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Fastly, Inc. (FSLY)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. My name is Tamika, and I will be your conference operator today. At this time, I would like to welcome everyone to the Fastly Third Quarter 2024 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]

I would now hand today's call over to Vern Essi, Investor Relations at Fastly. Please go ahead, sir.

Vernon P. Essi
Vice President-Investor Relations, Fastly, Inc.

Thank you and welcome everyone to our third quarter 2024 earnings conference call. We have Fastly's CEO, Todd Nightingale and CFO, Ron Kisling with us today. The webcast of this call can be accessed through our website fastly.com and will be archived for one year. Also, a replay will be available by dialing 800-770-2030 and referencing conference ID number 7543239 shortly after the conclusion of today's call. A copy of today's earnings press release, related financial tables and Investor Supplement, all of which are furnished in our 8-K filing today, can be found in the Investor Relations portion of Fastly's website.

During this call, we will make forward looking statements, including statements related to the expected performance of our business, future financial results, product sales strategy, long-term growth, and overall future prospects. These statements are subject to known and unknown risks, uncertainties and assumptions that could cause actual results to differ materially from those projected or implied during the call. For further information regarding risk factors for our business, please refer to our filings with the SEC, including our most recent annual report filed on Form 10-K and quarterly reports filed on Form 10-Q, filed with the SEC and our third quarter 2024 earnings release and supplement.

For discussion of the factors that could cause our results to differ, please refer, in particular, to the sections entitled Risk Factors. We encourage you to read these documents. Also note that the forward-looking statements on this call are based on information available to us as of today's date, and we undertake no obligation to update any forward-looking statements except as required by law. Also during this call, we will discuss certain non-GAAP financial measures. Unless otherwise noted, all numbers we discuss today, other than revenue, will be on an adjusted non-GAAP basis. Reconciliations to the most directly comparable GAAP financial measures are provided in the earnings release and supplement on our Investor Relations website.

These non-GAAP measures are not intended to be a substitute for our GAAP results. Before we begin our prepared comments, please note that during the fourth quarter, we will be attending the RBC Capital Markets Global Technology, Internet, Media and Telecommunications Conference in New York on November 19th and the UBS Global Technology and AI Conference in Scottsdale, Arizona on December 4th.

Now, I will turn the call over to Todd. Todd?

Todd Nightingale

Chief Executive Officer & Director, Fastly, Inc.

Thanks, Vern. Hi, everyone, and thank you so much for joining us. Today, I will cover our Q3 results and the progress we've made, especially in growing revenue outside of our largest customers and in continuing to improve the profitability of Fastly. I will also discuss our go-to-market and technology initiatives. I will then hand the call over to Ron to discuss our third quarter financial results and our guidance in detail.

We reported third quarter revenue of $137.2 million coming in above the high end of our guidance range due to better-than-expected strength in some of our larger media customers and a balanced mix of share gains outside of our top 10 customers. We reported an operating loss of $520,000, the best results we have achieved in more than four years and materially better than the guidance range. This was the result of higher revenue and gross margins, coupled with the cost benefits from a faster-than-projected execution of our restructuring.

I'm also excited to share with you that Fastly reported a net profit of $2.4 million and positive adjusted EBITDA of $13.3 million in the third quarter, both record levels for the company. I'm pleased to share with you the progress we made in diversifying our revenue. This resulted in a more diverse revenue mix in the third quarter as we grew our top line 7% year-over-year.

In the third quarter, our top 10 customers represented 33% of revenue, down from 40% last year and down from 34% quarter-over-quarter. This is a good indicator of continued progress in diversifying our revenue and strengthening our business. Revenue outside of our top 10 accounts, which is key to our strategy and goals for the long-term success and growth rate of Fastly grew 20% year-over-year, significant improvement from last quarter's 13%.

Last quarter, we call this an inflection point and a moment of transition for Fastly. While the transition doesn't happen at single moment, we are already experiencing the benefits of a more focused investment in product, customer success and go-to-market.

Specifically, we released a major expansion to our security portfolio, onboarded new sales leadership, pivoted to a more bespoke engagement model with our largest multi-vendor customers and launched a new self-service demand generation. We are seeing early progress in our revenue diversification, customer acquisition growth and renewed focus on our largest enterprise customers. There is more to come. These changes will drive revenue diversification and faster, more reliable growth for Fastly.

Our customer acquisition efforts showed solid gains year-over-year in the third quarter. Our enterprise customer count was 576 compared to 547, representing a 5% growth rate year-over-year.

Quarter-over-quarter enterprise customer count actually declined 4% with some more customers dip just below our $100,000 run rate enterprise definition this quarter. We do see quarterly volatility in our enterprise customer count methodology, but we'll be tracking this very carefully and looking to drive growth in all of our mid-sized accounts.

We experienced normal churn levels with churn flat quarter-over-quarter, and while we saw 5% year-over-year growth rate in enterprise customer count, we aren't satisfied with this result and hope to accelerate our growth in enterprise customers in 2025. We had 3,638 customers at the end of Q3 and a net increase of 343 quarter-over-quarter for a growth rate of 10%. We believe this is the result of our new self-service sales motions, which I will discuss in a moment.

Our transition is heavily into our technology, innovation, heritage, and we believe it is key to the continued success in customer acquisition and wallet share growth. Fastly's platform is a software-driven edge network that offers best-in-class delivery, network services, security, compute and observability.

We continue to focus investment in leading technology and innovation that not only solidifies our platform, but also extends its features for the future of web application development. The functionality we offer allows our customers to bring their applications to life around the world. We believe that our unified platform approach will significantly enhance our customer retention and create efficiencies for Fastly and supporting our customer success.

Let me share with you some important developments taking place in our security offerings in particular. We continue to experience a favorable customer response from bot mitigation since its release in the first quarter. Our bot mitigation solution wholly developed within Fastly, attracts customers looking for simple onboarding and ease of use, opening the door for continued opportunities for cross-sell and upsell. Fast following on the heels of our successful launch of bot mitigation, we announced the general availability of Fastly's adaptive DDoS protection on the platform. This solution provides automatic protection from Layer 7 and other application level DDoS attacks.

Our platform enables frictionless onboarding and implementation of this solution with just a click of a button. We've had a long heritage of DDoS Protection at Fastly, partnering with some of the largest, most sophisticated customers in the industry. We are tapping into this intellectual property and productizing it to address the entire market so that our broader customer base can benefit. Additionally, this solution allows us to layer proprietary auto adaptive response intelligence within the offer. We believe this innovative DDoS releases a new enterprise customer acquisition vector for Fastly, in addition to driving customer growth and cross-sell opportunities.

Last quarter, I shared with you that we launched the beta version of our AI accelerator and AI proxy capable of delivering performance and cost savings to application builders, leveraging large language models. The interest and response has been very favorable from our customers and we've added LLM support beyond open AI to include Google Gemini as well. We expect AI accelerator will be generally available for purchase by the end of the year, and I'm excited to make this announcement as it demonstrates the increase of innovation velocity of Fastly and I look forward to announcing more product launches before year end.

I'll now discuss the transition taking place within our go-to-market efforts. Since joining us in the second quarter, our new CRO, Scott Lovett, has taken the first steps towards driving transformation within the sales order to close more new enterprise logos. He's particularly focused on driving wins in security with new and existing customers and with our new security offerings and deep experience in the space, we're excited about the opportunities ahead. Beyond sales, our go-to-market success is also the combination of branding, messaging and sharing our expertise with subject matter experts.

In the third quarter, we released the Fastly Threat Insights Report, providing the latest attack trends across the web application and API security landscape. The report found that 91% of cyberattacks targeted multiple customers using mass scanning techniques to exploit vulnerabilities. We also released the results of our new survey, Bot Wars: How Bad Bots Are Hurting Businesses, which revealed 59% of IP professionals reported an increase in bot attacks over the past year, with significant incidents costing companies an average of $2.9 million. These results seem closely in line with the interest we're seeing in our security portfolio and our new security offers.

We are now in the second year of our packaging efforts, which truly demonstrates our focus on simplicity, not just in our product, but in pricing and our ease of implementation. Our new self-service model with mix-and-match packages was rolled out last quarter, kicking off our initial PLG efforts at Fastly. These efforts have resulted in growing our overall customer count while also attracting critical developers to the Fastly platform. In the third quarter, our packaging efforts demonstrated strong growth and we more than doubled the number of packages sold year-over-year. Our new logo packages tripled and represented 43% of the packages sold in the third quarter, compared to 16% a year ago.

Lastly, our channel partners rounded out our go-to-market efforts. In the third quarter, our deal registrations grew 33% year-over-year and our year-to-date bookings grew 46% year-over-year. We anticipate more opportunities to leverage our channel and drive top line growth as we move forward.

Now let me conclude with a discussion on our outlook as we close out the year. Looking back one year ago, we did not foresee all the challenges we faced. In 2024, we suffered revenue declines from our largest customers and this in turn prompted us to realign our growth strategy and our investment strategy. Ultimately, we implemented a workforce reduction and overall transition that impacted every department at Fastly.

I believe we are pulling through these difficult times and we are turning a corner. The cost discipline and financial rigor on our drive towards profitability growth has never been better. We've shown signs of progress this quarter that should make the team proud. And though there's more work on the horizon, I'm pleased with the efforts across the board over these past three months. Heading into the fourth quarter, typically very seasonally strong, we do not believe we will be benefiting from as much of the typical sequential lift we've experienced in prior years, and this is reflected in our fourth quarter revenue guidance.

While this could be dismissed as conservatism on our part, it is more of a result of what we have shared over the past three quarters with the dynamics we are seeing taking place at some of these largest accounts. We do believe that we've moved past the worst of these impacts and have a strategy in place to keep our strong position at these very large accounts, while also focusing heavily on healthy revenue growth outside of our largest customers, driving important revenue diversification. I'm very optimistic on Fastly's prospects in 2025 and continue to believe our inherent platform advantages affords the opportunity to capture more share of the world's web application workloads.

And now, to discuss the financial details of the quarter and guidance in detail, I will turn the call over to Ron.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

Thank you, Todd, and thank you, everyone, for joining us today. I'll discuss our financial results and business metrics before turning to our forward guidance. Note that unless otherwise stated, all financial results in my discussion are non-GAAP based.

Revenue for the third quarter increased 7% year-over-year to $137.2 million, coming in well ahead of the midpoint of our guidance of $130 million to $134 million. Network services revenue grew 5% year-over-year to $107.4 million, and security revenue grew 12% year-over-year to $26.2 million. Lastly, our other segment, which represents our emerging products category, grew 85% year-over-year to $3.6 million, driven primarily by compute.

In the third quarter, we saw better-than-expected strength in life, sports and gaming with a balanced mix of share gains outside of our top 10 customers, offsetting traffic headwinds at certain of our largest customers that we've previously discussed. Our top 10 customers comprised 33% of our total revenues in the third quarter of 2024, compared to 34% in Q2 2024, reflecting the impact of the revenue declines from some of our largest customers and our strategy of targeting a more diverse customer base. Also, no customer accounted for more than 10% of revenue in the third quarter. Revenue from customers outside of our top 10 customers grew 20% year-over-year.

Our continued focus on customer acquisition has resulted in revenue expansion outside of our top 10 customers expanding our wallet share into the broader enterprise customer segment. Our trailing 12 month net retention rate was 105%, down from 110% in the prior quarter and down from 114% in the year ago quarter. This decline is primarily due to the revenue declines in some of our largest customers and we anticipate this will continue to be a headwind to our LTM NRR through the remainder of 2024.

At the end of the third quarter, our RPO was $235 million, up 6% from $223 million in the second quarter of 2024 and down 5% from $248 million in the third quarter of 2023. This increase is primarily due to contract renewals with our larger customers and increasing adoption of our packaging products which are sold on a subscription or SaaS basis.

This was offset by other larger customers working through the remaining obligations over their contract term. As Todd mentioned, we had 576 enterprise customers at the end of Q3, a net decrease of 25 compared to an increase of 24 in the second quarter. On a year-over-year basis, enterprise customer count increased 5%. Enterprise customers accounted for 92% of total revenue on an annualized basis in Q3, compared to 91% in Q2. Enterprise customer average spend was $880,000, up 9% from $804,000 in the previous quarter and up 3% from $858,000 in Q3 of last year.

I will now turn to the rest of our financial results for the third quarter. Our gross margin was 57.7% compared to 58.5% in the second quarter of 2024 and up 180 basis points from 55.9% in Q3 2023. As we benefited from better utilization on our fixed cost on higher-than-expected revenue offset to a lesser extent by increased bandwidth and transit costs on higher traffic. Our incremental gross margin hit a record 79% on a trailing 12 month basis, compared to 73% in the third quarter of 2023. Reflecting continued efforts on reducing our cost of revenue in an otherwise challenging top line environment.

Operating expenses were $79.6 million in the third quarter, better than our expectations. Lower employee costs related to the recent restructuring and a reduction in hiring accounted for a majority of the upside. This represents a 5% decrease in operating expenses compared to Q3 2023 and a decrease of 12% sequentially from the second quarter.

This better-than-expected favorability in our operating expenses combined with better-than-expected gross profit resulted in an operating loss of $0.5 million in the third quarter, beating our operating loss guidance range of $12 million to $8 million. In the third quarter, we reported a net income of $2.4 million or income of $0.02 per diluted share compared to a net loss of $8 million or a loss of $0.06 per basic and diluted share in Q3 2023.

Our adjusted EBITDA was positive in the third quarter, coming in at $13.3 million, compared to $0.7 million in Q3 2023. As Todd mentioned, I'm pleased to highlight that both net income and adjusted EBITDA set quarterly records for Fastly.

Turning to our balance sheet, we ended the quarter with approximately $308 million in cash, cash equivalents, marketable securities and investments, including those classified as long term. Our free cash flow for the quarter was negative $7.1 million and $11.4 million sequential improvement from negative $18.5 million in the second quarter. This improvement was primarily driven by an increase in our cash from operations to positive $5 million compared to negative $4.9 million in the second quarter.

Our cash capital expenditures were approximately 9% of revenue in the third quarter, coming in at the lower end of our guidance of 9% to 10% of revenue we shared on our Q2 call. As a reminder, our cash capital expenditures include capitalized internal use software. For 2024, we anticipate our cash CapEx will be approximately 9% to 10% of revenue.

I will now discuss our outlook for the fourth quarter and full year 2024. I'd like to remind everyone again that the following statements are based on current expectations as of today and include forward-looking statements. Actual results may differ materially, and we undertake no obligation to update these forward-looking statements in the future, except as required by law.

As Todd shared in his remarks, while we are seeing growth in new customer acquisition, which we believe will lead to further revenue expansion longer term, we are facing an unexpectedly challenging environment of revenue declines in some of our largest customers continuing throughout the course of 2024, adversely impacting our revenue growth.

Our revenue guidance reflects these dynamics in our business and is based on the visibility we have today. We expect somewhat flat-to-modest sequential growth in Q4 revenues compared to Q3 due to lower revenue at some of our largest customer. For the fourth quarter, we expect revenue in the range of $136 million to $140 million, representing flattish annual growth. Note we do not expect to experience any one-time revenue true-ups in the fourth quarter compared to the one-time $2.8 million and $3.3 million revenue amounts we recorded in the fourth quarter of 2023 and 2022, respectively.

We continue to be very disciplined in our network investment and cost of revenues, which contributed to our third quarter gross margins being approximately 70 basis points better than we initially expected. For the fourth quarter, we anticipate our gross margin will decrease approximately 150 basis points relative to the third quarter plus or minus 50 basis points. This sequential decline in gross margin is primarily due to increased bandwidth and co-location deployment costs associated with increased traffic in international regions.

We anticipate our fourth quarter operating expenses will be flat to modestly up from third quarter levels. Guidance for our fourth quarter operating results reflects the impact of the sequential decrease in gross margin and the beneficial impact of lower operating expenses. As a result, for the fourth quarter, we expect a non-GAAP operating loss of $5 million to $1 million and a non-GAAP net loss of $0.02 per share to a non-GAAP net income of $0.02 per share.

For calendar year 2024, we expect revenue in the range of $539 million to $543 million, reflecting annual growth of 7% at the midpoint. We expect to continue to see gross margin improvement in 2024 compared to 2023 as we leverage cost and incremental yet lower revenue growth.

We anticipate our 2024 gross margins will improve by approximately 70 basis points plus or minus 50 basis points relative to 2023. As a result, we expect our non-GAAP operating loss to be in the range of $28 million to $24 million, reflecting an operating margin of negative 4.8% at the midpoint, an improvement of approximately 29% in dollar terms over 2023's operating loss margin of 7.2%. We expect our non-GAAP net loss per share to improve to $0.12 to $0.08, reflecting the improvement in our operating loss expectations. And we expect free cash flow to be in the range of negative $40 million to $30 million in 2024 compared to negative $59 million in 2023.

Before we open the line for questions, we'd like to thank you for your interest and your support in Fastly. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question is from the line of James Fish with Piper Sandler.

James E. Fish
Analyst, Piper Sandler & Co

Q

Hey guys, congrats on getting the business here to the net income profitability in the quarter overall. Look, I think everybody's wondering here about the competitive environment with one of your competitors going bankrupts and Todd, you and I talked about that at a conference but what are you guys seeing in terms of that opportunity, in particular, especially given that entity had very large customers, even some overlapping customers, what programs are you putting in place to try to gain further wallet share with that as your bankruptcy?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, I think it's making the market like a super interesting place right now and there's definitely potential upside here. We've seen some accounts that have, in fact, shifted traffic towards Fastly, and that's largely the overlapping accounts where the transition is straightforward. But largely I think of this as a significant opportunity in 2025. I think that's where I'm going to see big shifts in that area in particular.

Maybe on a slightly wider length, I think it also underscores the importance of a platform strategy here, of building a very complete offering with strength, not just in network services, but security and compute and observability as well. And that's where we're seeing a lot of the momentum in our business. And I think it's going to help us transition these customers over to a more complete offer. So for us, we've seen a little bit of that so far, but I think the majority of the upside opportunity for us is probably in 2025.

James E. Fish
Analyst, Piper Sandler & Co

Q

Got it. And then maybe on the packaging side and security piece, specifically, what's the penetration or attach rate of security to customers generally at this point, specifically as well within your web delivery customers, where that may be a little bit easier to a cross-sell. What's the low-hanging fruit that Scott has here? Thanks, guys.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, it's super top of mind. We don't disclose that particular number here, but I would tell you, I think our cross-sell penetration is still very low. I think there's a lot of opportunity and that's exactly why we've focused on security innovation. And I'm sure you see certainly a surge here with two big releases in the last two quarters.

We focused that not just on security efficacy, but an ease of deployment and true simplicity in the platforms that customers who are existing content delivery customers can onboard best-in-class DDoS or bot mitigation or a WAF, even with a click of a button. And we're really targeting the product and platform innovation area here to drive this cross-sell where I believe we are far, far – we have far-to-little penetration on the cross-sell opportunity.

Operator: Your next question is from the line of Frank Louthan with Raymond James.

Frank G. Louthan
Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you. So it seems like the bump in the business here was a little bit more one time in nature. You're a little cautious that it was. Can you give us an idea of what was kind of driving that media business in the quarter and any thoughts about what possibly could be replicable? And then on the efforts you've made on the restructuring, can you walk us through where you've seen success there early on? Are you tracking to the same overall cost savings or you found some new, it's going to be a little bit higher or we just capture a little sooner than we thought? Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Sure. We saw some better than projected revenue in those top accounts. And I think you're right to say, we're being very careful not to project too much from those results into the out quarters and I think that's important. We know there's volatility there and we want to be really sure that we are projecting the correct – that we're giving you the correct revenue projection going forward. But I think the like the part of the growth rate and the revenue results in Q3 that's really important is that we saw 20% year-over-year growth outside of the top 10.

We're seeing momentum starting to build in this transition towards approaching the larger market, acquiring customers outside of media and driving a more diversified, more reliable business, and therefore more projectable and reliable growth rate moving forward on that diversified business. And there's no doubt that this transition has a lot to do with that, focus on diversification and focus on long-term reliable growth.

As far as the cost savings, largely, we we've been pushing cost control and operational efficiency and rigor for a long time. And we've had pretty consistent results in making improvements there, but our restructuring, we were able to do a little bit earlier, a little bit faster and more efficiently than we believed and we believe possible. And that drove a big chunk of the beat on the OpEx side to our projections. Ron, anything to add.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

No, I think it's – I think that's [indiscernible] (00:29:44) piece of the traffic. Again, we saw some favorability in the spending just based on the execution of the restructuring that basically is going to drive about a $14 million savings versus our original plan in 2024.

Frank G. Louthan
Analyst, Raymond James & Associates, Inc.

Q

Great. And when you mentioned getting business outside of media, can you characterize what are some of those workflows? What does that data look like that you're getting? Is it more software based? And then what is it? Are these new opportunities that you think have a long growth rate or is it just where you just happen to [ph] be guiding the (00:30:20) business?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, for sure. I think, number one, it's a lot of new logo acquisition and that drives very, very healthy growth rate in a couple of years as there is a more accelerated land-and-expand motion or I should say expand motion in the first 24 months on the platform. It's definitely business that is more diversified across the portfolio than the media business.

Outside of media, there's much more spend in security, compute, observability across the board. And we're starting to see – starting to see those results outside of media, which I think is really, really healthy for the business. It will help us drive margins and it will help us balance workloads across our infrastructure and a multi portfolio customer is stickier. They enjoy platform leverage. It makes their teams and their developers more loyal to the platform and more powerful within their own organization. So we are really excited about that.

Operator: Your next question is from the line of Sanjit Singh with Morgan Stanley.

Sanjit K. Singh
Analyst, Morgan Stanley & Co. LLC

Q

Yeah, thank you for taking the question and nice to see getting back to a nice speed cadence. I guess, my overarching question, Todd, is, is there like a mix between top 10 and non-top 10 that would essentially signal growth returning to the business? It sounds like the top 10 doesn't seem to be getting worse. But as I look at your Q4 guide, we're looking for about flat year-over-year growth. So probably more sort of year-over-year growth headwinds on the comp. And so is it like sort of getting that mix down to 25%, 20% because it looks like your non-top 10 customers are growing healthily in the double digits. So any thoughts there on like where those kind of two lines cross, where that sort of spits out reasonable growth?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, I think it's a good question, something we think about a lot. I believe that the growth rate at Fastly overall is going to be more and more dominated by this longer tail of customers. And that's why, I'm tracking so carefully the non-media growth rate and in the public disclosures, the non-top 10 growth rate.

And as that concentration reduces and we're going to index more and more on it. I think getting to 30% is going to be a pretty significant moment in time for us. And I think that really will be a healthy place to be. But to be honest, I think it's only upside in diversification. We've seen so much success in diversifying our business. And we're going to keep at this, not just in diversifying our revenue across the customer base, but increasingly in 2025, you're going to see us pushing really hard on the security side of our portfolio as well.

Sanjit K. Singh
Analyst, Morgan Stanley & Co. LLC

Q

And maybe you can just follow up there on the security side. So more updates to next-generation WAF, more updates to the bot management capabilities. Where are we in sort of driving that stronger sort of security sales motion? I'm sure, sort of interplays with the momentum you're seeing with partners, but what is sort of your outlook for security growth over the next couple of quarters?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, it's certainly top of mind, not just for myself but for Scott, our new CRO, comes from a security background and as we look to the restructuring that we just did and really the path forward, especially as we start 2025, we are deeply focused on sort of paring this R&D investment with real go-to-market focus in security. And so I really – I believe 2025 security is going to be a very, very top of mind area, not just in the R&D side, not just in the product line side, but across the board.

I think there's a ton of upside here. We've got and it was mentioned in the first question, we have a lot of untapped potential in the cross-sell. I'm seeing really good momentum in our security sales motion when it comes to new logo acquisition. And we have with – especially with the recent product developments, we have a really amazing opportunity to use security more and more as a way to onboard new customers to the platform for the first time and start to actually land and expand those customers into delivery and network services.

Operator: Your next question is from the line of Will Power with Baird.

William V. Power
Analyst, Robert W. Baird & Co., Inc.

Q

Okay, great. Thanks. Todd, maybe just coming back to the media side just to clarify a bit for me. I mean, it look like in Q3, your top 10 customers were actually pretty stable with Q2, which was at the surface seemed encouraging, I'm sure there are prior some – there are some crosscurrents within that. And yet it sounds like you're still expecting some headwinds seasonally in Q4 and maybe there's some conservatism in there, but still some questions. I guess I'm just – but it also sounded like you kind of think you got the worst behind you. And so I'm just trying to understand what underpins the confidence around the visibility that the worst is behind you given some of these headwinds in Q4. Maybe if you can just help triangulate that for me.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah, I mean, I think we have now a strategy that is certainly more dependent on the business outside of media. And we've seen this big shift from 40% all the way down to now 33% in just a few quarters. That's certainly helping us build a better projection, have more confidence in the growth rate and in the fullness of time, help us build a better and more higher and more reliable growth rate for the company. As far as the media business goes, we did see our higher touch customer engagement model that we put in place when we started to see these headwinds a few quarters ago.

We have seen really two, I think, significant benefits here. One is we've been able to serve these customers better by demonstrating better performance than the rest of the market, more reliability, better ease of doing business, which is so important. And with that better customer engagement, better executive engagement, I think we have a better projection for that business. But that business has changed a little bit. We're hoping that things like the [indiscernible] (00:37:05) situation will help fuel that part of our business back to growth. And we think we've never been in a better position, but we don't have visibility to a big return to growth in Q4 and that's what's baked into our projection.

That being said, this higher touch customer success motion has also given us, I think, a much better projection of that business, a better way to predict it and measure it and get telemetry from across the system, the business, the Internet, et cetera on what's happening here. And so it's sort of better engagement and hopefully a faster return to growth for our media business, but also a better projection and better building of our revenue model moving forward.

William V. Power
Analyst, Robert W. Baird & Co., Inc.

Q

Okay. And then maybe just I guess one other follow on. I mean, you touched on this a bit, but nice to see that there's actually even improved growth, I guess, in your customers outside of the top 10. Any common variables to call out there, either particular verticals are doing well in or particular use cases that are helping drive the success there. Both in terms of revenue and in terms of new customer adds, which – the enterprise number is down, the overall adds looks good.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I think the biggest trend I've seen and I think this is a little anecdotal, but the biggest trend I've seen is certainly that new customers are coming to Fastly, especially outside of media, looking for a complete edge solution, network services and delivery, security, observability and edge computes. And as we've filled out the last couple of pieces in our security portfolio, we're starting to see, I think, a lot more serious engagement on those new logos and finding more success and bringing them on board.

So to me, that's the big trend I've seen here, is – now finishing up the security portfolio has helped us build a more complete portfolio. And these new customers, that's what they're looking for. They're looking for a complete edge solution.

Operator: Your next question is from the line of Timothy Horan with Oppenheimer. Timothy, your line is open.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Sorry, guys. I think you said large customers are working through their obligations. I mean, do you have much visibility when those obligations are over? You know, where you're at on relative pricing basis and will those customers or timeline on that and maybe what's the visibility? I know you've been answering this a bit on retaining of customers. And I guess related to this, the whole CDN space has been under a lot, a lot of pressure. Is it volumes are coming in lower than expected or are the hyperscalers gaining share or are the new entrants [indiscernible] (00:40:00) where's the kind of – why has the revenue been so disappointing for the whole industry. And I guess with your large customers, I know you've been talking about it, but just need a little bit more color on those obligations here?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.
A

Yeah. In terms of the obligations, we have really good visibility to when the contracts come up for renewal and particularly with our largest customers with our increased engagement at senior levels, we have much better visibility into what their pricing expectations are, what drives their decisions around here. What I would say is we've sort of shared in the past is that we don't have a concentration of renewals in any particular quarter. They generally are kind of spread out across the year.

So we have renewals in each of those quarters that results in a little less sort of a single impact from when we see those contracts renew at new pricing. But I think we have much better visibility in terms of what those adjustments might be at contract days. We certainly have good visibility to when those contracts come up for renewal.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Yeah. And just looking at it through the lens of the whole market, I think we are seeing a little bit of a change here. There's been consolidation and there's fewer players in the space and even fewer, if you look at it from really full service edge platform players. And I think that has the opportunity to make the pricing environment healthier in 2025 than we saw in 2024. And I guess I'm a little optimistic that that's exactly what we're going to see.

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

That's great. And then just one question on the AI accelerator. Can you talk about how much you've improved latency on your platform and [indiscernible] (00:41:53) cost or any color around that and what you've experienced so far?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.
A

Yeah. AI accelerator basically brings the power of the Fastly platform to LLM style solutions and I think there's a video of me doing this demo, but the reality there is using a public LLM cloud, the latency on a relatively trivial question can be five or six seconds or more and that doesn't always feel like the most human experience.

There's no reason that every single one of those requests has to go all the way back [indiscernible] (00:42:38), and we can provide Fastly speed of response here and bring those request times well below a second, while at the same time lowering the total cost of the solution to the development teams, building that type of LLM based use case.

And the most common one is like support ChatBot use case with a very, very easy developer onboarding a single line of code. Customers can leverage the power of our semantic match, the power of the Fastly cache and at the same time lower their total cost [indiscernible] (00:43:18). It's awesome. I've gotten great response from customers and the data and I'm really excited to launch in the general availability this quarter.

Operator: Your next question is from the line of Jeff Van Rhee with Craig-Hallum.

Jeff van Rhee
Analyst, Craig-Hallum Capital Group LLC
Q

Great. Thanks for taking the questions. I've got several. So maybe on the enterprise customer count, just a little clarification. I know the non-top 10 was up 20% year-over-year. So generally, other than the top 10, very good quarter, the overall sequential drop. Can you talk about the pattern of that drop? I would have expected, given the strength of the non-top 10, that you wouldn't have that many fall below your 100,000 threshold in the quarter. Any other color there that you can share?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Sorry. I shared back [indiscernible] (00:44:06). So I did dig into those numbers quite a bit. It did not when I was trying to be very sensitive to is if we saw any sort of increase in customer churn which I did not see or even customers on their way to churn. But we do have a lot of customers that will swing above or below the number.

When you look at it in the disclosures, when you look at the average dollar spent by enterprise customers and the total amount spent by all of the non-top 10 customers, I think it tells the same story. We saw some folks drift below that that 25,000 per quarter threshold [indiscernible] (00:44:47) numbers. It is not a result that I love, to be honest. And we're going to be pushing very, very hard to make sure that we are driving growth in every single account, including those mid-sized commercial/enterprise accounts, to make sure that number is really reliably growing every quarter.

Jeff van Rhee
Analyst, Craig-Hallum Capital Group LLC

Q

That's helpful. And then, I guess, Ron on the financials. I think the guide for FCF last quarter was minus $10 million to $20 million. And I think if I heard it right, you said minus $30 million to $40 million here. So pretty much the message across the board was stability is sort of in line with what you thought coming into the quarter, but that one tick lower, just talk about what happened there?

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Yeah, I think in the in the quarter, we did see a little better cash flow from operations. We did also [indiscernible] (00:45:39) CapEx was around 9% in the quarter. And so a lot of those puts and takes. The other thing that we did have relative to free cash flow impact was the impact of sort of the restructuring in the quarter of which where we prior to the restructuring didn't have that in our calculations. But we'll save more than that by the time we wrap up the year with the $14 million in OpEx savings.

Jeff van Rhee
Analyst, Craig-Hallum Capital Group LLC

Q

Okay. And maybe just last for me then the conclusion to not count on a seasonal uptick here in Q4, can you just talk about anecdotally or quantitatively just how you came to that conclusion? Just curious what evidence built you to that to assume that other than I know you guys just want to keep the expectations down and conservatism, but any color there would be great?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Yeah. I mean, I think a couple of things. I think as we go into Q4, we did see some increased strength in our largest customers across gaming and live sport. But I think we go into Q4, some of those largest customers, we're going to see somewhat lower revenue. We also see an absence of some of the true-ups that we saw in the last couple of years that contributed to that seasonal uptick in the fourth quarter. And so when we bring those two together on top of the higher revenue we saw in Q3, we end up with relatively flattish Q3 to Q4 revenue outlook.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

And note that those true ups impact not only revenue but also gross margin, Jeff.

Operator: Your next question is from the line of Rishi Jaluria with RBC Capital Markets.

Christopher Fountain
Analyst, RBC Capital Markets LLC

Q

Hi. This is Chris Fountain on for Rishi Jaluria, thanks for taking my questions. I was wondering if you could give us an update on the efforts to diversify revenue within the top 10 customer cohort. But from the standpoint of mix shift and selling more security and other services into those customers, so that way you aren't as reliant on the delivery business? Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

You know, it's top of mind and as we look at how we are approaching those top 10 customers in a new way, we have everything on the table. The portfolio expansion is certainly a big one, but we do know that their spend is primarily going to be in delivery by the very nature of their business. That doesn't mean that the stickiness can't come from bespoke compute offering, and we saw pretty good results there across the business on the compute side and certainly on the security side, we are seeing a lot of security event activity in the media space.

And so I think there is more opportunity for us to gain that stickiness from security even if the bulk of our revenue continues to come from media. But I tell you, I think we are still at the beginning of that journey largely. I don't think we've reached every – we haven't reached our full capacity in diversifying the portfolio there. And again, in 2025, security is going to be a huge part of our focus and I think that will include the media account for sure.

Christopher Fountain
Analyst, RBC Capital Markets LLC

Q

Got it. Thank you. Just one other one. How should we think about the mix of security revenue increasing and what is embedded into Q4 guidance?

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

The yeah. As far as the security mix went in Q3, I think we could do a lot better than that. To be honest, I wasn't super pleased with that result and of course, the effects of these product launches that came in this quarter during Q3 and in Q2, we haven't seen that start to show up in the revenue yet and certainly we haven't seen the full effect of our new sales leadership here. I think we can do significantly better than that and it will be a big, big focus for the company in 2025.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.

A

Yeah, the only thing I'd add, I think is – I think that to Todd's point, I think you'll really see the bigger impact as we get into 2025 with the recent releases and the efforts that Scott is putting into the go-to-market efforts.

Operator: Your next question is from the line of Madeline Brooks with Bank of America.

Madeline Brooks Q

Hi. Yes, this is [indiscernible] (00:50:23) on for Madeline Brooks at Bank of America. I have two questions for you, but I'll start with the first one. My first question is what's the strength in 3Q expected or are expected especially with the recovery you noted in the few large customers. And then can you talk about the sustainability of these trends? Were there any one-offs such as the Olympics that contributed to this outperformance?

Todd Nightingale A
Chief Executive Officer & Director, Fastly, Inc.

Go ahead.

Ronald Wayne Kisling A
Chief Financial Officer, Fastly, Inc.

Yeah, I think, we did see better-than-expected results in the third quarter as we worked through the quarter. I think, where we saw strength was, we did see some strength from live sporting events, including global events where they end up [indiscernible] (00:51:06). But we also saw strength in gaming, [indiscernible] (00:51:10) tied to the release timings and so we saw better strength there than we anticipated going into the quarter.

And then as Todd mentioned earlier, share gains outside of the top 10, that growth was we expected to see acceleration. We mentioned that on the Q2 call, but that acceleration was a little stronger than we had anticipated going into the quarter.

Todd Nightingale A
Chief Executive Officer & Director, Fastly, Inc.

And we posted 13% year-over-year growth outside the top 10 in Q2 and shifting that to 20% in Q3. Again, this transformation and real focus on diversification of our revenue, I think we're starting to see results there and that's going to [ph] lead to (00:51:49) more long-term sustainable growth for the company.

Madeline Brooks Q

Perfect. Thank you. And then just looking at, you guys have been breaking out your network service security and other revenue, which is basically compute. And I know you talked about this in the last two questions, but could you maybe talk about and possibly quantify what we will see with this mix of revenue shift over time? We see like network services has gone from like 81% to now 48%. Will we start to see more of a deceleration there with an increase in security? Or how should we think about this a year from now or going into 2025?

Todd Nightingale A
Chief Executive Officer & Director, Fastly, Inc.

Yeah, look, I believe – I don't want any of our business growth to decelerate. I want every product line to accelerate for sure. But I think the pattern of further diversification of the revenue across the product lines is exactly what you're going to see. And I certainly believe in the fullness of time, we'll see that network services revenue come well below 70% and even lower than two thirds. That is certainly possible in this market. And I think as time goes on, we're seeing more and more diversification and perhaps more and more product lines as well.

Operator: Your next question is from the line of Rudy Kessinger with D.A. Davidson.

Rudy Kessinger
Analyst, D.A. Davidson
Q

Hey, guys. Thanks for taking my questions. Ron, I'm curious, in Q4, if you could maybe just on the revenue guide, maybe break out a bit between the top 10 and non-top 10. I know last quarter, like you said, you expected the non-top 10 to accelerate. Looks like accelerated a bit more. I guess the prior commentary suggested in my head top 10 customer revenue declines to about 30% in Q4. Is that still the expectation or is it a bit lower or a bit higher just based on what you saw in Q3?

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Yeah, I mean, we don't specifically quantify it. I think, we do expect to see some additional headwinds with certain of our largest customers going into Q4. That's reflected in our guidance. You know, that likely will bring down that concentration a little bit below what we saw in the third quarter. And I think what we will see is continued strong growth year relative to maybe what we've seen in Q2 and Q3 continue into the fourth quarter.

Rudy Kessinger
Analyst, D.A. Davidson
Q

Okay. And at this point in time, I guess, do you feel like Q4 is likely less contraction in the top 10 revenue or maybe potentially some more in first half next year? And then on gross margins, even if I adjust for the 90 basis point benefit that you had in Q4 last year, still guiding to about 200 basis points of a decline or compression in your gross margins in Q4 this year. Could you just maybe unpack that a bit? What's driving it and just how should we think about gross margins going into 2025?

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Yeah, I think in your first question, I think, we do believe we moved past kind of the worst of some of the impacts from our largest customers. We certainly dramatically improved our visibility to their behavior, but there's still going to be some headwinds going into Q4. But I think we're nearing the end of those headwinds and declines we've seen amongst a subset of our largest customers. I think we've got a good strategy to keep the very front position which we have with those customers. And you'll continue to see healthy growth outside of these largest customers.

On your gross margin, I think to your point, the other dynamic on top of some of those one-time benefits is really the investment that we're seeing to drive increased bandwidth and color deployments really associated with increased international traffic is one of the headwinds. And then we're seeing increased international traffic, which today typically has lower gross margins because our volumes are lower there, although as we continue to grow that, there's an opportunity for us to bring those international gross margins more in line with what we see in our major markets.

Operator: The next question is from the line of the Fatima Boolani with Citi.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.
Q

Oh, good afternoon. Thank you for taking my question. Todd, can you speak to the composition of the top 10 customers today versus a year ago? I can appreciate that you've been very, very hard at work to diversify away from this group and have done a good job kind of growing outside of that. But just curious if you can give us some color on what the composition of that top 10 today is versus a year ago? And then I have a follow-up as well.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.
A

Sure. It tends to be very media heavy. That doesn't just mean streaming video, but it could mean folks in the gaming space and the bulk download space of one kind or another. And some of those organizations have additional business as well attached that might look more like traditional web business. But of course, [indiscernible] (00:57:14) all from the same account.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.
Q

Got it. And Ron, you were kind of alluding to this and you've kind of discussed a number of factors around ongoing headwinds. But the magnitude of some of those headwinds maybe shrinking as we progress through into fourth quarter and maybe the start of next year, but when I specifically think about the net retention rate compression, when and where should we see this troughing out as it relates to what type of visibility you have in the business? If you can give us some kind of clues or some help or some guardrails on when we should trough out on the net retention rate compression trends. Thank you.

Ronald Wayne Kisling
Chief Financial Officer, Fastly, Inc.
A

Yeah, it's a good question. I think as we move into next year and as I said, think a lot of the headwinds from large customers are behind us. Given that the ARR is done on LTM basis, that's going to mute or slow kind of the growth out of where we see LTM NRR. So I would expect that we would see some expansion as you move in to sort of middle of the year and second half as you see some of the headwinds that we saw in 2024 drop off of the LTM calculation.

Operator: Our final question will come from the line of Jonathan Ho with William Blair.

Q

Hi, this is [indiscernible] (00:58:48) for Jonathan Ho, and thanks for taking my question. I'd like to go back to the security business and just to get some additional color on, where you're maybe seeing some more success. And then on the flipside, where are you seeing things potentially slow just in terms of type of customer or any specific products? Thanks.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.
A

Yeah, I think there's been a lot of success, especially around the last part of our security portfolio where I really believe we have a technology advantage across the board. The efficacy of that product is really a cut above and it leads our users to be able to run it in full blocking mode and get really the full value, not just the alerting.

In the platform, we've seen a lot of loyalty there and over the last year or so we've really moved all of that technology to be fully enabled on the Fastly platform so that the power of our edge and infrastructure is now deployed there, along with DDoS and bot, a very complete solution.

So think that unification of the platform is driving a lot of our confidence here and the way I see customers engaging with that last technology and now the add on as bot and adaptive DoS technology, DDoS prevention, I feel really good. I think it has the biggest upside outside of media especially in verticals like e-commerce, hospitality, travel, logistics, et cetera, fintech and it has a real potential for us is this untapped penetration into our existing delivery customers. And so I think there's just sort of upside and security. That's why it's going to be such an important focus for us in 2025.

Q

Thank you.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

A

Thanks.

Operator: I will now hand the call back over to CEO, Todd Nightingale.

Todd Nightingale
Chief Executive Officer & Director, Fastly, Inc.

Thanks so much. I want to thank our employees, customers, partners and our investors. We remain focused on execution on bringing lasting growth to our business and delivering value to all of our shareholders. Thank you so much for your time and your attention today.

Operator: This concludes today's call. Thank you for joining. You may now disconnect your lines.