



DigitalOcean

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C O R P O R A T E P A R T I C I P A N T S

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C O N F E R E N C E C A L L P A R T I C I P A N T S

Mark Murphy, *JPMorgan*

DJ Hynes, *Canaccord*

Michael Turits, *KeyBanc*

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Raimo Lenschow, *Barclays*

P R E S E N T A T I O N

Operator

Welcome to the DigitalOcean Q3 '21 Earnings Conference Call.

At this time, speakers are in a listen-only mode.

I would now like to hand the conference over to your first speaker today, Rob Bradley, Vice President of Investor Relations. Thank you. Please go ahead.

Robert Bradley

Thank you and welcome, everybody, to DigitalOcean's Third Quarter 2021 Earnings Call. With me on the call today is Yancey Spruill, our CEO, and Bill Sorenson, our CFO.

Today we will start the commentary from Yancey and Bill, and then we will answer questions we've received from our analysts. Our goal as always is to help investors understand our business model and outlook in the most efficient way possible. After we address those questions, we'll turn the call over to the Operator to manage an open Q&A period.

Turning to our Safe Harbor statement, I would like to remind everyone that 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 and industry trends, market opportunities and expectations for future financial performance and similar items, all of which are subject to risks, uncertainties and assumptions. You can find more information about these risks and uncertainties 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 will be discussing non-GAAP financial measures today. Reconciliations between our GAAP and our non-GAAP financial results can be found in our earnings press release, which was issued earlier this morning.

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

Yancey Spruill

Thanks, Rob. Good morning and thank you for joining us today

We are pleased to share our very strong third quarter results with you where we again delivered acceleration in revenue growth, Adjusted EBITDA, and growing cash flow. As a result, we are increasing our outlook for the balance of 2021 and reiterate our confidence in sustaining 30% or better growth in 2022.

The transformation of DigitalOcean is well underway, and we remain laser focused on achieving our first billion dollars of revenue in 2024. For the second consecutive quarter, we saw significant improvement in revenue growth versus the year-ago period, and an acceleration from Q2. Relative to Q3 of 2020, top line growth improved nearly 1,300 basis points and accelerated more than 200 basis points from the prior quarter. This continued growth acceleration results from strength across our key growth drivers: number of customers, net dollar retention and revenue per customer or ARPU. I will dive into each a bit more in a moment.

ARR increased 36% year-over-year to \$455 million. This represents a 1,200 basis point uptick relative to Q3 last year. ARR was flat on a sequential basis to Q2, largely due to lapping the step up in September 2020 revenue from new products. We are off to a strong start in Q4, and we are confident in our outlook for the rest of the quarter and feel great about our momentum heading into 2022.

Our profitability is an attractive differentiator for a company whose growth rate continues to accelerate. In Q3, we generated \$36 million of Adjusted EBITDA, which represents a margin of 33%, underscoring the efficiency of DigitalOcean's business model. Investors often ask whether we would be willing to invest even more into the business to grow even faster, the answer is we are doing so today. In fact, our margins could have been higher in Q3, but we see opportunities to invest that will enhance our growth in 2022 and are more than happy to hold back on current Adjusted EBITDA margins in order to give us a head start on product innovation and go-to market initiatives, driving growth acceleration into 2022.

Now that I've shared the headline results for Q3, I'd like to take this opportunity to provide more granular insight into our customer base. We have a large customer base with a very long tail dynamic, where a large percentage of our customers are testing ideas, learning how to code, and are in an idea formation stage of launching a business. A small percentage of our customers emerge to launch and build rapidly growing small and medium sized businesses.

One of the key drivers of our faster revenue growth is that we are nurturing and attracting increasingly larger and more rapidly growing businesses to our platform, what we would consider the typical SMB. These larger customers represent roughly 15% of our total customer base, yet generate roughly 85% of our total revenue. They grow substantially faster than our reported top line growth with ARPU growth of

over 50%, NDR of 118% in Q3, also better than our Company average and up meaningfully from 104% in Q3 of 2020.

These customers have a higher net expansion rate, as many of them buy multiple products, and churn at a much lower rate, in the mid-single digits versus low double digits for the entire Company. Importantly, the number of larger customers are growing several times faster than our overall customer growth rate. We expect these trends to continue where these larger customers grow faster, have a higher NDR, and therefore will represent a larger share of our total revenue mix over time. Our continued investment in product, direct sales and focus on customer support is paying off as the size of our customer base gets bigger, and we attract more of the SMB market.

Many of these fast-growing customers have incubated on our platform for a period of time before their businesses launch and they ramp. We have an incredible customer ecosystem where we nurture early-stage developers and entrepreneurs until they get liftoff of their ideas and support the growth of rapidly growing startups and SMBs as they get traction. To boot, we do this at a very low customer acquisition cost and at increasingly compelling unit economics as expressed by our NDR results.

With that context on the nature of our customer mix, let's discuss our Q3 performance levers to drive sustained revenue growth; that is customer growth, net dollar retention, and average revenue per customer.

Beginning with customer growth, we ended Q3 with 598,000 customers, an increase of 7% year-over-year. The slight sequential decline from Q2 was the result of our implementing enhanced security protocols to remove certain low value customers from our platform. Importantly, although these actions reduced reported customer count by roughly 150 basis points, they had no material impact on our reported revenue.

On the contrary, revenue growth, ARPU and NDR all accelerated and improved sequentially from Q2. I'm very proud of our team for leading in the era of trust and security. It's vitally important to our customers as they look to us to be the platform to build their relationship and business with their customers. We are making DO a more robust and secure platform for all of our customers to have confidence on which to build their businesses, while not impacting our ability to accelerate revenue growth.

Next, let's focus on the strong improvement we saw on net dollar retention in Q3. We believe that NDR is one of the most important gauges of the health of our business and a critical driver of near term and enduring growth potential. Our 12-month and older cohort of customers in the NDR calculation have historically represented over 80% of reported revenue. We are very focused on sustaining this improved NDR as it is a key pillar to our overall growth acceleration.

In Q3, NDR was 116%, as we continue to see customers stay on the platform, consume more product and churn less. The expansion of existing customer spend and reduced churn combined to drive the improvement in NDR in the third quarter. We have dramatically reduced churn and by keeping more customers on the platform, we are now set up for net expansion to continue to drive NDR acceleration.

Finally, a key contributor to our strong results in Q3 was 28% year-over-year improvement in ARPU. As I mentioned earlier, our larger customers are doing well and experiencing their own robust organic growth. This success not only leads them to consume more deal infrastructure, but also drives them to purchase additional products from us, particularly our platform as a service offerings that are well suited for these growing SMBs. This dynamic will continue as we broaden our product offering for SMBs, creating a stickier customer experience and giving us confidence we can sustain these current levels of growth.

To illustrate, just a little over two years ago, we had roughly zero revenue for products outside of our infrastructure as a service. Yet today, we're at roughly 10% of total revenue and solidly on track to achieve our target of 20% of total revenue when we generate our first billion dollars of revenue in a few years. This is not coming at the expense of growth in our infrastructure revenue. Rather, our customers inherent organic growth helps increase their infrastructure spend, while they also spend more on our relevant platform services.

Turning to our product strategy, there were two developments since our last earnings call that we are very excited to highlight today. First, we hired a new chief product officer who started a few weeks ago. Gabe Monroy joined us from Azure and will lead our product development strategy. Given his expertise in the infrastructure and platform as a service markets and experience helping significantly scale revenue on those platforms, we are confident that product innovation will be a much more prominent lever as a component of our growth strategy in the years ahead. We are excited to have Gabe aboard and look forward to sharing more of our plans for product innovation as we move into 2022.

The second piece of exciting news on the product front occurred with our acquisition of Nimbella. This expands our Functions as a Service or FaaS offerings. FaaS is a rapidly growing adjacent market opportunity that complements our IaaS and PaaS offerings. Nimbella is a cloud native offering that allows developers to build and run applications without having to manage servers, delegating that to DigitalOcean in the background, so they can focus even more on their customers in application development. Serverless has been a top five customer request and closely aligns with our mission to simplify cloud computing and will attract customers focused on increasing their agility and productivity.

Additionally, Serverless will be a driver of both NDR and ARPU growth as it will create a net new revenue stream as well as increased usage of deals infrastructure services, given the complementary nature of Serverless with our other offerings. Our team is busy integrating Nimbella on our platform, and we're excited to get this product into our customers hands next year.

In sum, we were pleased with the strong momentum with all three of our growth drivers as well as progress on the product front, which we expect to increase as we get into 2022. These moves continue to give us confidence in our positive trajectory and in our ability to sustain top line growth greater than 30%, for the balance of 2021 and in 2022.

Next, I want to highlight one of our 600,000 customers that exemplifies all these growth drivers in action. That is an SMB customer who has scaled on our platform and is using a breadth of our offerings, and as a result, their increased spend is contributing to our accelerating ARPU and NDR. This customer offers advanced training for IT security professionals and hackers through gamified hands-on learning experiences, including hacking methodology, penetration testing, and vulnerability research. The training is self-driven and users advance by completing a series of challenges, where points in rankings are garnered by users ability in solving progressively complex scenarios.

Over the last four years, they have grown from three employees to more than 100, and their user base exceeds 750,000 platform members representing more than 800 organizations. Driven by the need for simplicity and performance, the customer engaged DigitalOcean. Their platform was running on a hyper scalar with virtual machines and a relational database. But their CTO was familiar with DigitalOcean and appreciated our focus on simplicity, community support, and our highly performant capability. They conducted benchmarking test, which confirmed our ability to manage their workloads, and migrated them over to DigitalOcean.

Today, the customer takes full advantage of our product portfolio and runs approximately 95% of their infrastructure on DigitalOcean. As they continue to grow, they are leveraging our Managed Kubernetes, our database as a service, and App Platform in their architecture as well; 10% of their overall spend is

coming from our platform services, and 90% from our infrastructure, similar to our overall Company product mix. They spend over \$220,000 in annual run rate today, and that's up from zero since launching on our platform just three years ago. A powerful demonstration of how we help developers and early stage businesses get lift off, and then ramp up their businesses with our set of relevant products that support their rapid growth.

This is just one example of a customer leveraging DigitalOcean's platform and quickly scaling as they experience rapid growth. This is a perfect illustration of the customers driving our accelerating revenue and the supporting metrics. There are tens of thousands more just like this, and I look forward to sharing more about others in the quarters ahead.

In summary, the third quarter was strong across the board, as we are transforming DigitalOcean into a durable high growth and free cash flow generating business in a massive \$50 billion market growing to over \$100 billion in the next few years. We are confident in our trajectory, and we expect a strong finish to this year that will take us into 2022 with a great deal of momentum. I wish to express my thanks and gratitude for the hard work of each member of our DO team who is driving this success.

I'd now like to turn the call over to Bill Sorenson, our Chief Financial Officer, who will provide details on our Q3 financial results, and our updated outlook for the balance of this year.

Bill Sorenson

Thanks, Yancey. Good morning, everyone, and thanks for joining us today to discuss yet another quarter of strong revenue growth and continued acceleration in our key operating metrics.

The initiatives that our Management team undertook for this fiscal year are clearly paying off and showing continued traction. This provides a great foundation for next year as we look to continue to deliver our sustainable and durable 30% plus revenue growth. Yancey covered many of the key points in his remarks, but I'd like to provide some additional detail on the results and the key drivers to our growth. Following that, I will provide our financial outlook before taking your questions.

Management is keenly focused on the three levers of growth that Yancey highlighted, which really are the most critical metrics in our monthly dashboard. Revenue growth, ARPU, and NDR: each of these metrics clearly demonstrate the progress that we have and continue to make. In the last four quarters, all indicators have shown consistent and meaningful improvement.

For the third quarter revenue grew by more than 37%, up from 35% growth in Q2, and up over 1,000 basis points from last year when we grew 24%. ARPU was \$61.97, up 28% year-over-year, and up from \$58.07 just last quarter. NDR continues to grow, we averaged 116% in Q3, up from 113% just last quarter. These results clearly reflect the strength of our offering in both infrastructure and managed services, giving our customers easy access to the tools and technology that they need to grow their business.

What is particularly exciting for us is the growth we see in our larger customers, those who spend multiples of our average ARPU, and many of whom consumed several of our products. Investors have heard us discuss this trend before. But as these consumers consume more of our managed service products in database and Kubernetes, they in turn consume more of our core infrastructure product as well. These customers are spending more, expanding at a faster rate, and are churning substantially less than our average customers.

With the development of additional offerings such as App Platform, MongoDB, and the future launch of our recently acquired serverless offering Nimbella, we see the opportunity for further growth. This trend is

driving healthy growth in ARPU, and as importantly, NDR, because if these customers grow and expand with us, they stay with us, driving the expansion side of the NDR equation and reducing the churn side, and that was clearly evident in the third quarter as NDR accelerated further to 116%. This was a 300 basis point improvement from Q2, and is a critical component for durable 30% plus revenue growth.

We're seeing this uplift in NDR coming from a combination of net dollar expansion and a reduction of overall churn, particularly in the larger customers I just mentioned.

While we remain focused on the customer and their experience, we've also continued to focus on further improvements in terms of profitability and capital efficiency, while at the same time investing for the future to capitalize on the large growth opportunity in front of us. Cost control, along with a focus on return on investment, has allowed us to maintain Adjusted EBITDA margins above 30%. In Q3, Adjusted EBITDA reached 33% due to our revenue and gross margin over performance, but we expect that will moderate in Q4.

We will continue to invest across our business, focusing on new customer acquisition, both from self-serve and increasingly through direct sales, in onboarding and customer support, and finally, in new product development.

One item to note is that during the quarter, we were able to release a VAT liability of \$3.2 million. The elimination of this reserve increased operating income in the quarter but is excluded from the Adjusted EBITDA calculation. This reserve was established over three years ago, and after discussions with European tax authorities, it was determined that no additional liability was outstanding.

Also, during the quarter, as part of our ongoing security best practices, we removed a number of low value customers from the platform, which slightly reduced total billable customers. Our security measures have allowed DigitalOcean to achieve a meaningful reduction in bad debt, while improving the value and quality of our customers overall, as reflected in our continued growth in ARPU and NDR.

Customer growth is continuing in Q4 with early indications that recent investments in paid advertising or our fresh brand campaign, and the introduction of additional payment options are accelerating customer acquisitions.

Given our improved operating performance, we've been accelerating investments this year in order to get ahead of '22. By investing in people, as well as the systems needed to support our growth, we want to hit the ground running for Fiscal 2022. As noted, Adjusted EBITDA Q3 came in slightly above plan at 33%. For Q4, we anticipate that increased hiring will result in an EBITDA of approximately 31%, in line with our initial guidance.

Finally, we continue to invest in Capex to support our growth, and as importantly, to upgrade our existing fleet. For 2021, we're planning for Capex to be between 25% and 26% of revenue, consistent with the guidance we provided the beginning of the year. In Q3, Capex represented 24% of revenue, or \$26.3 million. This was a significant improvement from Q3 of 2020 where Capex was 32% of revenue. This number is slightly lower than our guidance for the full year as a result of some shipment delays which have since been rectified.

It's important to note that, in 2021, we will have invested \$100 million in our global infrastructure footprint. We've made material investments to support our rapid growth, while also modernizing our existing fleet. Fleet modernization, combined with the optimization of our infrastructure architecture, is increasing our return on investment as these efforts increase the revenue generating capability per server.

Our disciplined and ongoing investment in infrastructure, however, has not reduced our commitment to generating cash flow. In the quarter, DigitalOcean generated just over \$40 million in cash flow from operations, 36% of revenues, which is up more than 70% year-over-year.

Now I'd like to provide our Q4 and full year outlook. For the fourth quarter, we expect revenue to be in the range of \$117 million to \$119 million. We expect Adjusted EBITDA margin to be in the range of 30% to 31%. For the full year, we expect revenue to be in the range of \$426 million to \$428 million. We expect Adjusted EBITDA margin to be in the range of 30% to 31%, and we expect Capex as a percentage of revenue to be between 25% and 26%. Our forecasted results for 2021 provides a great foundation for '22. At this time, we're targeting approximately 31% growth for Fiscal 2022.

In closing, I want to remind investors that DigitalOcean is well positioned to take advantage of the exciting and large opportunity we have ahead of us. We have a product offering that is delighting SMB customers in virtually every country in the world. We have a brand name that is recognized and respected, and we're a major player in the fast-growing global developer community. That, along with improving profitability, increasing cash flow combined with no debt; with all of this, we intend to further expand our product set and pursue aggressive growth.

That concludes my remarks, and now let's turn it over to Q&A.

Robert Bradley

Thanks, Bill, and thank you for joining us today as we go over these strong Q3 results where we saw acceleration across the board. As is our process, we've asked for some questions ahead of time, which will address some schematic issues, and then we'll open up Q&A with the Operator.

The first question today came from Tim Horan at Oppenheimer, and he asked, "Is there some color you can provide on the small competitor landscape? How many companies have a focus on your niche? And are they catching up with you or falling behind?"

Yancey Spruill

Good morning. Thanks, Tim, for the question. I'd say there's a small handful of infrastructure as a service providers who compete on the small and in the developer and the SMB space. What I would say is we're playing in a \$50 billion market targeting SMBs and developers. That market is growing 27%. We are now growing substantially faster than our market for cloud, SMB and developer cloud. We're pulling away from the competitive set as we see it. That's happening from a combination of our go-to-market initiatives to drive more customer conversion, expansion and retention, and then our product strategy to give customers who are scaling on a platform more options to do more with us.

We're excited about where we are. We feel like we are well positioned and accelerating into 2022, and are really well positioned vis-a-vis the competitive landscape and feel like we're pulling away at this point in time.

Robert Bradley

Great. Thank you. The next question came from Brad Reback at Stifel, and he asked, "Are there any supply chain constraints to purchasing new Capex?"

Bill Sorenson

This is Bill Sorenson. Good morning, everyone. As we've talked about repeatedly, we take a view for the next six to eight quarters in terms of our requirements for both investing in growth as well as upgrading our overall fleet. We did reference that we had a slight delay in one of the projects we had scheduled for this year, which meant that our Capex in Q3 was a little bit lower. But across the board, we have not experienced any material delays. Again, because we plan so far in advance, we feel that we're in a very good position relative to what our needs are.

We are mindful of constraints that are being suffered by a number of industries. We're in pretty regular conversation with our major suppliers. We give them visibility into what our ongoing requirements are going to be, again, with that six to eight quarter-type horizon. Given that visibility that they have with us, we think it puts us in a pretty good position that if they do indeed experience any potential delays, we're well ahead of that and we can adjust accordingly.

I feel like we're in a very good position. We never want to be in a spot and we'll not be in a spot where we are caught out relative to meeting the accelerating growth that we're experiencing. We'll continue to invest there as we move forward.

Robert Bradley

Thank you. The next question comes from Pat Walravens at JMP Securities, and he asked, "Can you talk about the hiring of your new Chief Product Officer, Gabe Monroy. What about his background stood out most? And what did he bring to the table? How might this change the product strategy, if at all?"

Yancey Spruill

Thanks, Pat. Well, we're excited to have Gabe aboard. He's a builder, an entrepreneur, started a company, was able to sell it to Azure, and then stayed at Azure and has had significant success in leading teams there, leading product and building a really large business on the same trajectory that we're on. Understands developer and that migration, that journey that developers take to start a business and scale.

We're excited about the relevant experience and the scale, and we just can't be more delighted to have him come in here with a very strong point of view already on our marketplace, our customer base, our market opportunities. He'll be responsible for helping us lay out the product road map ahead, the priorities, and we look forward to sharing that with you all as we get into next year.

We ran a search. We had an incredible amount of people interested in the role, which is particularly exciting as a validation of where we're taking our business. I think Gabe is going to be an incredible driver of value for our customers and our investors over the next several years.

Robert Bradley

Thank you. The next question came from Michael Turits at KeyBanc, and he asked, "Investors are still trying to understand how customers evolve and grow with DigitalOcean. Could you help us understand how, as they grow, mature and have more requirements, how does DO support those customers? Do you ever see customers as they become larger, either move existing workloads or add net new workloads to one of the major public cloud vendors?"

Yancey Spruill

Thanks, Michael. We have this unique ecosystem where we attract tens of thousands of customers every month who are just here to test ideas, test code, learn how to code, learn and grow as developers and

entrepreneurs. We have a very low acquisition cost, very low friction to get those customers here. We generate nearly 5 million visitors to our website who are seeking to read our tutorials and other documentation. They come here; they test, they learn, they could be here for a month, two months, eight months.

In the last earnings call, we gave an example of a customer who was doing that for five years before they launched their business. Then we have that unique ability to support their scale as they go from zero customers to ten customers to thousands of customers, etc. If the infrastructure scales, we have a global network of infrastructure services that support their needs, and then increasingly with our managed databases, our Managed Kubernetes, our App Platform, soon to be our serverless, our marketplace; we have incremental applications that as their workflows evolve, their customers grow, their product sets grow, their geographies grow, their number of employees grow; we have incremental tools and services on the software platform side that enable us to grow with them.

The example of the customer we just cited is a powerful demonstration of how we can serve those customers on their journey. We're really excited about the opportunity to do that, and that's driving ARPU, that's driving our net dollar retention, and those customers are driving our revenue growth. At the front end, we have this engine that's fueling long-term revenue growth by having customers come here in a very low-friction, low-cost way, and then we can nurture those customers over time.

Robert Bradley

Thank you. The next question comes from Wamsi Mohan at Bank of America, and he asked, "Your growth has been accelerating well beyond 25% over the last few years, now over 10 points better than that; can you talk about the drivers of growth as a function of, one, how penetrated you are in the target customer base, and two, opportunity to drive blended ASPs double digits?"

Yancey Spruill

Thanks, Wamsi. Well, first and foremost, we're playing in a massive market. There are 30 million software developers, going to 50 million by the end of this decade. There's 100 million small- and medium-sized businesses in the world today, 14 million new added each year. Collectively, those groups spend about \$50 billion in the cloud today, and that is heading to \$120 billion by 2024, so massive market opportunities.

Given our penetration, 600,000 customers, roughly \$450 million of run rate, we're really early in the journey here and the opportunity in terms of penetration. Our go-to-market strategies and our product strategies are designed to help us attach at really high growth rates, at great unit economics, and to sustain better than double-digit revenue growth per customer at really strong expansion, net of churn rates expressed in NDR, and a robust customer growth rate over time.

We're early, and we've made a lot of progress in improving the core metrics and the attractiveness of our business in terms of growth rates, in terms of unit economics on ARPU and NDR, and operating margin free cash flow. We just have an incredible sea of opportunity ahead of us.

Early in the opportunity and excited and well positioned to go grab a big chunk of that. Again, we've said we're on track for that first billion of revenue by 2024 and see a sea of opportunity beyond that as well.

Robert Bradley

Excellent. The last question we have before we open up the line is from Raimo Lenschow at Barclays, he asked, "Your pricing has consistently been cheaper than Amazon Lightsail and Microsoft Azure. How can

you afford to keep prices lower given the scale advantages the hyperscale cloud providers offer? Is lower pricing the primary reason an SMB chooses DOCN over the hyperscale providers?"

Yancey Spruill

Thanks, Raimo. We have a really highly differentiated set of capabilities, but the primary reason customers come and stay with us is because of simplicity. Just in the time we've been on this earnings call, you could be up and running as a customer. It's easy, simple, intuitive. Even as we add more products and services, the nature of our offerings, simplicity is foundational, which for an early-stage small business is incredibly valuable. They don't have teams of people to get up and running with IT solutions, it needs to be easy.

Our community investment, we have tens of thousands of tutorials, digital pieces of documentation that drives millions of people to our website. We help people learn and grow, whether they're a big customer today or somebody just on their journey to launching a business. We help and enable our customers' success. I think that's foundational to the value proposition.

Third, we give support, human support to every customer regardless of size. That's highly differentiated from many of the other alternatives out there. We're all open source. We facilitate open source. We just concluded Hacktoberfest, the largest hackathon in the world, 150,000+ people in virtually every country in the world participate. We evangelize open-source software as a force multiplier for early-stage entrepreneurs to get code and launch businesses at a low cost, improve their velocity.

Our ecosystem helps fuel and enable entrepreneurs, so those differentiation, and then we offer a set of relevant services. We're not innovating for the broad breadth and complexity of enterprise, we are targeting simplicity, the basic tools and building blocks that our customers need. That enables us to do that at a compelling value. But it's simplicity and community, our support model, and the fact that we're able to—we evangelize open source. Those principles of differentiation are why people come, stay, and grow on DigitalOcean.

Robert Bradley

Great. Thank you very much. Paul, if you could open up the line for instructions in Q&A, we'd appreciate that.

Operator

Your first question is from the line of Mark Murphy with JPMorgan. Your line is open.

Mark Murphy

Thank you very much, and congrats on the (audio interference). I wanted to touch on the (audio interference).

Yancey Spruill

Mark, we cannot hear you.

Robert Bradley

Paul, it sounds like they have a problem, maybe with their connection. Why don't we go to the next question and then get back in the queue?

Operator

Definitely, sir. Our next question is from DJ Hynes with Canaccord. Your line is open.

DJ Hynes

Hey, good morning, guys. Thanks for taking the questions. Yancey, I want to put a finer point on the customer account dynamics. That's where I'm getting some questions this morning, so you mentioned 150 basis point headwind to customer count based on the enhanced security protocols you put in place. If my math is right, that's about 8,400 customers that were churned off the platform. Maybe just talk about what the issue was with those customers. Was this a one-time thing? Could we see more impact in Q4? Then I have a follow-up.

Yancey Spruill

The nature of why we did that, the internet is a place where people come to do good things and people come to do bad things, and we have to constantly monitor our platform for customer activity. We took the opportunity to increase some dials in Q3 that led to a number of customers, first month customers, basically no revenue impact, but a customer count issue. We don't change our dials every day, but we do periodically assess what's happening in the internet, in the world in general and on our platform, and we routinely will exit people.

I'd say we exit many customers a month normally. This was a little bit higher because we did change the protocols. We'll change some of the market locations we go to get people, Bill referenced some of that in his remarks. We expect to lap this relatively soon. We're off to a really good start in terms of growth. We've put some new initiatives in place to broaden the customer set.

This is part of what it takes to run a business that is running on the internet. We feel excited about the fact that we are taking a proactive stance, because trust is fundamentally what we sell. Whether people come here to just test an idea or to build a business, they have to trust that the platform is going to be secure, their IT reputations will be intact, and that requires us to manage the customer base of certain types of customers who come to the internet, come to DO to do things that we don't want them to be doing.

DJ Hynes

Yes. Yes. Okay. Makes sense. The follow-up would be, even if we normalize for that change, I get net new customer adds that are below the run rate we've seen over the last year or so, and again, I realize customer adds are not the relevant metric, it's ARR from these customers, but folks pay attention to this metric.

Maybe just talk a little bit about what you're seeing in terms of top of the funnel in conversion? Maybe you could bridge that to what your expectations are for Q4, I think there was a comment in there that mentioned some potential acceleration. Anything along those lines would be helpful.

Yancey Spruill

Yes. First, let me say, we've talked previously about a 10% annualized customer growth. We're holding to that target. Obviously, we've made some changes near term, but we think that as we get into next year, we should start to see acceleration of customer growth. Our top of funnel is healthy, and we're working a lot on driving conversion as we get through the funnel. We make all sorts of changes to the customer

experience, the customer journey, obviously adding products, adding payment options as we did this quarter helps to improve mid-funnel conversion, so no change in the thesis.

Again, we increased some of the dials that increased the number of people we removed from the platform. But every month, we will remove quite a few customers off the platform. They don't tend to impact revenue. It's a customer count issue. I'd focus you on ARPU and net dollar retention. Our retention and expansion metrics, in terms of where they are today versus where they were a quarter ago or certainly one year or two ago, have seen tremendous improvement, and that's through our nurturing the customer experience and their journey as they become a first day customer and over the life of the customer. That's what drives the economics in the near term, it's net dollar retention and ARPU.

What we've always said was that customer growth is a longer-term indicator of the health of the business. Because of the nature of us bringing so many customers in the self-serve, tens of thousands a month, many of them start small, and they're testing, they're learning, they're growing; we nurture them over time, and over time, one or more of those each day will launch a business that scales and then we support that scale.

It's a longer-term indicator. Longer term, we're confident we can get to and then sustain a 10% customer growth. In the near term, if you look to NDR and ARPU to support near-term revenue growth and revenue results.

DJ Hynes

Thanks for the color.

Bill Sorenson

If I could just add to that, DJ.

DJ Hynes

Yes.

Bill Sorenson

The one data point is it's early in the quarter, but our first month is really consistent with what we've been seeing historically over the last three to four quarters. Some of the things that Yancey mentioned, particularly around the payment methodologies that we're opening up for some of the developing economies, is certainly starting to help. We feel good about that.

DJ Hynes

Great. Thanks for all the color, guys.

Operator

Your next question is from the line of Michael Turits with KeyBanc. Your line is open.

Michael Turits

Hey, guys. A couple of things. First of all, maybe Bill or Yancey, can you be specific at all about what kind of net adds we should expect next quarter? Just to follow-up on the last one, are you done with this, let's call it, involuntary churn?

Yancey Spruill

Well, what I would say is the last couple of quarters, we've been about 8% to 9% customer growth annualized. This quarter, 7% net of 150 basis point impact, so in the near term, we're going to lap this and start to ramp as we get through this quarter and into next year. Again, we expect to get back to or get to and then sustain a 10% annualized year-over-year customer growth. You should see customers ramping this quarter off of the bounce off of last quarter, and we'll take that into next year. We feel very good about what we're doing, both top and bottom of funnel, what we're doing on direct sales, inside sales and outbound sales, what we're doing on the product side to attract customers, etc.

Again, 28% ARPU growth and net dollar retention of 116%, I'd remind you that was in the low hundreds just this time last year. We're nurturing customers, we're driving expansion, we're fulfilling a much higher level of customer support and success with them today that's driving the cohort. We still grew customers 7% year-over-year despite increasing the dials last quarter, and I feel confident we'll get back to 10% or get to 10% and then sustain it. You should start seeing us ramp up from Q3 back to where we were in recent quarters and then get above that hump at 10% and sustain it.

Michael Turits

Okay. Then my follow-up is about investment. You talked about investing for the opportunity, and referenced that back to people asking, could you be spending more? You're in the roughly 10% range of sales and marketing margin. The question is could it go higher? I think most recently, it sounded like it was pretty stable there, so what are your expectations over, let's say, as we get into next year for the sales and marketing margin?

Yancey Spruill

Yes. Well, at this growth rate, sales and marketing spend can grow 37% and still stay at 10% of revenue. We are investing heavily in sales and marketing, we'd love to invest ahead of revenue growth, meaning at a faster rate than revenue growth. We constantly talk about that as an executive team, where are the opportunities, and we evaluate them. We are biased towards growing faster. We don't think we're done at 37% growth. I think we can do better. We're investing to do so, both on the go-to-market sales and marketing side and the product side. We have a lot of room from 10% of revenue to go higher if you look at other players in our sector, and we look to do so.

We like the fact that we have strong EBITDA margins and we're generating free cash flow at this growth rate. We're going to always generate cash flow because that's our philosophy. But at the same time, we don't need to peg the needle on free cash flow and EBITDA today. We're looking to invest some of that when we can to drive an accelerating and sustain a higher growth rate. That's our bias, and that will continue to be our bias.

Michael Turits

Thanks, Yancey.

Operator

Your next question is from the line of Wamsi Mohan with Bank of America. Your line is open.

Wamsi Mohan

Yes. Thank you. Your ARPU growth was very strong in the quarter, and I think in your comments, you noted that the increase in ARPU, there was a significant contribution, obviously, from your larger customers. Any way to disaggregate how much of this ARPU growth came from the 15% of the customer base that's driving the 85% of revenue and how much is coming from the remaining? What are the underlying product consumption trends? Is it more usage or is it more increased usage of higher configurations? What is the underlying trend that you're seeing within those customers?

Yancey Spruill

Thanks, Wamsi. I think a couple of points. When you look at that 15% of our logo customers, that represent about 85% of our revenue growth, they're growing substantially faster than the Company total, the 37%. The customer growth is growing substantially higher than the 7%, several multiples higher than the 7% annualized run rate, so we're adding more of those customers there. Customers are moving through our ecosystem and scaling and launching businesses, and then they rapidly grow their revenue per customer. They have organic growth.

If you think about a business getting launched, it goes from \$100,000 to \$500,000 to \$1 million to \$2 million to \$3 million to \$5 million. Not big numbers in aggregate, but huge percentage growth. Well, that's an indicator that they're using more Infrastructure as a Service, just because they're adding customers, they're adding products, etc., around the world.

Then as they're adding employees and those customers, they need other services. They need more deployment tools, for example, as they add more people to write software, so they use an App Platform, they use a Kubernetes, soon they'll use our serverless capabilities. They need to manage the ecosystem of those customers, analytics targeting, etc., they need databases. We have other tools in our marketplace that they're able to leverage.

That PaaS and Software as a Service, that now represents 10%, allows customers as they ramp on our platform to have more things to do with DigitalOcean. Then they have a floor on that is just strong organic growth because they have organic growth, and that synergy between the Infrastructure as a Service and the Platform as a Service, it's not that we're growing Platform as a Service software services at the expense, IaaS is a flat grower that grows very robustly because of that organic growth.

That small cohort of customers that's growing, we're adding to those because every month, somebody graduates on our platform from a two-person developer team to launching a business and then they scale rapidly, and that's what's driving ARPU growth. There's a floor on ARPU just from the natural organic growth of our rapidly scaling SMBs, and then we're able to turbocharge that ARPU by giving them more products and services on the platform. That's why product strategy is so integral to sustaining these rapid rates of growth that we're now demonstrating.

Wamsi Mohan

Okay. Thanks, Yancey. Can you also talk about the Nimbella acquisition? You said serverless is a top 5 customer request. Conceptually, what percent of your user base is asking for this or likely to utilize this? What are some of the other top customer requests? Thank you.

Yancey Spruill

Yes. What I would say is Nimbella represents this generic theme around the simplifying software development and making it more application configurable. App Platform was a product that we launched

a year ago that fits in that category. We have a number of our customers who want this flexibility. They want the functions capability.

I'll give you another example. Mongo was another top request for our customers that we launched earlier this year, so you're seeing us be much more responsive to customer needs for scaling on our platform. We're two months into the Nimbella integration, it's going very well, we're really excited to have the team on board, and we're really excited to get this product into our customers' hands as we get into next year.

We think that serverless will be a core pillar of our Platform as a Service capabilities like Kubernetes and like our managed databases, and we have a lot of expectation that it's going to contribute meaningful growth as that product starts to get in the customer hands in the first half of next year.

Wamsi Mohan

Thank you so much.

Operator

Your last question is from the line of Raimo Lenschow with Barclays. Your line is open.

Raimo Lenschow

Hi. Thank you. One quick question and one more longer one. The quick one for Bill, if you look at the ARR growth, it was the same level as last quarter, and you mentioned some reason for that. Could you just go into a little bit more detail there?

Then for Yancey, if you think about the product expansions that you talked about. At the moment, you seem only at the very beginning of that journey with Mongo, serverless, etc. How do you think that this will play out over the next few years? Because if I look at the portfolio from like an AWS, Azure is by now more tens and hundreds of different versions, you don't want to go that far because you create too much complexity. But what you have at the moment seems like the very, very beginning of a journey to differentiate the product more. Thank you for that and congrats on the good numbers.

Bill Sorenson

Okay. Quick on the ARR. Remember, Raimo, this is a monthly number. It's taking a look at September. We had a very strong September last year, we had a number of improvements relative to the offerings to customers that basically improve our actual pricing per tier in a way, we eliminated some tiers, and effectively, what we saw was that customers were purchasing up, so that was very, very beneficial for us. We're lapping that. We would expect that number is going to be accelerating along with revenue as we move forward. But it is a monthly count, and so just to lap against a very good September a year ago.

Yancey Spruill

Yes. In terms of the longer-term issue around our product strategy, which I'm really excited to have Gabe here coming up to speed and looking at the landscape. What you said, Raimo, first off and foremost is so critical, at the forefront of our thinking is simplicity. We will add relevant features to existing capabilities, both on the infrastructure and our platform and software services and new capabilities to the platform. We'll do so in a way that makes them relevant and creates and ensures that simplicity is embedded across.

Because of our customers are early in their journey—these are customers, SMB is fewer than 500 employees. You're talking about businesses, tens of millions, maybe as much as \$100 million of revenue. They have a much narrower set, much more simplistic set of use cases, and the overlap of those use cases is high. Whereas in the enterprise, almost every new customer is a corner case and you're customizing and that's how the product set becomes so complex.

On the contrary with us, as customers go from \$1 million of revenue to \$2 million of revenue and they add more customers, they just need a database service, can't use an Excel spreadsheet to target their customers anymore. They all need a database. I think with that theme of, they're early in their journey, their level of complexity is nowhere near what an enterprise is; it makes our innovation strategy much easier because even when we add a database capability or serverless, it doesn't have to have the depth of complexity, because our customers are so early, and they crave simplicity. Simplicity will be weaved without.

Having said that, there's more innovation we can do, and we're very focused on that and look forward to talking more concretely about our plans as we get into next year.

We've demonstrated that adding relevant capabilities to the platform, we've gone from 0% to 10% of revenue, which is very rapid growth with databases, with Kubernetes, with App Platform, and our marketplace, just in the last two years. We're looking to replicate that over the next several years, and that will be an incredibly strong pillar to buttress growth rates that you're seeing now and sustaining those over time.

Raimo Lenschow

Yes. Thank you. Well done.

Operator

That concludes the question-and-answer session for the call. I will now hand the conference back to Yancey Spruill for closing remarks.

Yancey Spruill

I want to thank everybody for joining us today. As you can tell, we are incredibly excited about our results and about the opportunity in front of us. We look forward to continuing this conversation in the weeks, months, and years ahead. We're working incredibly hard to realize the limitless potential here at DigitalOcean, and it's a potential that's driven by enabling developers and entrepreneurs to test their ideas, build their businesses and realize their dreams. Have a great rest of the day.

Operator

This concludes today's conference call. Thank you for joining. You may now disconnect. Have a great day. Stay safe.