in our business, and Q2 clearly exemplified that.

Let me provide some more detail starting with gross margin. Gross margin was very strong in the quarter as we delivered 65% on a GAAP basis, up 700 basis points year-over-year from 58% in Q2 of 2021. Several initiatives led to this improvement, starting with our efforts to reduce the cost of our hardware, which we detailed to you in the past, and which has led to a decline in our depreciation and amortization. In each of the last three years, DigitalOcean has purchased over $100 million of technology hardware, making us a valuable customer to the world's hardware manufacturers.

Similarly, as a cloud platform with customers in 185 countries, we're a valued partner to data center operators as well. To that end, we have been working with our co-location partners to match up pricing to the scope of our relationship and our future growth trajectory, which has led to rate savings.

We've pursued a similar strategy with all of our suppliers, not only the server manufacturers, but all ancillary equipment as well. And the maintenance suppliers are a vast network. In each of these areas, we've achieved savings and we see the opportunity for additional savings in the future. With these enhancements, along with our forthcoming planned initiatives, we are targeting gross margins of 65% for the full-year, which would be a 500-basis-point improvement from 2021. As we go into 2023, we see continued improvement ahead for gross margin even as we expand our network into other territories, which we will detail for you in future quarters.

Another financial highlight in the quarter was non-GAAP operating profit. As you would imagine, an improvement in gross margins would lead to improvements in operating margins as well. But at the same time, our management team made the decision to be very disciplined with our spending to ensure delivery on our financial goals and demonstrate the leverage.

The results were impressive as we delivered a record non-GAAP operating margin of 17%, up from 9% in Q2 of 2021 and well above the guidance we provided in May. This was achieved at the same time that we launched our new serverless product, DigitalOcean Functions, and continued our investments in our growing sales team, both part of a multipronged strategy to drive faster revenue growth and increased cash flow generation. Aided by an improving gross margin along with more efficient marketing spend, lower bad debt, and real estate expenses and disciplined hiring, we exceeded our financial targets. Given this over-delivery, we're raising our profitability expectations for the year, which I will get to momentarily.

Next, I want to highlight that we generated substantial free cash flow in the quarter, showcasing our efficiency even during the period where we were investing in our new data center that we will be opening in Australia in Q4 of this year. Even with that investment, we generated more than $13 million of free cash flow, representing 10% of revenue. Given our strong first half free cash flow generation and our expectations for our pricing strategy to be a tailwind to both margin and free cash flow in the back half of the year, we'll be raising our outlook for this metric and investors should be confident in our trajectory towards free cash flow target of 20% as we continue our journey towards $1 billion of revenue in 2024.

Finally, I want to touch on earnings per share that came in at $0.20, which was $0.10 higher than the high end of our outlook in May and doubled consensus estimates on the street. Higher margins were one factor that helped with this result, but another driver was the previously announced buybacks. Year to date, DigitalOcean had spent $550 million repurchasing our shares at an average price of $43.83 per share. Simply put, we believe that we had the opportunity to repurchase shares at a substantial discount to the net present value of our strategy, and that we have sufficient capital remaining on our balance sheet to invest in growth opportunities.

Based on that, our board of directors approved two $300 million authorizations this year, and we deployed the capital accordingly. Today, we have $50 million remaining on our existing authorization. With the repurchase of 12.5 million shares this year, we've made an important reduction in our outstanding shares, providing a material benefit for growth in earnings per share and free cash flow per share year-over-year in 2022 as well as 2023.

As I said earlier in my remarks, Q2 is not without its challenges, but we made material progress in our financial operating goals, while at the same time investing in our growth initiatives. With those initiatives underway and the launch of our new pricing strategy, we expect further improvement in our operating metrics in the back half of the year.

Before updating you on our guidance outlook, I'd like to cover my announced transition. Since joining DO, along with Yancey back in 2019, my hope and expectation was that for a four-year run. As we approach that anniversary next year, Yancey and I began our discussions about the best way to manage that handle, allowing

sufficient time for a public search to find most qualified candidates and allow the time to ensure an orderly transition. To that end, the board and Yancey have provided me with the opportunity to continue in my current role, but at the same time, allow the company the chance to find the right successor without any timing pressure. So, I will continue as CFO until my successor is found and then work with her or him in an orderly transition, helping to ensure the ongoing work on our mission critical initiatives without missing a beat. I am incredibly excited about the prospects for DigitalOcean and the path ahead.

The strategic planning framework is in place. The key executives are on board and the capital resources are there to fulfill our goal of $1 billion in revenue and beyond. Now's the time to bring on a new financial executive to achieve that goal, and I look forward to working with them to do so.

Now, let me provide you with our thoughts on Q3 and the full-year. For the third quarter, we expect revenue to be in the range of $145.5 million to $147 million, which reflects 33% growth at the midpoint. We expect Q3 non-GAAP operating margins to be in the range of 17% to 18%, building on the momentum we have from Q2. For the full-year, we are maintaining our revenue guidance to be in the range of $564 million to $568 million, which at the midpoint represents 32% growth.

Given the expectations we have for improving in the ARPU and high spend customers, we are confident in our full-year revenue outlook despite the macro headwinds that are prevalent. And further, we expect 2023 to benefit as well. We'll share more about our preliminary look at 2023 on our Q3 call per our usual practice.

From a profitability standpoint, we're increasing our expectations and are targeting full-year non-GAAP operating margins to be in the range of 15% to 16%. Finally, we're increasing our free cash flow outlook as a percentage of revenue to between 9% and 10%, which is a 50 basis point improvement from our previous call at the midpoint.

That concludes my remarks. Let me turn it over for Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Tim Horan with Oppenheimer.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thanks, guys. Can you talk about the price increases a little bit, what percentage of your revenue streams do you think will be seeing a price increase? And how does that kind of get layered in over the next couple of years?

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

A

Well, the pricing went into effect and there's no phase-in, it went into effect in July for all existing and new customers. And, for our Droplet products, most, if not all of them saw a price increase. Obviously, we created a new $4 Droplet, that's a lower price point, as I referenced earlier. Our PaaS applications in general were not – we did not raise prices against them, for example, serverless database, et cetera. And so, it was mostly concentrated on our IaaS products on the platform.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Okay. And can you give us a sense of what percentage of revenue that represents? And are your larger customers not under term in buying contracts either one- or two-year contracts? Or are they all month to month?

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

A

Yeah. The overwhelming majority of our customers are on a monthly subscription. And IaaS, we just referenced is roughly 87% of our revenue – I'm sorry, 82%.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Got it. Well, I mean doing the math on that, it would suggest that the third quarter revenue should be substantially higher on this. I'm missing something, 20% price increase on...

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

A

Yeah.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Yeah.

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

A

Let's just be clear. I mean, this is a very uncertain outlook in terms of blockchain, which in Q2 represented about 5% of revenue. That vertical is under extreme pressure, as you know. And so, you got this dynamic where you

have tailwinds of net new customer attracted to the platform working well, new product with serverless working well, pricing working well, and being offset by weakness in the macro, principally in Europe and Asia, a lot of that is blockchain. But some of our other customers are growing more slowly on the platform.

And so, we don't control that. We don't control inflation, we don't control rate increases, war, all the rest of it. And so, I think our perspective is, given that we can't control those factors, that we're going to be very cautious on the outlook. That's exactly what we did in Q2 and hit those expectations. And at the same time, what we can control is what money we spend. And we are managing that very aggressively to prioritize incremental spend, if there is any, on the highest and best uses that will drive sustainable growth or drive efficiency on the platform so that we can deliver against margins and free cash flow. We are absolutely focused on that. And we're working with our customers to help them through tough times. And that will be our operating principle until there's a better clarity in the outlook, which we don't necessarily see certainly in the Q3. And that's reflected in our guidance.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Understood. Very helpful. Thank you.

Operator: Your next question comes from the line of Pinjalim Bora with JPMorgan.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Great. Thank you for taking the questions, and congrats on a stable quarter. I want to ask you – I think you said something like based on the traction you see in Q3, it sounded like you're seeing some green shoots, maybe. I don't know. Could you help us understand the – kind of the top of the funnel activity so far in July and August across your various [indiscernible] (00:31:23)? Is that stabler than Q2 or help us understand that.

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

A

Yeah. Thanks, Pinjalim. Let me clarify. So what I meant was that, on balance, our outlook for Q3 is for growth acceleration against Q2. And so, on balance, we expect the initiatives that we have in place, the product portfolio we have in place, pricing actions we've taken on balance to outweigh some of the uncertainty. And that's reflected in our in our guidance. And that's a little bit more fill in the blank to my point earlier.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Understood. Okay. And then the follow-up is, I guess the guidance you're maintaining. Help us understand what are the various components of it? If it is possible, what are you assuming for price increase versus what is the macro headwind? Anyway to kind of put a finer point and what are you assuming...

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

A

Do you mean for the full-year?

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

For the full-year.

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

I'm sorry.

Pinjalim Bora
Analyst, JPMorgan Securities LLC
Q

And are you – yeah. And are you assuming kind of a deteriorating environment from here or are you assuming kind of a stay the course environment for the second half?

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

When we look at our full-year estimates that we set in February, before the war, hours before the war but before the war, we had an outlook that suggested that we would do better than that and then we'd be raising. Peter told me eight months ago, we'd be having the same outlook for the year that we had that we would set for investors in February that was not in the base case. And so, by maintaining the outlook, what we're saying is the headwinds – there's been headwinds to our full-year outlook that would have been above what estimates we set in February. And those headwinds continue on. It doesn't mean we can't grind through the quarters as we are and it doesn't mean that we still feel that we can – we will achieve, which is why we're maintaining that outlook. But there are headwinds and we're managing against that. And I think what we came into this year expecting for a full-year revenue and a, let's say, [ph] beaten raise (00:33:46) set of scenarios, that's not occurring. Obviously, we haven't raised our outlook for the full-year yet. And that reflects uncertainty that we're seeing in the trade-offs between the green shoots, which there are many, and the offset, which is macro weakness across many of our cohorts and principally focused on blockchain. So that's the context, our original guidance that we set for the year, we expected to be making progress against that and raising that over the course of the year. We are not doing that. And that's reflected in the color that I just provided.

Pinjalim Bora
Analyst, JPMorgan Securities LLC
Q

Understood. Thank you. I'll get back in the queue.

Operator: Your next question comes from James Breen with William Blair.

James Breen
Analyst, William Blair & Co. LLC
Q

Thanks for taking the question. You had good ARPU growth year-over-year. Can you just talk about where the strength to move from there? How much of that was attributable to the pricing increases versus your customers taking more product? Thanks.

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

Well, our ARPU pricing did not impact Q2. So it went into – it was announced in the middle of Q2 but actual change to the pricing that people are paying for Droplets, networking, storage, et cetera didn't begin until July 1st, so it had no impact. So the continuing trend we see on ARPU growth is volume metrics on our infrastructure as customers grow their business on our platform, the fact that they can adopt more other services like our managed databases, our managed kubernetes in our serverless marketplace, all of those selective are extending wallet share for us as our customers ramp. And that's a big tailwind towards ARPU growth.

James Breen
Analyst, William Blair & Co. LLC

Q

Great. Thanks.

Operator: Your next question comes from the line of Vinod Srinivasaraghavan with Barclays.

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Hi. This is Vinod from Barclays. Just two questions. At Analyst Day, you talked about your customer cohorts within three buckets, learners, builders and scalers. Can you frame the difference in new logo growth and expansion during the quarter within these buckets and any color and your thoughts on the price increase impact on each of those cohorts in 3Q and beyond would be helpful. Thanks.

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

A

Well, we talked about $50 and up customers are builders and scalar. So we spoke to the growth there and in customer, and the revenue growth. So, that continues despite the challenges around us to be a pretty strong, 34% revenue growth, mid-teens, 16% customer logo growth, and that's 85% of our revenue. So people who move up on the platform from learner in testing the product, testing idea to launching a product and running a business, the $50 and up customer is roughly 85% of our revenue. And again, they spend a lot of proportion on an infrastructure that did see pricing impacts and those went into effect beginning in Q3.

And on the learners' side, we continue – we talked – I referenced the JournalDev.com acquisition where – which reflects building more content in our library. Now, over 40,000 digital pieces of digital content that drives pretty substantial people, the number of people each month to the platform between 9 million and 10 million. And then those are ripe for conversion onto the platform as learners. And those contribute the vast majority of our logos in about 15% of total revenue.

Vinod Srinivasaraghavan
Analyst, Barclays

Q

Got it. Thanks. And then can you just give us an update on how DO is employing a greater degree of AI I guess within the business, both internally to better target potential $50-per-month customers. And then also whether maybe productizing an AI offering is kind of on the long-term roadmap for the company. Thank you.

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

A

Well, the second piece, it absolutely is a product priority for us to offer that to customers to help them target their customers, better serve their customers. So, it's something that we are evaluating as part of our product strategy. As it relates to us using data science and other analytics tools to better target learners and early or early stage builders as they're ramping or potentially could ramp, we've developed certain triggers, certain signals. We developed whole workflows. A critical aspect of the sales progress is this area exactly of using those triggers and those signals, and it's early there. We can go much deeper into our cohorts than we currently do with the capabilities we have.

I mentioned earlier we're investing in capabilities and sales. It's one of the few areas we are prioritizing right now, and that is a critical area for us. Analytics being very good at analytics and principally to help us better target

those high potential customers early. We've seen enormous success with these early stage businesses who are ramping very rapidly. They're not in optimization mode, they're not in best practices mode, they're just trying to grab every customer. And we've had a high degree and high success rate when we engage with them to get them to think about where they're heading and to think differently about how they could use our platform to better drive their growth more efficiently. And that's been a big success factor in how we're driving $50 and up customers in terms of logo growth and the revenue growth. And I expect that to be a critical area for us to continue to invest in as we go forward.

Q

Thanks. Appreciate it.

Operator: Your next question comes from the line of Michael Turits with KeyBanc.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. This is Eric Heath on for Michael today. Congrats on clearing a solid quarter despite the macro headwinds. So Yancey, just you kind of mentioned on the last remarks, but just given the focus on margins for this year, just how are you thinking about maybe any alterations that outbound sales strategy, if at all? And then do you still kind of see that sales and marketing line stay in that kind of low-double digit range that it's been?

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

A

Yeah. I think that we have – as I mentioned, we have incredibly efficient payback on our customers, pay from the build – as we just referenced in how we acquire those learners, the vast majority of our logos, and also the leverage we see from our sales motions, principally our inside sales motion, our partner motions, where we're able to sign up a customer and a substantially higher orders of magnitude, higher ARPU, [ph] $20,000 (00:41:23) last quarter versus the average for the company. And so that offsets the dollar investments and it continues to be efficient. So although we may see sales and marketing as a percentage of revenue move up over time, did move up last quarter and yet we still made investments because of the leverage we see in this business.

And I think it's a really important attribute of DigitalOcean and it's a powerful contributor to why we're generating meaningful free cash flow that's ramping from here. And so we're going to continue to be efficient and at the same time, balance the portfolio of investments to invest where the growth is and it's in sales and it's also in top of funnel, which is why we bought JournalDev. And we'll continue to do – balance those two investment priorities with the goal of driving sales as a higher proportion of revenue over time.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. That's helpful. And then just on the net expansion rate, I mean, I know you talked about the fact that Europe and kind of the tough comp and what have you, but just curious maybe how we should think about that metric going forward given some of the macro headwinds and the price increase?

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

A

Well, we expect expansion to be higher in the second half than it was in Q2. And we're not going to provide any specific guidance on that, but the tailwinds around that are pricing some of the growth in the efforts of sales. Again sales is up proportionally, pretty materially from Q1 to Q2 in terms of overall percentage of revenue and that helps especially when we're doing inside sales and managing and helping builders grow faster and get a better optimize on the platform that drives ARPU growth in the base and contributes to expansion. So we expect net dollar retention to be meaningfully higher than it was in Q2 in the second half of the year.

Eric Heath
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Thanks, guys.

Operator: Your next question comes from the line of DJ Hynes with Canaccord.

David Hynes
Analyst, Canaccord Genuity LLC

Q

Hey, guys. Yancey, I came away from the Analyst Day feeling like partners were a big untapped opportunity for you guys. Any update on what you're seeing with managed hosting partners or digital agencies as it pertains to distribution?

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

A

Yeah. Those two aspects of the partner channel continue to be very active for us. Managed service providers are actually managing hosting capabilities for customers who don't want to manage it themselves, which is a lot of people and so that continues to be a source of the channel – a big aspect of the channel opportunity, and then the digital agencies, people who are the outsourced Chief Marketing Officers for startups.

And so, although we're not prepared to sort of quote stats today on it, we're making good progress on signing up new partners in – by region and by some of these vertical areas. But agencies and people who touch agencies or people who touch and MS, managed service providers, or managed service providers are a good opportunity for us to expand channel.

And again, what that does is for, whether it's the agencies or the managed hosting providers, there is a whole set of SMBs who don't want to deal with – even though DigitalOcean is simple and easy and intuitive to use, they don't want to spend any time on it and so they outsource that completely. And so they – that doesn't change the fact that as an early stage in ramping small and medium-sized business, we're still the right platform to run your infrastructure. And so, what the MSP opportunity and the digital agency opportunity or the channel opportunity in general does is it extends our addressable or serviceable market within the SMB space for people who even though were simple, easy, intuitive, don't want to do – have anything to do with it, they just outsource it. So, that's going to be a critical aspect of the channel strategy as we go forward.

David Hynes
Analyst, Canaccord Genuity LLC

Q

Yeah. That's great color. And then, Bill, just a follow-up for you. So, look, I think the question we're all going to get asked tomorrow is how much of the 33% midpoint Q3 growth is being driven by price? We can all take our own stab at the number, but maybe it's best to just ask you what you're assuming in the guidance.

William G. Sorenson
Chief Financial Officer, DigitalOcean Holdings, Inc.
A

Well, DJ, as Yancey pointed out in his remarks and I pointed out in my remarks, we were in a very uncertain macro environment right now. We are certainly seeing the benefit of the price increase, but we are also seeing some headwinds that we had started forecasting for everyone, beginning with our Q2 guidance. So, that really hasn't changed. We're approaching this quarter, still pointing to 30%-plus growth, still pointing to improve cash flow. And we're basically pushing a number of levers to help us get there and hopefully beyond. But it's early on in terms of the price increase. But the summary, we expect the tailwind from that as well as tailwinds from our investments in sales and we'll deal with the macro headwinds as we did during Q2.

David Hynes
Analyst, Canaccord Genuity LLC
Q

Okay. Thanks for the color.

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

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Yes. Thank you. I have two as well. Are you seeing your net expansion rate vary after your price increase in the US versus international? And international, obviously, there have been large FX moves and the ultimate price to those customers is proportionate – disproportionately gone up, I guess. So, are you seeing varying trends over there between US and international on the uptake or churn once you have instituted your price increases? And I have a follow-up.

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

Well, again, price increase went into effect Q3. We are seeing higher expansion in Q3 than we saw in Q2, but, obviously, for the first half of the quarter where we are today. So want to be clear about that. It's consistent with what I just said that we expect expansion and net dollar retention to rebound from Q2 as a low for this year.

As it relates to US, US has been less impacted by some of the macro than what we've seen in Europe and Asia. We have seen a little bit, but far less than what we've seen in Europe and Asia. And I think there's a couple of points there. One, I think we see more blockchain in Europe and Asia. Two, I do think and I made a point of making this in the remarks, we charge US dollars and – but obviously, our – for all of our customers. And obviously, with the strengthening of the dollar, even though we can't tie directly to some of the macro headwinds we're seeing in terms of our revenue impact, we have to believe that the 20-ish percent increase in the value of the dollar relative to other currencies over the first half of the year has to have some impact on our customers' businesses. Many of our – or all of our customers are digital businesses. Many of them have a lot of share in the US. And so, I think currency is a headwind, not directly for us as many of our peers in tech who may charge in different currencies have been reporting. But as a qualitative matter, it's certainly something that we think about.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thanks, Yancey. And then just to follow up, you said I think blockchain was about 5%. Was that – what timeframe are you talking about? Is that like a Q2 comment? And just for context, how much was it like maybe in 2021? And as you think about sort of some of the unwind over there, what are you expecting in the back half of

the year would be a reasonable amount to think of as a percent of revenue from that particular category? Thank you.

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

Well, I think it was lower single digits than 5%, and 5% was Q2. It was lower than that last year, but it's been growing rapidly through early Q2. And we would expect it to decline as a percentage in the second half. And we'll – based upon what we know today, obviously, that's a very uncertain volatile market segment. And we'll see how it plays out in the future years beyond where we are now.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thank you.

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

Quinton Gabrielli
Analyst, Piper Sandler & Co.
Q

Hey, guys. This is Quinton Gabrielli on for Jim Fish. Thanks for taking our questions. Maybe jumping on the back of that last question, we appreciated the blockchain disclosure. Is it fair to assume that this is the largest at-risk vertical in terms of percentage of revenue? Maybe if you could help us size the exposure between other potential at-risk verticals like e-commerce, tech startups, or maybe even just crypto as a whole, that helps?

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

Yeah. We don't do a lot of crypto. It's more in the blockchain. I would say e-commerce is a big vertical, streaming, media, education, gaming or others. What I would say is we're seeing more slowing there. That's sort of more in line with what everybody else is seeing. Obviously, blockchain is just an outlier with what's happening in the volatility of that market. And we call that out specifically, because of that, I think in the aggregate is by far the most meaningful vertical that we're seeing real impact. The others are just sort of a slower expansion. But if you net out blockchain, it's not as meaningful.

Quinton Gabrielli
Analyst, Piper Sandler & Co.
Q

Got it. That's helpful. And then, obviously, share buybacks in the quarter were strong. Can you talk about how the team is thinking about capital allocation moving forward across buybacks, inorganic opportunities, and then actually further data center build-outs if customers are asking for additional geos outside of the coming Australia building? Thanks.

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

Yeah. So great question. Our principal, primary use of capital is growing the business, whether it's inorganic through M&A where we've been relatively active over the last couple of years. You mentioned regional expansion, sales investment, product investment. We have Australia coming online, Sydney, Australia data center coming online later this year. We do have plans to expand beyond that, which we'll be disclosing relatively soon. So we'll continue to invest in that, prioritizing that and getting efficient in other places to help pay for that investment.

And then, as it relates to the balance sheet and our capital return, I think we've had a good start on driving the efficiency of the balance sheet. We want to make sure we have adequate capital to drive the growth and profitable growth strategy of the business. And I suspect, over time, as margins continue to expand and we have a lay of the land on what we're able to do with M&A, we'll have more to say potentially about further actions on the balance sheet. But for right now, I think we're in good shape.

Bill mentioned earlier, there's a little bit left on the last $300 million authorization from the board. And we'll continue to find M&A and opportunities and then invest organically. And M&A with – typically in the private markets, we all in the public markets correct immediately and founders who raise money at prior valuations tend to correct more slowly. And so, we'll hope to do some M&A soon, but wrangling the bid ask has been somewhat of a challenge recently, but we'll keep at it and focus the capital we have on those opportunities.

Quinton Gabrielli
Analyst, Piper Sandler & Co.

Q

Thanks. Appreciate it.

Operator: Your next question comes from the line of Patrick Walravens with JMP Securities.

Patrick Walravens
Analyst, JMP Securities LLC

Q

Oh, great. Thank you. I just want to make sure I understand something first, and then I'll have a broader question. But, the part I just want to make sure I understand, Yancey, is the impact of the FX changes in Europe and Asia is to effectively raise prices for those customers, right, and sort of shifts them on the demand curve. And so, things are more expensive, they buy less. Is that the issue we're talking about?

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

A

Well, again, we don't charge – we charge them in dollars. So, what we could say is, yes, it could have the effect of helping them decide to manage spend differently. But...

[indiscernible] (00:55:00)

Patrick Walravens
Analyst, JMP Securities LLC

Q

I just want to make sure I understood that.

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

A

Yes.

Patrick Walravens
Analyst, JMP Securities LLC

Q

Yeah. So, here's my big picture. My big picture question is, right, with all this stuff that's going on, what are the one or two most important things for you to focus on as CEO in the rest of this year?

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

A

We are – that's a great question. I think we have to slim down priorities and get the organization behind the areas that will drive growth and are driving growth. We mentioned earlier inside sales, the analytics, the whole sales effort, getting more productivity and growth out of our cohort and building the partner channel are critical to us and – I think, in terms of top line and then driving efficiencies where we can and – are going to be – and we're investing for those two things. And we're going to have to manage in a challenging environment. And I think that we're a very customer-oriented company and so that makes it easier to focus on delivering value for our customers and prioritizing that very firmly. And that's going to be the focus in the near term. And given that there's a lot out there that we can't control, we can control where we're going to invest our dollars, what activities are above the line and what activities are below the line and getting the organization focused and fired up around that is the principal priority for me right now.

Patrick Walravens
Analyst, JMP Securities LLC

Q

All right. Great. Thank you.

Operator: Your next question comes from the line of [ph] Marc Bachner (00:56:40) with Stifel.

Q

Hi. This is [ph] Marc (00:56:45), on for Brad. Just have a quick question on the assumption that you guys are putting in for the contribution of Russia, Belarus and Ukraine in Q3, [ph] I'd say (00:56:55) it's about 2.4% in Q2. So, just wondering if you'd have anything attributed to that, and if so, what that is? Thank you.

William G. Sorenson
Chief Financial Officer, DigitalOcean Holdings, Inc.

A

Well, our expectation was when we did forecast for Q2 that we would be seeing a material reduction in our Russian-related revenues, which we have seen [ph] fit (00:57:16) a little bit slower than we thought. But our expectations for the balance of the year is that we'll still be under pressure, which again is one of the macro headwinds we're looking at when we considered overall consolidated forecast.

Q

Great. Thank you.

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

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

Good afternoon. Thank you. I wanted to ask the question on visibility because I recall that it's something that you've been doing a work on. Yancey and Bill, what are some of the metrics and early indicators that you look at to determine the health of the customer base in any given quarter before you see consumption slowing?

And then, my follow-up is, your philosophy on pricing, there's a structural tailwind to your business from introducing high-value products and the mix shift becoming more positive over time. On the apples to apples pricing increases, to what extent do you think that those pricing increases could become part of your annual toolkit or a more consistent lever to pull as you think about long-term growth?

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

A

Do you want to take the visibility, and then I'll take...

[indiscernible] (00:58:26)

William G. Sorenson
Chief Financial Officer, DigitalOcean Holdings, Inc.

A

Sure. Sure. In terms of the visibility, Gabriela, there's several things that we look at. One is looking at our customers greater than $50 and above where we see the majority of our revenues, as you know, they now represent 85% of our overall revenues and spend. So, we look obviously at the metrics that we see for them. We look at the components for each. So, we watch very closely their expansion contraction and, most importantly, churn rates in any individual month for us to see what the expectations would be for them going forward. And we're continuing to orient the work that we do internally across this group. Yancey, you've heard, mentioned several times sales. Sales in some respects for us is around enablement. It's around working much closer with our greater than $50 spend customers and finding ways for them to increase their contribution.

And the feedback that we're getting from an increased outreach speaking more directly to thousands and thousands of our customers is helping inform us directionally where they're going, not only in terms of current trends, but also in terms of some of the things they want to see. Things like functions, which is one of the most requested items. So, we're gleaning more and more information around those customers. And that's a primary factor that we look at on a month to month basis.

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

A

Yeah. As it relates to philosophy, I love the question because it speaks to a couple areas. One, we're getting pricing leverage in the business because of our $50 and up customers, and I put pricing in quotes, because our $50 and up customers, which are now 85% of our total revenue, that's up meaningfully from just a couple of years ago. As we've added more managed services like Managed Databases, Managed Kubernetes, Serverless, it's extending the wallet share we can capture from a customer than we could three to five years ago when we were just basic compute, basic network bandwidth and basic storage. And so, that has the effect, that's what drives our – a big contributor to ARPU growth, that has the effect of driving pricing leverages in the aggregate economics of our revenue mix is product mix, going from 100% infrastructure-as-a-service three to five years ago, for example, [ph] to 82% (01:00:57) today. So, we're going to continue to invest in products that are valuable to our customers as they grow in the early stage from the builders to the scaler stages of SMBs. We're going to continue – I mentioned AI earlier. There are other areas that, as their workflow evolves, we can be helpful to them while also maintaining simplicity. So, that will be a tailwind on ARPU growth.

As it relates to a price increase explicitly, for example, mostly our IaaS here, I think that – which was the first price increase or price changes really, material price changes in 10-year history of the company, I think that reflects we have made a substantial amount of investment in community over 40,000 tutorials free of charge and other documents. Our support model embraces our customers, all customers regardless of price point. Our simplicity,

as we add more products and more capability to platform, we continue to ensure that simplicity – and a key aspect of simplicity, by the way, is consumption model. People [ph] aren't scrambling (01:02:10) and calling CIOs of – beating people up for breaking contracts and trying to renegotiate. And it works at the plus side and it works in the minus in the near term. But that's part of simplicity. It's part of removing friction and barriers that many of our competitors in the cloud have more complexity as it relates to that.

And so, we feel that that is a value proposition to our customers. And the actions we took in Q2 that went effective in July reflect the value. We want to have a great conversation with our customers about the value proposition and the differentiation of our value proposition to help them do the jobs that they need to do, help them with their workflow as they grow and scale. And we're going to continue to add product, make the product better, add security and reliability, which are incredibly valuable to our customers that are $50 and up as they ramp their customers on the platform. So, we'll continue to invest in the platform. We'll continue to do product extensions to get that ARPU tailwind from product mix.

And then, I don't necessarily think this will be a annual COLA increase, if you will, because the calendar flips. I do think we'll be – it won't be 10 years before you take the next action. And I think the context for any future actions will be like what we employed here, which is, as we have learned more about the value that we can deliver for customers, we learn more about their workflow evolution, how best to package, how best to serve that and innovate against that and then what's the right price to maintain differentiation, but be a compelling value to our customers. And as a reminder, we're roughly 50%, for example, of the hyperscalers, yet have a highly performant platform for people to build and scale the business. And that's our approach and philosophy going forward.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

I appreciate the detail. Thank you.

Operator: Your next question comes from the line of Josh Baer with Morgan Stanley.

Josh Baer
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you for the question. I appreciate all the commentary around pricing increases so far and certainly the uncertainty looking ahead. Wondering, looking back, what was the impact from pricing in the month of July?

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

A

What we've said is, I mentioned earlier, expansion was higher in July. And so, we're seeing a positive benefit in Q3, net of – pricing on net, that's reflected in our outlook. Our outlook is also highly tempered by uncertainty.

Josh Baer
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Got it. I mean, is like a mid- to high-single-digit annualized benefit from pricing a reasonable range for investors to take away tonight?

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

A

Our guidance stands for itself.

Josh Baer
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Okay. Thank you very much.

Operator: There are no further questions. I'll now turn the call over to Yancey Spruill for any closing remarks.

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

Well, thank you very much for joining us. We really appreciate the time, the continued support that you all have for our company. And we believe, given the uncertainty in the market, we want to be available and transparent. And so, we expect to speak with many of you over the coming weeks and obviously years ahead. And we want to get through this tough time as we are doing with our customers and our team internally with you all together.

My conviction has never been stronger about the limitless potential of this business, a potential that will be realized by enabling evermore developers and entrepreneurs to test their ideas, build their businesses and realize their dreams. Have a great rest of the day.

Operator: Thank you for participating. You may disconnect at this time.