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DigitalOcean Holdings, Inc. (DOCN)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the DigitalOcean First Quarter 2023 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] And finally, I would like to advise all participants that this call is being recorded. Thank you.

I'd now like to welcome Rob Bradley, Vice President, Investor Relations, to begin the conference. Rob, over to you.

Rob Bradley

Vice President-Investor Relations, DigitalOcean Holdings, Inc.

Thanks, Polly, and thank you and welcome everybody to DigitalOcean's first quarter 2023 earnings call. Joining me today is Yancey Spruill, our Chief Executive Officer; and Matt Steinfort, 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 second 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 could 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 will be discussing non-GAAP financial measures on our call today. Reconciliations between our GAAP and non-GAAP financial results can be found in our earnings press release, which was issued earlier this morning and in the Investor Presentation on our IR website.

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

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

Thanks, Rob. Good morning and thank you for joining us today. I'm pleased to share the results of another strong quarter for DigitalOcean. We made solid progress on our key priorities of adding valuable services for customers on our platform and reshaping our cost structure to accelerate our long-term free cash flow margin objectives. And despite the challenging macro environment, we met or exceeded all of our financial targets.

Our first quarter financial results were strong across the board. We delivered year-over-year revenue growth of 30%. As projected, our quarter-over-quarter revenue growth was more muted given the near-term macroeconomic headwinds we are experiencing. These headwinds have resulted in modest net expansion from our customer cohorts as their businesses have seen their own growth deceleration. And they have continued to focus on managing their spend in the midst of the ongoing economic uncertainty.

While it is unclear how long these macroeconomic headwinds will persist, we remain committed to achieving our financial targets this year. Matt will provide more detail on our Q1 results and Q2 and full-year outlook later on the call. Stepping back for a second from the current market conditions, I reflected that we just recently crossed the two-year anniversary of our IPO. Over the course of these two years, we have become a much stronger and durable company. We added significantly to our platform's capabilities and have enabled our customers to grow their businesses.

We dramatically improved our financial profile more than doubling revenue from 2020 the full year prior to our IPO to this year. And improved adjusted free cash flow from negative 18% in 2020 to 21% plus this year. We've added a number of valuable offerings for our customers like server-less functions, premium droplets, tiered-support, significant additions to our tutorial and content, additional database engines to name a few. And expanded our total addressable market through our Cloudways acquisition last year. That brings us managed hosting capability. Collectively, the improvements we've made through our offerings in our go-to-market have improved ARPU by more than 70%.

We've also returned significant value to our shareholders since Q2 2021, repurchasing 26 million shares for a total of \$1.3 billion. While we are proud of these accomplishments, we will continue to remain focused on delivering new offerings, significant operational improvements in the business, allocating capital to accelerate growth both organically and through M&A and delivering capital back to shareholders through a regular buyback program. We remain bullish on our incredible market opportunity and we know we are still early with plenty of room for significant growth in the years ahead.

Shifting back to our near-term plan, I'd like to reiterate our key priorities for 2023, which we believe will enable us to deliver our 2023 targets and will position us for accelerated growth when the macro environment improves. As shared at our last earnings call, we have prioritized three growth initiatives that underpin our 2023 revenue targets. These initiatives are focused on sales and go-to-market, product monetization and delivering the synergies from our Cloudways acquisition. Each of the initiatives will build on the \$660 million Annual Recurring Revenue Foundation we had entering 2023.

First, we will continue to strengthen our go-to-market capabilities. Over the course of the company's more than 11-year history, our highly efficient self-service, go-to-market motion has been the primary source of new customers. People leverage our platform and become paying customers because of the simplicity and ease-of-use of our cloud tools, the documentation and support we provide all customers, the openness of our platform, and the attractive price to value that we offer for our services. Collectively, we are focused on building on our customers' ecosystem of Learners, Builders and Scalers. We're investing to attract more Learners, providing an environment to nurture and launch an idea into a business.

We're extending our product capabilities to enable the long-term successful growth for the Builders and Scalers on our platform. I'd like to think of our self-service model as one of the world's most efficient regeneration engines, where customers pay small amounts to learn and test on our platform. And they represent a ripe opportunity to foster their development such that over time, they become rapidly growing businesses on our platform. Importantly, the cost to acquire these customers is very low. Our ability to attract Learners who have a high intention to become Builders and Scalers has been an important evolution of our self-service go-to-market strategy.

We're evolving our tools and upfront content to attract higher spending customers and we are also changing our onboarding process to better serve these high-intent customers early in their DigitalOcean journey to reduce the time they spend as a learner and become higher spending customers sooner. Additionally, we have invested significantly in enhancing our ability to engage with a higher percentage of the 146,000 Builders and Scalers on our platform.

We are seeing good traction from leveraging data analytics to have our sales teams better target candidates for upgrades or additional product adoption, including moving their multi-cloud workloads to DigitalOcean from other providers. This expanded customer engagement effort is bearing fruit, as our legacy cohorts of Builders and Scalers continue to increase spending at robust rates. And we continue to add to these cohorts at strong rates of growth.

Our second key initiative is to continue to deploy new capabilities or new bundles that both increase the value we provide to customers and drive up ARPU and our share of wallet. These product monetization efforts are focused primarily on our fast growing Builder and Scalar customer segments. As we listen closely to their feedback and extend our capabilities and response to help them continuing to scale their own businesses.

As an example of a recent monetization initiative, we launched a premium dedicated droplet in Q1, which targets bandwidth-intensive applications such as video streaming and adtech businesses. We've seen strong adoption of this product extension as it improves the ability of our customers to scale efficiently. In other words, it enables cloud optimization for our customers.

The premium dedicated droplet is example of our packaging, our existing capabilities to better serve the needs of a specific customer application, providing additional value for which our customers are willing to pay. We were already an attractive destination for bandwidth-intensive use cases given our capabilities in value pricing.

However, bandwidth-intensive customers had to customize our base service through additional software to configure to their specific use case, which added time, complexity and cost to their use of our platform. Based on their feedback, we launched this new tailored solution which speeds up their deployment and reduces their cost to maintain and grow their business, which offers them a more efficient path for growth.

This new product SKU is an example of us creating higher ARPU opportunities for customers through packaging our services versus an outright increase in price. We believe we have an opportunity to enhance the customer experience on our platform with other examples like this on an ongoing basis. Another example of extending our platform to meet the needs of our larger customers was the expansion of our backup storage capabilities. In this case, we augmented our platform inorganically acquiring a complementary early-stage product company, SnapShooter in Q1 to add backup and snapshot storage features.

This acquisition is a part of a broader initiative to augment our overall storage capabilities, we expect to continue enhancing the functionality across our storage portfolio over the next several quarters into 2024. Looking ahead at the product roadmap over the rest of 2023, we will continue to invest to enhance our storage offerings to meet the needs of our Builder and Scaler customers. By addressing a broader set of storage use cases at larger scale, we will make it attractive for existing customers to put more of their cloud workloads on DigitalOcean and make it attractive for Builders and Scalers on other cloud platforms to bring their workloads to DigitalOcean.

We are also evaluating other strategic platform extensions, such as the introduction of GPU and AI/ML offerings would be a strong complement to our existing capabilities and expand our total addressable market. Although, we are refactoring our cost structure in 2023 to deliver significantly better margins and free cash flow. We don't want this year to be solely about efficiency. [ph] We're obviously (00:11:27) setting ourselves for faster growth in the future and the opportunity enhance our offerings with GPU and AI/ML services as a focus.

The ongoing organic and inorganic investment in our platform through product expansion and modernization efforts is key to driving long-term growth. We are leveraging the numerous customer conversations we're having during this challenging market environment both to educate customers and how they can leverage our existing products and services differently to help them optimize their spend and to understand how to prioritize their product development roadmap.

Our focus on the large SMB customer segment that traditionally has been underserved by more enterprise focused technology companies is a direct contributor to the stable churn we've seen over the last year, even as our growth has decelerated. Our commitment to simplicity, higher-touch support, extensive relevant content and direct engagement with our customers is a key differentiator for DigitalOcean and has created a very loyal customer base. Remaining close to our customers while their own businesses see a slowdown in growth is going to position us well to capture more than our fair share of revenue opportunity as growth rates normalize and reaccelerate over time.

The third growth initiative is the continued investments in our recently acquired Cloudways managed hosting capabilities. Cloudways business continues to perform well, managing its growth despite the weaker macro and is an accelerant to our overall growth expectations for the balance of this year. We are pleased with the progress we've made on integration in our first six months post the acquisition. We have seen a 46% increase in new Cloudways' customers in Q1 2023 over last year's Q1.

And some of that increased results from the way we have leverage our well-established self-serve product to drive customer leads to Cloudways. We are encouraged by the early results of the recent additions of the product capabilities and pricing changes we announced to Cloudways, a strong ratification of their value proposition and brand. We continue to be very optimistic about the long-term potential for Cloudways is a driver of value for our customers and investors.

Before I conclude, I want to take a moment to address changes that we've made to our leadership team. Just as we've been focused on aligning our operating model, cost structure and investment priorities on achieving our

long-term growth and free cash flow ambitions. We've also been working to build a leadership team that can scale and help us deliver on these objectives.

To that end, we've made a number of changes and additions this year to augment our team. First, we've created an important new role, Senior Vice President, Communications to bring additional focus and expertise to our efforts to connect with our customers and support them along their journey. Nancy Coleman, a seasoned executive with experience in technology businesses at similar stages of size and scale has taken this role to drive communications to our stakeholders as we increase awareness of the company's capabilities and elevate our storytelling across our customers, employees and investors.

The addition of this role is another important step in the effort to upgrade our go-to-market capabilities that started with the integration of our sales, customer success and marketing efforts under our Chief Revenue Officer at the beginning of 2023. We have also taken steps to better align our product development investments with our key growth priorities. With the Q1 departure of our Chief Product Officer, we took the opportunity to consolidate for that product development under our CLO, combining our infrastructure and new product development teams to drive better coordination and synergies. And to move product strategy under our Chief Strategy Officer to ensure that our product level strategy efforts are tightly aligned with our overall corporate strategy and long range plan.

This creates a simpler and more efficient organizational structure and will drive improved development execution and tighter alignment across our broad set of strategic priorities. To further augment our go-to-market capabilities, we also announced the addition of Chris Merritt to our Board of Directors. Chris is an accomplished sales executive and has a broad history across multiple business models in technology, including both self-serve and direct sales motions.

He most recently spent 10 years as the Chief Revenue Officer at Cloudflare and helped them scale their business from \$1 million to \$1 billion in ARR during his tenure. We look forward to adding Chris' perspective to our board and executive leadership team. Collectively, these recent changes support our strategy to become the preeminent cloud infrastructure provider to small and medium-sized businesses.

In summary, we're very pleased with both our progress early in 2023 delivering against our revenue growth and free cash flow targets and our ability to maintain the 2023 target set on our last earnings call, despite the ongoing macroeconomic challenges. We continue to invest across an array of product infrastructure and go-to-market areas while refactoring our cost structure to position the company for durable, profitable growth and they are growing \$98 billion annual market for developer in SMB cloud infrastructure.

I will now turn the call over to Matt to provide details on our financial results and our outlook for the balance of the year.

Matt Steinfort

Chief Financial Officer, DigitalOcean Holdings, Inc.

Thanks, Yancey. Good morning, everyone and thanks for joining us today to discuss another quarter of strong results with revenue, margins, earnings and free cash flow that continue to demonstrate the resilience and growth potential of our business model.

I will focus my remarks today on our first quarter results, on our progress on several key initiatives and on our updated financial outlook. We delivered revenue of \$165.1 million in the first quarter, which was 30% growth year-over-year and 1% growth sequentially from the fourth quarter of 2022. We saw resilience in our cohort performance despite the ongoing headwind of continued cloud optimizations by customers with an NDR of 107%

for the quarter. Churn continues to hold steady, which is a great accomplishment in this lower growth environment, with top-line pressure coming instead from lower expansion and elevated contraction that continued through the quarter.

In the current environment, holding churn at historical levels is a testament to both the value of our platform and the loyalty of our customer base, even as they focus on optimizing their spend and retaining our customers will position us for success when they themselves return to growth. Our resilient customer graduation model continues to be a source of strength and durability in the face of the challenging macroeconomic environment.

Fed by our extensive pool of Learners that spend less than \$50 per month, we saw a net sequential increase after both graduation and churn of close to 2,000 new Builders who spend between \$50 – \$50 and \$500 per month and more than 350 new Scalars who spend more than \$500 per month. Builders and Scalars continue to be the drivers of our growth, representing 86% of revenue and growing ARR at 41% and 24%, respectively, despite together being only 24% of our customer base. Our go-to-market and product monetization initiatives remain largely focused on meeting the needs of these growing customers.

We exceeded our outlook on both adjusted EBITDA and free cash flow margins in the first quarter through the continued disciplined management of our expenditures and the swift execution of our previously announced cost reduction initiatives. Adjusted EBITDA was 34% of revenue, which compared favorably to 29% in Q1 of 2022. The improved margin was driven by a 22% year-over-year decrease in sales and marketing expense and a 2% year-over-year decrease in R&D expense, as we reshaped the cost structure to align with the lower market growth expectations and accelerated our timeline to reach our long-term free cash flow margin target.

Adjusted free cash flow margin was 16% of revenue, up 4% from Q1 of 2022. This strong result was due to both the higher adjusted EBITDA margins and the timing of several capital projects that we expect will occur later in 2023. Q1 2023 will be the low point in 2023 for margins. The first quarter of each year includes the cash flow impact of annual bonuses as well as higher payroll taxes and other seasonal cash impacts.

Additionally, our cost savings actions occurred in the middle of the first quarter, which resulted in savings being only partially realized in the period. As we progress through 2023, we expect to steadily improve profitability and to exit the year with adjusted EBITDA margins in the low-40s and with adjusted free cash flow margins approaching 30%. Our strong adjusted EBITDA and free cash flow margins results came despite the anticipated near-term pressure on gross margin, which on a GAAP basis came in at 56% in the first quarter compared to 63% in Q1 of 2022.

The year-over-year decline in gross margin is the expected result of the previously discussed increase in co-location expenses following the expansion of several facilities, including the new Sydney data center and the short-term impacts of higher power costs in Europe. Data center expansion is a key element of our growth strategy as we increase our footprint to meet growing customer demand. While margins are initially impacted with these expansions, we will grow into the new capacity over the coming quarters improving their utilization of margin profile.

We also expect to see a declining – flat to declining power costs in Europe over the course of 2023, which will also provide additional margin improvement. Despite the gross margin pressure, we effectively managed our overall operating expenses to exceed our profit outlook for the first quarter and we are on track to achieve our margin goals for the full year.

Our non-GAAP earnings per share of \$0.28 was within our guidance range, but was impacted by a one-time international tax expense from the Cloudways acquisition in 2022 that reduced our non-GAAP earnings per share by \$0.03. As we shared on our last call, we identified a total of \$60 million of annualized cost savings, \$25 million of which were related to head count and \$35 million of which were related – were non-head count related. That would enable us to accelerate our long-term cash flow margin targets into 2023.

We have made good progress on these savings and optimization initiatives with our February reduction in force and with the rationalization of expenses in direct marketing, software licenses, travel and entertainment and other third-party spend. We are pleased with our progress so far this year and we are confident that we will be able to achieve the full-targeted 2023 savings.

In addition to our strong margin performance, we also made meaningful progress on our ongoing share buyback program. As we have discussed, we are highly focused on driving outsized growth in both earnings and free cash flow per share as the long-term drivers of shareholder value creation through continuous improvement in operating margins, coupled with our commitment to return capital to shareholders.

During Q1 of 2023, we made meaningful progress on the share repurchase front, repurchasing 7.8 million shares for a total of \$266 million at an average share price of \$34.27. As of the end of last week, we had approximately \$175 million remaining of our \$500 million approved repurchase program. And we expect to deploy the full remaining balance of the authorized repurchases over the course of 2023.

The company's strong balance sheet and significant free cash flow generation enable us to invest in growth initiatives, continue to make acquisitions and repurchase shares on an ongoing basis. We expect to continue our repurchase program up to 125% of free cash flow in 2024 and beyond. Given our progress to date on the buyback and our anticipated utilization of the remaining balance over the course of 2023, we expect to end the year with approximately 103 million to 105 million in weighted average fully diluted shares outstanding for the full year 2023.

It is important to note that our fully diluted shares outstanding includes 8.4 million shares associated with our convertible debt, which has a conversion price of \$178.51. We anticipate that the combination of our ongoing buyback program and the eventual resolution of our convertible debt will more than offset any dilution from stock-based compensation and will result in a 15% to 20% decrease in our share count over the coming years.

Turning towards our financial guidance for Q2 2023, we expect revenue to be in the range of \$169.5 million to \$170.5 million. For the second quarter, we expect adjusted EBITDA margins to be in the range of 37% to 38% and non-GAAP earnings per share to be \$0.40 to \$0.41 based on approximately 103 million in weighted average fully diluted shares outstanding.

For the full year, while we continue to see headwinds from customer optimizations and we are still early in our go-to market and product monetization efforts, we are comfortable with our previously provided guidance and expect revenue to be in the range of \$700 million to \$720 million.

With our strong margin performance in Q1, 2023 providing room for incremental growth investment, we continue to expect adjusted EBITDA margins to be in the range of 38% to 39% for the full year. Having better visibility into the impact of our share repurchase program, we now expect non-GAAP earnings per share to be in the range of \$1.70 to \$1.73.

For the full year 2023 free cash flow will increase as a result of our improved profit margin and lower capital expenditures, driving 21% to 22% free cash flow margin, excluding the one-time costs associated with our workforce reduction and transaction costs. Like adjusted EBITDA, free cash flow will ramp throughout the year. And we expect free cash flow margin to approach 30% by the fourth quarter.

That concludes our prepared remarks and we will now open the call up to Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And your first question comes from the line of Wamsi Mohan from Bank of America. Your line is open.

Wamsi Mohan

Analyst, BofA Securities, Inc.

Q

Hi. Yes, thank you so much. Yancey the larger hyperscalers are all [ph] noting deceleration, saw it at over the edge and your NDR decelerated in 1Q, ARR grew (00:27:05-00:27:11) at the slowest pace sequentially. Clearly, there are all these macro headwinds. You're still maintaining your revenue guide for the year. Can you talk about maybe what is giving you the confidence in your fiscal year guide? And how the weaker macro is changing customer behavior that you're seeing?

And I would quick second part if you could on just your AI comments. We did run a survey of DigitalOcean users that reflected a lot of the positive elements of differentiation that you called out. We also noticed AI became a top tier for a workload case at your Scalars and Builders. Any color on if these are all inferencing used cases and are these the customers that are asking for the GPU clusters you referenced? And how that might impact your CapEx profile? Thank you so much.

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. Just first on the AI dynamics, we have businesses running AI-based models and businesses on our platform today and they've been doing it for many years. We've always, from the founding, invested in really high performance computing. And so although GPUs offer some differentiation and enhancing of that compute, we still offer very high performance compute, strong bandwidth capability. So we're looking at product extension. And yes, GPU tends to be capital intensive. But we obviously know capital intensity very well and expect, our foray into this area over time to be well within our previously made comments about long-term free cash flow margins, capital – CapEx as a percentage of revenue.

But we do think it will enhance our addressable market with some of the newer business models that are emerging and give some of our existing customers more options beyond just, for example, our premium dedicated droplet product is very compelling for bandwidth-intensive and computational-intensive use cases that could be AI. But we will create broader offerings and have more to say about it as we go into the near term.

On the first comment, I think what we're seeing in the broader environment is first off, we're very excited about the fact that our churn has been very stable over this past year. It ticked up a little bit, but we know – we've noted with some of the blockchain and the dynamics in Russia are mainly causing that. But we did see churn even improve – decline as we move through Q1 and into Q2. So that's a very strong thing that we focused on because in a weakening environment, you want to keep your customers, and I think our team is doing a very good job of that.

Secondly, what we're seeing is that our customers are – we have a consumption-based model. And what's driving the lower NDR and the slower growth is the fact that their expansion has slowed pretty meaningfully over the last year. That's the main drivers why NDR has contracted and why our growth is – growth rate is contracted. And we talk with them anecdotally with our sales, our customer success teams, we did a – we've done formal surveys and the sentiment continues to be that the dynamics of our customers is that their demand environment's weakening.

They really appreciate the consumption based model because it allows them to adjust accordingly. And – but we continue to focus on that and we've made really good progress in certain instances, even with our customers that have multi-cloud workloads on DigitalOcean and others of talking with them about moving there – and actually moving their workloads from other cloud providers. So it's a difficult environment in terms of things that we can't control. However, I think our engagement with our customers, our focus on support, our customer success and our compelling different products is, we're working through this with our customers.

And so, we reiterated the range because when we – if we go back to how we talked about our guidance in the beginning of the year, the low end of the range contemplated no real change, no real contribution from incremental initiatives and even a slight weakening in the macro. We didn't necessarily see a slight weakening in the macro. As you recall, our Q1 guidance contemplated a relatively flat sequential from Q4. So, it was well within our expectations. In Q2, and what we're seeing now with the initiatives that we have launched both to the go-to-market and some of the products that we have already in market, we have others coming online are seeing ramping.

And again, to get to that high end of the range calls for the success of those products. So, we are comfortable with the range given the downside on the low end reflecting what we think is probably slightly better than what we set that several months ago. And these initiatives coming online during the years clearly seeing traction as customers are looking for ways to get more value. So that explains the holding tight on our guidance for this year.

Wamsi Mohan

Analyst, BofA Securities, Inc.

Q

Thanks, Yancey.

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

Michael Turits

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, guys. Congratulations on stability and certainly on the margin efficiency expansion. Matt, I wonder [ph] if you could add in the entity (00:32:59) as well. I guess, could you just talk about your thoughts on gross margins and CapEx for the year? Obviously, you've done a great job on the OpEx side. A little bit of pressure on gross margins and then you're benefiting it seems from some timing, but also some efficiency on CapEx?

Matt Steinfert

Chief Financial Officer, DigitalOcean Holdings, Inc.

A

Yeah. I'll start in reverse on that with the CapEx. CapEx came in at 15% of revenue for the quarter, and that's generally consistent with what we expect kind of for the full year. So I mentioned timing. We don't expect that the CapEx as a percent of revenue is going to increase in any material way from the first quarter. On the gross margin front, that's something that we had known is coming, right. We signalled that, right at – we have made investments in our data center footprint. We've added the Sydney data center. We've expanded some capacity in

certain markets and that causes a near term kind of increase in the cost structure. It was about 350 basis points impact around co-location year-over-year.

We also invested in some upgrades around bandwidth to improve some performance and – of our network that was about 125 basis points. And then there was another 125 basis point impact from the European utility cost, which we don't think persist much longer than 2023. But the important thing is that despite the increase in the cost, on the gross cost side we were able to effectively manage and exceed the EBITDA margins and the free cash flow margins. And by the end of the year, we expect to be north of 60% on the gross margin front. But it's just a really temporal challenge on the gross margin.

Michael Turits

Analyst, KeyBanc Capital Markets, Inc.

Q

Great and thanks for the detail and color and congrats on stability and efficiency.

Operator: Your next question comes from the line of Raimo Lenschow from Barclays. Your line is open.

Raimo Lenschow

Analyst, Barclays Capital, Inc.

Q

Hey, thank you and my question was more on the optimization or the end demand signals you're seeing, Yancey. And obviously, like, if you think about like the big enterprises and they would renegotiated cloud's rates and the renewals in Q3, Q4 and then you kind of done, what you're dealing with. How do you see the picture playing out for you? Is that kind of an ongoing enrolling, kind of optimization that is going on there? And what's – what are the sequence that you're looking for to see if there's a change or are you just kind of basically, cleanly where ever the cycle goes, you go? Thank you very much.

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

A

Yeah. So we've now been about 12 months into this lower growth dynamic as our businesses – our customers have been expanding slower. Again, with the consumption based model, it corrects immediately. So we've been living with this again for a year. I think a key signal and importantly, as I pointed out, the churn has been stable and is actually improving right now. Those are two really important – that's a really important sign, first.

The second is, for the turn, we'll be looking at for expansion to begin, the fact that our customers are actually consuming more cloud because their businesses begin to expand again, that that'll be a key signal for us. It's relatively stable, but slower than it was certainly a year or two ago. And that explains the lower NDR and the overall growth rate. As it relates to optimizations, I would say the consumption-based model kind of builds in optimization. Because as their builds business slows they pay for what they use. So as their customers are consuming less, they consume less bandwidth, et cetera, they just spend less. Their bill corrects immediately.

So we have a built in optimization, if you will, into our model, which is why we saw this earlier than some of the people with one or longer year contracts. What I would say about the conversations we've been having with our customers is, as their businesses have slowed and typically our small businesses tend to have really rapid growth rates, they're taking a pause and they're looking at architecture.

They're looking at longer term or intermediate term dynamics around how they run cloud. And they've led to some great conversations with us putting customers in different packaging that actually gives them on a more efficient growth path similar to the case I just cited with the premium dedicated droplets. So this has been a great

opportunity for us in a challenging environment where our customers are nervous for us to work with them. To put them on a more efficient path that they feel better about so that they can manage through the current period of time.

And be poised when they do accelerate, to have a more efficient growth path, that's going to see growth for us, but also more peace of mind for them. So we're taking this opportunity to get closer to our customers, which I think in a recession or certainly a super low growth environment, which the tech industry or our industry is in, is the approach that we decided to take.

Raimo Lenschow

Analyst, Barclays Capital, Inc.

Q

Yeah. Okay. Perfect. Thank you.

Operator: Your next question comes from the line of Mike Cikos from Needham. Your line is open.

Mike Cikos

Analyst, Needham & Co. LLC

Q

Hey, guys. Thanks for taking the questions here. I wanted to circle back to Matt's prepared remarks, I think, to open up you had cited these elevated contraction rates. And I just wanted to see if we could get a better sense of the shape of those rates. How did 1Q play out as far as those contractions we were seeing with April now behind us, if there any change there?

And then the second question was, I know that you guys reiterated the calendar 2023 guidance. But at the end of February, you had also announced a price increase for Cloudways. Can you give us a sense of what's embedded in your guidance based on that Cloudways price increase? Or was that already in some way incorporated in your previous thinking? Thank you.

Matt Steinfort

Chief Financial Officer, DigitalOcean Holdings, Inc.

A

Thanks, Mike. Yeah. Just to close out on that one the Cloudways price increase was contemplated in the guide, so that was baked into our plan. We made the decision at the time we acquired Cloudways, which was right when we were just recently done the price increase for overall deal that we would wait until we closed that transaction and got a little further in and did some analysis before we just blanket increased the prices of Cloudways. But – so we did that, it took effect in April. But it was that – we knew that going into the planning process and into the guidance.

On the contraction, as Yancey, said that if you think of what NDR? NDR is a function of three things, it's churn, it's expansion and it's contraction. And the net of all those three gives you your NDR. And so, if you look at the decline in the NDR from first quarter – from fourth quarter to first quarter, churn didn't contribute to – in a negative way to that reduction, churn held flat. In fact, as Yancey said, we've seen kind of month-over-month through the course of 2023 an improvement in the churn rate – modest improvement in the churn rate.

So the delta that you're seeing is – in the NDR is driven almost entirely by the combination of lower expansion and more contraction, which is very consistent with the optimization and kind of the pause that Yancey just described in our customer base. So if you're trying to get a math kind of view of it, just look at the NDR and assume churn flat kind of quarter-over-quarter and that'll give you the result for expansion and contraction.

Mike Cikos*Analyst, Needham & Co. LLC*

Q

Awesome. Thank you for that color. And did you guys quantify the benefit from the Cloudways price increase for this guidance we have now?

Matt Steinfort*Chief Financial Officer, DigitalOcean Holdings, Inc.*

A

No. No, we did not.

Mike Cikos*Analyst, Needham & Co. LLC*

Q

Okay. All right. Thank you. I'll turn it back to my colleagues.

Operator: Your next question comes from the line of Brad Reback from Stifel. Your line is open.

Brad Reback*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Great. Thanks very much. So with the current guide sort of pointing towards a mid to upper teens exit growth rate for the year and the CapEx growing at 15%. Should we think about that being the long-term sustained growth rate for the business?

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

A

We're – our guidance reflects our outlook for the year. And weren't commenting on longer-term growth expectations for the business. We continue to invest to drive growth that's in our higher than what you just cited. But at the same time, there is things that we can't control beyond. And so we're focusing on what we can control, which is why we made a very strategic decision months ago to accelerate to longer-term free cash flow margins today.

And as Matt just cited, we'll be approaching those even in this quarter, but certainly as we exit this year. And what that positions us for is in area of lower growth, this is the growth rate that persists. We have attractive margins and returns on capital. If growth reaccelerates and we are investing in new products as we decided today to do that, we'll have more investment capacity as well as deliver more leverage in the operating model.

So, we're pleased to reiterate the guidance for the year. We're pleased actually with quite a few of the trends that we saw as we move through Q1 and as we're into Q2 here. And as we get to the back half of this year and certainly in the early next year, we'll have more to say about 2024 and perhaps beyond depending upon how the macro is shaping up.

Brad Reback*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Great. Thanks very much.

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

Pinjalim Bora*Analyst, JPMorgan Securities LLC*

Hey, guys. Thanks for taking the question. Yancey, maybe could you talk about the Cloudways performance, especially around the multi-cloud adoption that you were talking about? I'm assuming Cloudways will be a beneficiary of that. How are you driving that motion? And secondly, it seems like the pricing increase in Cloudways proportionally higher for some of the competitive offerings, some of your peers. What are you hearing from those customers on that price increase and how do you think that plays out?

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

Well, Cloudways is performing very well. There has been a slight uptick in the growth rate since the close, really owing to a lot of the acceleration and new customers is incredibly exciting. Those customers were who were coming to DigitalOcean had a mismatch expectation before the close of the deal that they were expecting a more managed experience. Many of them churned. And we've done a great job in saving those customers and getting ready to Cloudways out of the box. And they're going to be long-term customers.

So we're materially increasing value as a result. So that – really excited to have a bullet – first bullet on the synergies of the complementary platforms and actually realizing those synergies so early and so significantly. And so, we're really excited as we continue to look at other areas on the sales and marketing side to better match customers, whether it's at Cloudways or at DigitalOcean into the right fit either it's day one or over time. So, we feel very good about that.

In terms of the pricing change, it's early six weeks after it's got effective. We feel good about the early returns on that. And as Matt cited, that had been baked in, that was put on pause as we closed the acquisition last year. So it was contemplated earlier this year and it – Cloudways had done a previous price increase four or five years ago and it was time and feel good about the early feedback. And what we're seeing in terms of demand on the platform since that announcement and it's got into effect.

Pinjalim Bora*Analyst, JPMorgan Securities LLC*

Got it. Thank you.

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

Gabriela Borges*Analyst, Goldman Sachs & Co. LLC*

Hi. Good morning. Thank you. Yancey, I wanted to ask how you think about the impact of AI on the Cloudways business in particular? One of the risks that I'm trying to understand is to what extent Cloudways is helping bridge, what may be a technical gap to help get your customers on DigitalOcean software? And to what extent that bridging essentially gets potentially abstracted away by other AI tool? Would love to hear, how you think about it? Thank you.

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

Well, I think in the bigger picture, AI is a very compute-intensive, storage-intensive, bandwidth-intensive product set. However, the ultimate products are successful product shakeout, and so, i.e., it's infrastructure is a service

intensive. So I think overall AI tools, applications will ultimately be a tailwind for our business. And as I cited earlier, there are already businesses who are running AI models that are whole premise as artificial intelligence, that are serving customers at reasonable size on our platform today and have been for years.

So as it relates to sort of the core compute, what we would be looking to offer is capabilities that allow our customers to leverage AI on a tools or build language models or run a complex compute algorithms beyond what they can do today at on our platforms, which is why we also acknowledge that we're looking at GPU. So I'm not sure I understand specifically your question or that's something that we are necessarily concerned about in terms of the infrastructure part of our business, because we think infrastructure enables AI applications and frankly, we should be a beneficiary over time. We've already been a beneficiary from AI models, businesses running on our platform as of today.

Gabriela Borges*Analyst, Goldman Sachs & Co. LLC*

Q

Thank you for the detail.

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

Quinton Gabrielli*Analyst, Piper Sandler & Co.*

Q

Hey, guys, this is Quinton on for Jim Fish. Thanks for taking our question. It's another quarter of learning behind the team following Cloudways deal. Has there been any changes in the other managed service providers willingness to offer DigitalOcean just due to your accelerated investments in Cloudways? Or have those kind of channel relationships remained relatively unchanged following Cloudways? Thank you.

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

A

So the managed hosting managed services business is very large and very fragmented around the world. This was obviously a key diligence concern for us as we were going through the negotiations and the conversations with Cloudways a year ago. And the sentiment was that it would not be an issue. And the reality is that it is not an issue. We are not seeing other managed service and hosting providers that are have been meaningful customers on DigitalOcean.

We have not seen them move volumes away. In fact, one of the larger ones on our platform that is a multi-cloud managed hoster moved cloud services onto our platform as a part of the optimizations in Q1. So, the direct answer to your question is, we have not seen it. We weren't concerned going into the deal after diligence and it's not something we've seen in this two-plus quarters that we've owned the company.

Quinton Gabrielli*Analyst, Piper Sandler & Co.*

Q

Got it. Helpful. Thank you.

Operator: And that concludes our Q&A session for today. I would like to turn the call back over to Yancey Spruill for closing remarks.

Yancey L. Spruill

Chief Executive Officer & Director, DigitalOcean Holdings, Inc.

Thank you all for joining us. We truly appreciate the opportunity to update you on our progress and in transforming our business into a durable, high growth business and a free cash flow machine in both good times and in bad. We look forward to continuing the conversation in the weeks and months ahead as we work hard to realize this limitless potential of this opportunity we call DigitalOcean. Have a great rest of the day.

Operator: This concludes today's conference call. Enjoy the rest of your day. You may now disconnect.

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