
INSIDE CALENDAR Q3 2023 OBSERVABILITY EARNINGS:

WHAT THE QUARTER TELLS US

STEVE MCDOWELL, CHIEF ANALYST
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OBSERVABILITY MARKET

The observability market is centered around advanced monitoring and analytics solutions for IT systems. This market has grown significantly with the increasing complexity of modern IT environments, particularly with the widespread adoption of cloud computing, microservices, and containerization.

KEY FEATURES OF OBSERVABILITY SOLUTIONS

- **Real-Time Monitoring:** Continuous tracking of IT infrastructure, applications, and services to provide real-time insights into their performance and health.
- **Log Management:** Collecting, processing, and analyzing log data from various sources to identify patterns, anomalies, and potential issues.
- **Tracing and Analytics:** Detailed tracing of transactions and workflows across distributed systems, helping in pinpointing bottlenecks or failures.
- **AI and Automation:** Incorporating artificial intelligence and machine learning for predictive analytics, automated problem resolution, and performance optimization.

MARKET TRENDS AND DRIVERS

- **Complex IT Environments:** The shift to cloud-native architectures, such as microservices and serverless computing, increases system complexity, driving the need for sophisticated observability tools.

- **Digital Transformation Initiatives:** As businesses digitize their operations, the reliance on efficient and uninterrupted IT services grows, highlighting the need for comprehensive monitoring solutions.
- **DevOps and Agile Practices:** The integration of observability tools with DevOps practices supports continuous integration and delivery, enhancing software development and operational efficiency.

Of the three largest publicly traded players in the observability space, only Dynatrace and Datadog have reported earnings this cycle. Splunk is scheduled to report on November 28, but its performance may be colored by its pending acquisition by Cisco.

We'll look at Dynatrace and Datadog as proxies for the overall market.

DYNATRACE

Dynatrace reported its fiscal Q2 2024 earnings on November 2, 2023, handily beating Wall Street expectations on both the top and bottom lines.

The company demonstrated strong financial performance during the quarter:

- **Revenue:** Total revenue for the second quarter was \$352 million, representing a 24% year-over-year growth.
- **Subscription Revenue:** Subscription revenue for the second quarter was \$334 million, up 26% year-over-year.
- **Gross Margin:** Non-GAAP gross margin for the second quarter was 85%, up 1 point from the previous quarter and 2 points from the same quarter the previous year.
- **Operating Income:** Non-GAAP operating income for the second quarter was \$106 million, accounting for 30% of revenue.
- **Net Income:** - Non-GAAP net income was \$93 million, or \$0.31 per diluted share.
- **Annual Recurring Revenue (ARR):** ARR for the second quarter was \$1.34 billion, representing a 24% year-over-year growth in constant currency.
- **Net New ARR:** Net new ARR on a constant currency basis was \$59 million in the quarter. This exceeded expectations, driven by notable 7-figure competitive wins and ongoing expansions in the customer base.
- **Customer Growth:** Dynatrace added 160 new logos (new customers) during the quarter.

- **Customer Expansion:** 64% of Dynatrace's customers are using three or more modules, indicating strong customer adoption and expansion of existing relationships.
- **Gross Retention Rate:** Dynatrace maintained a gross retention rate in the mid-90s, contributing to a net retention rate of 114% in the second quarter.
- **Free Cash Flow:** Free cash flow for the quarter was \$34 million. On a trailing 12-month basis, it amounted to \$330 million, or 25% of revenue.
- **Balance Sheet:** Dynatrace ended the second quarter with a strong balance sheet, including \$702 million of cash and no debt.

Overall, Dynatrace's financial performance for the quarter was robust, reflecting its growth in recurring revenue, profitability, and customer acquisition, all of which contribute to its position as a leading player in the observability and application security market.

CHALLENGES

Dynatrace did not articulate any specific challenges or obstacles to growth during its earnings call.

OUTLOOK

Dynatrace has provided a positive forecast and outlook for the future, indicating its confidence in its growth prospects and continued success.

FY24 Guidance Summary

Based on information available as of November 2, 2023, Dynatrace is issuing guidance for the third quarter and updating guidance for full year fiscal 2024 in the table below. This guidance is based on foreign exchange rates as of September 30, 2023. Given recent strengthening of the U.S. dollar, we now expect total foreign exchange to be a headwind of approximately \$5 million on ARR and a tailwind of approximately \$7 million on revenue for fiscal 2024. This represents an incremental headwind of approximately \$16 million to ARR and \$8 million to revenue for the full year when compared to our prior guidance. Growth rates for ARR, Total revenue, and Subscription revenue are presented in constant currency to provide better visibility into the underlying growth of the business.

(in millions, except per share data)	Current FY 2024 Guidance	Prior FY 2024 Guidance	Change at Midpoint
Total ARR	\$1,480 - \$1,490	\$1,475 - \$1,490	\$3
As reported	19% - 20%	18% - 20%	50 bps
Constant currency	19% - 20%	18% - 19%	100 bps
Total revenue	\$1,409 - \$1,419	\$1,400 - \$1,415	\$7
As reported	22%	21% - 22%	50 bps
Constant currency	21% - 22%	20% - 21%	100 bps
Subscription revenue	\$1,334 - \$1,344	\$1,326 - \$1,341	\$6
As reported	23% - 24%	22% - 24%	50 bps
Constant currency	22% - 23%	21% - 22%	100 bps
Non-GAAP operating income	\$377 - \$386	\$357 - \$367	\$20
Non-GAAP Operating Margin	27%	25.5% - 26%	125 bps
Non-GAAP net income	\$328 - \$337	\$309 - \$320	\$18
Non-GAAP net income per diluted share	\$1.09 - \$1.12	\$1.03 - \$1.06	\$0.06
Diluted weighted average shares outstanding	300 - 301	300 - 301	-
Free cash flow¹	\$313 - \$320	\$303 - \$312	\$9
Free cash flow margin	22% - 23%	22%	50 bps

(in millions, except per share data)	Q3 Fiscal 2024 Guidance
Total revenue	\$356 - \$359
As reported	20% - 21%
Constant currency	19% - 20%
Subscription revenue	\$337 - \$340
As reported	21% - 22%
Constant currency	20% - 21%
Non-GAAP operating income	\$94 - \$97
Non-GAAP Operating Margin	26.5% - 27%
Non-GAAP net income	\$82 - \$85
Non-GAAP net income per diluted share	\$0.27 - \$0.28
Diluted weighted average shares outstanding	299 - 300

All growth rates are compared to the third quarter and full year of fiscal 2023. Reconciliations of non-GAAP operating income, non-GAAP net income, non-GAAP net income per diluted share and free cash flow guidance to the most directly comparable GAAP measures are not available without unreasonable efforts on a forward-looking basis due to the high variability, complexity and low visibility with respect to the charges excluded from these non-GAAP measures; in particular, the measures and effects of share-based compensation expense, employer taxes and tax deductions specific to equity compensation awards that are directly impacted by future hiring, turnover and retention needs, as well as unpredictable fluctuations in our stock price. We expect the variability of the above charges to have a significant, and potentially unpredictable, impact on our future GAAP financial results.

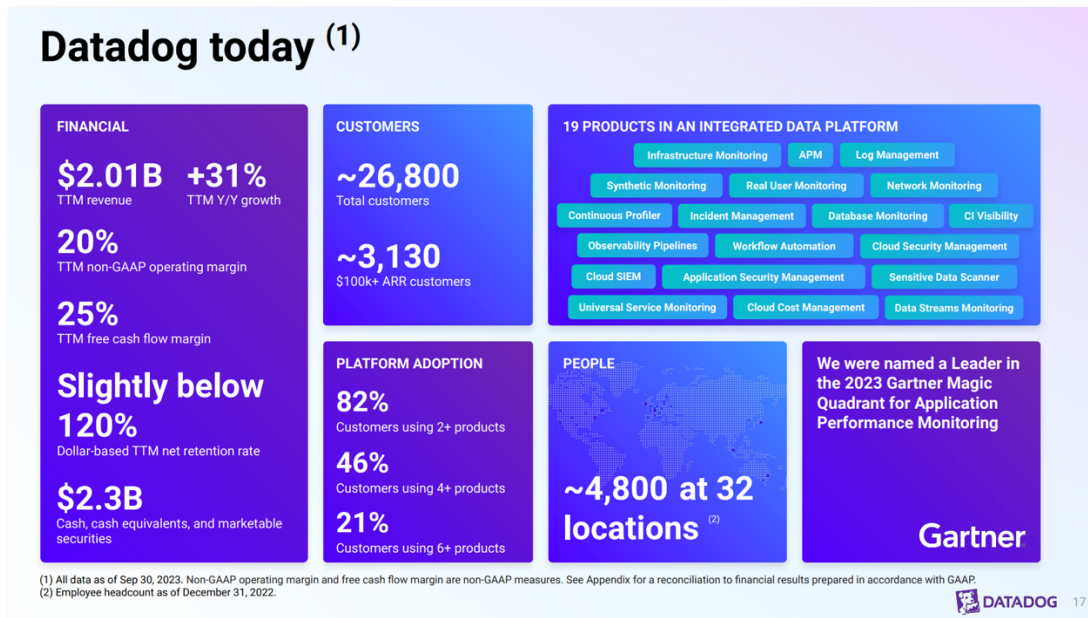
Here are the key aspects of Dynatrace's forecast and outlook:

- **ARR Growth:** Dynatrace expects its Annual Recurring Revenue (ARR) to continue growing. The company raised its full-year ARR guidance to a range of \$1.48 billion to \$1.49 billion, representing 19% to 20% growth year-over-year in constant currency. This demonstrates confidence in its ability to attract and retain customers.
- **Revenue Growth:** The company anticipates strong revenue growth, raising its full-year revenue guidance to a range of \$1.409 billion to \$1.419 billion, reflecting 21% to 22% growth year-over-year in constant currency. This growth is driven by the expansion of its customer base and the adoption of its observability and security solutions.
- **Profitability:** Dynatrace remains committed to maintaining a balanced approach to profitability. Despite investments in R&D innovation and go-to-market activities, the company raised its full-year non-GAAP operating margin guidance to 27%, indicating its ability to manage costs effectively while growing the business.
- **Free Cash Flow:** The company expects robust free cash flow generation, with guidance in the range of \$313 million to \$320 million. This reflects a free cash flow margin of 22% to 23% of revenue, demonstrating its ability to convert revenue into cash.
- **Customer Expansion:** Dynatrace foresees further expansion opportunities, driven by new customer acquisitions and existing customer growth. The company's strategy includes attracting high-value new logos and increasing net retention rates, with a focus on expansion activity.
- **Investments:** Dynatrace plans to make strategic investments in various areas to drive future growth. These investments include expanding partnerships with global system integrators and hyperscalers, increasing sales capacity, and implementing targeted marketing initiatives.
- **Innovation:** Dynatrace continues to prioritize innovation in areas such as AI, application security, and developer observability. The introduction of Davis CoPilot, expansion of Grail, and the acquisition of Rookout demonstrate the company's commitment to delivering cutting-edge solutions to its customers.

Dynatrace's forecast and outlook for the future are optimistic, with expectations of continued revenue and ARR growth, profitability, and strong free cash flow generation. The company's focus on customer expansion, strategic investments, and innovation positions it well for long-term success in the observability and application security market.

DATADOG

Datadog reported its fiscal Q2 2023 results on November 7, 2023. Like Dynatrace, Datadog beat consensus estimates along all dimensions.



Here are the key highlights for Datadog's strong quarter:

- Revenue Growth:** Datadog's revenue for the quarter was \$548 million, representing a significant 25% increase compared to the same quarter in the previous year. This revenue figure also exceeded the high end of their guidance range.
- Customer Growth:** Datadog continued to expand its customer base, ending the quarter with approximately 26,800 customers. This marked growth from about 22,200 customers in the previous year.
- ARR Growth:** The company reported that approximately 3,130 customers had an Annual Recurring Revenue (ARR) of \$100,000 or more. These high-value customers contributed to around 86% of Datadog's ARR.
- Free Cash Flow:** Datadog generated free cash flow of \$138 million during the quarter, with a free cash flow margin of 25%. This indicates the company's ability to convert its revenue into cash and maintain profitability.
- Platform Adoption:** Datadog's platform adoption remained strong, with 82% of customers using two or more of the company's products. Additionally, 46% of customers were using four or more products, reflecting the breadth of Datadog's platform offerings.

- **Business Drivers:** Datadog experienced improved usage growth during the quarter compared to the previous quarter. While there was a moderation in cloud optimization activity by some customers, new logo activity remained robust, with a record number of new deals with over \$100,000 in annual commitment.
- **Milestones:** Datadog achieved significant milestones, including its Infrastructure monitoring ARR exceeding \$1 billion and its APM suite (Application Performance Monitoring) ARR exceeding \$500 million. The company's log management product also exceeded \$500 million in ARR.

Datadog demonstrated solid financial performance, revenue growth, customer acquisition, and continued adoption of its platform during the quarter. The company's ability to attract high-value customers and generate free cash flow reflects its position as a leading player in the observability and monitoring space.

CHALLENGES

Datadog mentioned a few challenges and observations during the presentation:

- **Cloud Optimization Moderation:** Datadog noted that the intensity and breadth of cloud optimization activities among its customers appear to be moderating. While optimization efforts continue to impact its business positively, the company believes that the level of optimization it had experienced in recent quarters is slowing down. This moderation in cloud optimization could potentially affect the pace of growth in certain areas of Datadog's business.
- **Larger Customer Growth:** Datadog acknowledged that larger spending customers are growing at a slower rate compared to smaller spending customers. This observation highlights a challenge in expanding its customer base among larger enterprises. However, Datadog continues to work on retaining and expanding its relationships with existing larger customers.
- **Economic Uncertainty:** The company alluded to the broader macroeconomic environment, mentioning that it has continued to grow its business across product lines despite a more cost-conscious demand environment over the past year. Economic uncertainty and market volatility could pose challenges in terms of customer spending and budget allocation.
- **AI Adoption:** While Datadog sees signs of AI adoption among its customer base, it recognizes that AI-related usage is more pronounced among next-gen AI-native customers. The company's challenge is to encourage AI adoption across industries and customer sizes to drive more significant cloud and observability usage.

While Datadog faces challenges such as moderating optimization trends and competitive pressures, the company believes that it's well-positioned to address these challenges through its ongoing investments in innovation, expanding its product offerings, and maintaining a strong focus on customer value.

OUTLOOK

Datadog's outlook is positive and reflects its confidence in its long-term growth prospects.

Financial outlook (as of Nov 7, 2023) ⁽¹⁾

	4Q23	FY23
Revenue	\$564-568M	\$2,103-2,107M
Non-GAAP operating income ⁽²⁾	\$129-133M	\$453-457M
Non-GAAP EPS ⁽²⁾	\$0.42-0.44	\$1.52-1.54
Weighted average diluted shares	Approx. 355M	Approx. 351M

(1) Financial outlook are forward-looking statements. See Safe Harbor for important information about these assumptions and forward-looking statements.
(2) Non-GAAP measures. See Appendix for a reconciliation of these non-GAAP measures to the most directly comparable GAAP measures.

Here are the key points related to Datadog's future performance gleaned from its earnings call:

- **Secular Growth Drivers:** Datadog believes that digital transformation and cloud migration are long-term secular growth drivers for its business. As organizations continue to adopt cloud technologies and modernize their IT infrastructure, the demand for Datadog's observability and security solutions is expected to grow.
- **Platform Expansion:** Datadog's strategy involves expanding its platform to provide end-to-end observability and security solutions across various datasets, products, and boundaries. The company plans to continue innovating and delivering more solutions to meet the evolving needs of its customers.
- **DevSecOps Emphasis:** Datadog is focused on making DevSecOps practices easy to adopt for all customers. By offering packages like Infrastructure DevSecOps and APM DevSecOps, the company aims to help customers monitor and secure their entire technology stack efficiently.

- **AI and Large Language Models (LLMs):** Datadog recognizes the importance of generative AI and LLMs in the future of technology. The company plans to integrate with more components of the AI stack and develop its own LLM observability products to drive growth in cloud workloads and deliver AI-driven innovations to customers.
- **Customer Acquisition:** Datadog's new logo activity remains robust, with a record number of new deals exceeding \$100,000 in annual commitment for two consecutive quarters. The company expects these new logos to become larger customers over time as they expand their usage of Datadog's products.
- **Multiyear Deals:** Datadog has observed an increasing preference among customers for multiyear deals, indicating a desire for longer-term strategic partnerships. This trend aligns with Datadog's goal of being a mission-critical partner for its customers.

Datadog's outlook is optimistic, with a focus on sustaining its growth momentum, expanding its customer base, and delivering innovative solutions to meet the evolving needs of organizations in a cloud-centric world.

ANALYSIS

The observability market is healthy and showing solid growth. Datadog and Dynatrace each reported revenue growth of ~25%, with even greater growth projected for the current quarter. This despite Datadog's statement that its growth continues to be constrained by the broader macro-economic environment.

The observability space is outperforming nearly every other segment related to core IT infrastructure, even with the impacts from the macro that Datadog highlighted.

Functional consolidation is clearly behind much of the continued growth, with the marriage of observability and application security now critical factors for enterprise digital and data transformation efforts.

Dynatrace highlighted during its earnings call that the company is seeing customers prioritizing vendor consolidation and standardization of observability solutions across their organizations. This is consistent with what we hear from others and reflects conversations we have with IT organizations.

IT organizations are looking for unified observability solutions. The vendors able to provide that will be the winners in the long term.

The uncertainty caused by the pending acquisition of Splunk by Cisco will enable new opportunities for Splunk's competitors in the market. We expect to see disproportionate growth in the short-term for some vendors in this space as business is redirected from Splunk; that churn should settle following completion of the acquisition.

Overall, we expect the observability market to continue growing, driven by increasing IT complexity, the need for efficient system performance management, and the ongoing evolution of cloud computing. Innovations in AI and machine learning are likely to further enhance the capabilities of observability platforms, making them more predictive and proactive in managing IT environments. The competition between market players like Dynatrace and Datadog is likely to spur continuous innovation, leading to more advanced and user-friendly observability solutions.

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