06-Nov-2024

Freshworks, Inc. (FRSH)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to Freshworks' Third Quarter 2024 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Joon Huh, Head of Investor Relations. Please go ahead.

Joon Huh

Senior Vice President-Finance, Investor Relations & Treasury, Freshworks, Inc.

Thank you. Good afternoon, and welcome to Freshworks' third quarter 2024 earnings conference call. Joining me today are Dennis Woodside, Freshworks' Chief Executive Officer and President; and Tyler Sloat, Freshworks' Chief Operating Officer and Chief Financial Officer.

The primary purpose of today's call is to provide you with information regarding our third quarter 2024 performance and our financial outlook for our fourth quarter and full year 2024, as well as our preliminary outlook for full year 2025.

Some of our discussion and responses to your questions may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on Freshworks' current expectations and estimates about its business and industry, including our financial outlook, macroeconomic uncertainties, management's beliefs, the timing and amount of future repurchases of our Class A common stock, the anticipated benefits, costs and the timing of our workplace realignment and associated reduction in head count and certain other assumptions made by the company, all of which are subject to change.

These statements are subject to risks, uncertainties and assumptions that could cause actual results to differ materially from those projected in our forward-looking statements. Such risks include, but are not limited to, our ability to sustain our growth, to innovate, to reach our long-term revenue goals, to meet customer demand, and to control costs and improve operating efficiency. For a discussion of additional material risks and other important factors that could affect our results, please refer to today's earnings release, our most recently filed Form 10-K, and our other periodic filings with the SEC. Freshworks assumes no obligation to update any forward-looking statements in order to reflect events or circumstances that may arise after the date of this call, except as required by law.

During the course of today's call, we will refer to certain non-GAAP financial measures. Reconciliations between GAAP and non-GAAP financial measures for historical periods are included in our earnings release, which is available on our Investor Relations website at ir.freshworks.com. I encourage you to visit our Investor Relations site to access our earnings release, supplemental earnings slides, periodic SEC reports, a replay of today's call, or to learn more about Freshworks.

And with that, let me turn it over to Dennis.

Dennis M. Woodside

Director, President & Chief Executive Officer, Freshworks, Inc.

Thanks, Joon, and thank you, everyone, for joining us today on the call. I'm pleased to report that we had a strong third quarter. We outperformed across all our key metrics and exceeded our previously provided estimates for growth and profitability. The Q3 results reflect our focus on product innovation, operational discipline and our strategic imperatives.

Revenue grew 22% year-over-year to $186.6 million, and we generated free cash flow of $40.1 million, resulting in a free cash flow margin of 21% for the quarter. We nearly doubled our free cash flow compared to last year, representing a margin improvement of more than 700 basis points year-over-year. Adding our revenue growth and free cash flow margin for Q3, we exceeded the Rule of 40 in the quarter. We're proud of the operational efficiencies we're creating while scaling our business.

We ended the quarter with more than 69,600 total customers, with a net add of more than 800 customers. This represents the highest organic net adds for customers in the last four quarters. We welcomed notable customers onto the Freshworks platform, including Republic Airways, University of Oxford, ChampionX, the City of Bellevue, Sparebank 1, and TechStyle Fashion Group, to name a few.

Last quarter, we outlined our three key strategic imperatives to drive durable, profitable growth as we scale the business. The first imperative is that we invest in our largest, fastest growing Employee Experience business. This includes ITSM, ITAM, IT operations, and ESM.

Our second imperative is to continue delivering AI capabilities across our platform to increase productivity for our customers in Employee Experience and in Customer Experience. Our third imperative is to accelerate growth for our Customer Experience solutions, which include our customer service and sales and marketing products.

Today, I'll share proof that our strategy is working. I'll start with our first pillar, EX. Our EX business is strong with over $390 million in ARR and a year-over-year growth rate of over 40% in Q3. Today, more than 17,800 customers are using our EX solutions to deliver exceptional IT and employee service management. By prioritizing investments in EX, we are moving upmarket and winning more mid-market and enterprise deals.

We won 16 new and expansion deals over $100,000 in ARR in EX, including several against our largest competitor in Q3. Mid-market and large companies who rely on enterprise-grade software to compete at a global scale are choosing us over the competition. These companies operate in every sector, including public and private enterprises. They choose Freshworks to do what our competitors cannot, arm them with powerful yet affordable software that's as easy to implement as it is to use. This is our winning formula.

They tell us that they're tired of being forced into oversized solutions that are hard to implement and operate. Our expanded capabilities have earned us the right to compete in larger deals, and we're winning many of them. Leading innovators across industries are using our AI-powered EX software to deliver exceptional employee experiences.

In education, Georgetown, University of Pennsylvania, Pitzer, University of Aberdeen, Brunel University and many more are using Freshservice. For example, the University of Oxford chose Freshservice and Freddy Copilot for its simplicity and ability to scale with the university's ITSM needs across IT, finance and HR teams. Professional sports teams, including Premier League football clubs, Major League Baseball teams, NFL franchises, and Formula 1 racing teams are choosing our software. In retail, customers like Carrefour Belgium, Paul Smith and TechStyle Fashion Group have chosen Freshworks to overhaul their ITSM solutions.

We're also creating more value from the Device42 acquisition by cross-selling advanced ITAM capabilities to existing Freshservice customers. We're expanding our ability to win deals in a broader group of large, mature companies. One example is Republic Airways, a large regional airline that also contracts with major airlines such as American, Delta and United. We won this deal against our largest competitor in IT. This customer needed better visibility and control over their IT assets and configurations. Using Freshservice and Device42, Republic Airways now has a consolidated view of its numerous IT and hardware assets, which allows it to meet FAA compliance and resolve incidents more efficiently.

In line with our strategy, we are prioritizing more R&D investment for EX to fuel our high-growth businesses. In Q3, we shifted over 200 technical resources from other areas to our EX product and engineering teams. These resources are now accelerating our product development of ITSM and ESM capabilities, including new change management features, enterprise-grade access and control functionality, and new Freddy AI capabilities. By adding these resources to EX, we have significantly pulled forward our product roadmap, in some cases up to four quarters. We're winning in EX and we're excited about our business momentum.

Our AI products are gaining significant adoption and usage, and we are seeing monetization momentum quarter-over-quarter. As a reminder, we offer two AI products that are generally available today: Freddy Self Service to deflect frontline questions, and Freddy Copilot to assist agents. We monetize Freddy Self Service on a per session basis and monetize Copilot through a per seat add-on of $29 per month.

In Q3, paid Copilot adoption grew more than 35% over the previous quarter to over 1,700 paying customers. These customers can achieve more than 30% reduction in resolution time with Copilot while improving customer satisfaction. We increased attach rates for Copilot in new deals over $30,000 in ARR to more than 50%, and SMB customers continue to attach at double-digit rates. ARR from Copilot grew meaningfully quarter-over-quarter, with a slight majority coming from the EX business. We're still early on, but we continue to monetize Copilot ahead of our initial expectations.

One example of a customer finding great value with Copilot is Razorpay, a leading payment gateway services company in India with over 5 million customers. They needed an AI solution to scale their customer support without compromising quality. By implementing Freddy Copilot, they achieved remarkable results, automating 70% of routine queries and reducing resolution times by 30%. Our AI products enabled them to handle 20% more customer interactions, while simultaneously improving first contact resolution and boosting customer satisfaction scores.

Freddy Self Service continues to show positive momentum. We have more than 1,100 paying customers that are using Freddy Self Service for customer support. The number of paying customers has doubled since the beginning of the year, as many are realizing deflection rates of more than 40% to 50%. ARR from Self Service grew nearly 10% quarter-over-quarter in Q3. Customers are turning to us because they are looking for a robust platform of support solutions with leading AI capabilities that can help them scale.

Springer Nature is a global publishing company with more than 10,000 employees across 50 countries. Their customer agents were manually fielding a high number of queries from around the globe, so they needed an automated solution to help them address the high volume of L1 queries. With the adoption of Self Service, they were able to deflect the low-level support queries while achieving a CSAT score of 90%.

Finally, we recently announced the public beta of Freddy AI Agent. This marks a new generation of autonomous frontline agents powered by Freddy AI. Our Freddy AI Agent provides users with always-on, trustworthy and conversational service that can resolve service issues quickly, efficiently, and without human intervention. While automation capabilities have been available to our CX customers for years, Freddy AI Agent represents the new generation of Self Service capabilities and is now available for both our CX and EX customers.

A key differentiator is that customers can set up Freddy AI Agent in minutes by simply pointing it to their knowledge base, public URLs, support facts or policy documents. Our AI Agents don't require prescriptive, button-like flows that are time consuming to load and rigid in user experience. Instead, Freddy AI Agents engage in a personalized, humanlike conversation with memory and advanced reasoning to clarify queries, retain context, and have multi-turn conversations.

For more complex issues, the AI Agents can intelligently triage and seamlessly pass these to a human agent. Following months of testing in our own environment and with select customers, we have received valuable feedback and seen impressive business outcomes. For example, the large UK-based retailer, Hobbycraft, uses Freddy AI Agent to accurately respond to the wide and complex range of customer product questions. With minimal training, they went live and created instant customer support outside of normal business hours and across geographies.

Another customer, [ph] Bchecks (00:14:51), deployed their autonomous agents within 20 minutes. We will directly monetize usage of the CX version of Freddy AI Agent as soon as it moves from public beta to general availability, which is expected in Q1 of 2025. The EX version of Freddy AI Agent will be included exclusively in the enterprise plan for Freshservice. We will indirectly monetize this via higher [ph] WIM (00:15:20) rates and mix shift towards the enterprise plan.

Turning to our CX business, I'm happy to say that growth improved in Q3. Our CX business finished with over $360 million in ARR, growing nearly 10% year-over-year. We also improved our net customer adds in CX, doubling our net adds from the prior quarter. The most significant gains were from our international regions, driven by reduced churn and improved conversion of free to paid agents. In fact, Q3 was the lowest churn quarter ever for our customer support products. Our goal is to continue improving customer retention through product improvements and targeted outreach aimed at reducing churn. We ended the quarter with over 56,100 CX customers.

We are seeing several opportunities to cross sell CX to EX customers and vice versa. We saw this with the City of Bellevue in Washington State. The city provides essential municipal services and has over 1,600 employees. Initially, they chose Freshservice to modernize their service management operations, and now they've added Freshdesk Omni to create tailored workflows for external service requests. Another example of a cross-sell is Travel Counsellors, which has over 2,000 employees in 6 countries. After seeing productivity gains with Freshdesk, they adopted Freshservice and are now actively using Freshworks AI-powered solutions across their customer and employee experiences.

Furthermore, we are seeing signs that AI is a net tailwind to our CX business. The vast majority of companies are looking to their trusted software partner like Freshworks to provide the latest AI capabilities. This is demonstrated by the increasing customer adoption each quarter and the growing attach rate for both Copilot and Self Service. The vast majority of companies we hear from are not planning to build their own internal AI solutions or plugging in small, unproven vendors to deliver the latest AI capabilities.

Our AI capabilities are already helping us win new deals and creating more expansion opportunities. In fact, CX customers represent a large portion of our Copilot customers and all of our Freddy Self Service revenue today, including many B2C customers. At the same time, our total agent count continues to grow. We are laser focused on building our business to deliver AI innovations and accelerate monetization, both through a consumption model like Freddy Self Serve bots and a per seat model with Freddy Copilot. We believe this will position us to be an AI winner in the future.

In line with our strategy, we combined our customer service and sales and marketing units into a single CX team across product management, engineering, and marketing in Q3. In addition, we are focused on simplifying our core Freshdesk product experience to improve the ease of implementation and maintenance, and thereby increase the time to value. As part of our efforts, we are building on our core ticketing foundation to create a more seamless experience for support teams. We also introduced new collaborator features to improve response times and CSAT scores. We're excited about all the progress we have made in executing on our strategy this past quarter. We're confident in our ability to deliver sustained long-term growth, and we're bullish about our future.

To reaffirm our confidence in the company's strategy, we announced earlier today the board authorization for a share repurchase program of up to $400 million. We have a strong balance sheet with over $1 billion in cash. We are streamlining the business, and we expect to generate substantially higher cash flows in the coming years. We view this as a great investment opportunity to buy Freshworks shares at today's levels. Even after the share repurchase activity, we will maintain a very healthy balance sheet with well over $600 million in cash, which gives plenty of capital to invest organically in the business or through strategic acquisitions.

Now, let me turn it over to Tyler to cover the financial details.

Tyler Renwick Sloat

Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

Thanks, Dennis, and thanks, everyone, for joining on the call and via webcast today.

We're pleased to report that we have exceeded our revenue, non-GAAP operating income and free cash flow estimates this quarter, showcasing the strong financial discipline in our business model as we execute on our strategic imperatives. Our commitment to driving growth while maintaining a vigilant focus on operational efficiency has allowed us to further expand our non-GAAP operating margin to 13%, increasing more than 500 basis points quarter-over-quarter.

In Q3, we grew free cash flow 82% compared to last year to $40.1 million, resulting in a free cash flow margin of 21%. We are committed to making operational improvements that will position the business for profitable growth and sustained long-term success.

For our call today, I'll cover the Q3 2024 financial results, provide background on the key metrics, provide our forward-looking commentary and expectations for Q4 and the full year 2024, and close with our preliminary outlook for 2025. I'll include constant currency comparisons for certain metrics to provide a better view of our business trends. As a reminder, most of our discussion will be focused on non-GAAP financial results, which exclude the impact of stock-based compensation expenses and other adjustments.

Starting with the income statement. Total revenue in Q3 increased to $186.6 million, growing 22% for both as reported and on a constant currency basis. Professional services revenue contributed $2.2 million in the quarter, as we continue to shift services revenue to our growing partner network. Device42 revenue contribution was approximately $8.8 million for the quarter. Our EX business, which includes ITSM, ESM and Device42, continues to be the main contributor of our growth. As Dennis mentioned, the EX business ARR grew 40% year-over-year, with approximately 10 percentage points being contributed from Device42

Moving to margins, we maintained a strong non-GAAP gross margin of nearly 86%, improving from Q2, as we remain diligent and efficiently scaling the business. This represents an improvement of approximately 170 basis points compared to the prior year.

Our non-GAAP operating income came in at $24 million, representing a non-GAAP operating margin of approximately 13%, and ahead of prior expectations. This outperformance was due to higher revenue growth and lower personnel-related costs, as well as continuous improvements in our sales and marketing spend.

Moving to operating metrics. Our two key business metrics are net dollar retention and customers contributing more than $5,000 in ARR. As we observed in the first half of the year, gross expansion trends continue to be pressured in the current market environment. At the same time, we saw a slight improvement in our overall churn rate this quarter. Net dollar retention for Q3 was 107%, which includes a 2 percentage point benefit from FX. Looking forward to Q4, we estimate a net dollar retention of approximately 106% as reported and 104% constant currency, as we expect to see similar pressures on expansion for the rest of the year.

For our second key business metric of the number of customers contributing more than $5,000 in ARR, this metric grew 14% year-over-year to 22,359 customers, representing quarterly net adds of 615 customers. This customer cohort represents 90% of our ARR.

For our larger customer cohort, contributing more than $50,000 in the ARR, this cohort grew 33% year-over-year to 3,008 customers, representing quarterly net adds of 169. This cohort represents 50% of our ARR. For total customers, we added approximately 800 net customers in the quarter and ended with over 69,600 customers.

Now, let's turn to calculated billings, balance sheet and cash items. Our calculated billings grew approximately 19%, or 18% on a constant currency basis, to $196.3 million in Q3. Excluding the impact of Device42, calculated billings grew approximately 13.5%. One item to note for billings. Our calculated billings includes the reported revenue plus the change in total deferred revenue in the quarter. With the increase in longer-term deals, especially from Device42, the changes in long-term deferred revenue balances are starting to have an impact on the billings calculation. Since these amounts are included in other liabilities, we've added disclosures in our 10 Q filing to note the amounts. The difference in the long-term deferred revenue balance was an increase of $1.3 million in the quarter, and this is included in our calculated billings number.

Looking ahead to Q4 2024, our initial estimate for calculated billings growth is 16% to 17%. For the full year 2024, we expect calculated billings growth to be approximately 16% to 17%, with approximately 2 percentage points to 3 percentage points coming from the impact of Device42.

Moving to our cash items, we generated $40.1 million in free cash flow for Q3, outperforming our estimates thanks to the operational improvements we have implemented earlier this year. Given our strong cash flow performance again this quarter, we are increasing our full year 2024 estimates for adjusted free cash flow, which will exclude certain cash payments I will discuss later, to $150 million.

We continue to manage and offset share count dilution by net settling vested equity amounts by using approximately $12 million during the quarter. This activity is reflected in our financing activities and is excluded from our free cash flow. We plan to continue net settling vested equity amounts going forward, resulting in expected Q4 cash usage of approximately $10 million at current stock price levels. For the year, we expect to use approximately $16 million to net settle vested equity amounts. We ended the quarter with cash, cash equivalents, and marketable securities of $1.05 billion.

Turning to our share count for Q3, we had approximately 331 million shares outstanding on a fully diluted basis as of September 30, 2024. The fully diluted calculation consists of approximately 303 million shares outstanding, 25 million related to unvested RSUs and PRSUs, and nearly 3 million shares related to outstanding options.

We have made great strides in improving our operating efficiency over the last – in the past two years, as we inflected to generate non-GAAP operating income and deliver significant free cash flow. We also know that we have an opportunity and need to better focus our efforts around our key strategic imperatives.

As Dennis mentioned earlier, we shifted a number of technical resources in Q3 to further invest in the EX business as part of the strategic review process. To add more focus on our EX, AI, and CX priorities, we are also realigning our global workforce, putting us on a path to have a bigger impact for our customers. This includes a difficult decision to reduce our global head count by approximately 13%. We believe this will help us accelerate our growth, free up resources for reinvestment, and simplify the way we work so that we are running Freshworks in a way that is efficient and scalable.

As a result, we expect to incur a charge of approximately $11 million to $13 million in our Q4 results, and these charges will be excluded from our non-GAAP operating results going forward. Additionally, we expect to use approximately $12 million to $14 million in cash that we would exclude from our adjusted free cash flow amounts going forward. To be clear, this onetime cash impact is not included in our full year 2024 adjusted free cash flow estimate of $150 million that I provided earlier.

Now, on to our forward-looking estimates. For the fourth quarter of 2024, we expect revenue to be in the range of $187.8 million to $190.8 million, growing 17% to 19% year-over-year. This includes approximately $4 million from Device42 for the quarter. Non-GAAP income from operations to be in the range of $22 million to $24 million, and non-GAAP net income per share to be in a range of $0.09 to $0.10 assuming weighted average shares outstanding of approximately 302.1 million shares.

For the full year 2024, we expect revenue to be in the range of $713.6 million to $716.6 million, growing 20% year-over-year. This includes an estimate of approximately $15.8 million from Device42 for the year. Non-GAAP income from operations to be in the range of $80.8 million to $82.8 million, and non-GAAP net income per share to be in the range of $0.38 to $0.39, assuming weighted average shares outstanding of approximately 305 million. These non-GAAP estimates do not include the workforce actions we announced today and are based on FX rates as of November 1, 2024, so any future currency moves are not factored in.

Looking ahead, we're currently going through the planning process for 2025. We are layering in our growth objectives and taking into consideration the market demand environment and recent changes to the business. Based on our current planning efforts, the preliminary estimate for full year 2025 is revenue growth in the low to mid-teens, with meaningful expansion of non-GAAP operating margin to above 16% and free cash flow margin to above 25%.

As a reminder, we will be lapping the one-year anniversary of the Device42 acquisition in June, so we'll see tougher year-over-year comparison for revenue in the second half of 2025. We're taking a prudent approach with our preliminary estimates for next year to drive durable growth while improving efficiencies. Q4 has historically been our largest quarter and an important indicator for us, so we'll have a more prescriptive view of 2025 on the next earnings call.

As Dennis mentioned, given our strong financial position and improving cash profile, we have the opportunity to expand our capital allocation strategy. As such, our Board of Directors has authorized a share repurchase program of up to $400 million. This inaugural buyback program not only underscores the confidence we have in the durable and profitable growth of our business, but also reinforces our commitment to delivering long-term shareholder returns. We look forward to executing this repurchase thoughtfully as we advance our growth strategy.

Let me now turn the call back to Dennis for closing comments.

Dennis M. Woodside

Director, President & Chief Executive Officer, Freshworks, Inc.

Thank you, Tyler. As I reflect on our progress from Q3, the results are a clear indication that our strategy is working. I'm heartened by our product innovation, operational discipline, and strategic focus that positions us to drive durable, profitable growth. We are excited about the many opportunities in our business and the transformative potential of our AI solutions. Thank you to our customers, partners, employees, and shareholders for your ongoing support, and we're looking forward to a strong finish to the year.

And with that, let us take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Scott Berg from Needham & Company.

Robert Morelli Q

Analyst, Needham & Co. LLC

Hi, this is Rob Morelli. Thanks for taking the question. Great to hear some of the competitive wins on the mid-market and enterprise. Can you just touch on maybe some of the trends you saw in the SMB sector and how that business fared versus your initial expectations? Thanks.

Dennis M. Woodside A

Director, President & Chief Executive Officer, Freshworks, Inc.

Yeah. So, thanks for the question. We saw some real positive signs in Q3 around SMB. But that really is a continuation of some trends we've seen in prior quarters. If you go back three quarters ago, we had net adds of around 400 customers. Last quarter – or two quarters ago, it was 600, in this last quarter it was 800. And that trend is the result of some focused product investments we've been making in ensuring that customers get to value faster, and then some efforts we've made on the sales side and the service side to help those customers see the value in our products, which has helped churn in particular. We've also had some positive momentum in converting customers from free plans into pay plans. They're seeing value in AI, they're seeing value in the conversational solutions that we have on the CX side, in particular. So, that SMB businesses is starting to come around. We've been talking about it for a while and I think we saw some real positive signs this past quarter. We're excited to see how that plays out in Q4 and into next year.

Robert Morelli Q

Analyst, Needham & Co. LLC

Got it. Helpful color. And then on the reduction of force, any areas that were, I guess, impacted more than others or was it pretty broad-based? Thanks.

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah, it was pretty broad-based. I would say at the margin, we made some reductions in sales and marketing that are more focused on putting more of our effort around fewer markets, bigger opportunities. But generally, it was fairly broad-based. And really what we were doing is focusing our teams on the things that matter, the three big areas that I've been talking about, EX, and really driving that business up into the mid-market: AI, AI capability across all of our products and getting that CX business back to more robust growth.

Robert Morelli
Analyst, Needham & Co. LLC

Q

Got it. Helpful. Congrats on the quarter, and thanks for taking my questions.

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

Thanks, Rob.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Pinjalim Bora from JPMorgan.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Oh, great. Thank you for taking the questions. Congrats on the quarter. I want to ask you, I think I heard CX business kind of improved a little bit from, I think, 7% to 10% or something like that in ARR. What is driving that? Are you seeing – has seat growth kind of crossed at this point? Is that a [indiscernible] (00:35:55) is that kind of a bold statement at this point to make or – and what are you seeing in general and seat growth in CX and ITSM?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah. So, couple things. So, first of all, yes, the CX business has seen an increase in growth in Q3. And that's really the continuation of this trend that's persisted for a couple of quarters where we've started to see net adds pick up over the last three quarters. We've seen churn come down. As I mentioned, churn for our CX business was at an all-time low in Q3. That's the result of focused products investments that we've made and some improvements we've made in how we support and service customers.

In terms of seat additions, we're seeing seat growth continue across the business, but in CX in particular. So, we're pretty optimistic about where that business is heading. We're doing better operationally at driving growth from the business. I mentioned the free to paid conversion being higher this past quarter as a result of some real focused efforts. And as the SMB comes back – we've talked about this for some time, our CX business skews SMB, SMBs were more affected by higher interest rates, and we saw that in the form of lower expansion rates. But if SMBs come back, we're very well positioned to see that reflected in that CX business.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Yeah, understood. One follow-up for Tyler. Maybe talk about the assumptions around the 2025 number around ITSM/CX. Are you kind of assuming CX to grow above 10% for next year within the different components? And are you taking in anything from [ph] AI at this point (00:37:43)?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

Hey, Pinjalim. So, we wanted to put some numbers out there for 2025. Maybe, we saw what consensus is at and we're kind of in the middle of our planning efforts right now for next year. Also, Q4, as you know, is a really big quarter for us. So, there's still a little bit of unknown there. What we do know is that we have a lot of control on the bottom line, and we're very optimistic about our capability to kind of achieve and overachieve on the numbers, specifically the greater than 25% free cash flow margin.

We haven't broken out – so we just put out a range for revenue based on what we're preliminary seeing right now as we go through the planning process. At the end of the year, we will break that out more and obviously provide a lot more color, and we haven't provided any details on the product breakdowns.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Brent Thill from Jefferies.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks. Just back to the improving execution. I mean, when you think about how you kind of split between macro getting better, your own internal team executing better in the field, how would you kind of characterize the split and is there improvement across both, is there more improvement on execution than macro improvement? How would you characterize that mix?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah. Thanks, Brent. So, first of all, speaking about EX. So, on the EX side, we've continued to have success in moving upmarket. And you see that in the 40% headline growth, 30% organic growth for that business. And that's because the solution that we have in terms of fast time to value, low TCO, enterprise-grade product, that really is resonating, in particular, with customers that have, say, 5,000 to 20,000 employees. That's where we're really gaining a lot of traction, and that's regardless of what the macro is doing.

We're also seeing traction in AI. And again, I don't think this has much to do with macro, but we're seeing widespread adoption of Copilot. It's now half of all of our large deals have a Copilot element to them right out of the box, and we have a lot of upsell that has Copilot.

And then CX, we've been executing against this playbook to improve that product experience, improve the first 30 days for some time. We've started to see signs of improvement in the prior quarter. This past quarter, we made a big emphasis on driving better conversions of free users that are really just dabbling in the product into paid deployments, and that's worked out quite well. So, again, it's hard to separate what's macro and what's us. We've done a lot of work to drive the business, and I have to say, a lot of that credit goes to the teams here.

Brent Thill
Analyst, Jefferies LLC

Q

Okay. And, Tyler, good to see mid-teen margins. I would assume that's more of a pit-stopping kind of the long-term playbook has – has more in it over time. How are you balancing kind of that framework, growth versus profitability?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

Yeah, I mean, we're clearly – so I think you're talking about kind of what we said for next year, which is kind of mid-teens non-GAAP operating margins and income, and then the free cash flow greater than 25%. Look, we're definitely focused on being efficient and producing cash and bringing profit to the bottom line. But that being said, we're definitely also very focused on investing in growth and it's part of kind of some of the things we announced, but really specific to the strategy that we outlined, right? And we're really focused on kind of doubling down on that strategy and then definitely are still investing in growth.

Brent Thill
Analyst, Jefferies LLC

Q

Great. Thanks.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Brent Bracelin from Piper Sandler.

Brent A. Bracelin
Analyst, Piper Sandler & Co.

Q

Thank you. Good afternoon. Really appreciate the preliminary look into next year, and obviously the focus on improving margins here with the global restructuring. Dennis, I just wanted to frame in light of that, in light of the strong balance sheet, in light of the appetite to double down in really the mid-market enterprise. Can you talk about like opportunity for smaller M&A? How fragmented is the market? How broad is the product today in that Freshservice area and how much more room can you fill out the portfolio there to accelerate growth potentially?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah. So, thanks, Brent, for the question. So, look, EX is a fantastic market. The market's growing double-digit rates. The competitive landscape is very clear. You got ServiceNow [ph] who cares (00:42:48) about the biggest companies in the world. We do run into Atlassian. There's a number of small players and some incumbents. But nobody is really focused on that mid-market and lower end of enterprise where you have sophisticated IT departments that need a solution, they want to automate their IT operations, ITAM, ESM and they need an enterprise-grade platform, and that's what we provide. There's a lot of growth in that market. So, just ESM alone, right, that's where we're investing some of the resources that we reallocated into the EX team to going deeper in ESM, in particular in HR workflows, where we have a lot of customers asking us help us out with onboarding, help us out with off-boarding.

Managed service providers, another big area of opportunity. We have over a thousand MSPs on our platform today, and our product doesn't have the kind of capabilities that – they really want to manage multiple customers. So, we're building that and that should help spark more growth for our MSP biz. Device42 and ITAM is a huge opportunity for us and beyond ITAM, we see areas in ops, generally AO ops potentially, observability, all these are spaces that are open to us. We have a lot on our plate right now to execute against the areas that I identified, but we're pretty optimistic about that.

Of course, we're always on the lookout for acquisitions that we can tuck in and scale. We'll tend to look for areas where we have roadmap holes or capability gaps and we want to scale up faster. So, that's another tool in our toolkit as we continue to scale the business. And generally, we're committed to delivering long-term value for our shareholders. So, we're going to be smart about the investments that we made. Right now, Device42 is on everybody's minds here, how do we scale that and we've seen real good progress in the first couple of months of having D42 under the same roof.

Brent A. Bracelin
Analyst, Piper Sandler & Co.

Q

Great to hear. Thank you for the color.

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Thanks.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Elizabeth Porter from Morgan Stanley.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you so much. I wanted to understand the fiscal 2025 guidance just a little bit more. It sounds like EX is still strong and CX is getting better and you also have the opportunity to drive better monetization with Freddy. Just given organic billings right now, we're already in that mid-teens range. Are there any areas that you are kind of incrementally cautious on, or help us think about some of the puts and takes?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

Yeah. Hey, Elizabeth, this is Tyler. So, again, we're right in the middle of our planning process, right, for next year, and we're kind of going through everything. As a reminder, we're going to lap the annual anniversary of the Device42 acquisition. So, the back half of the year, the comparables do get more difficult. And so, we've taken that into account. We've also, I think, taken kind of prudence into account in terms of how we're looking at the year. And right now, yeah, we're saying that low to mid-teens.

Now, as Dennis just mentioned, there's a whole bunch of things that we are, say, accelerating on roadmap on the EX side in particular. There's also a whole bunch of AI investments that we're going to continue to make. And as we see dates firm up from when these are coming out, and as we can see expectations of what this might mean from a business model impact perspective, we'll build those in. We'll provide a lot more color at the end of the year with our Q4 earnings. But we wanted to put that out there because that's kind of our best view right now.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Yeah. Certainly appreciate the look. And then just as a follow-up, I wanted to dig in on Freddy and ask about – I know it's early, but the uplift that you're seeing to some average deal sizes when customers do start to adopt Freddy, and is it typically rolled out to a smaller segment of users and then kind of expand from there...

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

... [ph] great to know (00:46:56) how that motion goes?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

Yeah, Elizabeth, this is Dennis. So, Freddy is rolled out to all customers. In fact, we have substantial adoption among SMBs. SMBs in many ways can benefit the most because they're the ones that have – have – in some cases, B2C businesses that they – and they need to handle lots of consumer questions, they don't have a lot of people to staff. So, it really has been across all segments for us. As I mentioned earlier, our attach rates are going up. So, our attach rates this past quarter on larger deals, that's for us a 30,000-and-up deal. We're north of 50%. And that's improved from last quarter. So, that's for Copilot. So, we're seeing that Copilot product getting a lot of traction. Customers are seeing up to 30% improvement, in some cases more, in terms of speed of resolution, and that allows them to free up their agents to do other things, allows them to scale their business faster.

On the Self Service side, we've seen our customer count double since the beginning of the year of paid customers for Freddy Self Service. And we just launched Freddy AI Agent, which is really designed to be super easy out of the box, get up and running with AI within 30 minutes with an agent that can answer any question that pertains to your products. Anything that's in a FAQ or in a product manual, you can train the AI Agent on, and then your customers can ask questions directly to the agent and get answers that do not require a human. So, as a reminder, we've been monetizing Copilot just since February and our Self Service product today, while it's quite powerful, it does require a level of programming to manage. So, with the introduction of AI Agent, that opens up a new market segment for us, a customer that wants to do more faster in an easier way. So, we're pretty optimistic about AI and how it's affecting both our CX and our EX business. It's just – at this point, it's becoming a core to all of our upsells and all of our new deals.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Ryan MacWilliams from Barclays.

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Q

Guys, this is Eamon Coughlin on for Ryan MacWilliams. Thanks for taking my question. Just curious how linearity looks throughout the quarter, and if you've left the quarter with better visibility on 4Q and fiscal year 2025.

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

Yeah. Hey, thank you for the question. This is Tyler. So, we have two businesses, right, from a go-to-market perspective. We have this inbound business that feeds the SMB, which – linearity for the SMB actually in Q4 is pretty even. And especially because – and we've talked about this in the past that SMB actually slows down a little bit in the holidays in season, because they tend to act more – just more like an individual. That being said, over time, we've shifted more and more to our field business as driving the majority of bookings and revenue for us, and that field business looks much more like an enterprise sales motion. So, the monthly linearity of that tend to be back end loaded. And we have visibility to the extent that deals are out there, but that does tend to be back end loaded. They're larger deals and have been increasing in size over the last couple of years, and we've been talking about that. So, it's a mix, but definitely has become more back-end loaded.

Eamon Coughlin
Analyst, Barclays Capital, Inc.
Q

Got it. Great. Thanks, Tyler. And then an improve – it's an improvement in macro environment needed for Freshworks to get back to the 110-ish [ph] NDR (00:50:40) or are there other levers that you can support this metric near term?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.
A

So, first of all, I would just say, an improvement in macro is not required for us to continue to drive the growth that we're seeing. And I don't think that the improvement – it's not entirely clear, but I think we've done a lot to drive growth, in particular in that CX business and that EX business as well. So, I think we've got a lot of growth levers ahead of us, regardless of what the macro kind of throws at us and are – again, are pretty excited about going into 2025 with where we are and the momentum that we're building in the last half of this year.

Tyler, anything on the NDR?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.
A

No, for net dollar retention, as Dennis just mentioned, the work we've been doing, we're really pleased with how churn has been going. And Dennis mentioned, CX had an all-time best churn rate in Q3 and we're just going to continue those efforts.

From an expansion motion, we've been talking about the reduction of our expansion rate for two years now, and that really is driven by agent addition expansion. Now, our agent counts are going up and we're clearly expanding with customers still, but we've been very, very focused on how can we expand with customers outside of agent addition. It's a lot of the – the AI products we've been talking about, it's a lot of addition strategy as well as things like Device42 and ESM. So, these are all things that we are in control of ourselves and we are actively working on. Now, clearly, interest rates in particular impact SMBs and if that starts to turn, then we think that would be a benefit for us and a tailwind, we just can't count on it.

Eamon Coughlin
Analyst, Barclays Capital, Inc.
Q

Got it. Great. Thanks, guys.

Operator: Thank you. One moment for our next question. Our next question comes from the line of DJ Hynes from Canaccord Genuity.

David Hynes
Analyst, Canaccord Genuity LLC
Q

Hey, guys. Dennis, I was hoping maybe you could double-click a little bit more on Device42. I mean, obviously, we have the headline numbers. It looks like you're taking a little bit more of a conservative cut. Q4, which I think makes sense at this point, but just can you speak to kind of the demand you're seeing for asset management, integration of the employee base, kind of how you're thinking about the lift it will take to rewrite that product? Color along those lines would be helpful.

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.
A

Yeah, sure. So, let me just break it into the go-to-market imperatives and the product imperatives. On the product imperatives, it's very clear. The first deliverable that you'll see in Q1 is a much improved integration between Freshservice and Device42 that our customers have been asking for, that allow bidirectional sync of information in a very seamless way. The second milestone will be towards the latter part of next year, which is a cloud-based version of Device42 that we can sell seamlessly alongside Freshservice. So, we're on track for both of those. Lots of work is going on to ensure that they're successful and excited to start with the launch of the new integration.

On the go-to-market side, the priority has been building pipeline and in cross-selling Device42 into our existing base of thousands of IT customers, and in bringing them into deals where we have larger accounts that are looking for a sophisticated IT asset management solution. So, a lot of Q3 was spent feeding the pipeline, getting D42 involved in deals, getting into the sales cycle. Now, we're in the process of starting to close down some of those deals. Some of them are going to last into Q1 and then making Device42 just a core part of our selling motion. So, we're pretty excited about where that stands, Device42's pipeline. Raj Jalan, who's the CEO of Device42, [ph] said this has (00:54:27) never been this big because they've just got an influx of demand from our existing customers. So, I think it's a real winner for us over time. It's still really early, but we're excited about it for sure.

David Hynes
Analyst, Canaccord Genuity LLC
Q

Excellent. And then, I had a follow-up on your comments on agent seat count on the CX side of the business. It's good to hear that they continue to grow. I'm curious specifically about what that looks like for customers using Freddy Self Service. I know you said 1,100 of them. Are seat counts there growing as well, is it flat, are they down, like when they incorporate Self Service, what happens to seat counts?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.
A

Yeah. Overall, seat counts are going up. So, I don't have a breakout in terms of different customer cohorts, but overall, they're going up. And I think that that just says that customers are going to have a mix of AI and human agents, they're going to find value in freeing up the time of the human agent from the more mundane task, but that's what we're seeing so far. We're seeing continued growth of seats while customers are taking on AI as well across the base.

David Hynes
Analyst, Canaccord Genuity LLC
Q

Yeah. Yeah. Okay. Very good. Thank you, guys.

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.
A

Thank you.

Operator: Thank you. One moment for our next question. Our next question comes from the line of Patrick Walravens from Citizens JMP.

Pat Walravens
Analyst, Citizens JMP Securities LLC
Q

Great. Thank you. And let me add my congratulations. Hey, Dennis, can you just talk a little bit more about your conversations with customers on the AI front? Like, what is the problem that they're looking to solve or benefit that they're hoping to capture the most often? Is it just self-service for users, or is it something broader?

And then when they're actually looking at implementing it, what is the biggest challenge that they have in terms of actually implementing these capabilities?

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.
A

Yeah. Thanks. Thanks, Pat. So, our customers are looking to do a couple of things. The first is they want to arm their agents with the best information, the best tools available to make them the most productive. And in some cases, that's improving the quality of answer that they can provide by suggesting an answer, because the AI has already been trained on things like product manuals and FAQs, the agent doesn't have to do laborious research before answering a question that's coming in from a customer, so they can answer more accurately in a more timely fashion. The customer, at the end of the day, is more satisfied because the answer is more accurate and the agent is more productive, they can answer faster, free their time up, either answer more questions or do other work. So, that's one area. And that's where Copilot has really taken off and become really clear in the marketplace as a solution that improves agent productivity 30% or more, and we've seen that time and time again across customers.

On the L1 support task, they're looking to deflect questions coming in that are routine [ph] route (00:57:33) – this is the first task that they're looking for, routine [ph] route (00:57:37) and free their agents from that kind of mundane work, frankly. And so, the first thing they're looking for is how can I create an agent that is fully trained on my information, my FAQs, my product manuals, and answer questions right out of the box from customers. That's what Freddy AI Agent does, and that's why we're getting a lot of positive feedback on that. And again, it's a quest to both improve the productivity of their existing staff, improve the experience of their customers. So, we're seeing success on both fronts. And I think net-net, what they're not doing is they're not saying, hey, I'm going to build it myself, and they're not saying, hey, I'm going to go find another point solution, they're looking to us in the first instance to solve that problem for them. If they're looking for a new customer support tool, that's the first question they're asking, tell me about your AI story.

On the EX side, it's the same thing. They're looking to automate the employee experience, have virtual agents handle more direct questions that employees are asking of IT, free those valuable IT agents up to do something else. And likewise, they're looking to empower those AI Agents or those human agents that they have with tools that make them more productive. So, that's a little bit of a flavor of what I hear, and I think we're really well positioned to solve those problems.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

That's super helpful. Thank you.

Operator: Thank you. Our final question – one moment. Our final question comes from the line of Michael Funk from Bank of America.

Michael J. Funk
Analyst, BofA Securities, Inc.

Q

Yeah. Thank you for the question this evening, guys. Keeping with the AI theme, can you share what you're seeing with the change in spend or contract value when customers adopt AI? I realize it's very early days today, but any kind of metric there would be helpful.

Dennis M. Woodside
Director, President & Chief Executive Officer, Freshworks, Inc.

A

So, because it's very early days for us, it tends to be a net expansion because they didn't have AI before. Remember, we monetize our products in two different ways for the products that have been in GA. We monetize Copilot as a per-seat adder, $29 a seat per month as a sticker price. We monetize Freddy Self Service as on a consumption basis, right? Customers purchase seat pack or session packs of a thousand sessions for $100 a pack. So, when customers come in and they've not had AI before, it's a net expansion on a dollar basis, or we're going in on a new sale that's priced separately and that's a net increase in the deal value over what we would have without AI. So, generally, for us, it's been a net expansion of ACV, and you also see that in the average customer value for us in our numbers.

Michael J. Funk
Analyst, BofA Securities, Inc.

Q

Okay. The incremental margin [indiscernible] (01:00:41) similar or higher or lower when you add AI into a contract?

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

I'll take that one, Michael. So, incremental margins right now are similar, right? And we've done a very good job on gross margins, I would say, for a company of our size and we're going to continue to focus on that. We've also said, hey, there should be a little bit of noise in that number. Right now, we're kind of above mid-80s on gross margin. We said, hey, low-80s to mid-80s is really, really good. We've built in what expectations are for the costs that we're going to incur to serve AI to our customers. But at the same time, we're obviously very – we are focused on our pricing and packaging strategies there.

Some of the future revenue will come from specifically Freddy Self Service and Freddy AI Agent that we just announced, right, because that would be more usage based. And as customers use it, right, they will have to buy more bot packs over time to supplement that usage, and so that will be a revenue stream that is kind of to come as opposed to already with us right now. So, we're very focused on margins there. I think we've done really, really well, and obviously we're delivering even the numbers we put for next year what we think are really good bottom line figures.

Michael J. Funk
Analyst, BofA Securities, Inc.

Q

Great. Thank you all for the time.

Tyler Renwick Sloat
Chief Financial Officer & Chief Operating Officer, Freshworks, Inc.

A

You bet. Thanks, Michael.

Operator: Thank you. This concludes today's conference call. Thank you for participating. You may now disconnect.