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Freshworks, Inc. (FRSH)

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CORPORATE PARTICIPANTS

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

OTHER PARTICIPANTS

Luv Sodha
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Luv Sodha
Analyst, Jefferies LLC

Good morning, everyone. Thank you again for joining us. My name is Luv Sodha. I'm part of the software equity research team here at Jefferies and we are super lucky to have Tyler Sloat join us. Tyler is the CFO at Freshworks. We've had a long relationship going back to the Zuora days, but Tyler joined Freshworks back in 2020 and he's led the company ever since.

QUESTION AND ANSWER SECTION

Luv Sodha
Analyst, Jefferies LLC

Q

So maybe just to kick it off at a high level. Tyler, if you could just talk about the Freshworks story, where things stand right now and how things are shaping up for the rest of the year?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Okay, awesome. Well, first of all, thanks for having us, Luv. Best named analyst in the Wall Street, Luv Sodha. Freshworks, so I joined, as Luv just mentioned, I've been with the company for little over four years, actually. Started talking to G almost five years ago. Freshworks started as Freshdesk customer support software, really started with the thought that SaaS had kind of broken its promise. That SaaS was – the idea of SaaS is just to be software made for the end user, really easy to use, onboard at affordable prices. So our Founder, Girish, we refer to as G, started Freshdesk and built a purpose built for that and really started with selling to the SMB. Out of India, so we're a US company that was kind of founded out of India, which really with that roots, a lot of us with – we have access to highly technical talent at efficient rates. But also all of our functions are built out of India, which has allowed us to be really operationally efficient everywhere, which has also allowed us to kind of go attack global SMB, which is really, really hard to go do.

Freshdesk evolved had success in early days, started to see customers using our Freshdesk product for internal IT use. And said hey, you actually – that's great. The ticketing is pretty similar, but you actually need a purpose built IT solution and so we've built Freshservice. Freshservice is now about half of our ARR and which has been the largest contributor to ARR growth for a while now.

Along the way we also started Freshsales and Freshmarketing (sic) [Freshmarketer] (00:02:24) that we refer to as kind of our CRM product, which is our third kind of product base. All of our products are built with the same thought. To build them for the end user, build them for the actual say agent or anybody else who's going to be in there, which has a common DNA to it which I already mentioned that has to be really easy to onboard, really fast ROI, has to be efficiently priced with a great user experience. And as we've stayed true to that DNA and added feature functionality over time, we've then been pulled into larger and larger deals.

And so we've kind of moved away from just selling to the SMB but now are very relevant to kind of mid-market low enterprise, specifically for our Freshservice product, which never really had a huge SMB base, because customers don't – SMB customers don't need an IT solution. But really what's selling to the high-end of SMB into the mid-market, and now getting pulled in to kind of lower enterprise and really competing now with kind of ServiceNow as commercial team.

That Freshservice product, we continue to lean in on. We just announced our first acquisition since we went public, which is Device42, which is really an ITAM solution, IT asset management, and kind of both SaaS and physical that had been something we had kind of on the light end, but something we knew was a gap competing in that lower enterprise that we think is going to round out that solution. We've been reselling Device42 actually for over a year, so we know it works with our product and we know that we can compete with it. So we're very excited about that and we're going to continue to lean into Freshservice.

CX, in general, CX is our kind of support product. That has seen, what I would say, pressures over the last couple of years, specifically on expansion rates where expansion rates were incredibly predictable for years. And we've said that, hey, expansion rates have been coming down for the last two years, kind of driven, I think, from a lot of disruption in the market, perhaps, but also just in kind of macro that companies coming out of COVID just weren't hiring as much.

At the same time, I think that whole market is kind of being turn a little bit in terms of AI. We were ahead of this. We always had kind of some AI products. We've always had this. Our AI is called Freddy and you can go back for years, even during the IPO we talked about Freddy, but that really has been super-sized over the last year. And we came out with what we said are going to be our main Freddy products kind of utilizing the latest and greatest that's Freddy Copilot, Freddy Self Service and Freddy Insights.

Freddy Self Service which is relevant across kind of both of our product lines, but a lot of CX is about ticket deflection on the inbound without human intervention. And it's really through bots that's going to be utilized. And then Freddy Copilot is about, hey, make your agents more productive once stuff does come in and enable them to do their jobs better. Those two products are being sold today.

Freddy Insights is going to be about the management layer. At the corporate level, how do you actually manage and look across all of your aging population to be able to make really good decisions? And so we do think that kind of the future is going to be around that. We have been selling Freddy Copilot with GA in Q1. And kind of at the end of Q1 we actually had a decent amount of bookings there but nothing super mature. And we said we'd hopefully talk about that at the end of Q2.

Freddy Self Service has been out there, but that's one that you got to sell, then it comes, got to build bots, then they actually have to start to see that bot deflection and then they have to buy more packs of bots so that will take some time as a roster. So that's the high level summary, Luv.

Luv Sodha
Analyst, Jefferies LLC

Q

That's awesome. That's pretty comprehensive. Maybe just to touch on, you mentioned in Q1 that one of the topics was Dennis taking over as CEO. And it sounds like the transition was in the works for some time. But, just talk about at a high level what changes Dennis might be planning to make and how does that change the execution internally?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah, sure. So we announced really two things at our last earnings. The first one was Device42 that I just mentioned, which was the acquisition. The second was that G, our Co-Founder is stepping aside from as CEO and he's becoming Executive Chairman. We had hired Dennis Woodside 18 months ago, a little bit over that now as our President at the time, but we also put him on the board and we're pretty clear that when he joined, the entire management team reported to both of them. They were two in a box.

And so internally, from an operational and day-to-day perspective, it wasn't that dramatic. We got a lot of questions about why now? Maybe we could have done a better job of messaging it, right, saying, hey, in this period of time. But internally we said, okay, this is pretty natural and natural things, it was really twofold. One, G, he really just wants to focus on products and he wants to focus on product vision, product execution and actually culture of the company. And that's what he's going to be doing. And part of that, he's also spending a lot more time in India and also frees up his time from things like this, which he doesn't really relish.

The second thing is that Dennis came on board and a lot of it from an execution operations perspective is making sure we had the right people in the right places, reshaped a lot of the management team, the last piece of that from the management team perspective was adding Abe as our Chief Field Officer. Abe started at the middle to end of Q1. Before that, we had hired Mika as our Chief Customer and Marketing Officer. She started in Q4 and that was really a recognition. Those last two pieces of, hey, we have two different businesses as the company has evolved. We've got this SMB kind of inbound business that feeds the SMB and the commercial 100% and then falls over a little bit to the enterprise and mid-market.

That's really what we started with as what we've always had, but we also now have this field motion that we need to actually mature and get much better at. And that's driving most of our growth. And so we kind of split up the go-to-market, hired Mika, hired Abe that was kind of last piece. So I think once that was done, G said okay now I can move to product and Dennis, you can take over.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. That's perfect. We saw this across a bunch of companies that we cover. It seems like in Q1, at least the macro pressures, especially as it relates to SMBs sort of got more challenging. You obviously called that out as well. Could you just talk, at a high level, what drove this incremental weakness, if you will? And are you seeing any of that change so far?

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

Yeah. What's interesting for us, it wasn't incremental, right, and we weren't talking about pressures in kind of SMB in general. But also in CX, which is kind of synonymous with SMB or SMB is synonymous to CX, if that makes sense, mean that our CX products or support products sell from kind of the lowest end all the way up and our largest customers are CX. But, the majority of our SMB is CX. And so when we talk about those pressures, they kind of go together a little bit.

Nothing was incremental in Q1. What we said is those pressures persist, right. And when we look at Q1 for CX and SMB, when we look at what happened, it's like, well, we actually had a decent quarter, it wasn't horrible. But if those pressures persist and they actually continue on this trend, we think for the year we've got to make some adjustments.

The other thing that happened is that Q4 is actually really strong. And for CX in particular, Q4 was actually a really pretty good expansion quarter. But in hindsight, a lot of that expansion was driven by early renewals with expansion and some of that coming out of Q1. That's one that's not super predictable for us. And so when we came to Q1, we didn't have the same levels of early renewals that what we saw in Q4, which is also kind of more of a testament that we're moving more to a mid-market enterprise kind of field motion. And this is just more natural behaviors as opposed to more of a normal cadence of month to month in the SMB space. And so when we looked at that, I was like, okay, let's adjust the year based on what we think might happen. And we thought it'd be prudent.

Luv Sodha
Analyst, Jefferies LLC
Q

Got it. As you look at maybe the rest of the year, wanted to dig in more on the CX side of the business. Is there any of this weakness that you're seeing in that business, especially as it relates to the retention rates, if you will? Is that tied to AI at all? And are we seeing any impact, at least, of the customers that you do serve? Is there an impact on agent count at any of the customers that you have?

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

Yeah. So I think the question is, hey, have you actually seen examples where AI is actually reducing agent counts, right? And the answer is no. No, we have not seen that. I don't know of a customer that has reduced because, say, Freddy has come in or they're doing something else. That doesn't mean that hasn't happened, but I don't know of any specifically.

I think the interesting thing about CX for us is that we've been talking about expansion decline, expansion rates coming down for two years now, and that's well before any other AI influence. And so I think a lot of that is macro, meaning that the rates were so high going into COVID and then companies just hired like crazy and then a lot of them adjusted coming out. And then there's just a lot of market disruption in that space.

What we did see even before generative AI is that there was a lot of, say, bot players that came out and specific companies just focused on pieces of your entire CX journey. And some of them got to $100 million, $200 million in ARR. And we know them pretty well. That I think they're all in a lot of trouble now. And because the kind of the playing field has been leveled for everybody and you don't really need their technology anymore. And so we feel that we're really well-positioned because we do have a full omni-channel solution, really backed by what we think is going to be very powerful AI. And we just need to make sure that we get that even what we have today into our customers' hands and getting them using it.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. And over, let's say, more – asking a more longer term question, but like two to three years from today. Still sticking with the CX business, how do you view the growth profile of that business? Could it sustain what it's growing at today? And do you see AI potentially – like the total ARR that you're generating from these customers, do you see that growing even though agent counts might go down vis-à-vis are there ways to monetize that?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah. So in September we had an Investor Day and we kind of put out projections for 2026 and we also said, okay, when we get there, this is what we're going to look like and we kind of painted out the growth rates, the assumed CAGR of some of our products in that. And in there we said CX is going to be a high-single digit grower, which is not super exciting, especially compared to Freshservice, which is, kind of a mid-30 square. When we put out those numbers, we built that based on what we saw today and then kind of trend lines on where they're going. So it actually presumes that growth rates are actually going to continue to decrease a little bit.

Do we think that Freddy can actually reverse that trend? We got this question this morning. Yeah, I do think it could in two ways. One, not just how we can increase ARPAs by attaching Freddy Copilot, Freddy Self Service and eventually Freddy Insights into all of our customer base. But I do think that this is going to be something that actually just helps us win better. And over time, we'll see how pricing for all these AI components go on whether it's not – whether it's kind of included as table stakes in terms of you have to have these capabilities to even compete, right. And I think that actually will be something that happens is then do you have to build pricing into higher additions and things like that? That could happen. I mean, everybody will have to watch costs over time and see how that happens. But I do think that you're not going to be able to compete for deals unless you have these capabilities.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. Focusing in on the three SKUs that you have for Freddy, so you have the Self Service, you have the Copilot, both of which are GA now. The Copilot, $29 per agent per month. Just talk about the adoption you're seeing there. And, I mean, we can do the math and see like it's a pretty sizable uplift in terms of spend for a customer. So, what are you realizing in terms of that uplift if you will?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah, I think it's pretty new still. So, we actually had decent Freddy Copilot bookings in Q1. We said after Q2, hopefully we can come out with some metrics on how it's going. Even then it wasn't like it was super material and I think the challenge for us is really going in to our customer base and making sure they understand all the capabilities. We had a customer advisory board, I guess, three or four weeks ago in London, brought in a bunch of our customers from Asia and Europe. And at my table I said, these are some of our biggest customers and huge users and they love us, asked hey, who? And we just done like a AI presentation.

I said, hey, before we talk about who's using it right now, and only like one out of eight raise their hands. And like, why? It's like, well, it's just, it's hard to go train the agents. We got to figure out how to retrain them and these are people, customers of pretty big Asian populations. All it tells me is, okay, we're not really good at enablement yet because the technology is there. Yet, the ones who stood up and said they are using it, they said it's fantastic. And I think as we onboard, we need to make sure that every single customer is just part of the onboarding, this is just part of it. And that you do their initial agent training there and then we actually have to build this muscle and get a little bit better at it, which is more an enterprise customer engagement model to go in and teach our customers how to use because there is things you have to go enable at the agent level to go do things.

That I think it's going to be really, really powerful. It's going to change the way all of our agents kind of do their jobs. And that $29, we'll see how it goes along because that's a list price. And we presume that there's going to be discounts against it on big enterprise deals. But we do think it actually could be material thing over time.

Self Service is a little bit different. We sell Freddy Self Service but we actually don't – you don't monetize Self Service in a product itself, you monetize it through bot usage. And there's actually still a hurdle for bot usage today, which is building the bots, because once you build the bots, then all the capabilities are behind it. But that building is still somewhat of a hurdle today. So we're actually looking at going in and for our non-technical customers doing some of that work for them. And then we will be releasing, which is called – some call it [ph] flowless (00:18:05) bots, which was actually removing that capability, the requirement to build that the bots actually just kind of generatively build themselves. That is, some we haven't announced a date on, but it actually is kind of in testing right now. And that will, I think, be another game changer.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. I wanted to ask one on the Freshservice business. Obviously, that part of the business is growing pretty well. Last time at Investor Day you'd said low-40s and obviously the CAGR implies pretty healthy growth rate north of 30%. I guess what sort of gives you that confidence that this business could grow well into 2026 at pretty healthy growth rates?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah, Freshservice has been doing really well. And it's a product that we've been continuing to lean into the market dynamics, the competitive dynamics, but the market dynamics for ITSM are just really favorable for us. It's a product that we've been able to innovate really, really quickly on and then, kind of all of a sudden, not all of a sudden, but over the last two years have really been recognized as kind of the number one SaaS alternative underneath ServiceNow. In that space, you have a ton of legacy still, which is kind of BMC Remedy, Ivanti, Cherwell and you have kind of players that are really hitting the SMB and kind of lower mid-market, which is Atlassian and ManageEngine built by Zoho. In that mid-market low enterprise space I think we are deemed as kind of the number one alternative.

What has happened as we've continued to kind of innovate is that, we just start to get pulled into more and more deals. I got a question in a conference a couple weeks ago, I was like, hey, are your win rates against ServiceNow going up or down? And I said, I don't know the exact numbers, but I actually anecdotally think they're going down. And it's actually a good thing. It's just because we're actually seeing them in many more deals, because, you can go back to look at our roadshow stuff like we talked about Freshdesk and we said, hey, we have this second product, Freshservice. And it's really now we kind of have this first product, Freshservice and we're getting, really pulled in to what for us is a larger enterprise, which is a 10,000 to 20,000 person company. For ServiceNow I think it's their commercial team. And we're seeing them a lot more now. Doesn't mean we might as much, but we're seeing them a lot more because we're getting many, many more at-bats, and I would expect that to continue.

It's also the reason why we did the Device42 deal, really an investment in Freshservice and investment in that entire space that's going to make us much more competitive, even that lower mid-market. The other thing we have there is Freshservice for business teams, which we brought out last year. And I'd really say like what we brought out I think is Version 1.0 where really, architecturally changed the product to allow us to go engage with teams like HR, teams like finance to really have kind of apportioned instances within Freshservice that there's security and stuff around, which is one of the hurdles. And then now we will just continue to start building out the workflows, the purpose built workflows for those functions, and that will start to resonate more and more as well.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. Margins have obviously become more important for you. And you have that stated aspiration out there of getting to Rule of 40. Could you just talk about like even though you are delivering substantial efficiencies to-date, what's the plan going forward and what are the plans to getting to Rule of 40 vis-à-vis the growth versus profitability?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yes. I mean, ironically, we were Rule of 40 in Q1. It's just that more is coming from free cash flow than from growth than long term what we want. So we said, hey, yes, we'll be Rule of 40 by 2025, half from growth, half from free cash flow margin. We've always been really efficient as a company. In fact, even before we went public, we're essentially producing some cash. We invested in infrastructure. We went public. Also building out the field presence is pretty expensive. But now we've kind of flipped back to producing cash and we're not going to move back. We started the year saying we produce $110 million and we raise that to $125 million after Q1. We're going to continue to do that.

The thing, though, is that we're going to also lean in to growth where we can and where we think we will get a good return. We will spend money to go do that. There's some timing on operating income from Q1 to Q2, which I've had questions about, and those are just timing nuances on the quarters and some spend that kind of got pushed out. But we're really happy about how we're doing on the efficiency side.

Luv Sodha
Analyst, Jefferies LLC

Q

Got it. Is there a question back there? Sure.

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Have you experimented at all with [indiscernible] (00:23:11-00:23:16).

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

So bots are a consumption. And so that on everything else, no. We have some aspects of the products that are in some add-ons or are consumption based, but the majority is all agent based still.

Q

[indiscernible] (00:23:34)

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

I don't know. I mean, I think that I think you would have to build your product to be able to measure like stuff like workflows and things like that really accurately and to not have debates with your customers. Agents, I think, are very predictable. As a CFO, I actually don't love consumption models too much, specifically ones that get out of control. I think that's what you're seeing with some of the companies that have done like a bunch of logging and things like that where they actually hit some growth hurdles because they get a lot of pushback from their customers, right. And so I think you have to have this really nice mix of predictability, but also utility. I'm paying for what I get. And so, I think, bots is the first one that I think is, we've had it out there as consumption for a long time, but we would expect that to increase as a percentage over time.

Luv Sodha
Analyst, Jefferies LLC
Q

Perfect. One last one, if I may. Just on the net dollar retention piece. If just at a high level, if you just break down what components sort of drive that and what could potentially the second quarter be sort of at the bottom as it?

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

Yeah. So coming into the year, we said Q1 would be 106%. We hit 106%. I think the nuances last year we said we thought we're going to hit 105% all year long and every quarter we said, I think we're going to hit 105%. I actually did think we're going to hit 105% at one point.

What's happened is that, there's two sides of the coin, right. Churn, we've actually done really pretty well on as a company. We went public, our churn was in the low-20s. Now it's in the solid mid-teens. And that is really kind of a testament to getting much better to engage with our customers. The products has gotten much better, but also the mix shift has changed, right? Freshservice has great churn characteristics and moving to larger customers as well.

Freshdesk, actually at CX, the churn rates have actually come down. We've done a really good job on that. So churns come down, but we're not going to get a lot more from churn specifically as we're selling to the SMB. So maybe a couple hundred basis points over time. So it's really expansion rates where we've been kind of hit that had really been putting pressure on net dollar retention.

We didn't hit 105% last year because we kept doing incrementally a little bit better on churn. And the 106% we saw that Q1 is kind of what we said we're going to do. And then for Q2, I say it's going to be between 105% and 106% because it's literally the numbers I have around in right in between. And so, we'll see where it ends. And expansion is one thing. It's not 100% predictable for us because it often happens at the end of the quarter. Right now, it's kind of that 105% to 106% is what we are seeing as a bottom point. But we'll update it obviously at the end of the quarter.

Luv Sodha
Analyst, Jefferies LLC

Got it. Perfect. Let's give a big round of applause to Tyler for joining us. Thank you again.