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Confluent, Inc. (CFLT)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Shane Xie
Director, Investor Relations, Confluent, Inc.

Hi, everyone. Welcome to the Confluent Q2 2021 Earnings Conference Call. I'm Shane Xie from Investor Relations and I'm joined by Jay Kreps, Co-Founder and CEO; and Steffan Tomlinson, CFO.

During today's call, management will make forward-looking statements including statements regarding our financial outlook for the third quarter and full year 2021, the expected performance of our product offering, increased adoption of our platform, growth in our customer base, our market opportunity, our ability to capitalize on the shift to cloud, growth in Confluent Cloud revenue, our long-term growth and our overall future prospects.

These forward-looking statements are subject to risks and uncertainties, some of which are beyond our control which could cause actual results to different materially from those anticipated by these statements. Additional information on risk factors that could cause actual results to differ is included in our SEC filings, including our IPO prospectus dated June 23, 2021 and Form 10-Q for the quarter ended June 30, 2021 that will be filed with the SEC today. We assume no obligations to update these statements after today's call except as required by law.

As a reminder, certain financial measures used on today's call are expressed on a non-GAAP basis. We use these non-GAAP financial measures internally to facilitate analysis of our financial and business trends and for internal planning and forecasting purposes. These non-GAAP financial measures have limitations and should not be considered in isolation from or as a substitute for financial information prepared in accordance with GAAP. A reconciliation between these GAAP and non-GAAP financial measures is included in our earnings press release and supplemental financials, which can be found on our Investor Relations website at investors.confluent.io.

And with that, I'll hand the call over to Jay.

Edward Jay Kreps

Co-founder, Chief Executive Officer & Director, Confluent, Inc.

Thanks, Shane. Welcome to our second quarter earnings and this will be our first earnings call as a public company. I'm excited to be here today and I want to start by thanking our employees, our customers, our partners, and our investors all of whom helped us get here. I appreciate the support and I look forward to what's ahead.

I'm pleased to report that we began our life as a public company with strong second quarter results. Revenue growth in the second quarter accelerated to 64% year-over-year totaling $88.3 million. Confluent Cloud revenue continued to outpace growth of our overall business with growth of 200% year-over-year. This is a significant acceleration from the trailing 12-month growth rate of 134%. Confluent Cloud now accounts for 22% of total revenue.

I'm extremely pleased with the results our team delivered and we're well positioned for the quarters ahead. Before I get into the details of the quarter, I think it would be helpful to provide an overview of our business for those new to the story, as well as some perspective on the factors driving the rise of data in motion.

We're living in a digital-first world. The role of software has fundamentally changed how companies operate and how they engage with customers. Software has moved from applications around the edge of a company to the very core of how companies do business. This is really an end-to-end reimagining of companies from the front end customer interactions to the back end operations that drive how companies produce and deliver their products and services. And this is happening across companies of all sizes, in all geographies, and virtually every industry.

The change in the role of software is driving a corresponding change in the role of data. Historically, companies operated on a paradigm of data at rest, where data was stored in disparate databases across the IT stack. This was sufficient when the applications using this data operated largely as disconnected islands, mostly outside the core operations of the business. However, modern software applications need to integrate and work together to drive cohesive real-time operations of experiences.

This need to connect disparate systems and move operations into real-time has driven a need for data in motion. With data in motion, organizations have ubiquitous access to data in real-time as it's generated. This enables all the disparate systems in a company to react and respond to whatever is happening. Data in motion represents a major new category in the world of data infrastructure, one that my co-founders and I pioneered starting during our time at LinkedIn with the development of Apache Kafka and continuing on to Confluent where we built the modern platform for harnessing data in motion.

This new category has gone mainstream. Confluent is now helping to power use cases in virtually every industry and with companies of all sizes including cloud native companies like Square, Grab, Xero and many more. In addition, Walmart is using data in motion to build real-time inventory updates. The CDC uses data in motion to stream data from healthcare and testing facilities across the US for accurate insights into the state of the COVID-19 pandemic. Citigroup combines historical and real-time data to provide sophisticated analytics to equity traders.

Confluent sits at the center of the rise of data in motion. Our goal is to create a central nervous system for organizations by connecting applications and infrastructure around real-time data streams. We believe this central nervous system is easily the most strategic part of the emerging next-gen data stack.

I'd also like to address why Confluent has emerged as a leader in this space and our strategy for continuing that leadership. A primary reason is the unique differentiation in our product offering. The combination of moving first in our space, getting to scale the investment earlier, having a more complete vision, and working with the best customers has helped us build a product for data in motion that has significant advantages over open source Kafka or any other competitive solution.

I'd like to use the call to give an overview of these advantages as well as some of the new features we've launched in Q2. We think of ourselves as building around three key pillars of differentiation – being cloud native, being complete, and being everywhere. I'll address each of these in turn and discuss some of the recent updates in each of these areas.

First, cloud native. We've taken open source Kafka and built something that's completely redesigned as a cloud native service. There is a fundamental difference between software solutions that are designed for on-premise environment and put in the cloud versus platforms that are built to operate as elastically scalable multi-tenant cloud services. This distinction cuts right to the heart of how these systems are built and it's incredibly important to customers in selecting the products they use. Our cloud product offers the protocol of Kafka on a platform that is fundamentally re-architected as this kind of elastic cloud system.

What that means is that it's serverless. This means customers don't need to think about managing individual servers, their memory or CPU or other low level characteristics. It's elastic. It can scale up and down as needed with load automatically balancing as the customer's needs and usage patterns change.

It also integrates natively with the vast array of cloud networking security and other technologies in the major cloud providers to help customers manage their data easily and securely. In the second quarter, we added several features that strengthen our cloud native capabilities. We added support for Azure Private Link. This is Azure's private networking layer that allows usage of Confluent with additional security and control of the connectivity, and it deepens our integration in Microsoft Azure.

We also added role-based access control and audit logs within Confluent Cloud, strengthening our security story. These security features enhance the overall value of our platform by enabling customers to spend more time building impactful customer experiences and products versus implementing security controls that are not core to their business.

A good example of a customer putting our cloud native capabilities into practice is AO.com which expanded its usage in the second quarter. AO.com is a digital retailer in the UK and they leverage data in motion to treat each customer visit as a unique moment, combining real-time digital signals with historical purchase information to give customers a hyper-personalized experience. Confluent Cloud allows AO to deliver capabilities at a rapid pace and to do so with the security features needed by its privacy and compliance regime. Pace became even more crucial during the pandemic because the world moved so rapidly from predominantly in-store shopping to online. The speed at which AO was able to create new use cases that improved the customer journey with Confluent Cloud is helping AO to cement its online market leadership position even as it continues to adapt to ongoing changes.

The second pillar of our product differentiation is completeness. Kafka is the foundational layer in the emerging stack for data in motion. But to make harnessing data in emotion easy, customers need a complete offering that makes developing in this new paradigm easy. We have hundreds of features that are central to the modern data in motion stack and I'll highlight a few key ones which represent significant investment by Confluent.

First, we have over 120 connectors that make it easy to capture or deliver real-time data streams from existing databases, infrastructure layers, SaaS, APIs, and cloud services. These connectors mean customers can set their data in motion without spending years writing integration code. Second, we offer advanced stream processing capabilities in a familiar package with ksqlDB. This is a layer that brings SQL, the language of traditional databases, to the new world of data in motion. This lets engineering teams use the skills they've spent years developing to work with data in this new paradigm.

In the second quarter, we made great progress extending the completeness of our platform. We announced the availability of the fully managed connectors for MongoDB Atlas as well as Datadog, and we're excited to offer this integration into other best-of-breed platforms. We also launched significant features in ksqlDB that extend the richness of its ability to process data in motion and query the computed results.

The completeness of our platform was a driver in the second quarter for traction with a new customer, the Department of Veterans Affairs. The VA purchased Confluent in order to modernize the service it provides to veterans and increased the speed of delivery. This effort reduces the reliance on legacy applications, improves the timelines and quality of benefit claims processing, and enables the reuse of developed capabilities while reducing rework for the VA. Confluent IP that is critical to the VA includes our Oracle CDC Connector, Multi-Tenant Security, FIPS 140-2 compliance. And for example, the VA is modernizing their claims processing application from an offline batch processing job that distributes 1.2 million veteran claims nightly to a real-time processing solution that results in faster and more accurate benefits delivery to veterans.

The third pillar of our product differentiation is being everywhere. Just as a central nervous system needs to span all the parts of the body, Confluent needs to span all the environments a modern company operates in and connect them all seamlessly into one fabric for data in motion. This means operating across all three major clouds as well as legacy on-premise and private cloud environments. By having one platform that spans these, customers can tap into data, locked up in legacy systems on-premise, and open that up to modern applications in the cloud, connecting these all seamlessly and securely through Confluent.

This capability is a core requirement for our customers' hybrid cloud and multi-cloud strategies, and it's uniquely differentiating for Confluent as we're the only provider in the data in motion space to span all these environments. A perfect example of this is BMW. By adding Confluent Cloud and extending the use of Confluent platform, we're helping BMW Group to optimize all of its production and logistics processes which can help us everything from the time of a car is ordered to when it's delivered. Hundreds of applications that cover these processes will run through Confluent. BMW Group will leverage Confluent to support its IoT environment across its 24 manufacturing plants.

In the second quarter, we strengthened our everywhere story with the launch of Confluent for Kubernetes or CfK. CfK lets customers get many of the cloud native benefits of Confluent Cloud in Kubernetes-based private cloud environments on-premise. It provides a complete API-driven experience for deploying and self-managing Confluent platform. We also expanded to six new cloud regions, making Confluent Cloud available in a total of 59 regions across AWS, GCP, and Azure.

We also launched Health+, which provides real-time visibility to customers to ensure the health of their data in motion infrastructure in on-premise environments. Traditional on-premise infrastructure support is a slow process of reactively diagnosing issues working with a vendor support team, involving lots of painful back and forth, and often protracted downtime while diagnosing issues. In order to operate the thousands of clusters in Confluent Cloud, however, Confluent has developed advanced capabilities for continuously monitoring thousands of Confluent clusters and using algorithms to make these operations reliable, efficient, and proactive.

With Health+, we are now beginning to extend these cloud-based capabilities to our on-premise customers allowing them to send a continuous stream of monitoring data from their on-premise environments into Confluent Cloud and plugging into the same data in motion platform that powers our cloud operations to help them optimize, monitor, and ensure the availability of Confluent in their on-premise environments.

The importance of Confluent to hybrid and multi-cloud architectures was further highlighted by the growing relationships that we have with the major cloud providers. Just last month, we were named a Google Cloud Partner of the Year for the third year in a row. Google Cloud has recognized our leadership as a technology partner for smart analytics, highlighting our commitment to customer success, and delivery of innovative impactful solutions on Google Cloud.

These three pillars – being cloud native, being complete, and being everywhere – are what we've built around for many years now and would have led us to have the leading product in this emerging space. We think we're in the very early innings of a large opportunity ahead of us and we're really excited to continue executing on this strategy to become the industry standard for setting data in motion.

With that, I'll turn the call over to Steffan to walk through our financials.

Steffan C. Tomlinson

Chief Financial Officer, Confluent, Inc.

Thanks, Jay. Good afternoon, everyone. I'm pleased to be here with such a great team. In Q2, we successfully completed our IPO and delivered strong operating results. Since this is our first earnings call, I'll provide an overview of our differentiated business model. We designed our business model to empower our customers to harness data in motion everywhere their data and applications reside. We sell our software platform as two subscription offerings – Confluent Cloud and Confluent Platform.

Confluent Cloud is a fully managed cloud native SaaS offering available in AWS, Azure, and GCP. Customers can either purchase credits as part of a committed contract or sign up with a credit card under a pay-as-you-go model. Revenue is recognized based on consumption. Confluent Platform is an enterprise-ready, self-managed software offering that can be deployed in our customers' on-prem, private cloud and public cloud environments.

A portion of revenue is recognized upfront is licensed and a substantial majority is recognized ratably over the contract term. Confluent Cloud and Confluent Platform together make up our subscription revenue which typically accounts for 85% to 90% of total revenue. The remaining 10% to 15% comes from our services offering which is attached to our subscriptions. Services revenue is recognized as delivered.

Given the various revenue components and billing terms in our model, remaining performance obligations, or RPO, and current RPO rather than billings are important metrics to measure the health of the business. RPO provides insight into the organic momentum of our business as it represents contractually committed revenue to be recognized in the future regardless of billing terms and variability in cloud consumption patterns.

Now, let's turn to the results. Q2 was a robust quarter with strong customer momentum and accelerated top line growth and net retention rate, demonstrating the power of our platform and our land and expand strategy. I'll start with the customer momentum we saw in the quarter. Leveraging the self-service motion and pay-as-you-go arrangements in our Confluent Cloud offering, we've been able to significantly broaden our number and reach of customers in both the enterprise and commercial segments.

In Q2, we added approximately 290 net new customers bringing our total customer count to 2,830, up 104% year-over-year. As customers see the value of our offering for their initial use cases, they often expand into more use cases and other lines of business across their organization. This expansion effect is reflected in the strong growth of our large customer base. We ended the second quarter with 617 customers with at least $100,000 in ARR, up 51% year-over-year, and 70 customers with at least $1 million in ARR, up 112% year-over-year.

Another key metric of customer success is dollar-based net retention rate, or NRR. In Q2, NRR was above 130% compared to 117% in the prior quarter. The robust improvement was driven by strong renewals and expansions across both our subscription offerings. We've seen quarterly fluctuations in NRR in the past and we expect the fluctuation to continue due in part to the timing of large initial deal sizes expanding in the first year, the transition of our cloud business to usage-based billing and churn.

We're operationally focused on driving NRR consistently above 120% in the near term and our goal longer term is to drive it consistently above 130%. Going forward on a quarterly basis, we plan to report NRR relative to our near-term target threshold of 120%.

Turning to revenue, we saw growth acceleration across all of our revenue components. Total revenue was $88.3 million, growing 64% year-over-year, a significant acceleration from Q1. Subscription revenue was $78.5 million, up 67% year-over-year and accounted for 89% of total revenue. The two components of our subscription revenue continue to exhibit strong growth. Confluent Platform revenue was $58.8 million accelerating to 46% growth year-over-year and accounted for 67% of total revenue.

Confluent Cloud revenue was $19.7 million accelerating to 200% growth year-over-year and accounted for 22% of total revenue, up 4 percentage points sequentially and up 10 percentage points from a year ago. As more organizations extend their data in motion platform to the cloud, we believe we're positioned to capitalize on the secular trend of cloud migration.

From a geographic mix standpoint, we continue to see strong demand for our offerings around the world. Revenue from the US grew 58% year-over-year to $56.8 million representing 64% of total revenue. Revenue from outside the US grew 77% year-over-year to $31.5 million, representing 36% of total revenue, up 3 percentage points from a year ago. We're still in the early innings of our international expansion, and we see a significant opportunity in front of us. We'll continue to invest in local operations in the highest propensity countries where we see increasing Kafka adoption. We expect these targeted investments to drive our international revenue mix higher over time.

Turning to remaining performance obligations. We ended the second quarter with $327.2 million in RPO, up 72% year-over-year. Current RPO, which we estimate to be 69% of RPO, was approximately $224.6 million, up 63% year-over-year. As a reminder, our current RPO is an estimate and could fluctuate due to the variability of consumption patterns of our cloud customers.

Our growth acceleration in RPO was driven by the broad-based momentum across our product offerings with Confluent Cloud's triple-digit growth being the largest driver. RPO also benefited from a large multiyear expansion deal. While the deal had a modest impact on Q2 revenue, it increased the growth rate differential between RPO and current RPO.

Before turning to gross margins and profitability, I'd like to note that I'll be discussing non-GAAP results unless otherwise noted. Q2 total gross margin was 70.1%, up from 68.7% a year ago. Subscription gross margins which include Confluent Cloud and Confluent Platform, were 77%, up from 76.1% a year ago. The majority of the increase is attributed to realizing efficiencies in infrastructure cost, the increasing mix of multi-tenant hosting and product optimizations for Confluent Cloud.

Confluent Cloud has lower gross margins than Confluent Platform as we're in the early stages of achieving leverage and scale for the infrastructure that supports our cloud offering. And as Confluent Cloud continues to scale and account for a larger share of total revenue, we anticipate gross margins to fluctuate in the future.

Turning to profitability. Operating loss was negative $36.8 million, representing operating margin of negative 41.7% compared to negative 37.9% a year ago. Free cash flow margin was negative 51.4% compared to negative 42.2% a year ago. And net loss per share was negative $0.31 using 118.6 million basic and diluted weighted average shares outstanding.

The year-over-year decline in profitability was primarily driven by our plan to catch up with hiring in FY 2021 as well as continuing to invest for growth. As a reminder, we hit the pause button on hiring at the front end of the pandemic in FY 2020, but we didn't resume hiring in earnest until late Q3. Given the size of our addressable market and the strong unit economics inherent in our model, we believe it's critical to invest in scale across all organizational functions to capture our market opportunity.

Moving on to the balance sheet, we ended the second quarter with $1.04 billion in cash, cash equivalents and marketable securities which includes the $786.6 million in net proceeds from our IPO.

Turning now to guidance. Starting this quarter, we're providing quarterly and annual guidance on total revenue, non-GAAP operating loss or income, and non-GAAP net loss or earnings per share. For the third quarter of 2021, we expect revenue to be in the range of $89 million to $91 million, representing growth of 45% to 48% year-over-year, non-GAAP operating loss in the range of negative $62 million to negative $60 million, and non-GAAP net loss per share in the range of negative $0.24 to negative $0.23 using approximately 259 million weighted average shares outstanding, which includes the full quarter weighted impact of shares post IPO.

For fiscal year 2021, we expect revenue to be in the range of $347 million to $351 million, representing growth of 47% to 48% year-over-year, non-GAAP operating loss in the range of negative $199 million to negative $195 million, and non-GAAP net loss per share in the range of negative $1.07 to negative $1.05 using approximately 188 million weighted average shares outstanding.

I'd also like to provide some modeling points. We expect FY 2021 non-GAAP taxes to be in the range of $2 million to $3 million and FY 2021 capital expenditures and amounts capitalized for internal use software cost to be approximately 2% to 3% of total revenue.

In closing, our strong second quarter results underscore our ability to execute against a large market opportunity. As a category-creating company, we're just getting started and we're well positioned to drive durable growth and profitability over the long term.

With that, Jay and I will take your questions.

QUESTION AND ANSWER SECTION

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thank you, Steffan. To ask questions, please use the raise hand feature on your Zoom screen. We ask that you limit yourself to one question and one follow-up. And with that, we'll take our first question from Sanjit Singh of Morgan Stanley and he will be followed by Mark Murphy. Sanjit? Sanjit, I think you're still on mute.

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

Q

Okay. Sorry about that, Shane. Congrats to the team on a really strong debut as a public company. The results were really impressive particularly on both the Confluent Platform and the Confluent Cloud side. I want to talk a little bit about Confluent Cloud and why do we sort of see the escape velocity in that part of the business today? If I look at your cloud mix, last year, it was only up 3 points year-on-year. The last two quarters, the cloud mix is about up 600 basis points and up 10 points this most recent quarter, so Jay, I was wondering if you could just sort of expand on like why now on Confluent Cloud? Is it sort of feature parity? Is it just the strong customer adds? Why are we seeing that this is really starting to take off?

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. It's a great question. It's really a couple different things that contribute to that. The first is the product differentiation. I talked about that like really getting each of those pillars to be meaningful to customers, being cloud native, being complete, being everywhere. I think that matters a lot. I think secondly really getting the foundations of a cloud product to be incredibly solid, the security story how you work with us, et cetera. I think that unlocks a lot of customers that may have been skeptical of managed cloud infrastructure especially with a smaller company.

And then finally I think is the maturing of our go-to-market and really learning how to take advantage of the capabilities of the cloud product. We've gone through a transition to a usage-oriented model that really helps. I think we're still in the early days of taking advantage of that. So I think we're just getting started. But that's been a big adjustment for us over the last year plus to really sell like a SaaS company. And so, I think all of those things contribute significantly.

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

Q

That's super helpful. And then certainly my next question was sort of around the velocity in terms of adoption. I think on the roadshows, you guys are talking about [indiscernible] (00:27:54) about reimagining how applications and the data infrastructure interact with each other. And that's exciting on one hand, but the other part is new and sometimes new means friction. And maybe it's sort of related to Confluent Cloud. But in terms of greasing the wheel so to speak, to drive that adoption, is Confluent Cloud kind of the key lever to pull here or are there other things that you guys can do to get customers to buy into the architectural [indiscernible] (00:28:26).

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. Yeah. That's a great question. So there's really two dimensions, right. One, we started the company with something that was – an idea that was very powerful and companies who want it. But as you said, it was hard at that point to do it. And that is absolutely friction. And so the project for Confluent is make it easy. Make it easy to get the value and there's – I do think there's two dimensions to that. One is operations. It's easy to just run a net new massive distributed platform at scale with production quality and the cloud is really the solution there. That really just takes that problem away. We obviously have a set of product features that help on premise, but the cloud we can just do it for you. So, 30 seconds later you're world class with this new capability.

But the other side is the development side. How easy or hard is it to build applications against this. Kind of the core of Kafka is this almost low level primitive, we're reimagining these kind of applications. But what we've really focused on is making it easier and easier. So, having over 100 different connectors that allow you to just capture streams with no code that you have to write, you just plug in and the data floods.

And then, KSQL is a huge part of this, making it really easy to take the very high efficiency language of traditional databases. The thing that software engineers all kind of know and understand and apply it to data in motion. That makes it much easier for people to just get going. I think there's a lot more we can do in this direction. I don't think we're done in making it easy to be able to get the value out for different use cases, making it more and more efficient to develop in this new way. But I think we're seeing that acceleration in the open source adoption and in the underlying business and in the results that we're showing.

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

Q

Okay. Well, great to see the first quarter results and congrats on a great start.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Thanks so much.

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thanks, Sanjit. We'll take our second question from Mark Murphy of JPMorgan. And Mark will be followed by Kash Rangan. Mark?

Mark R. Murphy
Analyst, JPMorgan Securities LLC

Q

Okay. Yes. Thank you so much, Shane. I want to add my hearty congratulations on just a stellar operating performance in the quarter. Steffan, I wanted to ask you, it's a little rare to see net retention move in such a large increment that way in a single quarter. Could you just describe the – whether it's the math underlying it, is it not a last 12-month average in your definition or is it? And then maybe what's the customer behavior that just changed so materially there in a single quarter?

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Well, for starters, it's a trailing 12-month metric for ARR. And the underlying drivers of the strength were really we saw a great improvement in gross retention for both Confluent Cloud and Confluent Platform. We saw a really healthy expansion. But one of the things that was a real bright spot in the quarter was for customers who are running both Confluent Cloud and Confluent Platform in the same environment. The net retention rate is meaningfully higher than the average net retention rate for the company. And so, we're starting to see the network effect really take hold.

And I give that dynamic because it's important to understand some of the underlying drivers. As you remember on our IPO, we talked about we were operationally focused on driving NRR to be consistently above 120% in the near term and in the long term above 130%. So this quarter was a great proof point that we've got above 130%. We're going to see fluctuations along the way. But we put in the operational rigor and focus through the sales and go-to-market organization, through the product organization and we're really seeing that pay off. So we're very pleased with that.

Mark R. Murphy
Analyst, JPMorgan Securities LLC Q

Okay. Thank you. And Jay, as a follow up for you, I'm interested in what you think are the most important steps that you can take just in order to be highlighting all the differentiated features in the Confluent offering versus when people look at the plain vanilla version of Apache Kafka, so that you can be maximizing the value of the subscription relationship.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc. A

Yeah. It's a great question. I mean that there's kind of three pillars of differentiation, really making sure that that's clear and that customers are experiencing that as a critical project for us. So the underlying foundation of that is making sure each of those pillars is really strong, which I think we've done a great job of. The next is really making that broadly known and I think making sure that people are signing up and trying the cloud product, making that easy is critical. We've made really significant hires in the marketing organization over the last six months or so, which I think is a big part of that as well. And so, all of that I think is going to help us to kind of take that story out more broadly and have it proceed any discussion we have with potential customers.

Mark R. Murphy
Analyst, JPMorgan Securities LLC Q

Thank you very much.

Shane Xie
Director, Investor Relations, Confluent, Inc. A

Great. Thanks, Mark. Our next question comes from Kash Rangan of Goldman Sachs, and Kash will be followed by Brad Sills.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC Q

Thank you so much. Congratulations again on your first quarter as a public company. First one for Jay. So, Jay, really impressive cloud numbers here. I wonder if you could dissect the strength of the cloud business into how much of that was incentivization on go-to-market front versus maybe landing points for cloud customers are higher than where they were a couple of years ago, meaning that the first decision to go with Confluent starts with the Confluent Cloud product itself. Maybe there's a bit of consideration, maybe there is another factor, maybe existing Confluent Platform customers decided to do more in the cloud. If you can just dissect what is driving the strength of the cloud business from a product mix and go-to-market perspective, that will be great.

And Steffan, I do have one for you. To the extent that the cloud accelerates on a sustainable basis, what do the economics of the business look like? Is the [ph] ultimate CAC (00:34:38) of the cloud business materially different or about the same as the core business? And to the extent you have accelerated transition to the cloud, what should we be thinking about as far as the implications of the Confluent business model longer term? Thank you very much. Again, congratulations.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. It's a great question. So this is one of these multifactor things where you can't boil down to just one thing that changed. So what go better yet, the product got significantly better. I think people underestimate how large a lift it is to build a really world-class cloud infrastructure product. Just doing that at scale across every cloud, across every region, having a full suite of networking technologies, the underlying security cable, it's a lot. And until you kind of have that, you're really not ready to work with the best customers. And I do think we've kind of crossed the threshold there that starts to have us really see that unlock. And that may be surprising given the amount of time we've invested in our cloud offering. This is something we've worked on for years, but it is actually a big deal to do something that's properly cloud native and do that right. And I think that's starting to pay off.

I talked a little bit about just the evolution and sophistication of the go-to-market organizations really adapting to this usage model and starting to take advantage of that. I think that's paying off as well. I think part of it is also a larger shift in the world around us. There are – the movement to cloud is much more broad based and people are much more open to the realization that there's going to be a set of independent cloud data systems beyond just the cloud provider.

They're going to be absolutely critical to their architecture and they're starting to place bets against that. And I think that, that kind of growing awareness helps us as well. And so for a lot of these customers, they want to get out of running open source things themselves. They want to put their best engineers in the best place. And they're looking for companies that can help them do that. They can actually give them the kind of world-class product that they need to be great in these areas. So it's all of those things. I wish it was just one simple thing, but it all ends up adding up to do that.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC

Q

Got it.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

And on the second question, Kash, this is a multiple year kind of point of view. So don't read it for quarter-by-quarter, but just thematically with cloud being a bigger component of our business and we see it trending higher over time for sure, it has lots of positive impacts on a longer term basis. So we believe that the NRR profile of our cloud customers should be a lot higher than just call it traditional set of customers who are running CP. From a revenue visibility standpoint and a consumption-based standpoint, we see that as having a positive read through the business longer term. Our gross margins will definitely fluctuate given the gross margin profile of cloud is in the more nascent stage than Confluent Platform.

We're on a multi-year journey and we've seen great improvement so far, but that will provide a little bit of fluctuation. And then when it goes to unit economics, we think the LTV to CAC profile of our Confluent Cloud business should be growing over time. And so that will be a positive tailwind for the business.

And then lastly, I'll say on the R&D side of the house, and I can't underscore that anymore. But the complexity of the engineering organization in terms of being able to service on all three major cloud providers, plus doing more integrations, et cetera. The investments we're making in the product organization are very much tailored to the coming of cloud-first company, but really plugging into the whole central nervous system aspect of the dynamic. Because in order to serve our customers, we have to be on-prem and in cloud, and so there's just more engineering investment related to being the central nervous system. The cloud is definitely like our first priority.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC
Q

Wonderful. Good to hear that. Thanks for the very detailed answers and congratulations again.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.
A

Thanks, Kash.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC
Q

You bet.

Shane Xie
Director, Investor Relations, Confluent, Inc.
A

Thanks, Kash. We'll take our next question from Brad Sills with Bank of America. And Brad will be followed by Michael Turrin.

Brad Sills
Analyst, BofA Securities, Inc.
Q

Oh, great. Thanks guys so much and congratulations on a nice quarter, a first quarter as a public company. Great to hear from you guys. My question is really on one of the metrics that stands out to me which is that customer count greater than $1 million in ARR, real strong result this quarter, more than doubling year-over-year. My question is what is the point in which a customer crosses a certain threshold when they become more – they look at Confluent as more of a strategic partner and really start to accelerate that expansion across the organization, start to use Confluent in more meaningful ways such that they get to that size of a customer. Is there a certain catalyst that you see or common theme when a customer hits that point and what is that and how are you driving that?

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.
A

Yeah. That's a fantastic question. So, yeah, we look at the adoption as kind of having three phases. There's kind of early developer interest. People are getting in. It's more experimental. It's maybe attaching to early development. There's a phase where there's kind of disparate production application. So it's used in this part of the company for something. It's used in that part of the company for something. And then, really this third phase is really important. This is the beginning of that central nervous system where it starts to connect across and it starts to be thought as a kind of default way that data is exchanged between applications, a default way that data flows.

I wouldn't use that million-dollar-plus customer as kind of a proxy for later-stage customers. Now, obviously, if you have one really big use case, you could pay more early on. But typically, at that point, you have very significant usage. And it is our goal to be the best in the world at taking customers down that journey. We want the most people possible to start an experiment in as little friction away with our cloud product as possible. We want as many of them to get into production successfully with applications. We want that to grow and really become a foundational part of their data architecture over time.

And so there is a million and one things we do to try and accelerate that. At scale, that's about having the right relationship across the different parts of the organization, making sure they kind of see the value of the direction that they're in any way heading as this technology takes off and really kind of take the relationship to the next level. And I think it's a very healthy development to see that that's our goal for all of our accounts.

Brad Sills
Analyst, BofA Securities, Inc.

Q

That's great to hear. Thanks so much, Jay. And one more follow-up, if I may. When you think of Confluent, we think of the company as really riding that adoption of next generation applications, really the infrastructure for applications that require that real-time capability at scale and integration of the data. But when we talk to customers, we also hear that they're looking to Confluent to help modernize legacy applications that even those need some of this real-time capability. So, I guess my question is how much of that replacement cycle do you see has driven the result so far? Do you see that coming in increasingly? Obviously, you're very well positioned for modern next-gen applications. What about the legacy? There's a lot of that that could move to Confluent, I would imagine.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. That's exactly right. It's subtle, but I think it's one of the really powerful things about how this product works. There's many technology products which kind of come in and say, hey, rebuild everything on us and it'll be great. And the problem is that there often isn't really the ROI to rebuild major systems running part of the business. And yet, there is pressure and the business has to adapt and do new things and work in new ways.

And so, the challenge is how can you do that? New applications, they're not islands. They don't stand alone. They plug into a larger business and system that they have to be a part of. And that's really the power of what we're doing. When we talk about the central nervous system, it's both connecting up to the old systems, the relational databases and mainframes and old ERP systems that have core parts of the business in them and allowing that data to flow out continuously in real-time trigger action and activity in the new stuff that may be out in the cloud that's built on new platforms and vice versa, right.

And this is actually really a core requirement to be able to enable these kind of new applications. Typically, the challenges and do you want to be on a mainframe? It's how can you pull apart the new things and allow them to be built if they have to integrate back into the old stuff? And that's the challenge for a lot of enterprise customers. That's why you see this so commonly bridging, and so it isn't really greenfield versus brownfield. It's actually kind of both and often both even at the same time for the same application. The next generation customer experience front end has to bridge back and be fed by data in some of the older operational systems. These things need to change a bit at a time. This is a key part of what makes that possible. And I think it is key that it is ultimately the architecture companies want to get to, right? It is – the new Silicon Valley tech companies are starting this way as well. So it's not just a transitionary thing. It really is how they want to get there, but works with both.

Brad Sills
Analyst, BofA Securities, Inc.

Q

That's great. Thank you so much, Jay. Thanks, Steffan.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Thanks, Brad.

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thanks, Brad. Our next question comes from Michael Turrin with Wells Fargo, and Karl Keirstead is next.

Michael Turrin
Analyst, Wells Fargo Securities LLC

Q

Hey, great. Thanks. Thanks. Good afternoon and congrats on another milestone here with the first earnings report. Jay, Confluent was named GCP Tech Partner of the Year for a third year in a row. Can you maybe expand on positioning with the major cloud providers? How important is agnostic positioning for Confluent customers and is there a competitive or cooperative dynamic you can shed light on there for investors?

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. The cooperation is actually really strong. And it's not just with Google. It really is with all three of the cloud providers. And part of it is what I just said in the previous question that that bridging to enable the new applications is really, really critical for them to get that next new workload up and operational in the cloud in many cases. And that's why they're excited about this. This is why you would see reference architectures have Confluent, feeding big query and feeding these other cloud systems. That's what makes the cloud providers excited about what we're doing.

That said, they have – each cloud provider has a handful of different products in their environment that we would compete with. And it's certainly a complicated dynamic. I think it's well handled now in all three of the major clouds. The limitations of a lot of these offerings is kind of in that cloud native complete everywhere basket. A lot of them don't really have the complete story. And most of these are just in that one cloud provider. It doesn't bridge into the other clouds. It doesn't bridge into on-premise and so that larger story isn't necessarily possible. What they're doing and that's why I think they want to work with us.

Michael Turrin
Analyst, Wells Fargo Securities LLC

Q

Yes. That's great. Steffan, you're providing an outlook for both Q3 and the full year. Can you comment on the degree of visibility you have in the model whether the mix of cloud affects that at all or maybe just comment on the overall approach of the guidance here as well?

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

It takes several items into consideration when constructing guidance. If you look at our pipeline, we look at our sales forecast. We also look at the visibility we have for revenue coming off of the balance sheet. And so, from a revenue standpoint because the revenue model is a mix of ratable upfront and consumption, the ratable piece gives us really good visibility. And we continue to fine-tune our consumption forecasting and modeling. But we feel very good about just – high confidence level, I should say, in again our guidance. And that's based off of the attributes I just walked you through.

Michael Turrin
Analyst, Wells Fargo Securities LLC

Q

It's a great start here. Nice job for the team. Thank you.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Thank you.

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thanks, Michael. We'll take our next question from Karl Keirstead with UBS. And Karl will be followed by Derrick Wood.

Karl E. Keirstead
Analyst, UBS Securities LLC

Q

Thank you, Jay and Steffan and Shane. Congrats on this first quarter. Good way to start. So maybe I'll start with Steffan. Steffan, was there anything unusual about the results in the quarter to call out? You had mentioned in a quick comment that maybe that large multi-year extension provided at least a modest boost to revenues. Maybe you could characterize that.

And then also, was there anything funky in terms of deals slipping? I remember during the IPO process that you had an occasion where some 4Q deals slipped into 1Q. Anything like that occurred in the second quarter that's worth calling out?

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Yeah. Good question. So on the large deal that we called out in the script, it didn't really have a material impact on revenue, but it did impact RPO because it was a multi-year deal. And you look at the growth rate between RPO and current RPO that did have an impact there. I can tell you that it was a great expansion opportunity for us. We viewed it as a very big vote of confidence. And we also had other large deals in the quarter two. But we wanted to call that one out in particular.

And then as far as anything else going on in the quarter that was unique, it was just a very solid quarter kind of across the base. You look at the metrics around $100,000 ARR customers, $1 million plus ARR customers, net retention was clearly a bright spot for us. And that's been a point of focus for us over the last year. Just continue to drive NRR performance and you think about things that like Erica Schultz has done in terms of operationalizing NRR throughout the field sales organization. And when we think about what Ganesh has done from an engineering standpoint around product feature, functionality, velocity to improve the stickiness, I can tell you the gross retention in the quarter was very healthy and that's a great indicator for us as well.

Karl E. Keirstead
Analyst, UBS Securities LLC

Q

Okay. Great. And then maybe a follow-up, one of the metrics we haven't spoken about yet which I tend not to focus on too much is overall customer count because that can sometimes get skewed by the long tail of SMBs. But doubling your customer count in the quarter is impressive and so I wanted to ask to what extent, Jay and Steffan, you look at that as a good leading indicator. And then secondly was the cloud version of the product sort of a disproportionate catalyst for new customer growth. In other words if cloud was 22% of revenues, did it have a much larger effect on bringing in new customers? Thank you.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah, it's a great question. So the cloud offering is definitely the foundation of how we're getting out to customers at scale. And so the vast majority of customers are on Confluent Cloud numerically, right? So when we're looking at growth in total customers that is what's going to predominant and it is very much that kind of self-service low friction. Now as you said, you can come in and buy $1.50 worth of Confluent and that may not be an indication of a long-term journey with us or it may be the beginning of something great, right? And so, it is a stack that's going to fluctuate quarter-to-quarter as we change some of our marketing techniques where we're putting spend, remove friction from the onboarding process. You're going to see changes as we do that.

We obviously look at that whole journey what our customers are doing, are they becoming active, do we have continual usage of the products, et cetera. So, to answer your question, strategically I think it's very important. Quarter-to-quarter there will be fluctuations in that as we change our techniques and approach in system for offering credits and incentives and so on.

Karl E. Keirstead
Analyst, UBS Securities LLC

Q

Awesome. Thank you.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Thank you.

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thanks, Karl. Our next question comes from Derrick Wood with Cowen. And Derrick will be followed by Rob Owens.

J. Derrick Wood
Analyst, Cowen & Co. LLC

Q

Great. Thanks for taking my question. Really great job out of the gate. I wanted to ask on the go-to-market. You guys have been building out new go-to-market teams over the last year. Just wanted to get a sense to what the maturity of those efforts look by region: US, EMEA, APAC? Kind of where do we stand with standardizing sales playbooks, driving up sales capacity, and how do you see that progressing through the year?

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Yeah. It's a great question. I would say, first of all, we remain a young company, right? So, in that overall arc, I still think there's a ton that's happening in there. As Steffan alluded, I think Erica and the rest of the team has done an amazing job and they brought in good talent in every region. We've seen great performance across the board from the team. So, I think we've made huge steps. I think there's still a lot that we're doing that will make it even better.

I don't know if there's anything you would add to that, Steffan.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Yeah. A couple of things. One is we started in the US and we've expanded in EMEA and most recently in APAC. And so to answer your question, Derrick, we're still in the early stages of growth in all three major theaters. I can tell you that we had paused hiring last year prudently because of COVID. And we've caught up on hiring or we're catching up on hiring. And from just a head count standpoint, we're on track relative to hiring the sales talent that we need. In 2021, we have more ramping reps than ramp trips, and in 2022 given the fact that we have a 12-month onboarding process and ramp process, we're going to have proportionally more ramped people in 2022 than in 2021. So, that gives you a little bit of color commentary on the geography and then also just hiring progress.

J. Derrick Wood
Analyst, Cowen & Co. LLC

Q

Perfect. Thanks. And then Steffan, couple quick tactical questions really. From an internal comp perspective, have you made any changes to incentives to sell cloud versus platform and are there two different incentives? And then when it comes to the cloud engagements, how much is pay-as-you-go versus committed contracts? And is that shifting at all as we progressed through the year? Thank you.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

On the compensation side of the house, at the start of this year, we did put in, call it, slightly more incentives for folks to sell Confluent Cloud. And so, that's in place and that's paying off, which is good. And as far as the mix between pay-as-you-go and committed contracts, the vast majority of the revenue is committed contracts. Pay-as-you-go is growing off of a small base. So, like the percentage growth rates are very high. But if you look at just the proportions, committed contracts are vast majority of revenue at this point.

J. Derrick Wood
Analyst, Cowen & Co. LLC

Q

Got it. Thanks and congrats again.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.

A

Thank you.

Shane Xie
Director, Investor Relations, Confluent, Inc.

A

Thank you. We'll take our next question from Rob Owens with Piper Sandler. And Rob will be followed by Raimo Lenschow.

Rob D. Owens
Analyst, Piper Sandler & Co.

Q

Great. Thank you for taking my question. I guess for starters. Steffan, as we contemplated Q2, there was the thought that the Codecov breach could potentially impact the top line. And did that play out whatsoever in terms of customers or any push-outs?

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

The way that the company handled the Codecov breach, I thought, was very well received by the customer base. We were out in front of it. We're very clear with what we're doing, how we're responding. And so it literally had very little to no impact as far as the results came through. And if you look at just the cloud revenue growth, the 200% of the overall revenue growth, and also the growth in RPO, all of those played out, I think, better than we had expected. And so, hopefully, that gives you some color commentary.

Rob D. Owens
Analyst, Piper Sandler & Co.

Q

Sure. And I guess to that end then, as you contemplated guidance, you gave some commentary earlier, but you have a history of being conservative and I have a history of pushing you on that. How are you thinking about this third quarter and relative to some of those different puts and takes and what could actually happen to influence a flattish type of a sequential number? I know it's a couple million but given the strength you've seen in all the leading indicators, we would think that might be even stronger this quarter. Thanks.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Well, we're very pleased with the fact that we can basically raise guidance relative to consensus. We're looking at 45% to 48% year-over-year growth in total revenue. And there is a seasonality component a little bit to our business. Our salespeople have semiannual comp plans for this year. And so, Q2 and Q4 tend to be seasonally stronger than Q1 and Q3 just by the nature of how the comp plans work. And so we also take that into consideration while constructing guidance, but we felt very good about not only the guide for the quarter, but the guide for the year being 47% to 48%. And so, hopefully again that gives you some confidence and some clarity.

Rob D. Owens
Analyst, Piper Sandler & Co.

Q

All right. Thank you very much.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Thank you.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.

A

Thanks, Rob. We'll take our next question from Raimo Lenschow with Barclays.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Hey. Thanks for squeezing me in and congrats from me as well. Jay, I know the question is going to look out a little bit more into the future, but if you look at other vendors like Mongo that kind of went towards the cloud, they started out with the free kind of cloud that you're kind of working on with, but then they started thinking more east towards Asia and then the big Chinese clouds came up. What's your thinking there around that going forward in terms of that in terms of a white label? What's the market opportunity here? And then I had one follow-up for Steffan.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.
A

Yeah. I think we're early in that process. We have watched some of the other countries [indiscernible] (00:58:10). I think those are great options. Obviously our first priority is building just a world-class product in these first three major clouds.

Was there a follow-up? [ph] Did you receive that (00:58:30), Raimo?

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.
A

Hey, Raimo. We can't hear you.

Raimo Lenschow
Analyst, Barclays Capital, Inc.
Q

Okay. Sorry. My Internet connection is unstable. Hey, Steffan, and the question from me is going back to Mark Murphy's question from earlier. Those changes in NRR in one quarter is pretty remarkable. I've actually never seen something like that before. Could that like, how do you think about that going forward? Do you think it's going to be more stable going forward? And like, what could be factors here? Thank you.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.
A

Yeah. So, one additional point I'll make on NRR is because it's a trailing 12-month metric, if you look at the historical patterns for NRR, we called out that Q2 of last year, we actually had some churn based off of Q2 and Q3 candidly. We had some churn because of COVID et cetera. The Q2 churn is now out of the equation. So that's also a tailwind to NRR. But the bigger components were definitely just the better gross retention and the expansion opportunities that we saw play out. We do think that there's going to be fluctuation. We've been very consistent on that point.

And where NRR lands in a particular quarter, it's always hard to forecast which is why we're not guiding on it. But what we are saying is we are committed to driving NRR consistently above 120%. And we were very pleased that in this quarter we were actually above 130%. So that's an additional comment that I wanted to make on how NRR there was a slight benefit because some of the churn that happened a year ago is now out of the base. So, hopefully that gives you a little bit of extra color commentary.

Raimo Lenschow
Analyst, Barclays Capital, Inc.
Q

Perfect. Yeah. Very strong quarter though. Congratulations.

Steffan C. Tomlinson
Chief Financial Officer, Confluent, Inc.
A

Thank you.

Edward Jay Kreps
Co-founder, Chief Executive Officer & Director, Confluent, Inc.
A

Thank you.

Shane Xie

Director, Investor Relations, Confluent, Inc.

A

Thanks, Raimo. This concludes our Q&A section. Thank you very much for your questions and participation. I will now turn it back to Jay for closing remarks.

Edward Jay Kreps

Co-founder, Chief Executive Officer & Director, Confluent, Inc.

Well, thanks to everyone for your time today. We feel the quarter represents one more step forward on our larger journey. And so a huge thanks to our team, our customers, and our investors for making this possible. Take care.