



Is Cloudflare a Buy After Its 20% Post-IPO Pop?

Description

Cloudflare ([NYSE: NET](#)) made its public debut in September 2019, [rising 20%](#) in its first day of trading, which valued the cloud-based internet security and app delivery software suite at \$1.5 billion. [Cybersecurity](#) has been a fast-growing segment of the technology industry, and numerous start-ups have had IPOs this year to capitalize on the trend. Infused with new cash from the sale of shares, Cloudflare looks like it has a bright future ahead. As with all new public companies, though, a lot can go right, but a lot could go wrong too.

What Cloudflare does

Cloudflare describes its numerous services as disruptive to current IT markets, offering things like VPNs, firewalls, app and content delivery controls, and domain name systems. The cloud-based software suite is aimed at businesses large to small, and some products are free to use — like the company's 1.1.1.1 mobile app, which is designed to speed up and add security to an internet connection (for business and personal use).

Cloudflare is hard at work adding more adjacent products to its lineup, addressing 5G mobile networks, Internet of Things (IoT) solutions, and computing and storage solutions. Cloudflare cites an IDC study showing that its current core portfolio of software competes for \$31.6 billion a year in spending, with that number expected to grow an average of 10.5% a year to \$47.1 billion by 2022.

The promising numbers

Although a small outfit at this point, Cloudflare boasts having 10% of the Fortune 1,000 as paying customers. The company also says 70% of its customers use at least four products. That obviously leaves a lot of room for further expansion — by acquiring new customers and also expanding relationships with existing ones.

The sales strategy has yielded some impressive results. Revenue of \$84.8 million in 2016 grew to \$192.7 million in 2018, and a high-double-digit rate of growth continued through the first six months of

2019.

Metric	Six Months Ended June 30, 2019	Six Months Ended June 30, 2018	Change
Revenue	\$129 million	\$87.1 million	48%
Gross profit margin	77.4%	77.8%	(0.4 pp)
Operating expenses	\$137 million	\$99.1 million	38%
Net earnings (loss)	(\$36.8 million)	(\$32.5 million)	N/A

Pp = percentage point. Data source: Cloudflare.

As is par for the course for high-octane software firms, Cloudflare boasts profit margins close to 80% on services sold but has high operating expenses to maximize the top line. The company hasn't turned a corner on the bottom line yet, and free cash flow (basic profits calculated by subtracting cash expenses and capital expenditures from revenue) was negative \$39.0 million during the first half of 2019. That leaves investors with nothing more than the price-to-sales ratio to stick a value on the stock — which currently sits at 6.4 times trailing 12-month revenue.

A crowded space and “unique” share structure

Investors who purchase Cloudflare would obviously be making a bet on the long term, hoping for a bigger future payoff in exchange for operating losses now. With the world of IT only getting bigger, it's not a far-fetched hope that Cloudflare will be able to grow its sales in the next decade. However, that price-to-sales ratio of 6.4 is far lower than other recent IPOs. [Fastly \(NYSE: FSLY\)](#), for example, which also provides web content delivery, currently has a price-to-sales ratio of 15.5. Endpoint security specialist [CrowdStrike Holdings \(NASDAQ: CRWD\)](#) goes for a sizzling 45.5. Even cybersecurity industry leader **Palo Alto Networks** (NYSE: PANW) — “only” growing sales by about 20% a year — goes for 7.0 times 12-month revenue.

There are a few factors at work. First, according to Cloudflare's financial statements, revenue has decelerated. Year-over-year 2017 sales growth was 59%, and that rate fell to 43% in 2018. The first half of 2019 would imply reacceleration with a reported 48% year-over-year increase, but it's worth bearing in mind that [security and web delivery is a crowded space](#) right now. As Cloudflare expands, it is going to bump into competition and face some pushback from the incumbents it is trying to replace, which will inevitably force a slowdown from its current torrid pace.

The bigger issue investors might be eyeing, though, is the share structure. When Cloudflare had its IPO, it issued new shares (Class A stock) that get one vote per share on corporate decision making. Existing shareholders, management, and the company's more than 1,000 employees all hold Class B stock, which get 10 votes per share. If you're a small investor, voting rights might not matter much directly, but this does affect institutional and other large investors. Concentrated voting rights with insiders could be viewed negatively, and it could reduce demand for shares and put a cap on Cloudflare's valuation down the road and limit outsiders from having a say on the direction of the business.

As long as results continue to go swimmingly, there should be no issues with that. Nevertheless, there are risks: operating losses and cash burn, heavy competition, and a share class structure that might give some big investors pause. For investors willing to go through some serious roller coaster-like

swings, Cloudflare looks like a decent bet. I'd caution against making a purchase just yet or advise at least keeping an initial position small, as I like to await a quarterly earnings report and management comments first before making a final decision. But with the business growing fast and Cloudflare's end markets getting bigger, this one is at least worth keeping on your radar.

CATEGORY

1. Investing
2. Tech Stocks

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1. Syndicated

TICKERS GLOBAL

1. NASDAQ:CRWD (CrowdStrike)
2. NYSE:FSLY (Fastly, Inc.)
3. NYSE:NET (Cloudflare Inc.)

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