Cloudflare, Inc. (NET)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

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<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>31 - 15</td>
<td>Higher Risk</td>
<td></td>
<td></td>
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<tr>
<td>Market Cap (mil):</td>
<td>9,273</td>
<td>Price Target ($) :</td>
<td></td>
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<tr>
<td>Shares Out (mil):</td>
<td>330.1</td>
<td>L-Term Rev. Gr Rate Est:</td>
<td>Q1</td>
<td>(0.19)A</td>
<td>(0.04)A</td>
<td>(0.02)E</td>
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<tr>
<td>Float (mil):</td>
<td>41.9</td>
<td>L-Term EPS Gr Rate Est:</td>
<td>Q2</td>
<td>(0.22)A</td>
<td>(0.06)E</td>
<td>(0.05)E</td>
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<tr>
<td>Avg. Daily Vol (mil):</td>
<td>4.03</td>
<td>Debt/Cap:</td>
<td>Q3</td>
<td>(0.16)A</td>
<td>(0.05)E</td>
<td>(0.04)E</td>
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<tr>
<td>Dividend ($) :</td>
<td>0.00</td>
<td>ROE:</td>
<td>Q4</td>
<td>(0.06)A</td>
<td>(0.04)E</td>
<td>(0.02)E</td>
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<tr>
<td>Yield (%):</td>
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<td>Total</td>
<td>FY P/E</td>
<td>NM</td>
<td>NM</td>
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<tr>
<th>Headquartered</th>
<th>IPO/Founded</th>
<th>Dec</th>
<th>2019A</th>
<th>2020E</th>
<th>2021E</th>
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<td>San Francisco, CA</td>
<td>2019/2009</td>
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<tr>
<td>Management</td>
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<tr>
<td>Matthew Prince</td>
<td>CEO/Chairman of the Board</td>
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<tr>
<td>Michelle Zatlyn</td>
<td>COO/Director</td>
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<td></td>
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<tr>
<td>Thomas Seifert</td>
<td>CFO</td>
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Company Description

Cloudflare has its headquarters in San Francisco, CA, and was founded in 2009 by Matthew Prince, Michelle Zatlyn, and Lee Holloway; the company widely launched the Cloudflare system in September 2010. The company defines its broader mission as, “To build a better internet.” Cloudflare addresses a variety of use cases with the help of its global network; the company’s network spans ~200 cities and operates within 100 milliseconds of 94% of the world’s internet-connected population. Cloudflare has built up a large base of users as a result of the free plan it offers, which includes features like its CDN and DDoS protection.

In terms of specific products, Cloudflare addresses a variety of use cases across security, performance, and reliability. Security products offered include a web access firewall, DDoS protection, infrastructure protection through its Magic Transit product, and a zero-trust product, Access, among others. In terms of performance, Cloudflare offers a content delivery network as well as other products including intelligent routing and image optimization. Reliability products include load balancing and DNS. The company’s platform, which includes products like Cloudflare Workers, helps developers build serverless applications. Finally, the company offers two consumer products, 1.1.1.1 and Warp.

Competition

Given that Cloudflare seeks to disrupt a variety of markets, from traditional firewalls to CDNs, the company does face robust competition. However, Cloudflare, as a whole, has been growing significantly faster than many of these competitors. Though it is difficult to assess exactly which markets Cloudflare is taking share in given that the company does not break out revenue to specific products, we believe it is likely Cloudflare is taking modest share from CDN competitors like Limelight and Akamai, among others including Verizon. Cloudflare total growth has also outpaced growth of other CDN upstart Fastly, though it again is difficult to determine what portion of the company’s growth is coming directly from its CDN and other performance products. It is also important to note that Cloudflare seeks to compete in a different segment of the market than companies like Akamai and Fastly, and we believe its CDN product is picking up share at the SMB end of the market.

In security, Cloudflare seeks to compete against a wide variety of legacy players, especially firewall companies like Cisco, Fortinet, Check Point, and Palo Alto Networks. These companies have managed to innovate to varying degrees; for example, Palo Alto has made a fairly aggressive push toward cloud and continues to show strong growth and Fortinet has made investments in technologies like SD-WAN. Check Point is one vendor which has not innovated as much in recent years and has shown much slower growth as a result of this lack of substantial change. We believe Cloudflare does have interesting security offerings that may ultimately disrupt the marketplace, though we see the majority of enterprises as likely to employ a hybrid infrastructure, not one completely delivered from the cloud. Cloudflare does also have to compete with other cloud-centric disruptors like Zscaler in security.

Ultimately, though Cloudflare faces strong competition in the markets it serves, we see potential for the company to take share against legacy competitors given its cloud-centric product offerings. We believe Cloudflare has a solid advantage over legacy players who may eventually seek to make more of a pivot to cloud given that the company has already built up a network spanning the globe. We believe companies will continue to make a shift toward cloud and that Cloudflare is becoming increasingly well-equipped to benefit from this broader trend.

Investment Thesis

- **Grow enterprise customer base.** While Cloudflare has an overall base of over 82k paying customers as of 4Q19, the company counted only 550 large customers (greater than $100k in annualized billings) in that same quarter. The company has made

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significant investment in growing its S&M headcount in recent periods. We see potential for Cloudflare to continue to grow its large customer base, penetrating further into the enterprise with its increasingly broad suite of products. Additionally, we see upsell opportunity from within Cloudflare’s existing customer base.

- **Continue to develop new products.** Cloudflare has broadened its product portfolio to expand far beyond a CDN in recent years, and we believe there is continued potential for the company to build out new products going forward. We believe the company can leverage its broad network to continue to develop products that meet a variety of customer needs, and the company has continued to invest in its R&D capabilities. While both Cloudflare Access and Cloudflare Workers are relatively new products, early commentary around them has been positive, which we believe points to the company’s ability to create compelling products.

- **Potential to take share from legacy vendors.** In security, we see Cloudflare seeking to compete more directly with a variety of vendors, including the major firewall providers, and other cloud-centric disruptors, like Zscaler. While we believe companies are likely to employ a hybrid infrastructure, we do see a continued shift to the cloud in security and believe Cloudflare is positioning itself to take advantage of this trend. We also believe Cloudflare is positioning itself for further growth and share gains from its performance and reliability portfolio of products.

- **Valuation.** Our $30 price target represents a 2021E EV/Sales of 18.4x, versus peers trading at a median of ~17x. We believe Cloudflare is in the early stages of capturing what we see as a large market opportunity and that its multiple can expand with continued enterprise growth.

**Risks & Caveats**

- **Failure to gain adoption of new products.** We see significant opportunity for growth from some of Cloudflare’s newer offerings. However, if these offerings fail to gain market adoption, Cloudflare growth may slow and overall results may suffer. We see Cloudflare having to work to educate potential customers on the use cases and capabilities for some of these emerging products, especially as the company expands into additional markets.

- **Strong competition in markets.** We believe Cloudflare faces significant competition in the vast majority of the markets it seeks to address, whether in networking or in security. These competitors are oftentimes significantly larger than Cloudflare, which may present the company with additional challenges as it seeks to expand its install base. Again, we see education of these customers as being key to Cloudflare’s strategy, which may prove challenging.

- **Business/reputational risk surrounding clientele.** Cloudflare has historically allowed customers from all over the world to use its products without screening its clientele. This philosophy has led to controversy in the past, including in notable incidents involving the website 8chan, after it was connected to multiple shootings, and The Daily Stormer, which helped provoke violence in Charlottesville, VA. Cloudflare did later cut ties with both of these companies. Ultimately, Cloudflare faces potential business and/or reputational risk if the company continues to be connected with violent or otherwise unsavory groups.

- **Deterioration of strategic partnerships with JD/Baidu.** Cloudflare’s partnerships with JD and Baidu allows the company access to those companies’ networks in China. Given current geopolitical tensions, the continuation of this agreement may be somewhat out of Cloudflare’s control. Cloudflare results could suffer if these agreements terminated for any reason given some customers likely want/require access to this specific market.
Appendix - Important Disclosures and Analyst Certification

Approved on 27 May 2020 07:45EDT/ Published on 27 May 2020 07:50EDT.

3 Robert W. Baird & Co. Incorporated and/or its affiliates have received investment banking compensation from Cloudflare, Inc. in the past 12 months.

1 Robert W. Baird & Co. Incorporated makes a market in the securities of NET.

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