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Datadog, Inc. (DDOG)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Q2 2022 Datadog Earnings Call. My name is Cheryl, and I will be your operator for today's call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session. [Operator Instructions]

I will now turn the call over to Yuka Broderick. You may begin.

Yuka Broderick
Head-Investor Relations, Datadog, Inc.

Thank you, Cheryl. Good morning and thank you for joining us to review Datadog's second quarter 2022 financial results, which we announced in our press release issued this morning. Joining me on the call today are Olivier Pomel, Datadog's Co-Founder and CEO; and David Obstler, Datadog's CFO. During this call, we will make forward-looking statements, including statements related to our future financial performance, our outlook for the third quarter and the fiscal year 2022, our gross margins and operating margins, our strategies, our product capabilities, and our ability to capitalize on market opportunities. The words anticipate, believe, continue, estimate, expect, intent, will and similar expressions are intended to identify forward-looking statements or similar indications of future expectations.

These statements reflect our views only as of today and are subject to a variety of risks and uncertainties that could cause actual results to differ materially. For a discussion of the material risks and other important factors that could affect our actual results, please refer to our Form 10-Q for the quarter ended March 31, 2022. Additional information will be made available in our upcoming Form 10-Q for the quarter ended June 30, 2022 and other filings with the SEC. This information is also available on the Investor Relations section of our website along with the replay of this call. We will also discuss non-GAAP financial measures, which are reconciled to their most directly comparable GAAP financial measures in the tables in our earnings release, which is available at investors.datadoghq.com.

With that, I'd like to turn the call over to Olivier.

Olivier Pomel

Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

Thanks, Yuka, and thank you all for joining us this morning. We are pleased to report strong results in Q2 as we executed well and we extended our category leadership. Let me start off with a review of our Q2 financial performance. In Q2, revenue was $406 million, an increase of 74% year-over-year and above the high end of our guidance range. We had about 21,200 customers, up from about 16,400 in the year-ago quarter. We ended the quarter with about 2,420 customers, with ARR of $100,000 or more, up from 1,570 in the year-ago quarter. These customers generated about 85% of our ARR. We generated free cash flow of $60 million, and a free cash flow margin of 15%. And our dollar-based net retention rate continued to be over 130%, as customers increased their usage and adapted more products.

Now, moving on to this quarter's business drivers. In Q2, while we overall saw strong customer growth dynamics, we have seen some viability in growth from our customers. We saw a larger spend in customers continue to grow, but at the rate that was slower than historical levels. Its effect was more pronounced in certain industries, particularly in consumer discretionary, which includes e-commerce and food and delivery customers, and affected more specifically our products with a strong volume-based component such as Log Management and APM suite. Note, that we did not see this with our SMB and lower spending customers, who continued growing with us as they had in the past. While these [indiscernible] (00:03:42) growth data points and the current microclimate are leading us to be prudent with our full-term outlook, we remain very bullish about our opportunities and confident in our execution, as we continue to see positive trends underpinning our business.

First the number of host and containers being monitored by our customers is growing steadily, which points to continued momentum of cloud migration and digital transformation projects. Second, we have strong execution on the new logo side, as new logo AR was robust, as we added a record 1,400 new customers in the quarter, including the impact of turning off about 200 customers in Russia and Belarus in Q2. And we closed a number of sizable six to seven [indiscernible] (00:04:24) new logo deals during the quarter with diverse customers including a media conglomerate, a metal ore mining company, a US government agency, a SaaS business and a hyperscaler. Third, our pipeline of large new logos and new product cross-sales going into the second half of the year is strong. And fourth, churn remains low with gross revenue retention steady in the mid to high-90s.

Moving on to our products, we are pleased with the continued option and expansion of our products for our customers. The three pillars of observability, which are infrastructure, APM and Log Management all grew strongly in Q2. Our APM suite and Log Management now exceeds $0.750 billion of ARR. As a reminder, we define APM suite as including core APM, Synthetics, RUM and Continuous Profiler. In addition to that, infrastructure monitoring continues to grow strongly, on par with recent quarters. We're also pleased with the adoption of our newer products. Our newer products, excluding infrastructure monitoring, APM suite, and Log Management continued to grow ARR in more than 100% year-over-year. And we've seen a strong start with our CI Visibility product, which we announced on Dash last year, and started charging for just a few months ago.

CI Visibility already has more than 1,000 paying customers, including some product-specific new logos. Our platform strategy also continues to resonate in the market. As of the end of Q2, 79% of customers were using two or more products, up from 75% a year ago. 37% of customers were using four or more products, up from 28% a year ago, and 14% of our customers were using six or more products, up from 6% a year ago. Now, let's move on to product and R&D, where our teams delivered another strong quarter of innovation. In June, Gartner published a 2022 Magic Quadrant for application performance monitoring and observability. Datadog has once again been named the leader, and we have improved from last year on our scores and rankings in all dimensions. We attribute this first to our unified platform experience, covering dev, ops, security and all the personas in one place.

But we also see it as a recognition of the continued evolution of Watchdog, our AI engine, which takes over the complexity of monitoring cloud native architectures and provides proactive alert, guided troubleshooting and fully automated root cause analysis. We are very pleased that our APM product went from GA to best-of-breed in just five years, and I want, again, to congratulate our teams for this achievement. In June, we announced the general availability of Observability Pipelines, the 15th product in the Datadog platform. As a reminder, this is based on our 2021 acquisition of Timber, the company behind a very popular open-source project named Vector. As organizations scale their applications, the volume of telemetry data grows exponentially. Engineers must manage large volumes of metrics, traces and logs, and route them from many sources to many destinations. And this complexity leads to vendor locking, core data quality, risks of sensitive data leaks, and an increase in overall management costs.

By using Datadog Observability Pipelines, customers can control their cost and volume of data, pick up all data sources from their destination, standardize and improve on data quality, and redact sensitive data to help maintain compliance. Next, we announced the general availability of Audit Trail in June, helping businesses safely adopt the Datadog platform while maintaining compliance, enforcing governance, and building greater transparency. And this week we announced a general availability of Service Catalog. With cloud architectures, customers are often creating hundreds or thousands of interconnective services which are owned and developed by globally distributed teams. This large network of services often makes [indiscernible] (00:08:18) difficult, and it can be challenging to understand what to do to [ph] remediate (00:08:21) issues or who to call for help.

Our Service Catalog inventory services defines team ownerships and displays configurations interdependencies very similarly to what CMDBs might do. But where CMDBs are typically manually populated, our Service Catalog can identify this information automatically as it was specifically designed for the cloud edge. Finally, this morning we announced that we acquired Seekret, which is spelled S-E-E-K-R-E-T. Seekret's API observability platform gives engineering teams the control they need to better manage a private, public and third-party sets of API. With Seekret, we will accelerate on our path to bring customers visibility into their APIs, and over time unlock new exciting capabilities for our APM suite and our security platform. That's it for product update this quarter. And needless to say, we're all very grateful to our engineering and product teams for their continued hard work.

Now, moving on to sales and marketing. Let's discuss some of our wins in Q2. First, we signed a seven-figure upsell with a global services and audit company. This customer is going through a large-scale digital transformation, including migrating from on-prem data centers to multiple clouds, and in particular Azure. They are consolidating nine disparate, legacy and open-source tools to Datadog as their strategy platform, and purchased all of our products as well as our premier support and technical account management services. Next, we had a seven-figure upsell with a managed service provider in Asia that is a top [indiscernible] (00:09:54) partner in the region. This customer transitioned from their legacy monitoring tool to Datadog and adopted the entire Datadog platform. They are experiencing rapid growth [ph] of their sales of (00:10:05) MSP services to AWS and CDN customers, and they are expanding their opportunity as well as ours in APAC.

Next we had a seven-figure land with a multinational media company. This customer has aggressive expansion plans for a streaming service, including in international markets. But they found that their current mix of open-source and legacy solutions wasn't meeting their needs. They calculated Datadog would pay for itself simply by accelerating resolution of just one of their major incidents and avoiding loss of revenue. This customer started with Infrastructure, APM and Log Management with the opportunity to expand to more usage and products as the company scales. Next, we had a six-figure land with a Fortune 500 logistics company. Three years ago, this customer chose legacy monitoring providers and home-grown solutions over Datadog.

Now our platform has come a long way since then. Meanwhile, incumbents were unable to meet this customer's needs, particularly around their Kubernetes adoption, leading to thousands of high-profile incidents a year with a high time to resolution. Additionally, this customer expects to save nearly $3 million in developer resources by consolidating multiple products with Datadog. Finally, we had a six-figure land with a gaming division at a hyperscaler. Previously this company was primarily using open-source and its own hyperscale native tooling, but despite deep technical expertise, home grown solutions were lacking granularity and consumed critical engineering resources. By using Datadog, this customer unlocked a prescriptive way to visualize alert and maintain their cloud gaming services.

In addition to these wins, we also had a number of sizable six and seven-figure new logo and expansion wins with companies that have recently experienced business contraction and announced staff reductions. These customers are looking to streamline their operations, save on engineering costs or consolidate multiple vendors on a strategic platform. We believe that software is a deflationary force, and we are confident in our ability to help our customers do more with less should economic conditions worsen. That's it for this quarter's customer highlights. I'd like to thank our go-to-market teams for their efforts and constant execution.

Now, let me speak to our longer term outlook. We recognize the macro environment is uncertain as we look into the back half of 2022. But we also see no change to long-term trends towards cloud-based services and modern DevOps environments, and observability remains critical to that journey. We continue to drive market leadership and offer our customers value, efficiency and cost savings to solve their complex monitoring problems. As a result, we continue to feel very confident in our opportunities. We believe cloud migration and digital transformation are drivers of our long-term growth, and our multi-year trends that are still early in their life cycle. And we believe it is increasingly critical for companies to embark on these journeys in order to move faster, serve their customers better, and in times like these become more efficient with their infrastructure and engineering investments.

So we plan to continue to invest in our strategic priorities to execute on these long-term opportunities. At the same time, we will continue to closely monitor the demand environment and recalibrate further if necessary to balance our long-term investments with financial strength. Before I hand it over to David, I wanted to make a couple of announcements. First, we are holding Dash 2022, our user conference on October 18 and 19 at the Javits Center in New York City. This is an occasion for us to showcase our latest product innovations, and we're excited to show everyone what we've been up to. We also will organize an investor meeting at Dash, and we'll share more details on it shortly. And last but not least, we are pleased to welcome Titi Cole to our board of directors. Titi is CEO of Legacy Franchises at Citigroup and brings over 25 years of experience in senior global leadership roles in the financial services industry. Her perspective and experience will be incredibly valuable as we continue to grow and scale.

With that, I will turn the call over to our CFO for a review of financial performance and guidance. David?

David M. Obstler

Chief Financial Officer, Datadog, Inc.

Thanks, Olivier. We delivered strong financial performance in Q2. Revenue was $406 million, up 74% year-over-year and up 12% quarter-over-quarter. As Olivier described, we executed strongly with robust new logo ARR growth, continued low churn and continued strong platform traction. But we did see some customers beginning to manage costs in response to macroeconomic concerns which impacted our usage growth with some of our existing customers.

Looking at our growth with existing customers, our dollar-based net retention was above 130% for the 20th consecutive quarter, remaining strong as we continue to see customers use more existing products and adopt new products on the Datadog platform. We saw usage growth with some existing customers decelerate in Q2, and that deceleration was concentrated in our larger spending customers as opposed to our lesser spending customers, where growth remained steady year-over-year. Amongst our industries, we saw relative deceleration in consumer discretionary customers which represents low teens percent of our ARR.

As a reminder, we are highly diversified in industries and segments. And we saw lower expansion rate weighted towards areas of our platform that have volume-based components, like certain aspects of Log Management and APM. Infrastructure monitoring ARR growth was relatively steady year-over-year. On the other hand, our gross retention remained unchanged and steady in the mid to high-90s. We believe that our gross retention has reached and is sustaining these levels because of the stickiness of our product and the criticality of our platform to our clients. And as Oli mentioned, on new logos we saw strong continued new logo acquisition and ARR growth broadly by geography and across industries and company sizes. Finally, our platform strategy continues to resonate with customers, with 79% of our customers now using two or more products, 37% using four or more products, and 14% using six or more products in the Datadog platform as of the end of Q2.

Moving on to our financial results, billings were $397 million, up 47% year-over-year. As in previous quarters, we had some differences in the timing of billings of a few large customers, which were billed in Q2 last year but were billed in Q1 this year. And pro forma for those adjustments, billings growth year-over-year was in the mid-50s. Remaining performance obligations, or RPO, was $881 million, up 51% year-over-year. Current RPO growth was in the mid-50s year-over-year, and contract duration was slightly lower than the year-ago quarter. In addition, we observed that some customers aren't changing their level of usage growth but are being more conservative in their commitments, which impacted billings and RPO growth, but not revenue growth. As we said in previous quarters, billings and RPO growth can fluctuate significantly and vary from revenue growth, whether higher or lower, due to the timing of invoicing and duration of customer contracts. To illustrate this, we note that billings growth for the first half of the year of 2022 was 72% year-over-year.

Now, let's review some key income statement results. Unless otherwise noted, all metrics are non-GAAP, and we have provided a reconciliation of GAAP to non-GAAP financials in our earnings release. Gross profit in the quarter was $328 million, representing a gross margin of 81%. This compares to a gross margin of 80% last quarter and 76% in the year-ago quarter. We continue to experience efficiencies in cloud costs reflected in our cost of sales this quarter. In the medium to long-term, we continue to expect gross margins to be in the high-70s range. Given our success in increasing our investments in R&D and go-to-market, our non-GAAP Q2 OpEx grew 65% year-over-year versus 56% year-over-year in Q1. This included our return to in-person office travel and events, which contributed $11 million to the sequential growth of OpEx. Operating income in Q2 was $85 million for a 21% operating margin, compared to operating income of $31 million or 13% operating margin in the year-ago quarter.

Now, turning to the balance sheet and cash flow statements. We ended the quarter with $1.7 billion in cash, cash equivalents, restricted cash and marketable securities. Cash flow from operations was $73 million in the quarter.

After taking into consideration capital expenditures and capitalized software, free cash flow was $60 million, with a free cash flow margin of 15%. Our free cash flow margin in the first half of 2022 was 25%. Now, for our outlook for the third quarter and the fiscal year 2022. First, informing our guidance, we are using conservative assumptions as to the organic growth of customers, taking into account the macroeconomic uncertainty and recent variability of the growth amongst certain customers. As Olivier mentioned, we see healthy trends in the hosts and containers monitored and strong execution in our business. But we recognize customers may have less visibility into their own businesses due to the macroeconomic environment.

So for the third quarter, we expect revenues to be in the range of $410 million to $414 million, which represents 52% year-over-year growth at the midpoint. Non-GAAP operating income is expected to be in the range of $51 million to $55 million, and non-GAAP net income per share is expected to be in the $0.15 to $0.17 per share range based on approximately 347 million weighted average diluted shares outstanding. For the full fiscal year 2022, we expect revenue to be in the range of $1.61 billion to $1.63 billion, which represents 57% year-over-year growth at the midpoint. Non-GAAP operating income is expected to be in the range of $255 million to $275 million. Non-GAAP net income per share is expected to be in the range of $0.74 to $0.81 per share based on approximately 347 million weighted average diluted shares outstanding.

Now, as regards to our margin guidance, I wanted to point out, first, gross margins have recently been at the top of our historical range. In operating expense, we have returned to in-office attendance, travel and events. We estimate that this was a 300-basis point sequential margin impact in Q2, and we expect an additional 100-basis point sequential margin impact in Q3. As Oli mentioned, in Q4 we will hold our Dash user conference, and we will participate in the AWS re:Invent, our largest trade show event of the year. The cost of these events will be approximately 400 basis points of margin impact. We're back to fully in-person events this year, and we're excited to get in front of customers and showcase our many product innovations.

Next, we have been successful in making R&D and sales and marketing investments, and we believe these will pay off in the future. While we plan to continue to invest, we will remain judicious and disciplined in our cost structure given macro uncertainties. As indicated by the guidance, we expect non-GAAP operating margins in the second half of 2022 to be in the low double-digits. We are healthily profitable on a non-GAAP basis and are free cash flow generative, and we have built a highly efficient frictionless business model, while driving high ROI on our investments over time. Our efficiency and financial strength affords us options in times of macro uncertainty that other market participants will not have, and we intend to make the best of this opportunity to drive our long-term growth.

But, of course, we are mindful of the environment and are closely monitoring our costs carefully, and we will calibrate further, if necessary, to maintain our financial strength. In conclusion, while we recognize there is greater uncertainty in the macro environment right now, we see no change in the importance of cloud migration and digital transformation, which are critical to our customers' competitive advantage. We believe we are well positioned to help our customers embark on these journeys, and we are investing aggressively into our long-term opportunities while maintaining our financial strength. I want to thank Datadogs worldwide for their efforts.

And with that we will open the call for questions. Operator, let's begin the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Sanjit Singh from Morgan Stanley. Your line is now open.

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

Q

Yeah. Thank you for taking the question, and I'm really impressed of Q2 results with 74% growth. I wanted to talk a little bit about some of the trends you're seeing in the business and particularly with respect to the guide. I guess, the first question is, as the quarter progressed, when did you start to see some of these slower usage trends and some of these verticals, if you could give a comment on that? And then, David, in terms of the guidance, in terms of how you are framing it, could you give us a sense of what you're sort of assuming in the back half with respect to Q3 and Q4? Is it some of the trends that you're seeing in July, did that improve or stabilize or worsen? Just to give us some sort of context on how you are framing the guidance for the back half, that would be super helpful.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Okay. So I'll start maybe with the linearity. We did see the viability in usage growth that we mentioned. We saw that start really in late April, May and June, so as we go deeper into the quarter. I should say that, if you're thinking of what happened at the beginning of COVID, this is not a sharp pullback as we have seen other time. What we saw is just for some customers still growth but slower growth for certain types of customers and others than what we would have seen historically.

I should say that, while we did see that for some of our products, especially ones that have more of a volume component like logs and some parts of APM, we did see continued healthy growth in host and – or I should say cloud instances and containers, which really are indicative of the fact that the cloud migration is proceeding as it was before. To fully answer the question also, I think maybe I'm getting ahead of what David is going to talk about a little bit, but in July we did see an improvement on those trends. But we still remain conservative in our outlook for the short-term because of the noisiness with the data we're seeing there. There's a few more variations, a bit more noise, and all of that is underpinned by some macro uncertainty. So we want to derisk the guide a little bit and be a bit more careful. David, do you want to comment on that?

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. On guidance, as you know, we have always been conservative in our guidance by using lower organic growth in my other metrics than we've seen historically, and continue to maintain that philosophy. I would note that, if you look at the raise here and the percentage of the beat that was passed through into the raise from Q2, it is lower, more conservative than we have done in previous quarters. And the reason for that is the macro uncertainty, where we can't be as confident about what happens given the macro uncertainty. So I would say there, if you want to take that, there were some incremental conservativism put into this. But I'd remind everybody that we've always been quite conservative in using assumptions that are lower than the past when we give guidance.

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

Q

That's super helpful. I appreciate all the context. And one more if I could sneak in one quick question. Olivier, on the comment on which sort of products may be seeing slightly lower usage, I fully understand like the volume-based products like logs, that makes complete sense. With APM though, I'm a little confused on why you might see some deceleration there because, correct me if I'm wrong, I think that's primarily based on host-based pricing. So any comments on like the APM side versus log side in terms of how some of the trends you're seeing in terms of usage across those two parts of the portfolio.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

That's a good question. So for APM, there's actually a part of APM that looks like logs, which is a – APM, part of it is host-based and part of it is traffic-based. If you want to run analytics and have longer retention on certain parts of your APM data, it's basically the [indiscernible] (00:30:27) logs. And that's the part on which we've seen some slower growth. It's still growing, both are still actually growing healthily, but I would say slower than they were in recent quarters for these types of customers. And you can do the same thing with [indiscernible] (00:30:40) a little bit more. You can reduce retention and these other levers customers have to control the spend there.

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

Q

Makes total sense. I got it. Thank you very much.

Operator: Thank you. Our next question comes from Raimo Lenschow from Barclays. Your line is now open.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Thank you. New version of my name. That's nice. Can I stay on that subject, Olivier? So if you think – is there a different pattern of how people work with you and use you if you say infrastructure volumes are – or infrastructure is not as much impacted or is not impacted at the log and APM part, like, are you more important on that side, because like, if I'm thinking like I need to monitor my applications as much as I need to monitor my infrastructure, so I'm just – like maybe help us understand a little bit the differences there. And then I have one follow up.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

No, it's just that these are – you have more like short-term levers to actually optimize a little bit in logs and APM and anything that's volume-based. What we've seen customers do is, I mean, really if we were to categorize customers, I would break them into three buckets. In one bucket is the customers that spend a lot with us, have us wall-to-wall in their business, not seeing their business slow down. That's what we mentioned in consumer discretionary and certain food delivery, for example. In those cases, naturally customers themselves are growing 10% instead of 50%, and they're using us everywhere already, therefore going to grow as well with them, that's natural. But that's only a small part of our customers. We're very diversified, and we also have a very small part of our customers that use us wall-to-wall at this point.

The second bucket I would say is customers have a significant spend with us. And are just seeing a little bit more uncertainty in the future, so their businesses might not be challenged today, but pretty much every CFO everywhere has a mandate to look more closely at their expenses. And what we see those do is, they're looking for optimization, they're looking for maybe to find some leaky faucet they can close. And you can typically find some of those in logs, for example. And this is not something new, I mean, we've discussed it before, every customer goes through cycles where they optimize a little bit, and then they grow again and then they optimize again. What happens in times like that is that you see customers bunched in the same quarter doing it all at the same time because they're all going through the same macro event. So we're seeing some of that there. And again, this is not comparable in breadth or in magnitude to what we've seen at the beginning of COVID, but still, we see that in the data so we wanted to call it out on the call.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

That's helpful. Thank you. Sorry, go ahead.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

[indiscernible] (00:33:30). I had promised three buckets. So I'll delivery you the three. The third bucket is customers that have lesser spend, which in this case would mean less than $500,000 a year on us. They're basically growing as they were before. They're actually growing more slowly than the larger ones, but the larger ones have slowed down a little bit while the smaller ones haven't.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

So I want to clarify, if you look after the call on our website, you'll see that, in APM it's host-based pricing but there's other parts that are like logs, as Oli mentioned, that are data-related, that are related to ingestion and indexing. And so what we're saying is that, the infrastructure part, both with the infrastructure and the APM didn't experience as much variability, but the ability to tweak the use of the data through both ingestion and indexing which is more of a part of logs but also a part of APM was where we saw that variability.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Okay. Perfect. And then the follow up, if you think about – and I'm sure you have thought about it, as you've thought about the implications for the second half, consumer discretionary sounds like the first thing that in the kind of downturn gets impacted. You also mentioned food delivery a little bit which is kind of seems more like the newer tech companies. Is that something that you kind of anticipate you go through the supply chain, so CPG comes next, retail comes next? So how do you think about it or how did you think about that when you were buffering for the second half? Thank you.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Yeah. So we're very diversified. So no particular part of the industry actually cover the large part of our revenue. And also I would say, in terms of those other customers that are far along in their cloud migration or they are cloud native to start with, we actually probably have more of them in the consumer discretionary than in the other verticals that we have. So all that came into consideration when we look at our guide.

Raimo Lenschow
Analyst, Barclays Capital, Inc.

Q

Okay. Perfect. Thank you.

Operator: Thank you. Our next question comes from Kash Rangan from Goldman Sachs. Your line is now open.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. I can pronounce Raimo's name perfectly well. So thank you. Thanks for giving me a chance to ask questions here. So I'm curious, when you look at AWS and Azure, I mean, much larger business, they had good bookings, I think backlog growth, whatever you want to call that. But if you can help us reconcile your cRPO growth, I'm sure there are company-specific things that pertain to how cRPO growth on a year-over-year basis, sequential growth basis, how do we look at that in the context of what's happening with the hyperscalers, and they did put up, even during an uncertain time, tremendous backlog growth, whatnot. So is there something specific to Datadog, maybe it's the 18% or so, high teens percentage exposure to consumer discretionary, maybe if you parse that out, there's a different way to look at the rest of the business, and if you could quantify how the rest of the business did route it to, how the hyperscalers were able to put up that kind of backlog. So I'm trying to just bridge the performance of Datadog versus the public cloud at an aggregate level if you don't mind. Thank you so much

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Yes. So I'll start on the reductions with the hyperscalers, and then maybe David can give you more color on the bookings part. So in Q2 we did a lot better than the hyperscalers, we were growing a lot faster than a lot of them combined. And they have decelerated actually more than we've done [indiscernible] (00:37:04). So we actually feel good about the ratio there, like, we are commanding a larger portion of the cloud revenue than we were last quarter. In terms of the go forward, so I don't think the hyperscalers have to guide specifically for that, but in terms of the business trends, we see that all of the leading indicators of success are looking good for us.

I've mentioned it on the call, but we're seeing great action with new logos, we're seeing great success with new product attaches, the pipelines going into the second half of the year are very good. We've also done very well with the capacity we've added and the hiring and everything that's a predictor of your success, all of that is looking good. What we don't have necessarily, in terms of the guide for the future is, we have a little bit of more noise in the data in terms of growth which makes us to be a little bit more conservative. David, do you want to give more color on the booking part of it?

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Definitely. So remind everybody that with our land and expand where we start getting used by clients, they scale up the growth, and when they get to a certain point through – this has been going on through the whole business model, they go to an increased commit. Because of that, there's variability in the billings and RPO that net-net over time, on average, go towards the ARR growth. Again, remember, we mentioned that the ARR growth is the best metric, and the way to look at that is that you look at the revenues, you use the linearity which is 34%, 35% of that and multiply that times 12, and that is pure because it doesn't get altered by when a bill goes out, either in timing or whether the bill is a previous commitment, plus an on-demand or new commitment.

So it's always going to be noisy with us. We understand that investors and analysts look at it. So we try to give some color on that, but remind everybody that is very variable and only over time comes back to the revenue growth. So just to remind everybody. And I think we said, we basically put in there that, in the first half of the year the growth of this was in the 70s. Pretty close to revenues. Why? Because there were some timing of billing in the first quarter relative to the second quarter that moved the first quarter up and the second quarter down but it really doesn't have much effect on the drivers of our business.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

And just to be very clear about this, like, philosophically, we don't actually manage the business to billings, and that's because it aligns us with our customers. So we manage it to usage which turns it to revenue pretty directly for us. What this means is, we're very heavily in an expanded mode. When we land, we typically land small. So that has a typically a small impact on billing. And when we expand, whether we actually do the expansion this quarter or next quarter doesn't really matter because it doesn't really change the usage of customer, it doesn't really change our growth profile, it doesn't really change the revenue that we're going to see from them. And so we see some noise there, and we don't manage the business to it.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC

Q

Thank you, Oli and David. I appreciate it.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Thank you.

Operator: Thank you. Our next question comes from Fatima Boolani from Citi. Your line is now open.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.

Q

Good morning. Thank you for taking my question. Oli one for you and one for David as well, please. Oli, you talked about some wins vis-a-vis DIY and open-source displacements in your prepared remarks. But I suppose in a more challenged or uncertain macroeconomic backdrop that the free or, if it ain't broke don't fix it-type model is potentially more attractive. So I'm curious if you can give us some color commentary on how you expect to sort of effectively compete with "free open-source alternatives" especially for some of your volume-based solutions. And then I'll follow up for David separately.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Yeah. So free is actually the most expensive typically because you have to bill it yourself, and it turns out people tend to be the most expensive thing for our customers. We mentioned in the script earlier that we actually had a number of sizable wins with customers that had announced layoffs, shortly before they actually bought from us for the first time or had big expansions with us. And that's because we have them be more efficient, we have them concentrate their efforts where it actually adds to their business, as opposed to reinventing the wheel and more expensive and execution for themselves.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.

Q

I appreciate that. And David, just for you, I think historically you've characterized that roughly three-quarters of the business is tied to committed and rate card committed-type contracts. And I think you were very categorical in mentioning that RPO levels are moderating, some of your customers moderate their commitment level. So I was curious to get your perspective on sort of the next six to 12-month impact on increased conservatism around the commit levels, as well as how that translates into the quarter of your business that is very much usage and overage-oriented, if you could just frame that for us and more of the six to kind of 12-month frame from here. And that's it from me. Thank you.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. Thanks for the question. We haven't seen any change in those numbers. We still have the land, commit, use, grow, get into on-demand, recommit. But we did say that, in the level of conservativism that was introduced to some clients that they may have stayed more into their previous commit plus on-demand. Because of that, that doesn't for that situation affect the revenues because they're still consuming the same, but they may want to retain more optionality. This is really sort of, in looking at financial management, with level of uncertainty, you generally would pay a higher price if you stay that way, but you'd be trading off the higher unit price, the marginally higher unit price for the more optionality. And we did see some of that. We don't know what's going to happen next, but we would think that if we continue to have macro uncertainty, there will be some customers that will opt for that type of pattern relative to the commitments.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

And we're fine with that, by the way.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

We designed the business that way. We don't offer large discounts for very large time commitments, and again, that's by design, like, we actually want to align our success with the usage of our customers, and we are happy to keep it that way, in times like that this is always better.

Fatima Boolani
Analyst, Citigroup Global Markets, Inc.

Q

Thank you.

Operator: Thank you. Our next question comes from Matt Hedberg from RBC Capital Markets. Your line is now open.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey. Great. Thanks for taking my question guys. Maybe David, a follow up, I think, really to Raimo's question earlier, in your guidance philosophy did you assume other verticals beyond consumer discretionary slow their usage, and maybe what are the assumptions from smaller customers? It sounded like they actually were fairly strong this quarter.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. To take the second part, I think that we saw that in our smaller customers we had very consistent net and gross retention. We always do that. So our guidance always takes the drivers which would be the organic or usage growth, and of the new logos, it always takes it down. So we do that in every quarter. I think you know that from following us. And in this quarter, I mentioned that by passing through less of the beat, we inject an incremental level of conservativism. But overall, the philosophy of basically taking all of those things down remains at the core of our philosophy of providing guidance.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Got it. Okay. And then, was there a geographic element to any of the, kind of, the slowdown in consumption? Was there a European element, or was it sort of just broad-based geographic?

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

There was not. We did not see that. It was not geographic. As we mentioned, it tended to be more either large spend or industry-based, but we did not see that geographical element.

Matthew Hedberg
Analyst, RBC Capital Markets LLC

Q

Got it. Thanks a lot.

Operator: Thank you. Our next question comes from Kamil from William Blair. Your line is now open.

Kamil Mielczarek
Analyst, William Blair & Co. LLC

Q

Good morning, everyone. Thanks for taking my question. One for Olivier, maybe. First of all, congrats on the acquisition of Seekret. Datadog has historically done a great job of rapidly integrating these products and launching them into new solutions. I think at Dash, you mentioned that the typical turnaround is one year for these products to become standalone Datadog solution. However, given the upward trend in cash generation and your cash and equivalents are now approaching $2 billion, have your thoughts changed around potentially making a more transformative acquisition, especially given the decline in market valuations today?

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

It's possible. Everything is open. We've looked at some of those in the past. We think the bar is higher for larger businesses like that. But we're really looking at valuations coming down and some more opportunities presenting themselves to us there. So everything is possible. But in general we're very active on the M&A side. I think we'll only be active as markets temper, as they are right now. But there's not much more I can say.

Kamil Mielczarek
Analyst, William Blair & Co. LLC

Q

Great. And just as a follow up, earlier this year, we spoke about Datadog building out its recruiting engine, and I see you've accelerated investments into sales and marketing again this quarter, I think even after adjusting for

T&E. Can you update us on where these incremental investments are focused? And given the macro environment, how do you think about the balance between preserving margin versus continuing to hire maybe more aggressively and coming out stronger on the other end? Thank you.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

So right now, we're aggressively recruiting, we're building capacity, we're successful at it. And I really see it as a predictor of future success. We're in this interesting situation because as a company we are very efficient. We've been very disciplined from the founding of the company. For those of you who have followed us for a long time, we burned less than $30 million on our way to IPO, and we've generated a lot more cash in that since then. So discipline is really in the DNA of the company. We also built the business around model that is frictionless and extremely efficient. And we've shown this efficiency, I would say, over the past two quarters by growing it very fast, while being fairly profitable.

So there's no doubt in our minds about the long-term profitability profile of the company. So what this does is that, it affords us opportunities to invest in times like this that the rest of the market will not have. Last year, everybody [indiscernible] (00:49:19) spend money, it didn't matter. This year, I think it's a little bit different. So we really see that as an opportunity to break from the pack even further and innovate build self-capacity and all those things. Now, obviously, as I said earlier, discipline is in the DNA of the company. So we're always looking at what our margins are, what the macro environment is, or we have all the deliveries we need to adjust so we can maintain cost stability in the future. David, do you want to comment some more?

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. I just want to add that, what we said all along was, we tried to maintain a steady investment profile which is focused on R&D and sales and marketing investments, and it's banded by what we can execute, what we feel we can hire, integrate, et cetera. And in periods where there is an acceleration, we've said this many times on the top line, we can't invest as fast as that when the top line went up to 80. So you're going to have margin expansion. That was exaggerated because there were some costs that didn't happen in COVID that are part of our normal business operations. So we try to maintain a steady profile of investment. And the variability is, when there's acceleration at the top line, you might see that because it flows through at such a high marginal rate. And then if you see a deceleration, you might see less of that margin expansion. So that's our philosophy, but it's always to invest and take advantage of the long-term opportunity.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

Last thing I'd say, we feel great about the opportunities. We feel great about the, as I mentioned earlier, the leading indicators of success, whether it's new logos, product attaches, or product pipeline and our ability to ship it, as well as the pipeline we see of customers that are in sales processes with us for new products or just brand new deployments. So we feel great about all that. And it makes us very confident into our investment. What's possible, though, is that, the demand environment is bit more challenged. It will be a bit of a longer time for us to show around these investments but we are fine with that.

Kamil Mielczarek
Analyst, William Blair & Co. LLC

Q

That's very helpful color. Thanks, guys.

Operator: Thank you. Our next question comes from Brent Thill from Jefferies. Your line is now open.

Brent Thill
Analyst, Jefferies LLC

Q

Good morning. David, I think everyone is still a little confused. You're seeing an inversion with what's happening with SMB and large enterprise. Many companies are calling out weakness in SMB and not in large. Can you explain why you think you're seeing this inversion, and are you embedding a more conservative view in the back half?

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. Not an inversion. I think what we said was, we did not see what you're saying, which is SMB and smaller customers did not act differently than they had. What we said was, whether it's an enterprise, mid-market or SMB, what happened was in certain segments, consumer, et cetera, we had a more conservative or a more of a cost mentality. And two, irregardless of where it was in – remember SMB for us is a 1,000 employees or less, mid-market 1,000 to 5,000, enterprise 5,000 and up, that in the larger areas where there had been substantial expansion, we saw a look at that cost. So those were the determinations. I mean, for us it wasn't Europe, it wasn't that SMB fell out, it was those things. And in terms of the second half of the year, we don't know, but in what we guide, always we assume lower organic growth in all the sectors than we have historically and that we might expect. So I think inversion is the wrong thing, because what happened was, the driver of the cost look was not whether it was an SMB, mid-market or enterprise, but the level of spend and the industry.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

[indiscernible] (00:53:45) we are critical to our customers, critically important. We deliver value, we help them be more efficient. So in general, whatever the size of the customer is, we're not on the chopping block. But the more customers spend on us, they're going to look for savings where they're spending money, and they're going to see that at the larger levels of spend with us. And as mentioned earlier, there's always a little bit you can optimize, especially with some of the volume-based products.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

And by the way, gross retention stayed the same at all the different levels, SMB, mid-market and enterprise. So when you're talking about, do you have the solution or are you continuing to use solution, we saw no change in the gross retention across all of our customer sizes.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks for clarifying.

Operator: Thank you. Our next question comes from Gregg Moskowitz from Mizuho. Your line is now open.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

Okay. Thank you for taking the questions. Oli, you're frequently speaking to a lot of Datadog customers. Anecdotally speaking, are they raising more questions about your pricing levels in this environment? Any commentary on that would be helpful.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

So we're actually very optimistic from our conversations with customers because there's more and more of them, they want to buy more product, they want to use more of our product, they want us to solve bigger problems for them. Everybody wants a better deal, but I think that's always been true and that's always going to be true, and that's even truer in situations like this where the CFOs have a mandate to be more conservative. But anecdotally, from what we see with customers, we're very bullish.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

Okay. Got it. And then you touched on some interesting examples in your script, but if you were to look back over the past six months or so, I'm wondering, whether or not there has been any change to the trajectory of customer consolidation or standardization on Datadog.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

So we keep seeing more and more of it. It's still not the majority of what we do. But we think, again, if there is prolonged macro issues in the market like we might see more consolidation and customers might want to really try to save on their legacy software by consolidating on us, so we definitely see that as a possibility. Again, that's not the majority of what we do today, that's not what we base any of our projections on, but that's something that we think might happen.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

Okay. That's helpful. Thank you.

Operator: Thank you. Our next question comes from Mike Cikos from Needham & Company. Your line is now open.

Mike Cikos
Analyst, Needham & Co. LLC

Q

Hey. Thanks for taking the questions here guys. I did just want to come back to that other point previously regarding the SMB versus enterprise, and really, is it fair to characterize some of the, I guess, movements you're seeing with these larger deals? Is it may be less of an impact to you at the SMB level either because you're less of their wallet share when they're looking to pay out their vendors, or is it possible that those SMB organizations just have less exposure to your more usage-based products?

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

They have the same exposure, that simply the difference is, is it worth your time to save $5,000. Probably not. If you're a much larger customer, it's worth your time to save $500,000. And that's what we see with those optimizations.

Mike Cikos
Analyst, Needham & Co. LLC

Q

Understood. And then the follow-up I had for you is, if I look at trends for multi-product adoption from your customers, I think this is the first time we've seen your two-plus product module adoption actually decline sequentially from 81% to 79%. Is the implication there that your customers are starting smaller now or deciding to opt, hey, we'll take another product from you at a later date? Again, if you could help me parse out that metric, that would be helpful.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

It's just mechanicals because I think we said 75% of our new logos are landing with two or more products, and we have more new logos. And so this pushes the number down a little bit.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

There's nothing, 81%, 79%. These are all just – there's nothing, no change in trend.

Mike Cikos
Analyst, Needham & Co. LLC

Q

Got it. Thank you, guys.

Operator: Thank you. Our next question comes from Peter Weed from Bernstein. Your line is now open.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you for taking my question. I'm interested in the customers that are doing some cost rationalization and trying to unpack, is that something that's targeted directly at Datadog or is it, actually, as part of a broader cloud rationalization that you see going on, it just happens to be that Datadog gets pulled into that and may even just see splash-on effect as customers are managing their overall cloud topology, and with the pricing that pulls down Datadog? Help me unpack those two things, whether or not it's Datadog-focused or more of a broader cloud focus.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

It's just focus on their cost structure. So they line up their expenses by decreasing – in decreasing order, and they heat up everyone at least in this year what it is that they can do to optimize. And again, you've seen a number of customers that had layoffs, so they're going after their cost structure, their hard cost structures or their workforce, and we're part of that. I think that it's a good thing because those customers spend a lot with us, we're very critical, we're one of the top vendors. That means for those of them who use us wall to wall, like, we are to a certain extent tied to their own trajectory.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. So you're saying that this is very focused on Datadog as a line item and not just a splash-on effect, necessarily a broader cloud rationalization.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

No. I'm saying they are focused on what they're spending money on. And for some of them they're spending a lot of money on us, they are spending more money on the cloud, and I guarantee you they are also trying to save money on that. And we know that the cloud providers are also working with these customers help them with their spend. I think everybody is aligning trying to make their customers successful there. And we actually have been involved in efforts where we work with the cloud providers and these customers to help them make the most of what they have. And again, in times like these, we want to be on the side of our customers, we want to help them, we want to help them get the most of what they spend on us, so we can have a long-term successful relationship with them.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Given the stickiness and what we do is just monitoring real-time applications for their clients, we feel that, what our experience has been that, it's less focused on other things than Datadog. But when you're looking at your cost structure, there are opportunities, as you said, to rationalize across, but generally, if you look at the gross retention you look at how important Datadog is to the businesses. And you read the newspapers, you see that it's focused on other things more.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah. No, that makes sense. And one other last question, if you may, I think you alluded to some timings of some contracts over quarters and this type of thing, and that there may have even been some improvements in July and some of the momentum of closing contracts. Can you comment on some of those improvements and how you see them kind of juxtaposed with some of the other caution that you're talking about in half two?

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

A

I think the improvement in July were not about closing contracts. The one I mentioned were about usage trends, which is fairly for us [indiscernible] (01:01:40) from the closings and the contracts and everything else. We also, again, have great pipeline, and we're very happy with what we've seen in the sales side in July. But [indiscernible] (01:01:50) we commented about the usage.

David M. Obstler
Chief Financial Officer, Datadog, Inc.

A

Yeah. Like they're always – I think we've been on calls over time, every call, if there's some timing difference, it's sort of positive. Billing was in this quarter. We try to point it out because when the bill goes out or when the commitment is not as correlated to the revenues as ARR is, so I think we said that on almost every earnings call, and we just remind everybody all the time that, because of the land-expand model that you're going to have variability plus and minus. And when it's plus, we want to remind everybody not to read anything into it, and when it's less, we want to remind everybody that that's not the major metric that drives top-line growth of the company.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC

Q

Sure. But I mean, if you've got utilization, it should turn into additional revenue in future periods. And I think you're mentioning kind of a positive trajectory. Do you see the sources of that kind of continuing?

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.
A

Yeah. Usage actually is revenue in the same period. Like, the two are one and the same. There's no delay between those two. [indiscernible] (01:03:02) one way or another was billings.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC
Q

Yeah. And I guess, what I'm getting at is, if you see that positive trajectory in July, it will turn into revenue in the period. But how are you seeing that going forward?

David M. Obstler
Chief Financial Officer, Datadog, Inc.
A

Yeah. But we're making marginal – we're telling you that, we're saying that, unlike in COVID, we had strong usage growth. We had usage growth in a lot of places and on average in the second quarter. What we're saying is that, in July, we saw pockets where there was a little better usage growth. But we're not calling the market here. We're basically reporting what we see and what we hope is the most helpful and informative way. So yeah.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC
Q

Okay. Thank you.

Operator: Thank you. This has concluded the question-and-answer session. I will now turn the call back over to CEO, Olivier Pomel for closing comments.

Olivier Pomel
Co-Founder, Chief Executive Officer & Director, Datadog, Inc.

All right. Thank you. I want to thank everyone for spending time with us on the call. And again, I want to thank all of Datadog employees for a great quarter and for continuing to be a fantastic company and sell products to our customers. So thank you all and we'll see you next quarter.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. Thank you for your participation. You may now disconnect.