Fastly Research (10/18/19)

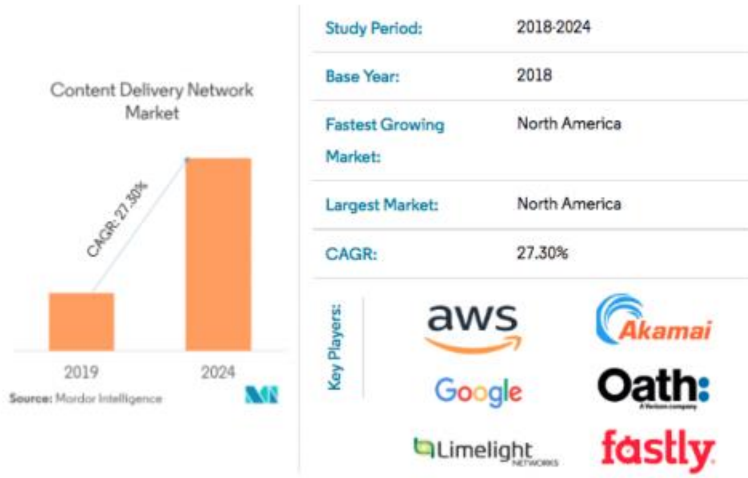
Description: Fastly, Inc. operates an edge cloud platform for processing, serving, and securing its customer's applications. The edge cloud is a category of Infrastructure as a Service that enables developers to build, secure, and deliver digital experiences at the edge of the Internet. It is a programmable platform designed for Web and application delivery. The company's edge network spans 60 points-of-presence worldwide. It serves customers operating in digital publishing, media and entertainment, technology, online retail, travel and hospitality, and financial services industries. The company was formerly known as SkyCache, Inc. and changed its name to Fastly, Inc. in May 2012. Fastly, Inc. was founded in 2011 and is headquartered in San Francisco, California.

Ticker: FSLY
Price: $23.46
Market Cap: $2.3B
Performance: +46.6% From IPO Price of $16 in mid-May 2019
Dividend Yield: N/A

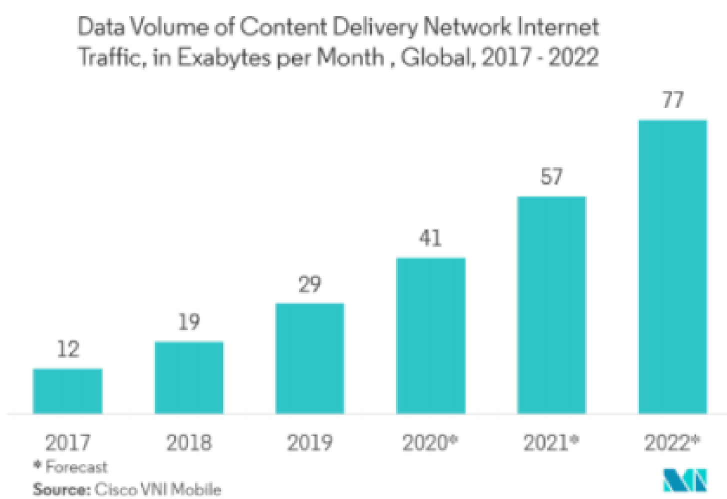
Analysis

Fastly (FSLY) is a new tech company on the markets that went public in mid-May. The company operates in the Content Delivery Network space and their most relevant peers are that of LimeLight Networks (LLNW), Akamai Technologies (AKAM), and Cloudflare (NET), which also just went public even more recently.

Before beginning, it's important to discuss the global CDN space. First and foremost, the industry is expected to grow at healthy pace. Analysts believe the global Content Delivery Network Market size is projected to grow from $12.4B in 2018 to $22.1B by 2024, at a CAGR of 27.30% during 2018–2024.



As we examine the global landscape of internet consumption, the trends only point north. The total world population using the internet stands at only 56.3%. Sometimes we get caught up in our own little world here in the States, but this just signals how much potential still remains for the CDN market and overall internet as a little less than half of the world's population still isn't on the web. As a result of oncoming demand, Cisco believes the amount of exabytes (a unit of information equal to one quintillion bytes, or one billion gigabytes) per month used globally will skyrocket from 29 to 77. In other words, by 2022 Cisco expects the world to use 77B gigabytes per month or 77,000,000,000,000,000,000 bytes per month.



What's the point of bringing all this up? Individuals and companies of all sizes will not want but rather require that their experience on the web from both a user and host will be pleasant.

Companies in the CDN space like LimeLight, Akamai, Fastly, Cloudflare, and many others are built on ensuring that users have a seamless experience by providing the following solutions:

1. Improving website load times - By distributing content closer to website visitors by using a nearby CDN server (among other optimizations), visitors experience faster page loading times.
2. Reducing bandwidth costs - Bandwidth consumption costs for website hosting is a primary expense for websites. Through caching and other optimizations, CDNs are able to reduce the amount of data an origin server must provide, thus reducing hosting costs for website owners.
3. Increasing content availability and redundancy - Large amounts of traffic or hardware failures can interrupt normal website function. Thanks to their distributed nature, a CDN can handle more traffic and withstand hardware failure better than many origin servers.
4. Improving website security - A CDN may improve security by providing DDoS mitigation, improvements to security certificates, and other optimizations.
5. Optimal streaming capabilities – As the global economy moves towards cord cutting, CDN's make streaming much better and this entails video on demand, gaming, music, etc.

As a side note, one interesting example that I recall from listening to Kevin O'Leary speak at a recent live event was his investment in Wicked Good Cupcakes. Mr. Wonderful explained to us that before the show aired on ABC he had to dial his friends at TD Ameritrade to allow Wicked Good Cupcake to use their bandwidth to handle all of the traffic on Wicked Good's site. O'Leary mentioned that the next day the show aired on CNBC he got a call from TD saying that the amount of traffic generated almost took down TD's servers.

I bring this point up because this is exactly the market Fastly and the others are catering to. In today's day in age, content consumption and the speed and flawlessness of delivery is crucial for people and businesses alike and we simply can't afford down time online otherwise sales go out the door and straight to competition. Even a site taking too long to load by a few seconds can mean millions of dollars in lost revenue every year.

As a result, that's why FSLY has experienced such high growth rates. In their most recent quarter, FSLY posted Q2 non-GAAP EPS of -$0.16 missing estimates by $0.03 on revenue of $46M (+33.6% Y/Y) beating by $0.69M.

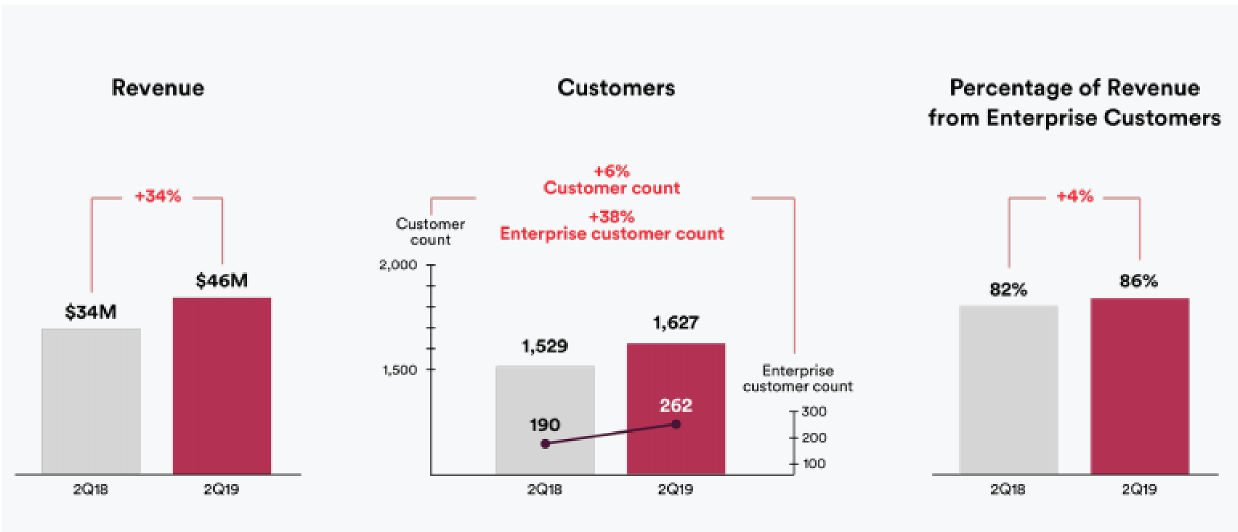
The market didn't take too well to this report but shares have bounced back since. Some other measures that need to be noted include:

- Continued momentum demonstrated by a strong Dollar-Based Net
- Expansion Rate (DBNER) of 132%, up from 130% in Q1 2019
- Total enterprise customer count of 262, up from 190 at the end of Q2 2018
- Enterprise customers generated 86% of our trailing twelve month total revenue, up from 82% at the end of Q2 2018
- Total customer count of 1,627, up from 1,529 at the end of Q2 2018
- Average enterprise customer spend of approximately $556,000, up 4% from Q2 2018
- Gross margin of 55%, indicative of accelerated investment in preparation for a seasonally strong second half of the year
- GAAP operating loss of $12 million; Non-GAAP operating loss of $9 million
- GAAP basic and diluted net loss per share of $0.26
- Non-GAAP basic and diluted net loss per share of $0.16
- Continued expansion of network with 64 Points of Presence (POPs) online, providing access to 52 Tbp/sec of global network capacity

	Three months ended June 30,		Six months ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Condensed Consolidated Statement of Operations:				
Revenue	$ 46,173	$ 34,448	$ 91,729	$ 66,946
Cost of revenue (1)	20,784	15,695	40,502	31,079
Gross profit	25,389	18,753	51,227	35,867
Operating expenses:				
Research and development (1)	11,244	8,099	21,420	16,078
Sales and marketing (1)	16,906	11,973	31,945	24,316
General and administrative (1)	8,920	4,130	17,620	9,832
Total operating expenses	37,070	24,202	70,985	50,226
Loss from operations	(11,681)	(5,449)	(19,758)	(14,359)
Interest income	861	147	1,277	284
Interest expense	(2,989)	(359)	(4,224)	(740)
Other expenses, net	(1,696)	(140)	(2,472)	(234)
Loss before income taxes	(15,505)	(5,801)	(25,177)	(15,049)
Income taxes	82	35	137	93
Net loss attributable to common stockholders	$ (15,587)	$ (5,836)	$ (25,314)	$ (15,142)

Across the board, the business is growing and this is great to see but there are some blemishes. Most importantly, losses have come in greater than expected as the company is nowhere near profitable, losing $15.5M on quarterly revenue of $46.2M implying -33.5% profit margins. Halfway through the year, the profit margin stands at -27.4%, so a worsening in this number in Q2. The research and development costs are necessary at this point in time as it is crucial FSLY builds out their network to grow their revenues but seeing general & admin costs double is a bit alarming. When analyzing the financials, it looks as though profitability is a long way from happening.

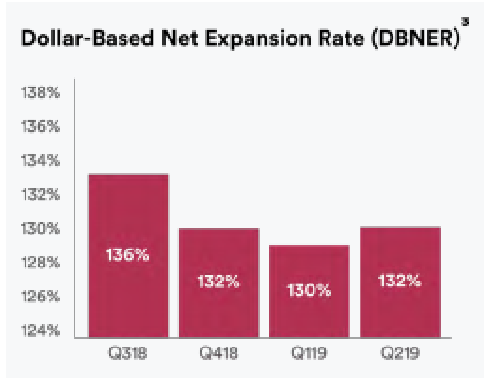
Secondly, the Q2 gross margins were 55% compared to 57% in Q1 and 54% in last year's quarter. This is pretty weak for the industry as Cloudflare's most recent gross margins are 77% and AKAM's gross margins are near 66%. LLNW's are a bit lower at 50.4%.



As per the latest 10Q, their 10 largest customers generated an aggregate of 30% and 35% of revenue in the trailing 12 months ended June 30, 2019 and 2018, respectively. This is good to see as it is extremely important that FSLY does not depend on such a small group of clients to make up such a large amount of revenues. CUBE anticipates this number to continue to fall and is a bright spot on top of their growing clientele which now stands at 1,627.

One of the bright spots that I don't think gets enough attention is FSLY's dollar-based expansion rate. This metric pretty much tells us what their current customers are spending with them throughout time. They calculate it by dividing the revenue for a given period from customers who remained customers as of the last day of the given period by the revenue from the same customers for the same period measured one year prior. period.

This number was starting to track downwards but it rose in Q2 to 132%.



For additional reference, their expansion rate was 147.3%, 132.0%, 140.3%, and 130.4% for the years ended December 31, 2017, December 31, 2018, and for the three months ended March 31, 2018 and 2019, respectively.

Looking ahead, FSLY expects growth Q/Q to rise about 4% and sees revenue growth for the year to be around 33.2% at the mid-range as revenue in 2018 was $144.5M.

Loss per share in 2017 was -$0.69, followed by -$0.63 in 2018, and is expected to be between -$0.51 and -$0.59 for 2019. CUBE would like to see this pace pick up much more in 2020 otherwise the Street may begin to get impatient.

	Q3 2019	CY 2019
Total Revenue	$47 - $49 million	$191 - $195 million
Non-GAAP Operating Loss	($13) - ($11) million	($40) - ($34) million
Non-GAAP Net Loss per share	($0.15) - ($0.12)	($0.59) - ($0.51)

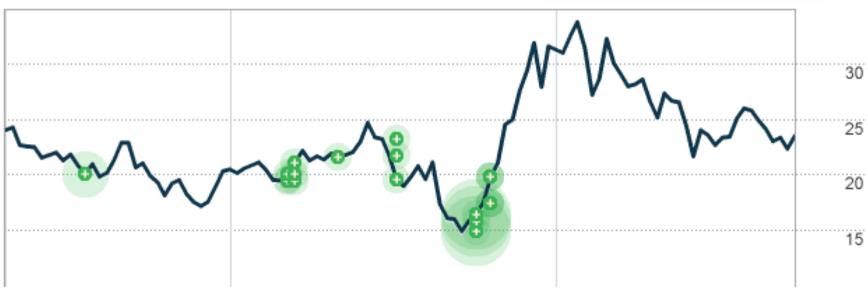
How do these stats compare to their competitors?

	FSLY	AKAM	LLNW	NET
Revenues TTM	$169.3M	$2.79B	$184.5M	$234.7M
P/S 2019 Revs	11.5x	5.3x	2.2x	17.0x
P/S 2020 Revs	8.7x	4.9x	1.95x	12.8x
Operating Cash Flow	-$15.6M	$318M	-$1.9M	-$6M
Gross Margins LTM	55.8%	65.4%	49.3%	77%
Rev Growth	33%	6.4%	4.1%	48%

CDN stocks are very unique in the fact that each and every one of these companies is in a different position. FSLY and NET are both in growth mode but have very different gross margins. At the same time, NET is valued at a much higher premium while AKAM is the established, lower growth, cash flow positive, and profitable player. At the same time, LLNW is the cheapest of the bunch fundamentally because the company has been battling negative growth and missed guidances for a while and also has the weakest margins of them all.

One thing has been for sure, Abdiel Capital has been adding to their position in FSLY big time and is much of the reason shares have skyrocketed from $16 to $35 after the earnings report. Take a look below to see some of the transactions:

Tran Date	Form	Insider	Code	10b5-1	Direct	Share Price	Shares Changed	Remaining Shares	Post Value
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	24.47	1,725	3,895,982	95,334,680
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	24.47	57,054	3,894,257	95,292,469
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	23.86	226	3,837,203	91,555,664
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	23.86	7,474	3,836,977	91,550,271
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	23.16	746	3,829,503	88,691,289
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	23.16	24,690	3,828,757	88,674,012
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	21.93	625	3,804,067	83,423,189
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	21.93	20,694	3,803,442	83,409,483
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	20.99	657	3,782,748	79,399,881
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	20.99	21,758	3,782,091	79,386,090
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	19.96	439	3,760,333	75,056,247
2019-08-22	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	19.96	14,531	3,759,894	75,047,484
2019-08-21	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	21.32	3,663	3,745,363	79,851,139
2019-08-21	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	21.32	121,619	3,741,700	79,773,044
2019-08-21	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	20.71	2,432	3,620,081	74,971,878
2019-08-21	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	20.71	80,738	3,617,649	74,921,511
2019-08-20	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	19.82	1,315	3,536,911	70,101,576
2019-08-20	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	19.82	43,763	3,535,596	70,075,513
2019-08-20	4	Abdiel Capital Management, LLC By Abdiel Capital, LP	P - Purchase		I	19.14	3,151	3,491,833	66,833,684
2019-08-20	4	Abdiel Capital Management, LLC By Abdiel Qualified Master Fund, LP	P - Purchase		I	19.14	104,814	3,488,682	66,773,373



The firm has been adding shares aggressively since July and now owns approximately 4M shares, or a $95M stake.

All in all, we expect FSLY to continue growing and are impressed by their superior net dollar expansion rates but the fact they have are nowhere near profitable or cash flow positive has us concerned. At double the P/S metrics than an established player like AKAM, we worry that if growth at FSLY dips under 30% without any sign of profitability in the next 2-3 years, shares can see a sharp adjustment in valuation to the downside. The overall CDN space is growing rapidly and out of all of the names it's tough to decide which is best because we prefer NET's margins, growth, and lesser cash flow burn than FSLY but the valuation at 17x this year's sales is just a bit too rich. On the flipside, there isn't too much upside potential with regard to growth at AKAM and we don't really want to bet on a comeback story in LLNW despite the cheaper valuation as management over there has hurt investors countless times. Personally, CUBE will stand on the sidelines until it becomes a bit more clear and evident who stands to gain the most in this space.

Technical Analysis

At this price range, we think FSLY is finding some decent support as the 100DMA is $22.77. That should serve a decent line to hold but it is tough to say because FSLY is a new stock on the market and has just started having a 100DMA so we don't know how good of a support is truly is. The stock was unable to break through the pivot point of $26.65 so that will serve as a ceiling in the near-term. The fact that it not only got rejected by that level but was also unable to hold its 50DMA of $24.95 is also concerning as it seems the stock has now lost a lot of momentum. CUBE expects shares to test the 100DMA and doesn't see shares falling to the high teens at this moment simply because Abdiel Capital has shown consistently they are ready to add on dips in that range so even if it does happen it will most likely be short-lived.

Given all of this, FSLY does have a pretty small free float of shares so the stock is very volatile and it may me one of those cases where it is more profitable to swing than it is to invest as the company still has a lot they need to work out from a fundamental standpoint with regard to earnings and cash flow. Seeing Abdiel hold off purchasing above the $24.50 mark also has us not wanting to do the same thing. If shares did fall back to the $16-18s it would be something CUBE considers, though.