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Freshworks, Inc. (FRSH)

Q2 2023 Earnings Call
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MANAGEMENT DISCUSSION SECTION

Operator: Hello, and thank you for standing by. Welcome to the Freshworks Second Quarter 2023 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]

I would now like to hand the call over to Joon Huh.

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

Thank you. Good afternoon, and welcome to Freshworks Second Quarter 2023 Earnings Conference Call. Joining me today are Girish Mathrubootham, Freshworks’ Chief Executive Officer; Dennis Woodside, Freshworks’ President; and Tyler Sloat, Freshworks’ Chief Financial Officer.

The primary purpose of today's call is to provide you with information regarding our second quarter 2023 performance and our financial outlook for our third quarter and full year 2023. 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 the business and industry, including our financial outlook, macroeconomic uncertainties, management's beliefs, 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 the forward-looking statements. Such risks include, but are not limited to our ability to sustain our growth, to innovate, to meet customer demand, and to control costs and improve operating efficiencies. For 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 Form 10-Q and our other periodic filings with 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 or 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 Girish.

Rathna Girish Mathrubootham
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

Thank you, Joon, and welcome, everyone. Thank you for joining us today on Freshworks earnings call covering our second quarter of 2023. We delivered a strong Q2 and outperformed our estimates across all our key financial metrics. Our revenue exceeded the high end of our financial outlook range coming in at $145.1 million for the quarter. We continued to improve our business efficiency, leading to free cash flow of $18.1 million, significantly surpassing our expectation. I am really proud of our team effort this quarter. We made a number of operational
changes at the beginning of the year to go after larger customers and target a more profitable segment of the market, and we are starting to see the benefits in our results.

As a reminder, we have included these financial highlights in the supplemental earnings slides on our Investor Relations website. We will also hold our first Investor Day on September 7 in San Francisco. I look forward to seeing you there. Now I'll get into our business drivers, beginning with product innovation.

In June, we showcased our Freddy AI strategy, introducing new generative AI capabilities that can be used across product lines. First is Freddy Self Service, which helps businesses offer personalized customer and employee service with conversational bots. Next is Freddy Copilot, which is a personal assistant that works like an always-on AI collaborator, offering contextual information and insights and offloading the repetitive tasks. And finally, with Freddy Insights, we are leveraging AI to provide even more proactive insights and recommendations through a conversational interface. All three Freddy AI capabilities can help IT professionals, salespeople, marketers, and support agents work more efficiently.

Powered by Freddy AI, our self-service experience, including fresh bots for CX and virtual agents in IT assisted customers in more than 220 million interactions in Q2. Later this week, we will be introducing new pricing for our AI-powered bot, which enables us to monetize our enhanced capabilities as we create value for our customers. In addition, we plan to introduce at a later date a Freddy Copilot add-on that provides access to our AI capabilities starting at a price of $29 per agent per month. Our goal is to put the power of AI in the hands of as many customer- and employee-facing teams as possible.

With respect to our customer service business, we will be launching our Freshworks customer service suite also later this week. This is our first solution built from the ground up with Freddy AI. The modern multichannel customer service suite brings together the power of AI advancements to conversation support and ticketing, all in one offering. And we believe it is the future of customer service. This will provide customers with automated self-service across channels and is expected to supercharge agent productivity and deliver proactive insights for leaders. We are proud to be opening this up to our customers in the next few days.

Turning to our ITSM business, with Freshservice, we continue to deliver capabilities that make employee experiences better and empower organizations to provide them efficiently and reliably. We are also extending the capabilities of Freddy AI to Freshservice. It now provides conversational self-service in employee's language of choice, including German, French and Spanish. After launching Freshservice for business teams in December of 2022, we continue to see validation of our initial thesis of a large market demand. Nearly one out of every five new accounts are adopting Freshservice for business teams for non-IT functions on their initial purchase. One of our customers, PitchBook, offers financial research and insights to capital market professionals. They were planning to meet another well provider of solution work, but it was cumbersome and not suited for their IT infrastructure and objectives. Since going live with Freshservice for their IT, facilities and RevOps department, PitchBook has decreased agent response and requested wait times by over 20% and automated IT processes for employee onboarding and uploading.

In our CRM business, we remain focused on delivering a sales and marketing solution powered by AI that helps teams message sharper, engage better, sell smarter, and close deals faster. Within Freshsales, we have improved how sellers operate and engage with customers by integrating generative AI across key modules. Freddy Copilot provides support throughout the sales process. This frees them to focus on building relationships and closing deals.
Within Freshmarketer, we are leveraging generative AI to help marketers gain insights into customer behavior, preferences, and purchase patterns, and launch highly personalized campaigns. In Q2, we released our integration with WooCommerce, which allows millions of storeowners to get access to our Freshmarketer solution.

In Q2, we also announced Freddy Copilot for developers, applying generative AI to the Neo platform and enabling a faster app development experience. In some instances, Freddy Copilot has cut developer's time from 9 to 10 weeks to less than a week. We also launched the Global Apps Framework to enable developers to publish a single marketplace app that can work across multiple Freshworks products. That is expected to provide developers faster time to market, less overhead of managing and building apps and better integrations across Freshworks products. In the last few months, we have made significant advancements in generative AI for our customers, and we plan to continue to leverage our efficiency and scale to bring these accessible solutions to companies of all sizes.

Before I hand it over to Dennis, I am pleased to announce the recent appointment of Frank Pelzer to our Board of Directors. Frank is currently the Executive Vice President and Chief Financial Officer of F5, Inc. and the former President and Chief Operating Officer of the Cloud Business Group at SAP. I'm excited to add his tremendous experience, building and scaling global cloud software companies to the Freshworks board.

Now, over to Dennis, who will detail how our changes in GTM have positively impacted our business.

**Dennis M. Woodside**  
*President & Director, Freshworks, Inc.*

Thanks, G, and thank you everyone. We appreciate you joining us for today's call. As you can see in our Q2 results, we're starting to realize some of the benefits of the strategic go-to-market decisions we made earlier this year. We are seeing that our actions that set us on a path to win bigger deals, expand within existing accounts and improve our operating efficiency are working to drive profitable growth for Freshworks. In January, we shifted our field teams to focus on landing bigger customers and this quarter we began to see the results.

In Q2, Freshworks customers paying us over $50,000 in ARR grew 33% year-over-year, up from the 30% growth we saw in Q1. This customer cohort now represents 46% of our ARR as larger customers are fueling the growth of our business. Recent examples include a large American consumer product company, a famous British car company, a well-known Japanese tech conglomerate and Clopay Corporation. Clopay is North America's leading garage door manufacturer and came two Freshworks to improve customer engagement. The increasing multi-channel interactions with garage door dealers through calls, mobile chats, website forms and physical walk-ins necessitated a unified platform for better agent and customer experience. Clopay chose Freshdesk, Freshchat and Freshcaller to achieve this, and continues to see significant customer service benefits.

Also in January, we solidified teams dedicated to ensuring our customers succeed and grow with us. We are seeing results from that change in Q2. Of our net customer adds over $50,000 in ARR, the majority is coming from expansion. Our net expansion for our mid-market and enterprise accounts was 12%, which is well above the average rate for the company. Our average realized price per seat for ITSM, for which we issued price changes in January, increased by 4%. And our multiproduct adoption rate increased in Q2, rounding up to 25%. A great example is Trainline, an international digital rail and coach technology platform serving train riders in 45 countries. Demand from US travelers doubled the downloads of the Trainline app in just one year, and they relied on Freshdesk and Freshchat for their customer service needs.

In Q2, Trainline Partner Solutions team expanded their usage and adopted Freshservice to manage their partners’ experience, citing improved time to value as the main deciding factor. An example of seat expansion is a leading
American steel company. After acquiring 12 companies in five years, this manufacturer selected Freshservice for one business unit and has consistently replaced legacy vendors one after the next with another Freshservice instance year-after-year. We’ve grown from 250 to 600 agents, providing them excellent time to value as they centralize IT workflows and govern multiple business units more efficiently.

In the first half of 2023, we made several tactical changes to how we go-to-market to acquire higher-performing customers efficiently. These changes have had a positive impact on our business. First, we adjusted our marketing budget to overweight the acquisition of larger, higher potential customers. This contributed to an overall improvement in efficiency demonstrated by non-GAAP sales and marketing as a percentage of revenue going from 51% in Q1 to 48% in Q2.

Second, we expanded our free offering for Freshsales products for a number of months to test and attract a larger pool of future paying customers at a lower marketing cost. We recently discontinued this expanded free test as we continue to optimize our offerings. But as a related consequence of both of those tactical changes, we added fewer customers spending less than $5,000 in ARR in Q2.

Third, we purposely moved more new customers from monthly and quarterly contracts to annual and multiyear agreements. This trend towards annual contracts contributed to our Q2 calculated billings growth increasing quarter-over-quarter. We ended the quarter with more than 65,600 total customers, including Claremont McKenna College, The State of Hawaii, Johns Hopkins and Dave & Buster's. While we added a lower number of customers compared to prior quarters, we increased ARPA and kept dollar-based churn relatively stable. We're confident that intentionally going after larger deals is creating a stronger and healthier base of customers to grow from in future quarters. All of these changes are helping drive further efficiencies in the business and improve profitability.

Now over to Tyler to go through the financial details.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Thanks, Dennis, and thanks again to everyone for joining us. Once again, we had a strong quarter in Q2. We beat our revenue growth estimates and created significant leverage in the business to expand both non-GAAP operating and free cash flow margins by 5 percentage points quarter-over-quarter. We are starting to realize the financial benefits resulting from the operational changes made earlier in the year, and we're creating a healthier foundation to position the business for profitable long-term growth.

For our call today, I'll cover the Q2 financial results, provide background on the key metrics, and close with our forward-looking commentary and expectations for Q3 and the full year 2023. I'll include constant currency comparisons for certain metrics to provide a better view of our business trends.

Now, 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, revenue grew 20% year-over-year, adjusting for constant currency. On an as reported basis, revenue grew 19% to $145.1 million as we saw negative impacts on currency rates for the dollar against the euro and pound over the past year.

New business strength in ITSM continued to drive much of the growth in Q2, while expansion rates overall ticked down slightly in the quarter. In Q2, our non-GAAP gross margins increased 1 percentage point quarter-over-quarter to 84%, as a result of efficiency improvements on our infrastructure spend, AWS costs, and other onetime items. Our non-GAAP operating expenses were relatively flat quarter-to-quarter and down more than $5 million
year-over-year. The majority of the decrease year-over-year was driven by lower sales and marketing expenses of $4 million as we improved spend in our go-to-market efforts. This includes shifting focus towards a more durable, higher-yielding customer base. All this led to a significant outperformance for non-GAAP operating profit of $11.7 million and non-GAAP operating margin of 8% in Q2. Given the many changes we’ve made over the past year, I’m pleased with the tangible improvements we’re making in our efficiency.

Turning to our operating metrics, net dollar retention was 108% in the quarter, which includes a 1 percentage point benefit from FX. In Q2, expansion growth was roughly in line with our expectations. Dollar-based churn performed better than our estimates, but slightly increased quarter-over-quarter. We are planning for the lower net expansion trends to largely continue and expect the net dollar retention rate to be in the 105% to 106% range in constant currency in the second half of the year.

Moving to our other key operating metrics number of customers contributing more than $5,000 in ARR, this metric grew 18% year-over-year to 19,105 customers in the quarter, and maintained a similar growth rate compared to the prior quarter. On a constant currency basis, this customer metric grew 17% year-over-year and now represents 88% of our ARR. For larger customers contributing more than $50,000 in ARR, this customer count growth improved to 33% year-over-year, with 2,186 customers and now represents 46% of our ARR. Adjusting for constant currency, this cohort grew at 32%. We added approximately 700 net customers in the quarter, which was lower than our historical quarterly figures. Nearly all of the difference was from the smaller customer cohort of less than $5,000 in ARR.

Net adds for this cohort was impacted by the tactical changes that Dennis mentioned earlier, as well as higher logo churn from smaller CX customers. We ended the quarter with a customer count of more than 65,600. As we continued our focus on attracting larger customers, building a healthier base and driving a higher ARPU.

Moving on to calculated billings, balance sheet and cash items. Calculated billings grew 22% year-over-year, both on a constant currency and as reported basis to $158.9 million. Factors including timing, duration of contracts, and revenue reserves in the quarter created a slight benefit, resulting in a normalized calculated earnings growth of approximately 21%.

Looking ahead to Q3, 2023, our preliminary estimate for calculated billings growth is 18% as reported and 17% on a constant currency basis. For the full-year 2023, we expect calculated billings growth to be similar to our expected annual growth rate of approximately 19% as reported and 19% on a constant currency basis.

During the quarter, we generated over $18 million in free cash flow, significantly ahead of our estimates and reflective of the efficiency improvements we’re making in the business. As a result, we added $10 million in cash, cash equivalents and marketable securities to end the quarter with a balance of $1.16 billion. We continue to net settle vested equity amounts using more than $15 million during the quarter, which is reflected in financing activities, as this activity is excluded from free cash flow. We plan to continue net settling vested equity amounts, resulting in Q3 cash usage of approximately $23 million using current stock price levels. Given the meaningful operational efficiencies we realized in the first half of the year, we are raising our free cash flow estimates for the full-year 2023 to $60 million, with approximately $18 million and $15 million expected for Q3 and Q4 respectively.

Turning to our share count for Q2, we had approximately 329 million shares outstanding on a fully diluted basis as of June 30, 2023. The fully diluted calculation consist of approximately 293 million shares outstanding, 34 million shares related to unvested RSUs and PRSUs and 3 million shares related to outstanding options.
Let me now provide our forward-looking estimates. For the third quarter of 2023, we expect revenue to be in the range of $149 million to $151.5 million, growing 16% to 18% year-over-year. Adjusting for constant currency, this reflects growth of 15% to 16% year-over-year.

Non-GAAP income from operations to be in the range of $6 million to $9 million and non-GAAP net income per share to be in the range of $0.04 to $0.06, assuming weighted average shares outstanding of approximately 300.2 million shares.

For the full-year 2023, we expect revenue to be in the range of $587 million to $595 million, growing 18% to 19% year-over-year. Adjusting for constant currency, this reflects growth of 18% to 20% year-over-year. Non-GAAP income from operations to be in the range of $24 million to $32 million, and non-GAAP net income per share to be in the range of $0.18 to $0.22, assuming weighted average shares outstanding of approximately 299.8 million. Given the US dollar trends over the past year, we saw slight negative impact to our growth rate in Q2. Our forward-looking estimates are based on FX rates as of July 28, 2023. So any future currency moves are not factored in.

Let me close by saying I'm pleased with our business performance in the first half of the year. Even though we made a number of changes to our go-to-market approach and business operations, the team continue to execute and manage through those changes to deliver on our growth targets for the business. We're starting to see some of the benefits from the changes as we improve our operating leverage and drive profitable growth. We're trying to carry this business momentum into the second half of the year and we remain excited as ever to look forward to our many opportunities ahead. With that, let us take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. I will start the Q&A now and now will ask our participants to please keep your questions to one. [Operator Instructions] All right. And our first question comes from Brent Bracelin with Piper Sandler. Please proceed.

Brent A. Bracelin
Analyst, Piper Sandler

Thank you for taking the question. Good afternoon. Obviously, looks like fundamentals here are stabilizing. Dennis, maybe for you. Could you double-click into the acceleration you saw in the $50,000,000 (sic) [$50,000] (00:24:07) cohort? I think it looked like the acceleration there improved from a 30% growth to 33%. Is that tied to some of the changes you made in internal execution or do you think there's something else that's resonating with those larger customers about the product? Thanks.

Dennis M. Woodside
President & Director, Freshworks, Inc.

Thanks for the question, Brent. So absolutely. We are starting to realize the benefits of lot of the changes that we made back in January. And that has enabled us to create an even stronger and healthier base of these larger customers to grow from. Our product has advanced at a very high rate over the last couple of years. If you look at the ITSM products specifically, we have ITSM, we have ITOM, we have ESM. Now, all those are resonating in the market and our sellers are doing quite well. So we're getting more at-bats and we've just put more wood behind the, you know, not huge deals, but slightly larger deals and you're seeing that in the numbers for sure.
Brent A. Bracelin
Analyst, Piper Sandler

Helpful and great to see you. Thanks.

Operator: Thank you. One moment for our next question, please. All right. It comes from the line of Ryan MacWilliams with Barclays. Please proceed.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Hey, guys, thanks for taking the question. Really excited to see the AI product announcements coming. Tyler, just on the contribution from the AI products and the new pricing, are these contemplated in forward guidance? And I guess how do you envision this layering into your model in the coming quarters or years? Thanks.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Hey, Ryan. Thanks for the question. So, no, we actually haven't built in any upside from the products and the pricing changes that are coming forth, because I think it is so early that we'll have to learn. But our guidance is essentially reflective of what we see today based on what we have and what we expect as well without any upside from AI?

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Great. And also pleased to see the strong profitability improvement in the quarter. What were some of the drivers there and did any changes in the head count materially contribute to this improvement? Thanks.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Yeah, you're right. We're really excited about the kind of efficiency initiatives that we put in place at the beginning of the year and how those have played out. And we've always felt we've had leverage in the model and feel that we continue to have leverage in the model, which we obviously built that into a lot of our guidance going forward. Headcount-wise, we haven't had to do anything dramatic. We've actually just been moving to kind of a culture of performance and everything else as we move forward and making sure we had the right people in the right places.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Appreciate the color. Thanks, guys.

Operator: Thank you. One moment while we get our next caller. All right. It comes from the line of Pinjalim Bora with JPMorgan. Please proceed.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Great. Hey, guys, congrats on the quarter. One question on just maybe talk about your conversations with your customers about kind of appetite for AI and kind of Copilot? Trying to understand how should we think of kind of
the ramp or uptake of FreddyCopilot within the CX business? And how are you thinking of pricing kind of the other Copilots and self-serve and insights tools?

Rathna Girish Mathrubootham  
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

Hey, Pinjalim. Thanks for the question. This is Girish. So we are working – first of all, our FreddyCopilot is incorporated as an AI assistant for all of our users, whether its customer service people or sales folks, et cetera. So, we have several early adopter customers who we are working with in terms of seeing it. One example I can give you is a customer, a shipping and postal company in New York is actually using this, customer service people are using some of the early features that we launched in terms of creating the place for customers, summarizing it and things like that. So we also are looking at making sure that the Copilot can help automate routine manual tasks. So we are excited. We are – and, like, more than 2,000 customers that we are working with, they're early adopters. So, we will see – we're trying to monetize the Copilot soon, in a matter of time.

Pinjalim Bora  
Analyst, JPMorgan Securities LLC

Interesting. Got it. Thanks. And on free cash flow, seems like, if I remember that correct, I think when you entered the year, it was about $10 million for the year and then you went to $20 million, now you're talking about $60 million. How much of that ramp is because of this change in duration towards annual?

Tyler Renwick Sloat  
Chief Financial Officer, Freshworks, Inc.

Yeah. I would say not that impacted, Pinjalim. It does have a little bit of impact to our billings numbers, but the actual change in annual collections, that’s not really driving our operational kind of performance. A lot of it is around just prudence that we've had on the cost side and prudence around hiring. The duration billing is pretty nominal.

Pinjalim Bora  
Analyst, JPMorgan Securities LLC

Got it. Thank you.

Operator: Thank you. And as a reminder, ladies and gentlemen, and as a courtesy to other analysts, please keep your questions to one. One moment for our next question. And it comes from the line of Brian Peterson with Raymond James. Please proceed.

Brian Peterson  
Analyst, Raymond James & Associates, Inc.

Hi, gentlemen. Congrats on the quarter. So, just one for me. On AI and all the product announcements you have, I know there’s a lot of in-market products that you're already selling today. But I’d love to understand on the sales and marketing front, as AI becomes more commonplace, do you see that change is kind of the medium-term ramp for those products as they build from where they are today? I'd love to get some perspective on that. Thanks, guys.

Rathna Girish Mathrubootham  
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.
Sure, Brian. I’ll take that. So, just as a quick brief, we announced Freddy Self Service for customer and employee self-service, Freddy Copilot, which is like an AI assistant for our users, and then Freddy Insights for data-driven insights to leaders. So, what we’re trying to do is like on August 3, when we are launching our new customer service suite, we will be monetizing our Freddy Self Service product, which through our Freshbots. And then our Copilot, which we are thinking of, it will be priced at $29 per agent, but it will be monetized later. We are still working with early adopter customers, as I mentioned, and Freddy Insights will follow that, so.

Operator: Thank you. One moment for our next question, please. And it comes from the line of Patrick Walravens with Citizens JMP Securities. Please go ahead.

Patrick Walravens  
Analyst, JMP Securities LLC

Oh, great. Thank you. And congratulations on the second really good quarter in a row. So, G, one area that I've been wondering a lot about is sort of the resources that you need to deliver generative AI solutions. So, in particular, do you have enough sort of Ph.D. level AI talent to design these? And then do you have access to the GPUs for the training and the inference?

Rathna Girish Mathrubootham  
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

So – but we are making those investments. So we have, like, I don’t know the exact count of how many Ph.D.s we have, but we have AI leaders from Microsoft [ph] who have made some (00:32:11) experience working in our team. So we are also working with some of the technology providers, whether it's Azure OpenAI or some of the other leading providers out that. We are also in the process of investing in AI to kind of build domain-specific and customer-specific large language models. So as part of that, we are thinking of setting up some AI labs in India. So that is in the plan.

Patrick Walravens  
Analyst, JMP Securities LLC

Great. And then what about – is this – with all this NVIDIA stuff, how hard is it to actually get access to the GPU power that you need to train these models?

Rathna Girish Mathrubootham  
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

Yeah, I think we have heard Satya Nadella say that if that becomes a scarcity, it may cause disruption. So that is one of the reasons why we want to set up investments so that we have access to that. And some of our, like, we see investors have also offered us access to GPUs through their connects. So I think we are – for now, we don't face a shortage, but, like, we are all waiting to see how things play out in the future.

Patrick Walravens  
Analyst, JMP Securities LLC

Okay. Great. Thank you.

Operator: Thank you. One moment before our next question please. And it comes from the line of D.J. Hynes with Canaccord Genuity. Please proceed.
David Hynes  
*Analyst, Canaccord Genuity LLC*

Hey, guys. Congrats on the quarter. Tyler, I want to ask you on the billings guide. So, look, if my numbers are right, I think in Q1 it was 20% constant currency growth, this quarter improved to 21% normalized. I think you said you’re guiding to 17% in Q3. I mean, from all the qualitative, you know, quantitative commentary, it sounds like you guys feel pretty good about business momentum. I'm just wondering if that's like typical prudence or are you seeing something in the business that would suggest things might slow again in Q3. Just any kind of high-level thoughts there would be helpful.

Tyler Renwic Sloat  
*Chief Financial Officer, Freshworks, Inc.*

Yeah. Thanks, D.J. No, we really are trying to call it as we see it. We don't see a slowdown per se. We did say that we expect net dollar retention to kind of come down to 105%, 106%. We had actually expected a little bit higher trend coming into the year. And we did see it in Q1. Q2 churn ticked up slightly, but actually was better than our expectations. We do still think there's going to be some continued pressure there. And that's why we're saying it's going to come down. And in the expansion motion, which we started talking about at the end of last year, it's still seeing pressure. And so, what we're trying to do is just call it as we see it. And then, obviously, we will update it as we go along.

David Hynes  
*Analyst, Canaccord Genuity LLC*

Yeah. Okay. Thank you, guys.

Operator: Thank you. One moment, please, for our next question. All right. And it comes from the line of Elizabeth Porter with Morgan Stanley. Please proceed.

Elizabeth Porter  
*Analyst, Morgan Stanley & Co. LLC*

Great. Thank you so much. I wanted to ask about the move upmarket in pricing. You guys have expanded the portfolio, which along with the go-to-market motion has allowed you to be more successful upmarket, yet pricing still largely balances being able to address both the low end of customers and the high end of customers. I know you called out price increases in ITSM, but just more broadly, how do you think about pricing as a lever as you focus more on upmarket customers? Thank you.

Dennis M. Woodside  
*President & Director, Freshworks, Inc.*

Hey, Elizabeth. This is Dennis. Thanks for the question. We see pricing as a lever that we absolutely are going to be focused on. We made one of our first pricing moves this year in our IT suite where we took prices up. And as I said in the remarks, we saw about a 4% price increase realized there. And the way we roll prices out, it's for net new customers and then renewing customers. We're seeing an opportunity with renewing customers across all products to realize more price as we have deals that are coming up for renewal that may have been on higher levels of discount than we need to make today, given the rapid advance of the product and the value that we're delivering to those customers. And that also is a lever for us to bring ARPA up. And you're seeing it in the ARPA numbers.
So I think as the company gets better at thinking about price and pricing to value, price will become a bigger lever for us going forward. It's absolutely one of those things I'm focused on. And we want to preserve our position in the marketplace. We still have a meaningful TCO advantage against all of our competitors, both in terms of our ticket prices, as well as the actual cost of implementing our software.

So we have room for sure. We want to be thoughtful about any kind of price changes, but there's absolutely room for us to be more sophisticated about pricing. You're seeing it with the AI pricing as well, where we're going to be pricing our AI add-on at about $29 a seat. You're seeing it with bot pricing, which we're going to announce later this week a revised bot pricing scheme, which will allow us to monetize bots at a higher rate.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Great. Thank you very much.

Operator: Thank you. One moment for our next question, please. And it comes from the line of Taylor McGinnis with UBS. Please proceed.

Taylor McGinnis
Analyst, UBS Securities LLC

Yeah. Hi. Thanks for taking my question. So, the billings performance relative to the guide was really solid. And if I adjust for days in the quarter, it looks like the sequential growth in the 3Q guide is roughly a point stronger than what you guided to in 2Q. I know that you said churn picked up a little, but I guess how would you characterize the demand environment in June and July versus what we'd seen previously? Are we starting to lap some of the rightsizing or slower expansion activity that could be helping? Are you seeing signs of improvement or is it largely just driven by some of the sales changes you've made?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Yeah. I think largely it's going along as we expected, Taylor. Clearly our guidance is taking into effect all the information we know right now. And so, in terms of how the quarter is going, it's as expected. The guide, like I said earlier, we are really trying to call it as we see it. I think if you look at billings, it was impacted slightly by kind of a move to larger customers that tend to pay annually in advance. And specifically, our new business in Q2 is really strong specifically with ITSM in the field motion. We would expect that to continue, but we've built all that kind of into our guidance.

Taylor McGinnis
Analyst, UBS Securities LLC

Great. Thank you so much.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Thank you.

Operator: Thank you. One moment for our next question please. Comes from the line of Adam Bergere with Bank of America. Please proceed.
Hey, thanks for taking my question. Can you expand on any differences you may be seeing in demand expansion and churn in front office versus back office solutions, for example, just comparing maybe the CRM business versus Freshservice? And then also, just thinking about front office versus back office, which do you think will have – which will – AI have a greater value proposition for? Thanks.

Adam Bergere
Analyst, BofA Securities, Inc.

Why don't I start and then have, G, talk about some of the AI stuff. I think generally speaking, let me just start kind of a little bit higher level. In terms of new business, we're seeing IT in particular do very well. And I think that's partly because the product has come a long way. We've introduced ITOM, ESM capabilities and a number of other aspects of functionality that makes the product really suitable for that solid mid-market business, which for us is about a 5,000-employee company. But our largest customers tend to be more of the customer service product set, and that's because we tend to have a lot more agents in a customer support team than you do over an IT. So we see quite a bit of expansion there.

We are seeing as we move into larger accounts, those larger accounts are expanding at higher rates than our smaller accounts. And that's also helping us drive that or sustain the net expansion rate that we've seen. So, I think the demand is slightly different in that we are seeing very strong demand on the IT side. We're seeing more muted demand for new business on the CX side. We're seeing reasonable demand, I would say, on the expand motion for CX, and IT is a newer product or newer large install base, there the expansion motion also is quite good with products like ESM. That gives us a whole new expansion motion for those customers. So, that gives you a little bit of a flavor. And, G, maybe you can talk about the AI stuff.

Dennis M. Woodside
President & Director, Freshworks, Inc.

Yeah. I'll quickly add, Adam. While we expect AI adoption and transformation across all products, I think the biggest change is going to come or the demand is going to come from customer self-service in the front office.

Rathna Girish Mathrubootham
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

Yeah. I'll quickly add, Adam. While we expect AI adoption and transformation across all products, I think the biggest change is going to come or the demand is going to come from customer self-service in the front office.

Adam Bergere
Analyst, BofA Securities, Inc.

Awesome. Thanks for the answers.

Operator: Thank you. One moment for our next question, please. It comes from the line of Alex Zukin with Wolfe Research. Please proceed.

Alex Zukin
Analyst, Wolfe Research LLC

Hey, guys. Thanks for taking the question. Just two quick ones for me. So, if we step back and think about just the arc of the demand trends and optimization trends in your end markets, as we look kind of coming out of the quarter versus going in, are we through kind of peak pain in your market? You had monthly contracts you were first in and arguably maybe even first out from some of these optimization trends. But can you maybe just comment? I'm not asking for the all clear, but just conceptualize kind of as you see the demand patterns evolving, coming out of this quarter, you mentioned it was a little bit better on the retention front than you were anticipating. I understand the guidance, but just help us understand that. And I've got a quick follow-up on AI.
Tyler Renwick Sloat  
Chief Financial Officer, Freshworks, Inc.

Yeah. Hey, Alex. It's Tyler. I'll take that one. I think just in terms of demand trends, I think they are kind of staying relatively constant, meaning that we do expect there to be continued pressure on the expansion motion. And we do think there's going to be a little bit of increased pressure on churn, which is why we're saying, hey, we [ph] think that dollar retention could (00:43:07) 105%, 106%. We do think it will stabilize there. And a lot of it is how just the number is calculated with the year-over-year and as we kind of annualize some of the stuff that happened last year. So from that perspective, we think there's still going to be a little pressure there.

On the field motion, we mentioned ITSM. We had some really good new business in the field and some really good execution. And, a lot of receptivity to our products mean that the markets are really receptive specifically for Freshservice, and we would expect that to continue.

Dennis M. Woodside  
President & Director, Freshworks, Inc.

Just to add a little bit more color there. And so, remember that the TAM and the markets that we're playing in are massive and relatively fragmented. Yeah, there are large competitors, but there's a lot of room. There's still a lot of legacy players that are not innovating as fast as we are and our product is improving every month. So, we have a lot of runway. The changes that we made on go-to-market and just driving this more balanced focus on both inbound and outbound sales, SMB, mid-market and enterprise, bringing in the leadership and the teams that can build a very large field business. Those changes just happened in Q1.

So, we're starting – as we said in the kind of an opening, we're starting to see the impact. But there's a long way to go. And I think there's a lot of upside. We're seeing more – we're more at that in more big deals than we ever had. We're closing more big deals every quarter than we ever had in prior quarters. We have goals around number of, as an example, 30K deals that we need to close in the quarter. Last quarter, we handily beat that goal. And those numbers go up every quarter. So I think that the long-term market, we're still pretty early in that and how the go-to-market changes are going to play out in the business. And we're feeling really good about how that's going to take us.

Alex Zukin  
Analyst, Wolfe Research LLC

So that's super insightful. I'm going to have to – and hopefully I'm going to roll with the conceptual questions. But I want to ask one about AI, because Dennis, you mentioned pricing, and G, you've talked about pricing a few times on this call. And look, I think everyone's a little struck by some of the pricing announcements for AI SKUs for the Copilot. You talked about $30, I think that's if the largest adoption is going to come from Freshsales [ph] and Pros, your (00:45:39) most popular SKU, that's a 60% uplift on customers that would be adopting [ph] Pro (00:45:41) that's obviously at list price. But just help us understand the, like, I guess the rationale for that pricing, why that's going to drive success? And ultimately, I know you're not guiding to it, but as we think about either how this layers into driving greater adoption of specific products or adoption of the Copilot SKU within your cohorts, like, what's at a high level the uplift or the growth tailwind over time we should expect from AI layering into the model?

Dennis M. Woodside  
President & Director, Freshworks, Inc.

So, Alex, I think it's still early days. I can give you a brief on how we're thinking about the pricing. We are still not decided on which plans exactly are going to have the $29 add-on, are we going to make it available for everybody? But the whole idea is to look at it from a productivity standpoint, a, if agents are going to be like, say,
20%, 30%, 40% more productive, because the Copilot has to get their job done faster, then businesses are going to save on agent cost. And so, like if it's a 20% productivity, like how can we actually get some – capture some of that value. So that's the thought process in terms of how we are thinking about this. But I think it's a win-win for both customers and Freshworks. Still early days, and maybe we'll have more color for you in our Investor Day on September 7.

Alex Zukin
Analyst, Wolfe Research LLC

Perfect. Thank you, guys.

Operator: Thank you. One moment for our next question please. And it comes from the line of Rob Oliver with Baird. Please proceed.

Rob Oliver
Analyst, Robert W. Baird & Co., Inc.

Great. Good afternoon, guys. Appreciate you taking the question. Dennis, appreciate all the color you've given in the prepared remarks and in response to the questions on that over $50,000 cohort, which sounds like it's going really well. I just wanted to ask on that. You did say at the outset that multi-product is now up to 25% of customers. So since the IPO, you guys have done nice job sort of migrating that up. When you look at the enterprise opportunity, and today, maybe the NRR expansion you're seeing there, is that mostly just seat expansions within core products already sold or are you already seeing meaningful cross-sell of, say, Freshservice into Freshdesk? And maybe if you could just talk a little bit about that opportunity for you guys, that would be helpful. Thank you.

Dennis M. Woodside
President & Director, Freshworks, Inc.

Yeah. So, I would say the strength is a combination of net new business. So a number of the wins that I talked about, like the large-scale company, well, actually that was an expansion, but the net new still is a big part of our growth story. And really that's because you have a lot of vendors or a lot of customers who are coming up on a three-year contract, a two-year contract. We were not really in the mid-market game two or three years ago, and they're looking for an alternative that provides higher value, a modern interface for their agents and fast time to value. We offer all that. So, we're getting more and more of those at-bats on the new side.

On the expansion side, we are seeing the opportunity to cross sell [ph] true cross-persona sales (00:49:00). And an example with a steel company that I mentioned in the remarks, that's an example of that kind of a cross-sell. The Trainline, another example of a [ph] cross-persona sell (00:49:13) where I think we started out on the support side and moved into the IT side. So, one of the things that we did [ph] at behavior is separate, (00:49:18) remember the kind of the hunting motion from the farming motion, and we need to perfect the art of going out and winning new business and we need to perfect the art of seeing opportunities within existing accounts, [ph] surfacing (00:49:32) new needs, and then getting in front of the right decision makers to prove that what we have, a solution that we have can add value to their business. And that's where we're starting to see that pay off in these [ph] true cross-persona (00:49:45) sales. That's where you get the big expansions. So that's a little bit of color of kind of how we're thinking about the opportunity there.

Rob Oliver
Analyst, Robert W. Baird & Co., Inc.

It's great. Appreciate that. Thank you.
Operator: Thank you. One moment for our next question, please. And it comes from the line of Brian Schwartz with Oppenheimer and Company. Please proceed.

Brian Schwartz  
Analyst, Oppenheimer & Co., Inc.

Yeah. Hi. Thanks for taking my question and congratulations on a real nice quarter. Just one more on the AI topic. G, Maybe just ask you a question, I’m thinking about the right pace of adoption within the install base for the AI products, is there any way of comparing that to any of your previous product launches or any insights on how we should think about the uptake of those products as they continue to get rolled out? Thank you.

Rathna Girish Mathrubootham  
Chairman, Chief Executive Officer & Founder, Freshworks, Inc.

Yeah. So thanks for the question, Brian. So I think first thing we are excited about is the August 3rd launch of our modern customer service suite. So we think that actually represents what could be the future of how customer service should look like, starting from Gen AI based natural language conversational self-service, handing off seamlessly to human agent support conversational service, handing off seamlessly to human agent support and then enabling seamless collaboration with ticketing. So we’re bringing it all together. Also, our customers who use standalone or buy standalone Freshdesk or Freshchat products will also have access to this. But it’s not a one-time event, Brian. So there’s a lot of stuff that we are going to continuously keep building in terms of all these three pillars of Self Service as well as Copilot as well as Insights. So, I think we will continue to see a rolling thunder kind of adoption as opposed to one big bang adoption.

Brian Schwartz  
Analyst, Oppenheimer & Co., Inc.

Thank you.

Operator: Thanks. One moment for our next question. And it comes from the line of Brent Thill with Jefferies. Please proceed.

Brent Thill  
Analyst, Jefferies LLC

Dennis, you mentioned the go-to-market changes in Q1, I'm curious how far are you into those changes. Do you have more that you're making or do you feel that the go-to-market sales team is in the right spot? You're going to run this playbook in the current form? Any more color in terms of how you’re thinking about that would be helpful.

Dennis M. Woodside  
President & Director, Freshworks, Inc.

Yeah, I think we're getting there, but there's still more work to do. So, remember, think of our business as an inbound business which is very meaningful for us. A lot of our larger accounts started out as an inbound lead, and then you've got the outbound business. And a lot of the commentary that I've had has been focused on the outbound business, because to me coming in that was such the kind of a near-term and clear opportunity.

One of the areas that we've been focusing on more recently is that inbound business. And really, okay, now that we've kind of got what we think is outbound on the right track, we're getting the right people in, we're starting to see some traction, what can we do in that inbound business to really fire that up? And I was talking about cross-
sell before getting better at cross-sell, servicing other products in, if you’re in Freshsales, servicing Freshservice, those sorts of things are tactics that we can do much better than we’ve done in the past and we’re starting to invest in.

So, really getting back to that product-led growth thesis and bringing some innovation to how our products can grow themselves. That’s another area of growth for us. So I think that we’re just finding more and more pockets of growth in the business. On the field side, the leaders that we’ve brought in really have joined us in the last two quarters. So, it takes time for them to get up to speed. They need to get their teams kind of focused in a way that they want. And we believe that that’s going to continue to pay off throughout the rest of this year. But Q2 was a good indicator that the changes are taking root and that we’ve got a lot of opportunity if we can get this right.

Brent Thill
Analyst, Jefferies LLC
Thank you.

Operator: Thank you. One moment for our next question, please. And it comes from the line of Scott Berg with Needham & Company. Please proceed.

Scott Berg
Analyst, Needham & Co. LLC
Hi, everyone. Congrats on the really nice quarter and thanks for taking my questions. I guess I also have a question for Dennis on the upmarket traction that you’re having there. I think we’ve probably all agreed, Dennis, at least from the outside looking in that your success in a short timeframe upmarket is probably a lot better than what we all expected. But how do you think about what that trajectory looks like? Can you move even farther into the enterprise or do you think you have a targeted end market that, I don’t know, reflects the high end of the mid-market, low end of the enterprise, however you’re structuring it? And then within that, do you think about competitors any differently if you try to target even further upmarket? Thank you.

Dennis M. Woodside
President & Director, Freshworks, Inc.
Yeah. So we think of our ICP today really is that 5,000-person solid mid-market business, right, where you have a sophisticated IT team, you have a demanding internal audience if it’s on the IT side or you have a demanding customer base if you’re talking on the customer support side. You need to offer on the customer support side, the kind of conversational interface that their end customers are demanding, chat and text service, all that stuff. And you want something that’s fast time to value. You can’t afford or you don’t want to pay for a large group of consultants just to implement your product. That’s where we really shine.

Now, that said, more and more larger companies are demonstrating those characteristics. So, the steel company that I mentioned, actually there’s a second steel company that we won this quarter. In both cases, they were looking for a solution that was easier to use, to implement, to modify workflows for, to solve for their, in both cases, IT issues. And so, some of these larger companies that are well above that 5,000-person ICP, they are demonstrating similar characteristics and that’s where we have an opportunity at that lower end of the enterprise today. Now, as our product matures and we have a very exciting roadmap for both the CRM products and IT products, as they mature, that’s going to open up more and more opportunity for us.

So, the art is to make sure that you’re focused on the near-term at the areas that have the highest opportunity and then pick off those larger accounts that happen to be demonstrating the characteristics that you know you can
satisfy and then gradually moving more and more upmarket. So I don't think that we think that there’s a hard limit on where we can go just based on the customers we have today. We just have to be thoughtful about how we get there.

Scott Berg
Analyst, Needham & Co. LLC

Excellent. Thanks for taking my question.

Operator: Thank you. One moment for our next question. And it’s coming from the line of Nick Altmann with Scotiabank. Please proceed.

Nick Altmann
Analyst, Scotiabank

Awesome. Thanks, guys, for taking the question. The margins in the quarter and the free cash flow guide was very impressive. So I guess my question is really around the tradeoff of growth versus margin improvements. I know there are some onetime items this year, but some of the underlying metrics suggest that there is some level of stabilization. So I guess with that in mind, how are you guys sort of thinking about margin leverage over the coming years in a time where things sort of be seem to be stabilizing, the go-to-market tweaks seem to be working nicely and you have a handful of new exciting SKUs coming online?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Yeah. Hey, Nick, it’s Tyler. I’ll answer that. You’re right, we’ve actually had great performance on the bottom line and margins are doing really well. We’ve always said we thought we had leverage in the model and we’re kind of just really focused on that. Now, we do want to be clear, we are not producing cash and profits at the expense of growth, and we are going to continue to invest in our go-to-market motions [indiscernible] (00:58:41) we want to make sure those are efficient investments that we get back the right returns, but we are really focused on continuing to invest there and continue to grow and to fuel that growth. And we’re going to do the same next year. And this is something we’ll probably talk about a bit in our Investor Day on September 7 as we kind of break that down. But absolutely, we think there’s a huge opportunity across all our product lines that we’re going to continue to fund capturing market for those opportunities.

Operator: Thank you, everybody, for your time. This is the end of the Q&A. Thank you all for participating. And you may now disconnect.