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DigitalOcean Holdings, Inc. (DOCN)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the DigitalOcean Third 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.

I will now turn the call over to Rob Bradley, Vice President of Investor Relations. Please go ahead.

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

Thank you, and welcome, everyone, to DigitalOcean's third 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 conference call, we will be making forward-looking statements, including our financial outlook for the fourth 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.

Finally, we'll be discussing 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 afternoon and is also in the investor presentation on our IR 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.

Thank you, Rob, and thank you all for joining us as we review our strong third quarter results. Another quarter in our ongoing commitment to delivering robust revenue growth and improving profitability and free cash flow. I'm proud of the entire DigitalOcean's team for delivering these results given the challenges in the operating environment this year.

I'd like to begin today by framing where our business stands in the context of where we've been and how we are set up to durable profitable growth even in these times of uncertainty. I'll then share some insights on our growth and profitability priorities as we close out this year and work our way towards 2023. I'll specifically address the early indicators resulting from our recent pricing initiatives and discuss our exciting Cloudways acquisition, which we closed on September 1. Bill will then provide more details on the financial results, our financial outlook for Q4, and then turn to your questions.

We have a highly resilient business due to several key factors and they've been clearly on display this year. First, we have a truly global geographic footprint with our revenue and customer base spread across 185 countries in similar proportion to global GDP. So, we are not dependent on any one region or country. Second, we have customer diversity with our top-25 customers representing less than 10% of total revenue. So, our revenue is not concentrated in a small number of customers.

Third, we serve a wide range of industry verticals and use cases from e-commerce, web and mobile applications, website hosting, media and gaming, publishing, ad tech and many more. So, we aren't overly reliant on any industry or business model. And finally, we also have a consumption-based revenue model, which creates the flexibility for our customers to pay for what they need as they scale their business, but also to adjust their use to address any economic headwinds they are facing.

This customer-centric model, with simplicity at its heart, builds customer loyalty that historically has been a great benefit to us, as demonstrated in our low churn levels, and will pay long-term dividends as we exit this turbulent environment. Collectively, these factors position us well when there is an economic downdraft, like we have seen this year, and allow us to achieve continued strong revenue growth, coupled with improving profitability.

With our consumption-based model, we were early in seeing the impact of the economic downturn during the first half of 2022. These economic headwinds, which include a global economic slowdown, high inflation, US dollar strength, the Russia-Ukraine war and the decline in blockchain, continued in the third quarter.

Undoubtedly, these factors contributed to slower growth within our cohort than we had forecast at the beginning of the year and, along with the reduction of revenue in Russia and Ukraine and significantly lower blockchain customer spend, has resulted in a 900 basis point headwind in Q3 to our stated goal of 30% growth.

Importantly, churn within our cohort has remained flat during this period and our customer engagement remained strong. So, we are very optimistic when things turn in the broader economy, we will be well positioned for

expansion across our cohort to be a tailwind on our top-line growth rate as it was throughout 2021 and even Q1 this year.

Despite these unforeseen challenges, we managed through it to deliver 37% total revenue growth with 33% organic growth. We aren't ready to call a bottom in terms of the lower growth across our cohort. And given the number of uncertainties in the broader macro, we will remain cautious in our planning and in setting expectations.

Q3 marked my three-year anniversary at DigitalOcean and it is a good time for me to reflect on our progress. In the summer of 2019, we inherited a business growing revenue in the low to mid-20s with negative 25% free cash flow.

We set a goal of getting the growth rate above 30% by focusing on the most impactful opportunities we saw: from improving the customer experience to reducing churn, which was upper teens; driving expansion in our cohorts through adding relevant products and features such as managed databases and Kubernetes; and building a sales capability to better penetrate our $70 billion addressable market.

This strategy was successful as we generated 35% growth in 2021 and will be above 30% this year. We expect to grow at least 30% next year from the midpoint of the 2022 guidance we are issuing today. NDR has improved from below 100% to the mid-teens as we cut churn in half and ARPU growth has improved from the mid-teens up to the mid to high-20s.

Our second goal is to dramatically improve the profitability cash flow profile of the business. Those that know me well can confirm that free cash flow has always been an obsession for me, not a revelation made in 2022 when the world started seeing signs of economic turmoil. We saw an opportunity here as capital intensity was too high, operating costs were too disconnected from revenue and the resulting operating and free cash flow margins were significantly negative, which simply was not acceptable.

Today, our non-GAAP operating margins are about 20% and free cash flow margins are double-digits, both with plenty of upside from here. This work over the past three years has created a powerfully efficient, high-growth business model built around simplicity, with incredibly attractive customer lifetime value to acquisition costs, a modest requirement for incremental product investment and an increasingly CapEx-efficient footprint to deliver value to our customers. These characteristics when combined are driving a 30% growth rate this year before Cloudways, with the strong and ramping free cash flow generation we are seeing today.

We remain committed to our combined goals of annual revenue growth of 30%, ramping free cash flow, and starting in 2024, free cash flow margins of 20% or better. Our $70 billion market opportunity is projected to continue to grow in coming years. The SMB economy is roughly 50% of global GDP. It's not going anywhere. And although it is not immune from the broader trends impacting our economy, smaller businesses are demonstrating how nimble and resilient they are during this period. There is a perception that SMB is subject to a more significant impact than enterprise from weak macroeconomic conditions.

The facts suggest otherwise, as the hyperscale cloud providers and other software companies, who are principally focused on enterprise customers, have reported similar levels of declines to their growth rates as us during this year. We believe having an SMB-focused business with geographic, industry and business model diversity, and a consumption-based model is a key strength of our company, plan to exit this turbulent economic period with a stronger set of capabilities grounded in an even better customer experience, resulting in greater market share.

The levers we use in the next few years will be somewhat different from those we pulled the last three years. The revenue and profitability targets, including achieving our first $1 billion of revenue in 2024, do not change. First, targeted product enhancements that represent large revenue opportunities will be one area of focus. This may come from internal development work or through acquisitions like our recent Cloudways transaction, which I will address in a bit more detail shortly.

One specific area of focus for us will be enhancing our storage offerings for SMB customers. Our storage revenue currently is high-single digits as a percentage of our total revenue. And we believe based upon benchmark and customer surveys that we can double the revenue mix percentage from storage-related capabilities over the next few years. Providing a more performant feature-rich storage platform, more specifically tailored to our SMB customers, will also drive growth across droplet, database, Kubernetes and serverless products.

The ARPU from our customers that use our object and block storage products is more than 25 times the ARPU from customers that do not use them. Many of our SMB customers may use us for compute, but go multi-cloud for storage. Being able to capture the full compute and storage suite from current and new customers is a big opportunity for us.

Second, we see opportunities to better align our pricing and packaging models with the different needs and wants of our diverse customer base. We took the first step here earlier this year which I will address in a few moments. But there are other opportunities we see to optimize our monetization approach with the specific and different needs of our customers. One example being packaging the various security protections we provide on the platform to address specific customer needs.

Third, we will continue to expand our sales and marketing engine around the world. This effort is working well, but it is still early. And we see a significant opportunity to sell more to our existing customer base as well as targeting new customers. We recently announced the launch of our partnership program called Partner Pod. As part of this program, our partners receive free training and enablement on sales, products and other topics; co-marketing opportunities and market development funds, so they can get help running [ph] other (00:12:43) campaigns and bring in new customers. We think a robust partner program is an essential part of the go-to-market approach for a global SMB business.

Growth from our sales efforts was up 225% year-to-date, and the mix as a percentage of total sales was just over 5% in Q3, up from 4% in Q3 2021 and essentially zero three years ago. We're making very good progress in building a sales capability that will continue to generate an increasing component of our overall revenue mix in the coming years.

Lastly, we expect to expand our global infrastructure in the coming years to better capture a more localized customer set in key markets. Our new data center in Australia will be launching this quarter. This has been a consistent ask from our customers and we are pleased to offer this expanded capability to our infrastructure footprint. We're in the planning phase for additional locations and expect to broaden our footprint to address other important regional markets as well as to enhance the performance of our entire network for our global customer base.

At the same time, on the expense side, we will continue to focus on operational excellence, optimizing our processes and deploying our capital efficiently which will help us to continue to drive operating and free cash flow margin leverage, regardless of the economic environment. We have made great progress over the past few years on improving our profitability profile, but there is more we will do here as well.

I would like to provide a bit more color on the two levers we pulled in Q3 that I just referenced. First, an action on the pricing of our portfolio products followed by our largest acquisition to-date. This provides critical insight into how we manage our business, consistently working on opportunities to grow faster, while also growing free cash flow.

Effective July 1, we introduced our new pricing model which we had been developing since last fall in 2021. This new framework, which we announced in May, incorporated higher prices for some of our products, including our flagship droplet as well as the introduction of a lower-priced droplet SKU. The rationale had two main components. First, to have our pricing reflect the tremendous value we have added to our portfolio over the years, in terms of reliability, performance, security and support; and second, to align our pricing structure to the different needs of individual developers and SMB customers.

Broadly speaking, after one quarter of operating under this new pricing framework, the positive impact on our business has exceeded our expectations, despite weaker macro trends that offset some of the benefits of the pricing changes. Specifically, both customer churn and the number of customers downgrading to the lower price SKU have been less than we forecast. Pricing initiatives generated a 1,200 basis point benefit to year-over-year growth in Q3. At the same time, the headwinds that we've discussed diluted the impact of those pricing changes in the quarter. But as those dissipate, our new pricing framework is going to endure as we continue to lead in the SMB cloud with a differentiated platform.

I'd also like to note that other players in the SMB segment of cloud infrastructure have followed us and introduced price increases subsequent to our announcement. These results have confirmed our thesis that our customer base sees tremendous value from the platform improvements we have made across time. We are still roughly half the cost of the hyperscaler pricing and our prices still constitute a small expense as a percentage of their revenue for our SMB customers that view us as a critical requirement to run their entire business.

These pricing actions have created a tailwind to other key performance indicators as well, including net new annual recurring revenue which was up 41% to $641 million; net dollar retention, which was 118%; and revenue per customer, or ARPU, which was up 28%. Perhaps the most important measure of the durability of our growth that also saw a dramatic uplift was with our high-spend customers. Excluding Cloudways, our high-spend customers, those that spend at least $50 per month, grew 29% year-over-year to 122,000 and now represent 86% of total revenue, up 300 basis points from Q3 2021.

Including the 20,000 greater-than-$50 customers within Cloudways, our total high-spend customer count increased to 142,000, a 50% increase year-over-year. Again, these customers are fueling our revenue growth and our ability to grow this business to greater than $1 billion in revenue and beyond is critically dependent on growth from this customer cohort.

Next, I'd like to speak to Cloudways. We are very excited about the Cloudways acquisition. And frankly, our conviction has grown stronger in the two months since we have been integrating our two companies. Our excitement is predicated on our shared passion for serving the SMB opportunity, the significant expansion of our serviceable market and the increased benefit we will realize for the deep customer insights that the Cloudways team possesses, which will accrue to our entire business as we build a unified go-to-market motion.

As investors view our $70 billion market opportunity that consists of infrastructure and platform-as-a-service for businesses that have fewer than 500 employees, that is to say SMB, they often think that the customers we serve are all the same. But in reality, that is not the case. While these customers represent a vast array of industry

verticals, geographies and use cases, perhaps, the most critical distinction is between customers that seek a managed experience versus a more do-it-yourself model for their cloud investor.

For IaaS, the historical business model for DigitalOcean, has been to target the do-it-yourself customers who have both the internal expertise and desire to handle their infrastructure. As we have scaled our business over the last several years, it has become very clear that there is a large universe of technology SMBs and a corresponding large market opportunity for us, likely as large as our core market, that want a managed experience. So, often we see the customers churn in the first few months in our platform, cite that they were looking for a managed experience, something that we have not offered until now.

With a more complete suite of offerings, we become an attractive provider to an even larger number of the 100 million global SMBs looking for a cloud solution. We are very optimistic about the potential for significant revenue synergies, and the early proof points are very encouraging.

Cloudways brings deeper SMB customer insights to DigitalOcean, as a managed service entails a deeper relation with end customers that provides valuable insights about the opportunities and challenges businesses are facing as they grow. As a good indicator of the value of this customer intimacy, Cloudways generates 2x the pricing for a similar-sized customer footprint. Obviously, this creates a big opportunity for us over time given the scale of our customer base.

We are already acting on this opportunity by moving to improve customer monetization and to make our product development and go-to-market efforts much more integrated. Cloudways' deep customer understanding and intimacy is a key ingredient to DigitalOcean's aspiration to become the SMB cloud provider.

The final piece of the puzzle with Cloudways is their very attractive revenue growth and free cash flow profile. They're growing faster with free cash flow margins, in line with ours, and we will invest to keep it that way and leverage Cloudways' capabilities to accelerate growth across the business by better placing customers into the service profile that best meets their needs.

We are already realizing some of the significant opportunity for revenue synergies for Cloudways, as we match customers in our combined platform with the best outcome for their objectives. The Cloudways acquisition and these synergies will certainly be a critical contributing factor to sustaining our 30% annual revenue growth target.

In summary, Q3 demonstrated our ability to operate in a challenging environment. We delivered 37% growth while delivering free cash flow margins of 15%. We achieved this in the face of significant macro headwinds. I'm very proud of these results and what it says about the durability and resilience of our business in tough times and speaks loudly about the power of our business model in better times.

Most exciting of all, despite the uncertain economy, we took decisive action that meaningfully increased our business capabilities with the Cloudways acquisition, which will help us better address the $70 billion SMB cloud market, which positions us for both self-serve and managed services customers. We will end 2022 with a larger and more profitable business, setting us up for continued success in 2023 and beyond.

With that, over to Bill to provide details on the quarter.

William G. Sorenson

Chief Financial Officer, DigitalOcean Holdings, Inc.

Thanks, Yancey, and thanks to all of you for joining us today to review our very solid third quarter results. Before we begin, I would like to review the fundamental elements of our operating strategy, which have not changed since becoming a public company and will continue to guide our efforts for the years ahead.

At our core, we focus on three key areas: revenue growth in excess of 30%, faster than the SMB cloud market growth rate; increasing profitability; and growing free cash flow for shareholders. Those fundamentals have not changed and will not change as we go forward.

Also, we frequently articulated that a variety of levers would be used to achieve those three objectives, including pricing and packaging, evolving our go-to-market strategy from purely self-serve to more direct customer outreach and interaction; and finally, accretive M&A opportunities that either expand and enhance our go-to-market capabilities or accelerate our product innovation. Entering the year with over $1 billion of cash on our balance sheet provided us with real opportunities to execute this strategy.

Pulling the right levers and executing well has been critical this year. Over the past few quarters, we've experienced the war in Europe, a global economic slowdown, a strengthening dollar in the collapse of the bitcoin market, all of which have put pressure on our top line. Despite these developments, we have delivered another quarter of better-than-30% growth, coupled with improving profitability and cash flow margin. And going forward, we will continue to do the same.

Today, I'm going to use my remarks to provide more color on the drivers of our top line revenue performance in the quarter; the gross margin impact from the adoption of the lease accounting standard, ASC 842, which we are required to do by the end of this fiscal year; and the contributors to the profitability we demonstrated in Q3 as well as our expectations for the remainder of the year. Following that, I'll share our outlook before turning it over to the operator to take your questions.

I want to begin with revenue, which came in at $152 million in the quarter, an increase of 37% year-over-year and the fifth out of seven reported quarters where our growth exceeded 30%. Q3 does include a net revenue contribution from our Cloudways acquisition. But even excluding that, our revenue grew 33% year-over-year and exceeded the guidance we provided prior to the acquisition by $1 million. Several initiatives helped us achieve these strong results.

The first of those initiatives focused on pricing and packaging, which we've consistently discussed as an opportunity. Q3 benefited from the implementation of increased pricing to reflect the improvements we've made in the product over the past several years. We strongly believe our new pricing model provides incredible value to our customers with our learners, builders or scalers. And based on the customer reaction, our customers are seeing this value. And our price increase was not unique to the industry, as we've seen other cloud providers, both big and small, follow our lead.

As we've long hypothesized, our product offerings were priced at too wide a gap to the DigitalOcean value proposition and the results that we have seen through the first three months of the new pricing taking effect is that our hypothesis was correct. Since July 1, we've had lower customer churn than we had assumed, lowered downgrades to the $4 droplet and lower negotiated discounts with our larger customers. In total, the price increase provided approximately $13 million of additional revenues in the quarter.

In order to learn more about the reasons for customer churn, whether pricing, macro factors or other, we conducted a survey with customers whose spend contracted since the price changes took effect. The results of our survey were enlightening. More than half of those surveyed cited needing fewer resources as the main driver

of their decreased spend, suggesting that our customers' demand environment has reduced, which is not surprising given the global backdrop.

In addition, less than a quarter of surveyed respondents cited DigitalOcean's increased price as the reason for their spend reduction. This gives us confidence at the value proposition of our offering indoors and we will have an ongoing benefit through the subsequent quarters.

Another initiative was in the area of go-to-market. We've long shared that a central component of our strategy has been to enhance our distribution capabilities to extend our customer reach and expand our serviceable market. Cloudways accomplishes these objectives and helps us accelerate our revenue growth. In the two months since we've acquired Cloudways, we've been pleased to see that their leadership team and business processes are even stronger than we expected.

And importantly, a key strategic benefit from the acquisition will be our ability to leverage the customer intimacy that Cloudways has nurtured for years to help us get closer to our sizable customer base in order to improve our service offering and capabilities and prioritize our product road map. And finally, we've continued to increase our investment in the DigitalOcean go-to-market team, so we can focus on our largest customers.

During the quarter, the contribution from this group continued to beat plan and will continue to be a focus area in the years ahead. All told, these initiatives contributed more than $17 million to our top line in Q3 and sets us up well for continued strong revenue performance in the year ahead. Despite the several material headwinds that we've discussed, we delivered 37% revenue growth for Q3 and will deliver 30% plus revenue growth for this year and 2023 as well. I'll address our guidance in a bit more detail in a few moments.

Now that we talked about our top line, I'd like to move to profit and loss, beginning with gross margin. As many of you know, we'll be adopting ASC 842, the accounting standard for leases in Q4, which applies to our co-location contracts that contain both data center cage and power components. ASC 842 results in company's straight-lining lease obligations over the respective lease terms for both these components. In anticipation of the full adoption of this standard, we adjusted the straight-line treatment for the cage component during Q3. This negatively impacted gross margins by roughly 1% in the quarter, as our data center agreements are frequently multiyear arrangements where the payments increase over the term.

In Q4, the impact of adopting the new standard will straight-line both our cage and power cost and will result in a one-time charge of roughly $7 million. This is a noncash charge that will not impact our free cash flow, but will put pressure on margins in Q4. However, we have taken numerous steps to limit our overall operating expense growth during the quarter. So even with this adjustment, we will still deliver a further improvement in our overall NGOI for the year. More on that in our guidance discussion. As just noted, this accounting standard does not change our free cash flow expectations and we remain on track and committed to delivering free cash flow margins of 20% in 2024.

In addition to the new accounting standard, we expect data center power pricing to increase as of January 1, particularly in Europe. We've been in discussions with our vendors and have factored this impact into our planning process for 2023. We're confident that we can manage price increases from power against our portfolio of other COGS spend where we are driving efficiency, including but not limited to better pricing on non-power aspects of our data center vendor relationships. And for next year, we expect to generate gross margins of 65% or better even with the noncash impact of the lease accounting standard treatment.

Next, I'll turn to operating margin, which was very strong in Q3, as we delivered $40 million of non-GAAP operating income, representing a 26% margin on a consolidated basis. We significantly exceeded the high end of our outlook by 800 basis points, driven principally by compensation. During Q3, there was a one-time bonus accrual reversal that contributed 600 basis points to this beat. But even adjusting for that, our margin was 20%, 200 basis points above the outlook we provided in August. This bonus reversal reflects our current expectation for 2022 revenue relative to the original internal plan.

The additional outperformance for profitability resulted from our continuing discipline to prioritize hiring against the key initiatives that either generate revenue or improve efficiency in the near term and, at the same time, limiting spending growth overall to only those elements needed to meet our operating goals. Additionally, we are maintaining lower spend levels on longer-term projects that we can then dedicate incremental resources to, as they become available.

Next, I wanted to share some of the drivers of our very strong free cash flow that we delivered in the quarter, which was $22 million and represented 15% of revenue. The improvement in cash flow was driven by the substantial improvement in non-GAAP operating income and adjusted EBITDA which reached 42% in the quarter and helped by better working capital performance from our prior plan, as payments came in lower than expected either due to negotiated reductions or different payment timing.

Several payments are scheduled for Q4 and are fully reflected in our Q4 forecast. I do want to reiterate that the new accounting standard will have no impact to our free cash flow targets. And similar to operating income, we'll be increasing our target for 2022, which brings me to our financial outlook. For the quarter, we expect revenue to be in the range of $160 million to $162 million, which reflects 35% growth at the midpoint. We expect fourth quarter non-GAAP operating margins to be 16%, which is below Q3 levels, principally due to the one-time charge of approximately $7 million for the adoption of the new leasing standard and higher compensation levels.

For the full year, we expect revenue to be in the range of $573 million to $575 million, which at the midpoint represents 34% growth. This range includes approximately $16 million of net revenue contribution from Cloudways for 2022. From a profitability standpoint, once again, we are increasing our expectations and are targeting full year non-GAAP operating margins to be 17%. And finally, we're increasing our 2022 free cash flow outlook as a percentage of revenue to between 10% and 11%, which is the second consecutive 50 basis point increase from our previous call at the midpoint.

With regard to 2023, we expect to grow at least 30% over reported 2022 revenue, targeting $746 million in total revenue based upon the midpoint of our guidance range. As we will benefit from product enhancements, pricing strategy, Cloudways and our expanding go-to-market efforts, we expect all of these to yield results even in the face of the broader macro uncertainties.

That concludes our remarks. And now, let's turn to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from Raimo Lenschow from Barclays. Please go ahead.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Thank you. Congrats. That's really good quarter in this environment. Yancey, just two quick questions. One is, if you think about the behavior you're seeing from clients in the macro downturn you saw at Azure, they were kind of putting less workloads on, they were looking to optimize their cloud spending because they had overcommitted. That seems like less of a problem for you. Like, what are you seeing there in terms of behavior that's coming out there? And then, I had one follow-up.

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

A

Yeah. So, what we're seeing and when we engage with customers and in conversations I've had, the feedback from our support to our broader teams that engage with customers is, they're very happy with our service. I think, Bill referenced the survey we did just to check in with customers a few months ago to learn more about contraction. Our customers are simply seeing a weaker operating environment, and a number of them express appreciation to us for the fact that we have this consumption-based model, because it allows them to adjust without calling us up and trying to renegotiate, et cetera.

So, what we're seeing is just a reflection of what they're seeing; and not them trying to shift things around, et cetera. So, none of us are happy with the world we're living in today for various reasons. But I think, our engagement with our customers and where our customers' sentiment, the positive sentiment they've had with us, has continued throughout this year; and frankly, even despite the pricing increase. The number of comments you've had from customers [ph] meaning (00:36:43) understand they get it. They still see lots of value. And we continue to work with them to help them through this, but we feel very good about the relationship we have and are building with our customers in this environment.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Perfect. Hey. Yeah, it makes a lot of sense. And then the second question was more on Cloudways. And now that you own the asset, like how do you think about it more in the long run, because it does offer a much, much deeper relationships and they're, obviously, much broader in terms of their offering? Like in that perspective, there is almost like a question like how do you see DigitalOcean in the long run as a vendor in terms of IaaS versus being a much broader provider for the SMB. Have you kind of started thinking about that already?

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

A

Well, we think a lot about that. And what we've – the comment in the script was, we are more bullish today than when we signed the contract, when we first approached them earlier this year about this combination. I think we're still learning as we dissect the opportunities between the combined companies. But one thing is pretty clear, there's a ton of synergies in this transaction both in terms of us better matching customers day one into a managed service.

I won't quantify it here, but we've had a decent amount of churn in our first 60, 90 days for customers who come to DigitalOcean, we got millions coming every month. They read tutorials. They'll sign up for an account and then they leave us in the first 60, 90 days. And a lot of them say, we were hoping for more help, more of a managed experience. We like DigitalOcean, but it's just not for us. And obviously, we've closed that gap here. Similarly, from their side.

And we've already seen it's early, so we won't give a lot of stats. Hopefully on the next call, we'll give more. But there is such an opportunity, I think, to give the market a more integrated view and that's why we're planning to integrate much more in terms of our go-to-market. There is just a lot of opportunity here. And as it relates to what DigitalOcean represents versus the broader IaaS market, we'll sort through that. But it's really about giving customers.

And what we're learning is, a lot of SMBs don't want to manage infrastructure. They love the cloud, because of the pricing and flexibility, but they actually just don't – they don't have to desire. And that's not how we were operating pre the deal. And I think when you start to think about 2x the price uplift for someone using a $6 droplet on Cloudways versus what they pay us because of the more managed experience, there has been a lot of upside opportunity for us when you look at our broader customer cohort.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Yeah. Sounds exciting. Thank you.

Operator: Your next question comes from Gabriela Borges from Goldman Sachs. Please go ahead

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good afternoon. Thanks for taking my question. I want to ask, Yancey, on the storage functionality that you talked about in the prepared remarks. When you think about your customers and what they're looking for in order to get that storage revenue doubling essentially as a percentage of sales, what do you think needs to be better from a DigitalOcean standpoint in terms of functionality?

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

A

I think when we look at the breadth of our customers, and there truly is a cutover when somebody is sub-50, and then they get to 200, 300, 1,000, or 100,000, there is a pretty broad diversity. And so, what we'll be looking to add capability is to support the growth and scale of larger customers whose use of object and block, depending upon the industry type and the use case in terms of more speed, performance, other features, et cetera. We have a very clear road map on this. Frankly, Cloudways – owning Cloudways – having them in the mix is very clarifying, given they serve the SMB market and will help us with product road map.

But we have a very clear area. We've been investing in this area. I haven't been talking about it much over the last, I'd call it, six quarters or so, and have been improving and adding to the capabilities. But we're going to look to really focus our efforts in the near term in this area because of the unlock is so substantial when you look at the multiproduct adoption and also just doubling the revenue as a proportion of mix. So, it's really features, functionality and performance to span a broader array of customers than what the capability is today.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

That's helpful. And as a follow up, if I may, on the e-commerce vertical in particular, we've seen trends that are a little bit different during COVID, where end market participants talk about e-commerce normalizing back to trend line. Curious, when you look at the Cloudways business and then your broader set of e-commerce customers, how would you describe the trend there? Is it still deteriorating? Do you feel like it's stable? Is there a path where maybe it accelerates near term? A little bit on the e-commerce vertical specifically. Thank you.

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

A

Well, given the high leverage to WordPress at Cloudways, it's a good proxy for your question. What I would say we've seen with Cloudways throughout this year is they have been impacted, but not to the same degree that we have in terms of their growth rate is lower than what they would have expected and coming into this year, I don't know that there's anyone in the world that that's not the case, but they're much closer – meaningfully closer to their plan than – coming into the year than today than what they would have expected versus us.

So, I do think it points to some of the trends you're seeing in other areas of e-commerce, very resilient as it relates to – and their new customer adds also very strong as well. So, I think that aspect, again, in an environment where you have to devote resources to doing it yourself, even though you may have a higher uplift there, given the fact that you don't have – you can devote your other resources to your core activities, we're learning more and more about that being a value. So, I think that sort of speaks to the question.

Gabriela Borges
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Your next question comes from Pinjalim Bora from JPMorgan. Please go ahead.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Oh, great. Hey. Thanks for taking the questions. I want to continue with Cloudways, I guess. I want to ask you, what are you hearing from customers who are using a competitive solution in terms of their likelihood of moving over? Are you having those discussions? And what are you thinking in terms of pricing, I guess, on Cloudways versus the increase that you did for DigitalOcean?

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

A

Well, Cloudways is a managed host or uses other providers. We haven't seen any change in the conversations or customers want to switch one to the other. We haven't adjusted prices since our announcement on Cloudways. And we'll continue to evaluate opportunities there. We're really focused now on how do we direct customers who come into our funnel, give them an option minute one in terms of whether they want to have a more do-it-yourself legacy DO versus the Cloudways. But haven't seen any change in traction, any change in the conversation. Customers with us – there has been no real change even during the course of this year on us versus someone else in the pricing or other issues.

I think the conversations with our customers are very healthy around how do we help them manage through this environment in terms of best practices, other areas that we can help them operate better. But as I mentioned earlier, and this is really important given some of the uncertainty, our churn levels remain consistent throughout this year and, frankly, where they've been since early last year. And I think that's very comforting, because when things do turn, they're here, in the consumption pricing model, although it's a headwind in the near term, it will be a tailwind as they resume growth.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Yeah. Understood. One question for Bill on the ARR, the sequential growth of $97 million, I think you gave us an idea of Cloudways, which is about $4 million. We can try to annualize and look at an ARR number, I guess. You gave us a little bit of an idea about pricing of $13 million. I want to ask you how should we think about the headwinds on that ARR number, on that $97 million sequentially, how should we think about the headwinds?

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

A

Well, the $97 million is being accelerated by the contribution of Cloudways, but it still was a massive quarter for us in terms of ARR pickup quarter-over-quarter. So, the combination of Cloudways into that number, along with the benefit of the additions from the price increase, gave us a pretty strong uplift. Going forward, the headwind calculation, Pinjalim, is anyone's guess at this point. I mean, we certainly are mindful and watching every month in terms of what we're seeing. I don't think we're necessarily out of the woods. We still are encouraged by the uptake that we're getting, particularly in the bigger customers. What we're seeing there is our greater-than-$50 and even our greater-than-$250 customers are still showing resilience. But it's hard to basically estimate what we think the impact would be going forward.

I still think we – not still think, we are still addressing 30% plus growth. We have a number of levers to get there. And we hope that the economic headwinds will turn to tailwinds that will give us further acceleration relative to the seeds we planted in terms of Cloudways with its managed service providing and also what we're doing here in terms of the customer enablement and our go-to-market initiatives through sales. So, we continue to be cautious, which, I think, if you followed us over the past three quarters, that's been the tone of our calls. So, we'll have to see what happens. But the multiple levers gives us confidence – still point towards 30% plus growth.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Operator: Your next question comes from James Breen from William Blair. Please go ahead.

James Breen
Analyst, William Blair & Co. LLC

Q

Yeah. Thanks for taking the question. Can you talk a little bit about the impacts that the price increases have had? And did it mainly come within this quarter or is there a sort of a tail to that as we move over the next couple of quarters? And then, secondly, just on the cost side, I understand the margins will tick down in the fourth quarter. How do you sort of see that moving from there? Will it stay sort of at this lower level for a while or do you see a rapid improvement? Thanks.

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

No, we're continuing to basically focus on expense improvements. One of the things Yancey said in our year-end result, we may not be able to control revenue in this environment, but we certainly can control spend. And the trajectory we see going forward will be increasing profitability next year and improving cash flow. We're still on target for 2024, targeting 20% free cash flow, as we move forward. So, expenses will be the key part here that we can continue to control. And we do see room for upside in greater efficiency, particularly as we target our initiatives against the bigger customers. And we're able to monitor payback. So if we're not getting paid back, we certainly can pivot as needed. And Jim, I'm sorry, the first part of the question was revenue related?

James Breen
Analyst, William Blair & Co. LLC
Q

Yeah. Just on the price increases that you put in place in July. Is there a long tail to that? Do all the customers immediately go to the higher price point or are there some that are gradually moving to the higher price points over a couple of quarters?

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

Well, not over a couple of quarters. We did provide discounts to some of our larger customers, which are basically starting to mature during this quarter. But we do anticipate that pricing will continue to impact the next two or three quarters before we get to the anniversary of the price increase. We do think that will be an important accelerant relative to our growth and help offset the impact of the economic headwinds.

James Breen
Analyst, William Blair & Co. LLC
Q

Great. Thanks.

Operator: Your next question comes from Tim Horan from OPCO. Please go ahead.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.
Q

Thanks, guys. Just two questions. Do you think the free cash flow improvement from 10% to 20%, is that relatively linear? I guess, should we be expecting like 15% next year or is it more backend loaded? And then, secondly, on the price increases by your peers, was it both hyperscalers as well as smaller providers like yourself, or is it weighted more towards the other end? Was the magnitude – or you think the magnitude is, that you're seeing now, in line with what you did. Thank you.

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

Yeah. So on the last question, all the hyperscalers have raised pricing this year. I was not referring to them. I was referring to folks who are competing in the SMB segment of the cloud. And I would say their pricing magnitudes were similar and, again, were announced after us – after our May announcement. So, I think the competitive positioning in the market is neutral to positive, which is also going to be a tailwind as the market flips in terms of the uncertainty. As for free cash flow, whether it's linear or not, you're going to see significant leverage next year from this year's full year result. And we're going to get to 20% or better in 2024, which is only 14 months away. And so, we can control a lot of that.

And we've taken up expectations this year despite massive headwinds in terms of top line. And if you think about three years ago being negative 25% free cash flow margin and we flipped that 3,500 basis points in less than 36 months. And so, rest assured, we will be hitting 20% or better free cash flow when the calendar flips to 2024.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thank you.

Operator: Your next question comes from Pat Walravens from JMP Securities. Please go ahead.

Patrick Walravens
Analyst, JMP Securities LLC

Q

Oh, great. Thank you. And congratulations, you guys, on the way you're managing this business. Hey, Bill, can we talk a little bit about the convert? So, it comes due at the end of 2026. It's $1.5 billion, conversion price is $1.79. Are you just going to generate enough cash to close the gap? Would you refinance it? How do you think about it?

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

A

Well, I think we have a number of opportunities, Pat, in terms of where we see ourselves being out there. What we've talked about is $1 billion by 2024. We certainly look to continue that trend from there at that 30% type of growth rate and a continued improvement in overall margin, which – the mantra for us is free cash flow improvement. Yancey is challenging us to 20% plus as we move forward. That's not a number we're putting out officially anywhere, because we have work to do there.

But when you look out two to three years from here on our trajectory and relative to the financial model, we think we're going to be eminently refinanceable. If not, also paying down portions of that convert or potentially looking at repurchasing portions of those notes over time as things become more clear from a macro perspective. So, when we got here, we were faced with limited capital availability. We managed to increase bank loans fortuitously.

We were able to manage our way through that and then reduce that debt. We've used the public markets for both equity and debt. So, we think we'll have a lot of levers relative to our business two to three years from now. And if you look at the majority of these converts, most of them are basically addressed 18 months to 24 months before maturity. So, we'll keep looking at our options, but we feel very comfortable that we'll have a number of them over the next several years.

Patrick Walravens
Analyst, JMP Securities LLC

Q

That's great. Thank you. And then, Yancey, can I ask you? It seems like in software where a lot of the acquisitions fell apart during the pandemic was just – turns out you can't really retain talent over Zoom, what are you doing to make sure that you keep the Cloudways team?

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

A

Well, frankly, our employee attrition has come down since the pandemic. So, we've leaned into remote in terms of engaging with our team. So, our employee attrition is actually lower. I'm pleased that in the first few months since

the announcement of Cloudways, their retention has been very strong. And we're highly engaged with them. They have critical roles in driving our business.

As I mentioned earlier, there's a lot of synergies here which gives – and from both sides. And so, there is a lot of collaboration, a lot of engagement. We have folks on the ground visiting with them. And so, this isn't a, we bought something, it's in the back corner acquisition; this is – we're focused on deeply integrating the two companies.

We also share a similar vision, if not an exact similar vision for the SMB opportunity. We share a vision for the heart of the value proposition around serving SMBs is simplicity. And so, like I said, we're very bullish and we're taking a very tight pulse to make sure we're doing a good job integrating, and taking feedback and adjusting where we need to. So obviously, we're buying an acquisition in this industry, as you suggest, is about the people, and we're prioritizing in accordance with that.

Patrick Walravens
Analyst, JMP Securities LLC

Q

Great. Thank you.

Operator: Your next question comes from James Fish from Piper Sandler. Please go ahead.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Hey, guys. Wanted to go back to actually Gabriela's question, more on the go-to-marketing side rather than the product. At what point does it actually start to make sense to bundle more of the compute and storage products together rather than try to sell them individually? And is it possible that you guys could give us an update on the NRR for just large – the greater than $50 a month cohort, I think it was 113% last quarter?

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

A

I'll address the first question and Bill can address the second one. I mentioned, one of the levers that we will pull going forward versus what we've done really in the first couple of years here, we're not done on pricing and packaging. And we're going to learn – and we are learning a ton about customer behavior and response to the pricing changes we made a few months ago. And we're going to take those learnings, plus other things that we're looking at. But the concept of packaging – and I think, all too often in the tech world, they think of product management as just technology products. Reality is, there's four Ps to that, and packaging is a critical aspect of that.

So, we see a lot of opportunity. And so, I want to make sure people don't look at the actions we took earlier this year as a one-off. There is more opportunity. And frankly, our customers would prefer, I think, for us to simplify the options for them and offer them packages versus having them to take a la carte. And that sort of speaks to this bifurcation as customers grow, as they're running businesses, an aspect of simplicity will be pricing and packaging. And so, we see opportunity. So, more on that to come. But the premise of your question is, absolutely, we see opportunity there.

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

A

And on the NDR greater than $50, we've seen a nice pop back up, as we expected we would as a result of the pricing improvements, and we're continuing to see that group hold in there. It's interesting to us that as you move

up the spectrum to higher dollar value customers, we are seeing better NDRs, we're seeing faster growth rate. And this speaks to, we believe, the opportunity for the bigger customers who present a foundational opportunity for us to accelerate growth from here once we get a little bit of benefit on the tailwinds – or the headwinds rather.

But it also speaks to the stickiness of the product. We're being used for a lot of these businesses to drive the foundations of their businesses and what they do, regardless of whether they're SaaS providers or digital agencies or mom-and-pop retail shops. So, we're encouraged by what we're seeing there in terms of them holding up. And part of our go-to-market initiatives are all around driving the NDR, that group even higher. Yancey mentioned earlier that when we see our teams interacting with our customers, we're looking at ARPUs that are multiples of where we are today.

They're accelerating the growth of those cohorts. So, we think that's the opportunity to be interacting more with these customers. And again, not to beat the same drum, but Cloudways in how they interact with their customers, provides a lot of learning for us. So, a lot of opportunity for us across the board. Self-serve has been tremendous for us. But when you get over $500 million, you got to start looking at other ways to drive revenue growth if you want [indiscernible] (01:00:02) handle on it, and that's what we're doing.

James E. Fish
Analyst, Piper Sandler & Co.

Q

Thanks, guys.

Operator: And our last question for today comes from the line of Wamsi Mohan from Bank of America. Please go ahead.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. Sorry, I was jumping between calls, so I apologize if you already answered those. But can you talk about what you saw in terms of linearity of demand in the quarter and any difference that you can maybe highlight across the various cohorts of spending? And perhaps, touch on how that trajectory might have changed or not in October versus the prior few months. And I have a follow-up.

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

A

Obviously, we did have – prices went up in July 1. And so, what I would say is we saw some noise in July and August tied to that. September started to normalize, as did October. So, we feel pretty good about the trajectory we have coming into Q4.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay. Thanks for that. And just to clarify, I'm not sure if you quantified. What is the impact of Cloudways in your at least 30% guide in fiscal 2023? And Bill if you could just maybe also address what is the impact from energy costs on your gross margin that you anticipate looking into 2023? Thank you so much.

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

A

So, the second one, Wamsi, stay tuned, we'll come back quantifying that. We do have a range. We have factored that in, which is how we're driving our assumptions around 65% growth in terms of where we're going. We think that that's something that we're going to have to manage through. A lot of people are going to be impacted by that. But we think that's going to be something that we can manage and is a part of our overall efficiencies. The first part of your question was...

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

A

Cloudways next year...

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

A

Oh, Cloudways next year. So, this year, we've talked to around $15 million to $16 million of contribution for Cloudways. Cloudways CAGR, over the past few years, has been in the 40% to 50% range, been growing very, very quickly. Obviously, it's off a smaller base. But again, the management team there, our dialogues with them, they understand their end markets very, very well. They understand the verticals that they're selling into them. They understand how they're managing – their offering delivers against the requirements for those verticals.

So, we hope with those learnings, they can help accelerate our growth as well. But they have been growing very, very nicely over the past few years. They certainly are feeling a bit of the headwinds that everyone is feeling, but they're continuing to power through those. And as we get into next year, we'll be really talking about all of this in a consolidated way. But we're very, very optimistic and bullish about what they can bring to not only rapidly increasing their base, but helping us monetize our 600,000 customers even more.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: This is all the time that we have for today. I will turn the call back over to the presenters for closing remarks.

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

Just want to thank everybody for joining us today. We're grateful for your support, especially in these tough times. Our goal is to be as transparent and communicative with you as we can. We look forward to speaking with you in the coming days, the weeks, the months and, of course, the years ahead.

Have a great evening.

Operator: This concludes today's conference call. You may now disconnect.