01-May-2024

Freshworks, Inc. (FRSH)

Q1 2024 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

OTHER PARTICIPANTS

Scott Berg
Analyst, Needham & Co. LLC

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Ethan Bruck
Analyst, Wolfe Research LLC

Brent Thill
Analyst, Jefferies LLC

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

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Daniel Reagan
Analyst, Canaccord Genuity LLC

Pat Walravens
Analyst, Citizens JMP Securities LLC

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to the Freshworks First Quarter 2024 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 turn the conference over to your speaker today, Joon Huh, Head of Investor Relations. Please go ahead.

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

Thank you. Good afternoon, and welcome to Freshworks first quarter 2024 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 first quarter 2024 performance and our financial outlook for our second quarter and full year 2024.

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, 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 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 Girish.

Rathna Girish Mathrubootham

Chairman, Founder & Chief Executive Officer, Freshworks, Inc.

Thank you, Joon, and thank you all for joining us on this call today to cover our first quarter of 2024. We delivered solid profitable growth in Q1, as we reported revenue of $165.1 million, reflecting an increase of 20% year-over-year. We meaningfully surpassed our estimate for free cash flow with $38.7 million in Q1 for a strong free cash flow margin of 23%. Our results reflect aspects of our growth strategy that are working, specifically in AI innovation, IT business momentum, and CSS adoption with larger customers, as well as the current macro environment.

Before talking about our product and growth initiatives for the business, let me start with the news we announced earlier today that we have signed a definitive agreement to acquire Device42. With more than 800 customers around the world, Device42 provides enterprise-grade IT asset management capabilities, which we believe can further strengthen our Freshservice offering.

This is our first acquisition since we became a public company in 2021, and I'm excited about how this will enhance Freshservice, which is currently our fastest-growing business. With this acquisition, we will be able to provide Advanced Asset Discovery and application dependency mapping across data center and cloud environments. Combined with our robust ITOM and ITSM capabilities, this will help IT infrastructure and ops teams track and understand their IT landscape to achieve greater efficiency in service delivery and reliability in IT operations.

Through the combination, we'll be able to offer a more comprehensive solution for our customers. We have historically partnered with Device42 on large enterprise opportunities in the field. And after the transaction closes, we look forward to serving customers as one integrated team. We expect the transaction to close later in Q2.

Turning to the quarter, I'm pleased with our progress across the business in Q1. First, we advanced AI innovations across our products and platform to improve agent productivity and customer satisfaction. The use of our bots with Freddy Self Service continues to strengthen deflection capabilities across customers' preferred channels. Companies, including Porsche eBike, Lightricks, and Travelopia can leverage self service capabilities to improve personalization and provide AI-generated answers from their knowledge base.

Over the past quarter, our customers have seen deflection rates of more than 40% resulting from these bots. During the quarter, we made Freddy Copilot generally available to customers, and I'm excited about the initial traction. We received early feedback that customer service agents are realizing more than a 30% improvement in their response time. While it's still early to track Copilot metrics, we are encouraged by the initial results.

Mahindra & Mahindra is an Indian maker of cars and farm equipment with more than $16 billion in revenue. Their on-premise ITSM solution became complicated to manage, had a clunky UI, and poor self service capabilities. The company says adopting Freddy Copilot on top of Freshservice has been a game-changer. The solution article generator feature, in particular, is enabling more than 1,000 engineers to make knowledge management more efficient and enjoyable. And now, the company plans to scale these products across other teams.

We also saw continued momentum in our IT business with mid-market and enterprise customers. Customers are choosing us because our products are enterprise-grade with a much lower total cost of ownership, including the latest AI capabilities. A global leader in golf equipment needed to find a way to solve for its 2,000 employees walking up to the IT service desk with simple or complex problems. After deploying Freshservice, they later adopted our Freddy Self Service capabilities. With the help of our latest AI bot, the company has been able to further automate requests and significantly reduce resolution times, and eliminate the lines waiting for IT help.

We continue to invest in helping organizations manage their IT infrastructure and operations. In Q1, we enabled IT teams to proactively communicate the status of critical services to their stakeholders using status pages. This has increased trust and led to reduced incident reports during service downtime. One such customer taking advantage of this capability is the Statue of Liberty-Ellis Island Foundation. With more features and improvements, we are winning more mindshare with CIOs as we go after the large market opportunity in ITSM, ESM, and beyond.

Turning to the CS business, adoption continues to grow for our Customer Service Suite, our multi-channel solution that combines conversational support with robot ticketing features and powered with AI. Companies like Monica Vinader and Stitch Fix are choosing CSS. Stitch Fix employs more than 5,000 people and leverages stylus and AI to deliver personalized clothing and accessories to over 3 million customers. Their previous customer service solution was expensive and complicated with outdated AI technology.

A long-standing Freshservice customer, Stitch Fix adopted the Customer Service Suite as their solution in Q1, largely because of our leading AI innovations, including our Copilot capabilities. Freddy Copilot is boosting productivity for agents as power-users have seen a reduction of resolution and response times of more than 30% and CSAT scores increase on average by more than 5%. As we continue to improve productivity for these agents, we believe this will lead to higher adoption within organizations and more expansion opportunities.

This quarter, we introduced sentiment analysis for real-time insights into the emotional tone of customer interactions. We also added generative AI-led quality management capabilities, like article suggestions and auto-completion, to help support teams deliver superior responses. Within one quarter, these capabilities generated over 38 million interactions.

Finally, I want to acknowledge today's news that I am transitioning into an Executive Chairman role at Freshworks; and Dennis Woodside, currently Freshworks President, will assume the Chief Executive Officer role. I am incredibly proud of what we have accomplished at Freshworks since I founded the company 14 years ago.

We are the first Indian SaaS company to be listed on NASDAQ, a true friend to more than 67,000 customers around the world and home to our 4,900-strong global Kudumba. Our business is strong and we have a fantastic platform to launch Freshworks into a sustainable and growing public company.

Through these 14 years of building and scaling Freshworks, our hiring philosophy takes inspiration from an ancient poem from Tirukkuṟaḷ, written by a Tamil poet and philosopher, Thiruvalluvar, 2,000 years ago. [Foreign Language] (00:10:56-00:11:01). Translated in English, it means find the right person with the skills and resources to finish the job and empower them to do it.

After seeing this play out beautifully over the years, the time has come to apply this to the CEO role at Freshworks, and I am fully confident that Dennis is the right leader to step into the CEO role. His deep understanding of the Freshworks business, his admiration and respect for our Indian roots, ability to attract world-class talent and the operational excellence he has brought in to Freshworks over the last 18 months gives me the confidence to pass over the baton to Dennis. And I look forward to being his trusted advisor in my new capacity to help make Freshworks software available to the Fortune 5 million. Moving forward, I look forward to working with our product teams to drive our AI vision and long-term product strategy.

I would like to thank the entire Freshworks team for all the support they have given me over the years and for delivering another solid quarter as we continue on our mission to deliver modern AI-powered customer and employee service solutions that increase efficiency and improve engagement for companies of all sizes.

I would like to congratulate Dennis, and now turn it over to him to share what we are seeing in the marketplace, how larger customers are driving our business growth and how companies are expanding the use of our products.

Dennis M. Woodside

President & Director, Freshworks, Inc.

Thank you, G. I am honored to build on what G started 14 years ago. What he has created is truly special. Our mission and strategy remain the same. We stand before extraordinary opportunities and have the right foundation to make it possible, a winning combination of our strong focus on delighting customers and our product innovation. I am committed and excited to continue our journey of growth.

As G mentioned, we efficiently scaled the business in Q1. With revenue growth of 20% and strong free cash flow margins of 23%, we exceeded the rule of 40 for the quarter. We continue to see momentum with larger customers choosing our enterprise-grade solutions. In Q1, customers paying over $50,000 in ARR grew 29% to 2,593, representing 49% or nearly half of our business.

Our solutions provide enterprise-grade capabilities combined with consumer-level usability to address the needs of large, complex organizations. For example, Cineworld Group is the world's second largest cinema chain with more than 700 movie theaters across the US, UK, and other countries. Their prior customer service solution wasn't allowing them to respond to queries fast enough and gain insights into their customers' experience. They adopted Freshdesk across their Cineworld, Picturehouse, and Regal customer service teams. Now, the company is able to quickly identify and respond to customer queries, understand root causes, and develop better steps to resolve them using the power of Freshworks.

I'm also very excited about entering into a definitive agreement to acquire Device42. We believe this acquisition will help us win more mid-market and enterprise customers as advanced ITAM capabilities for discovery and dependency mapping are becoming a critical part of the IT purchasing decision for large customers. With this acquisition, we intend to build on the up-market momentum and success that we're already seeing with Freshservice for IT customers.

Turning to expansion, in Q1, net dollar retention was 106% and customers using more than one product was 26%. We saw notable expansion and multi-product activity from Freshservice for Business Teams. We're also executing on the cross-sell of our two largest product areas in IT and customer service. An example of cross-sell is Dark Matter Technologies. Dark Matter employs more than 1,000 people and makes software that enables retail banks, credit unions, and credit vendors to simplify lending. Already a Freshservice customer for ITSM, they chose Customer Service Suite to replace their incumbent solution because it was easy to go live within their tight timeframes and simple to configure.

We remain bullish on the AI opportunity. We believe this will be a tailwind to our business and this is a big part of our future growth strategy. As G said, we saw promising signs of momentum from Freddy Self Service and Freddy Copilot in Q1 with over 30% improvement in productivity metrics for our customers. This has led to early signs of monetization since the Freddy Copilot add-on became GA this past quarter.

From a market demand perspective, we continue to see the impact of a challenging macroeconomic environment. While Q4 saw an uptick in expansion activity, we saw pressure on overall expansion rates for Q1 across our customer base in terms of agent growth.

For the SMB part of the market, where we attract customers through an inbound digital motion, there is still work to be done to improve this motion. We're seeing lower expansion rates and a lower number of net new customer adds as the macro-economy is having a meaningful impact on this part of our customer base. This led to slower growth for the CS business as the majority of the business is from SMB.

Given this current market environment, it's important for us to maintain a balanced approach to our investments. In Q1, we were able to create further efficiencies while investing in the business to drive future growth.

I'll turn it over to Tyler to talk about this in more detail.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

Thanks, Dennis, and congratulations. And thanks to all of you joining on the call and via webcast. I'm pleased with our ability to deliver another quarter of durable growth while improving our profitability. All the operational improvements that we implemented last year has created positive business momentum that carried into this year to drive further efficiencies and strong margin expansion in Q1.

For our call today, I'll cover the Q1 2024 financial results, provide background on the key metrics, and close with our forward-looking commentary and expectations for Q2 and the full year 2024. 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 Q1 grew 20% to $165.1 million on a reported basis and 19% adjusted for constant currency. Professional services contributed approximately $2.6 million to total revenue, which is a lower contribution percentage than prior quarters. This is intentional as we are shifting more services revenue to our partner network.

We continue to see momentum in our IT business specifically for new deals from mid-market and enterprise customers. We're also seeing up-market traction from the CS business as our largest expansion deals in Q1 were from our customer service products.

Moving to margins, non-GAAP gross margin increased to 85% as we continue to drive efficiencies in our infrastructure spend as we scale the business. Compared to the prior year, this represents an improvement of more than 200 basis points. We also improved our non-GAAP operating margin to 13% as non-GAAP operating income came in at $21.8 million, which includes a one-time benefit of $3.7 million related to employee benefits expenses.

Adjusting for this one-time benefit, non-GAAP operating margin would be 11% and still ahead of our prior expectations as we made ongoing operational improvements and shifted some marketing and legal spend into future quarters.

As we've talked about previously, our financial model is built for us to make investments in our many growth initiatives. At the same time, we have flexibility in the model to adjust our spend as we see demand change throughout the year to prudently manage our expense base and drive efficiencies.

Moving to operating metrics, our two key business metrics are net dollar retention and customers contributing more than $5,000 in the ARR. Net dollar retention came in line with our expectations at 106% in the quarter, both as reported and on a constant currency basis. While our customers continue to grow their spend for our products in Q1, we did not see the same elevated levels of large expansion deals that we saw at the end of last year. Overall churn modestly increased and continued to remain squarely in the mid-teens. Looking forward, we're planning for a Q2 net dollar retention range of approximately 105% to 106%.

For our other key business metric of number of customers contributing more than $5,000 in ARR, this metric grew 11% year-over-year to 20,549 customers in the quarter, and now represents 89% of our ARR. On a constant currency basis, this customer metric grew 12% year-over-year. For our larger customer cohort contributing more than $50,000 in ARR, this cohort grew 29% year-over-year to 2,593 customers and now represents 49% of our ARR. The constant currency growth rate for this cohort was also 29%.

For total customers, we added approximately 400 net customers and ended the quarter with over 67,500 customers. The lower net adds over the past two quarters has largely been a result of the lower number of our new CS customers, especially in the SMB. For the past few quarters, we have been focusing our efforts and go-to-market spend to target higher-yielding customers, which is resulting in ongoing increases for ARPA.

Now, let's turn to calculated billings, balance sheet, and cash items. Our normalized calculated billings growth was 17% in Q1, down 1 percentage point from the 18% normalized growth rate in Q4. As we've talked about before, billings growth rates can fluctuate quarter-to-quarter due to a number of factors.

In Q1, we had a negative impact primarily from lower early renewal activity compared to the prior quarter, resulting in an as-reported calculated billings growth rate of 14% or $174.7 million. Looking forward to Q2 2024, our initial estimate for calculated billings growth is 12%. For the full year 2024, we expect calculated billings growth to be approximately 16%, or approximately 1 percentage point below our annual revenue growth.

Moving to our cash items, we meaningfully outperformed our free cash flow estimates coming in at $38.7 million for Q1. This was a result of strong collections activities and an ongoing focus to drive efficiencies in our spend around head count and vendor costs. Given our strong cash flow performance in the quarter, we are increasing our full year 2024 estimates to $125 million, with approximately $28 million in Q2. We ended Q1 maintaining a similar balance with prior quarters for cash, cash equivalents, and marketable securities, with $1.2 billion.

We continue to manage and offset some share count dilution by net settling vested equity amounts and using $23 million during the quarter. As a reminder, this activity is reflected in our financing activities and is excluded from free cash flow. We plan to continue net settling vested equity amounts going forward, resulting in Q2 cash usage of approximately $16 million at current stock price levels. For the year, we expect to use approximately $70 million to net settle vested equity amounts.

Turning to our share count for Q1, we had approximately 322 million shares outstanding on a fully diluted basis as of March 31, 2024, representing a share reduction compared to the prior year and quarter. The fully diluted calculation consists of approximately 299 million shares outstanding, 21 million related to unvested RSUs and PRSUs, and 2 million shares related to outstanding options.

Let me now provide our forward-looking estimates. I'll go through the numbers first and then provide background commentary afterward. For the second quarter of 2024, we expect revenue to be in the range of $168 million to $170 million, growing 16% to 17% year-over-year; non-GAAP income from operations to be in the range of $6.5 million to $8.5 million; and non-GAAP net income per share to be in the range of $0.05 to $0.06, assuming weighted average shares outstanding of approximately 305.6 million shares.

For the full year 2024, we expect revenue to be in the range of $695 million to $705 million, growing 17% to 18% year-over-year; non-GAAP income from operations to be in the range of $58 million to $64 million; and non-GAAP net income per share to be in the range of $0.32 to $0.35, assuming weighted average shares outstanding of approximately 307.6 million. Our forward-looking estimates are based on FX rates as of April 26, 2024, so any future currency moves are not factored in.

We want to provide our best view of the business today in a changing market environment, so here are a few items to call out. First, on the Device42 acquisition, our forward-looking estimates do not include numbers from the Device42 acquisition. We'll cover details of the financial impact from the acquisition after closing. That said, we expect the transaction to be accretive to our revenue growth for this year and have minimal impact to our free cash flow estimates.

Second, our full year 2024 revenue estimates, compared to our prior estimate, the current estimate includes negative adjustments of approximately $2 million related to FX moves since last quarter and negative $1.3 million related to the intentional shifting of professional services revenue to partners.

Third, our Q2 operating income. As a reminder, we have seasonality in our business as Q2 expenses normally step up as the annual merit increases take effect, leading to lower margins quarter-over-quarter.

Let me close by saying, we're very focused on growing the business while creating a durable, profitable company to deliver long-term value for our stakeholders. We're innovating on our products, especially in the area of AI. We're building business momentum and gaining traction with larger customers. And we're driving efficiencies in the business that's reflected in our financial results. And we're excited about the many opportunities ahead.

And with that, let's take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from a line of Scott Berg with Needham & Company.

Scott Berg
Analyst, Needham & Co. LLC

Q

Hi, everyone. Thanks for taking my questions here. Dennis, congrats on the move to the CEO role and, G, I still hope we get a chance to speak with you going forward here. I guess a couple of things for me. I believe it was Dennis called out the kind of softness in the CS market, especially downstream in the SMB segment.

There's a pretty popular narrative out there on the impact that – whether it's customers of yours or others in the space are trying to use different AI tools to automate some of the labor out of some of these customer service environments. Are you seeing that impact your business at all in the quarter? And is there anything related to the slight reduction of full year revenues maybe because of any changes there in terms of how your customers are using the technologies? Thanks.

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

A

Thanks, Scott. It's Dennis here. So, we see Q1 on SMB really more as a continuation of some of the trends that we called out in Q4, where throughout last year we had seen SMBs under pressure from the macro environments for sure, rising interest rates that are limiting their ability to expand their business. And that directly impacts their investment in customer support. So, that trend continue – you saw that trend in terms of our net adds, which have come down quite a bit over the last year or so. And that's been offset by strength in IT and by strength in larger customers. You see that on the continued growth of the $50,000-and-up cohort.

So, do we expect AI to have an impact over time? Yes. At the same time, the adoption of our AI solutions has been quite strong. We put Freddy Copilot into GA about midway through the quarter. And although it's really early, we saw good adoption among that SMB segment as well as among larger customers. So, I think it's a bit early to say that the cause of SMB weakness was AI. That trend persisted prior to this quarter, but we certainly saw it this quarter.

Scott Berg
Analyst, Needham & Co. LLC

Q

Understood. Helpful. Thank you, Dennis. And then, G, you moving into the Executive Chairman role, like some are going to see this as kind of a surprise and a little bit sudden given the way the announcement was worded, at least without a formal transition. And I realize you're not going anywhere. But why is the time right today to make this change versus the beginning of the fiscal year, three, four months ago, or maybe later on this year?

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

A

Yeah. Hi. Thanks, Scott. So, I think the first thing is this is not – this was something planned as part of my succession, even when we hired Dennis 18 months ago. Like, our expectation was that he would eventually be my successor. And so, we have been working in a similar fashion where Dennis was helping Freshworks get the operational rigor, put in place a world-class team, and focus on go-to-market excellence, while I was actually focusing on all the AI stuff that you are seeing right now with Freddy and the product strategy.

I think the short answer is playing to our strengths. I think I've always been a believer in playing to strengths. And we feel that what's right for Freshworks is for me to focus on long-term product strategy and AI. And Dennis is a fantastic operator, coming with a world-class experience, looking at his experience at Dropbox, where he has scaled the company from $200 million to north of $1 billion in, like, four years or so. And so he brings the right expertise. So, this was the plan, and I feel comfortable that this is the right time to do it.

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

Yeah. Scott, just a little more on that. I think, first of all, the hardest thing in business and in technology is to build a company out of nothing and scale it to a point where your line of sight to $1 billion in revenue, you're serving tens of thousands of customers around the world, and G did that. And the advantage – we really have been operating, in many respects, in a way where G has been focused very much on technology, very much on the AI initiatives and what's coming, and I've been focused on the near term and what we need to do to scale the business.

So, to some degree, we've been operating in a way that's consistent with where we're headed for some time. Obviously, this formalizes it in a meaningful way. But I think, internally, it wouldn't be viewed as a sudden change necessarily, and we're excited about taking it forward from here.

Scott Berg Q
Analyst, Needham & Co. LLC

Excellent. Thank you for taking my questions.

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

Thanks, Scott.

Operator: Our next question comes from a line of Pinjalim Bora with JPMorgan.

Pinjalim Bora Q
Analyst, JPMorgan Securities LLC

Hey. Thank you for taking the questions. One question on the performance on the low end of the market. Is it possible to delineate between how much of the underperformance there is because of the worsening macro environment versus some of the changes in the go-to-market side that you put into place earlier in the year? And did I hear it correctly, is it mainly on the CX side versus ITSM?

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

Yeah. Thank you, this is Dennis, for the question there. So, the changes that we've made on go-to-market over the last year were primarily – not exclusively, but primarily in the field. So, that didn't really affect the SMB performance. We've called this out before where we have an effort underway to try to drive increased conversion of leads in SMB by taking a different approach to how we service those leads and sell those leads. We've made strides there, and we expect that that will bear fruit over time, but that is also fighting against a bit of a headwind that the macro is causing in that segment.

So, it's a little hard to distinguish what is macro and what is not. But certainly when we talk to customers, we do hear that they are under pressure, and that is resulting in prolonged decisions and, in some cases, no decision. I think with respect to whether it's CX or IT, SMB for us is primarily a CS business. And so, when we say SMB, that means primarily CS. That's where we're seeing that weakness, in SMB and CS.

Pinjalim Bora
Analyst, JPMorgan Securities LLC
Q

Understood. One high-level question, it's a little bit long winded, but if I think about the bot-based products in the market today that might handle, say, L1 queries and the Copilot kind of products, which sits besides an agent, how important is that context switch between these two layers for kind of the success of the efficacy of the AI? Trying to understand if a company uses L1 for one vendor and L2 for another vendor, does that actually increases the work for the company to create the plumbing between the two layers and maybe has an effect on the overall AI efficacy or success rates?

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

Yeah, I'll take that, Pinjalim. This is G. So, first of all, when you look at it from a customer experience standpoint, we all know that customers hate to repeat themselves when they call the call center and they're passed around, right? So, it's the same customer experience that's at the core here. So, when the customer is actually being helped by a bot, and let's say, for some reason, if the bots are not able to help, handing off the customer gracefully to an agent who has full context is really important. And that is something where, at Freshworks with our new Customer Service Suite, we have a complete omni-channel product that combines bots with human experience and ticketing for longer-standing use cases.

So if a company is using a different technology for bots and a different technology for human agents, they can still integrate and transfer that context, but they would have to do that extra work. But it's always important for the human agent to actually have that context of what transpired before the customer came in contact with them.

Pinjalim Bora
Analyst, JPMorgan Securities LLC
Q

Got it. Thank you.

Operator: Our next question comes from the line of Alex Zukin with Wolfe Research. Alex, your line is open.

Ethan Bruck
Analyst, Wolfe Research LLC
Q

Hey, guys. This is Ethan Bruck – hey. This is Ethan Bruck on for Alex Zukin. I just want to ask – I appreciate the color on the CS side. I'm just curious, did the ITSM outperform or also underperform against your internal expectations? And I appreciate the color on the moving pieces on the updated 2024 guidance. Just curious if you can describe if you feel it's now derisked and maybe any other puts and takes on how to think about it. Thank you.

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

I'll take the guidance part, and then I can hand it to Dennis for the ITSM piece. But I think you're asking for the clarification. What we did call out is like guidance for the year, obviously it's based on what we see today and how we expect to perform. Nothing from the Device42 acquisition is in there. But there is about just under $3.5 million impacted for the year, $2 million on FX and almost $1.5 million on professional services. And professional services, we commented on, this is a very prescriptive shift to partners and we're actually pretty excited about that.

It's just that we had had expectation of services revenue. A lot of that, we were taking the paper and then giving it to partners. And so, we saw both sides on the margin and on the top line revenue, which has actually come down because now we have partners who are having the capability to go deliver it themselves. I'll let Dennis answer the other piece.

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

A

Yeah. So, our ITSM business continues to perform very well, in particular in the field and in larger customers. So, the sweet spot for our ITSM business is a company from 500 to 20,000 employees. They have complex IT needs. They typically will have 100-plus agents in their IT department. They have tens of systems that our products need to integrate with. And they're looking for a scalable solution that serves all those needs across ITSM, ITOM, ITAM, and then for departments outside of IT, ESM. And so, we've carved out a great spot in that market as the most credible alternative to ServiceNow.

We're cloud-first. We're at enterprise scale at this point. We have many customers that are supporting businesses of 10,000, 20,000 people based on our product. An example that was called out this quarter was Mahindra & Mahindra, which is a $16 billion company in India, industrial, that was attracted to Freshservice for its Copilot capabilities and the ability to apply AI in the IT department.

So, that IT business is doing actually quite well for us. We called this out at the Investor Day back in September, where the growth rates of that business are quite strong. At the time, we called out high-30s, and we continue to invest in that business. That's a reason that Device42 for us was quite attractive. In talking to customers, we see more and more customers looking for advanced capability in asset management, and they're making purchase decisions around their ITSM alongside their decision about how they're going to manage the assets in the IT estate. So, IT is really actually performing quite well for us overall, and we're leaning into that business for sure.

Ethan Bruck
Analyst, Wolfe Research LLC

Q

Great. Thank you, guys.

Operator: Our next question will come from the line of Brent Thill with Jefferies.

Brent Thill
Analyst, Jefferies LLC

Q

Dennis, congrats on your new role. I was just curious to get your thoughts on the one or two things that you want to focus on in your new role. And just a quick follow-up, I know a number of vendors have been commenting on SMB concerns. But I think historically there's been some separation between macro and internal execution. And I'm curious, do you feel the internal execution is where you'd like it to be or do you feel this is all macro and there's nothing you can really do right now? Thank you.

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

A

Yeah. Thanks for the question. So, I think that on the first question, the area that I am very much focused on is driving execution of the business that we have now, and that relates to your point around SMB. Can we do more? And do we need to do things differently in that space? Yes, we do. And I've talked about this before at the Investor Day and then throughout Q4. We are in the process of modernizing our inbound motion, our digital-led motion. There's more we can do there to act in a way that our customers expect us to act.

Right now, we have a process that's a bit too manual. We need to do things like apply AI to that process. We need to make it easier for the customer to see value in our products than they currently can. So, that's the big focus, is execution, not just in SMB, but in the field as well. A lot of the changes that we've made over the last year are to build a base to drive that execution, bringing in the people that can help us scale.

And then the second area really is driving that – continuing that move up into the mid-market and into the lower end of enterprise. And that requires different approaches to how you sell, how you support, how you service, professional services, all those things, while bringing real innovation around AI into that space. So, I think those are really continuation of what G and I have been focused on over the course of the last year or so, but sharpening that up and making sure we drive that through.

I think on the last question, well, I guess I answered it in some respect. Yes, I think macro absolutely is a part of it, and yes, we can absolutely do more there.

Brent Thill
Analyst, Jefferies LLC

Q

And just a quick follow-up, Dennis. When you think about that modernization of a digital motion, I mean, how long does that take to complete? Is that a 2024 event? Is it going to be complete in the front half? How do you think about the actual timing of it?

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

A

It's a 2024 event, and the expectation is that we start seeing impact later this year.

Brent Thill
Analyst, Jefferies LLC

Q

Great. Thank you.

Operator: Our next question comes from the line of Rob Oliver with Baird.

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

Q

Great. Thanks. I'll add my congratulations, Dennis, to you and, G, to you as well. Dennis, my question is for you. And I know you commented that it's too early to say that generative AI is the reason for the agent weakness in Q1, but maybe to harken back to Scott's question at the outset, you also said that you're seeing early signs of Freddy monetization. So, I'd be curious to hear what sort of impact that is having within your accounts in terms of, I guess, seat and agent activity, as well as – and this came up in conjunction with Klarna – sort of that distinction between Level 1 and Level 2 deflections. I mean, we would expect that line to shift. So, curious to hear your view on that. And then I had a follow-up for Tyler.

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

Yeah. So, on AI, every sale and renewal that we're involved with, AI is at the center. Every customer wants to talk to us about our AI capabilities, our AI roadmap, how that can help them. They want to see examples. And we have two paths to monetize today. We have Freddy Self Serve (sic) [Freddy Self Service], which is L1, and then we have the Copilot, which assists the agent. Different pricing models; one's consumption, one's price per seat. Both are getting tremendous interest, and both are involved in sales in different ways.

In some cases, we're monetizing directly. People are paying us right off the bat. In other cases, we're using our AI capabilities as an inducement to close the deal. An example there really is Stitch Fix, which bought not just on the core, in that case, customer support platform, but it was on the back of Copilot and the AI roadmap. And then in other cases, we're using AI – and thinking of it really as an adoption play, where we want to get a customer, wall-to-wall, using AI across all their agents, get them seeing value for it, give it to them for a period of time for free on a limited basis or very low cost, and then monetize down the road.

So, it's very early. Our Copilot went into GA just in the middle of Q1. But the interest is there, the usage is there when customers are up and running. And the promise is there, because the value is ultimately there for the customer.

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

Great. Very helpful. Thanks. And then, Tyler, I was just wondering if you could give us a little bit more color just on the sort of billings expectations and linearity throughout the year. Obviously, a solid quarter this quarter, it's going to drop off fairly meaningfully. And just wanted to get your sense for the linearity there and what gives you the confidence in the better billings outlook sort of later in the year. Thanks.

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

Sure. Yeah, of course. We said normalized billings for Q1, 17%, 14% as reported, and we said 12% for Q2. That's an as-reported number, and our expectation is that would normalize up. What happens is that Q2 of last year, we actually had a pretty decent amount of pull-ins from Q3. We always have pull-ins, like early renewals with expansion, and we kind of have an expectation about that, but it's a little bit unpredictable. And so, right now, 12% un-normalized, and we do expect a little bit of pull-in. But that one, again, we'll have much better view at the end of the quarter.

For the year, 16%, yeah, as the numbers fall out and we can see the billing schedules going out, that's what we expect for the year, in line with the guidance that we gave, which does assume there's going to be a little bit of acceleration, but we can already see some of that in the numbers.

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

Okay. Helpful. Thanks, guys. Appreciate it.

Operator: Our next question comes from the line of Ryan MacWilliams with Barclays.

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Q

Hey, guys. This is Eamon Coughlin on for Ryan MacWilliams. Thanks for taking the question. Great to hear about the 30% improvement in productivity from your customers leveraging Freddy AI. But curious if there were any other key takeaways post the Freddy Copilot becoming GA. Like, how has the process been converting those beta customers, which I think totaled around 2,500 customers in 3Q, to paying customers?

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

A

Yeah. Thanks for the question. It's Dennis. What's been interesting to see is that the conversion and the interest is across all customer segments, both small and large. So, we're seeing a surprising number of SMBs who are new to Freshworks coming in and signing up directly for AI from day one. So, they'll try the product for a limited period of time, they'll see the value, and they'll pay for it. And the pricing actually is holding up quite well. So, the SMB side, I think, has been surprisingly strong.

I think when you get into larger customers, different customers are at different points in their adoption phase. Some are leaning in and going all in from day one. Others want to really understand the data implications, security implications. There's a long review process that takes a bit longer. But every single customer wants to talk about it, which I think is the exciting part. And that gives us a lot to talk about at renewal with existing customers. And certainly, every new prospect that we talk to, AI is at the centerpiece of the pitch.

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Q

All right. Understood. And how does the trajectory for rev retention look like from here? Anything to call out from upsells, churn, or seat that's worth noting, maybe what's implied for the 105% to 106% guide for 2Q?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Nothing's implied there. I think what we're seeing there is very similar to what we saw in Q1. So, we said 106%, it came in at 106%. Churn, we said ticked up slightly, but not materially enough to round to anything. And we've already done a really, really good job at bringing down our gross churn over the past couple of years. The expansion motion, as we've talked about in the past, we're very, very focused on how we're expanding with our customers outside of agent addition. Agent addition is still the number one expansion motion for us, and a lot of that is organic. But as we've talked about, that rate has decreased over the last couple of years.

What we are seeing is that good pickup of some of our newer products. And then Freddy Copilot in particular, there is actually some good add-on business there, but nothing that is going to move the needle higher than 105%, 106% for Q2.

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Q

Got it. Thanks, guys.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

For the year, [ph] to add on (00:49:25) – yeah. For the year, we expect it to be roughly the same in that 106% range.

Eamon Coughlin
Analyst, Barclays Capital, Inc.

Q

Perfect. Thanks, Tyler. Appreciate it.

Operator: Our next question comes from the line of Dan Reagan with Canaccord Genuity.

Daniel Reagan
Analyst, Canaccord Genuity LLC

Q

Hey, guys. This is Dan Reagan on for DJ. First, I just wanted to ask if you could elaborate on the expected synergies from the Device42 acquisition. So, you've historically partnered with Device42 on large enterprise opportunities. So, I'm just wondering how you're thinking about the go-to-market synergies from here beyond what you've been seeing. And then, sort of how it positions Freshworks with your up-market ambitions? Maybe any nice cross-sell opportunities with its 800 customer base? Any color there would be awesome.

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

A

Thanks for the question. So, we see Device42 in a couple ways. First of all, we've been partnering with them for the last 18 months. So, we have a product integration that allows a ITSM customer to easily flip into the Device42 environment. We've been co-selling with them to large customers. We called out one of the customers last quarter was a large apparel retailer. Device42 was integral to that sale. I was in Europe earlier last week, and one of our larger customers we are now up-selling Device42 in.

And so, we know that the product works. We know that our customers, especially these larger customers, they want to buy ITSM alongside a sophisticated ITAM solution. And we've seen the product in action. So, we feel like we've derisked product market fit. They have 800 customers worldwide. Most of those customers do not use Freshservice as their ITSM. So, we see synergies in a couple different ways.

As those ITSMs come up for renewal, we will know that they're up for renewal. We'll be able to get in front of those decision-makers and make a pitch and win some business there. And then amongst our thousands of customers, most of them don't use an advanced ITAM solution from Device42. So, we'll have a programmatic approach to selling advanced ITAM into our existing base. So, I think those are two areas.

And we definitely see a need for more advanced capability than we currently have among larger customers. So, for us, it eases this move up-market. It puts us in a better position vis-à-vis ServiceNow and Atlassian in particular, which have more in-depth ITAM solutions than we did natively, which is why we pursued the acquisition.

Daniel Reagan
Analyst, Canaccord Genuity LLC

Q

Excellent. Super helpful. And then just one follow-up. With the transition of Girish to EC and Dennis assuming the CEO position, congrats there. You've already provided a bit of color on this, but could you dive a little bit deeper into any changes in strategic initiatives and operational focus? You're focused on the low end improving SMB conversion, that's been discussed. At the high end, you have momentum, but now a newer focus with opportunities around Device42. Any color there on initiatives and any changes would be awesome. Thank you.

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

A

Yeah. So, no changes from what we said before. Really focused on that SMB opportunity and getting that business back to healthy growth. Focused on continuing to drive up-market, which is primarily IT. Focused on the AI opportunity, which is across all of our products. Those are the things that are really driving our business now. And then, lastly, just focused on continuing our expansion motion, expansion, cross-sell, up-sell as we have more products, now we have Device42, that's another product that we can cross-sell into our existing base.

Daniel Reagan
Analyst, Canaccord Genuity LLC

Q

Excellent. Thank you.

Operator: Our next question comes from the line of Pat Walravens with Citizens JMP.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

Oh, great. Thank you. Dennis, it's actually – it's Pat Walravens. So, I would love to go back to the agent replacement conversation. And let me share a quick anecdote with you, and then I would love to hear how things might be different or similar for Freshworks. So, I spoke to a large company at another vendor that has a couple thousand agents. They're adding the AI option from this other vendor, and they'll reduce the number of agents by a lot, maybe even half. And so, I said, okay, great. So, your contract value is going to go down, right? And the answer was, oh, no, the total contract value is going up. This other vendor is already moving to consumption pricing, and they baked that in, and we really don't mind that much because we're saving so much on the labor that the marginal increase in the software costs is just a much smaller amount than the labor savings. So, does that dynamic work for Freshworks, or is there something different?

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

A

Hey, Pat, this is Girish. This is exact...

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

Okay, G. Thank you.

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

A

So, this is exactly the same dynamic, and we had already also explained it earlier. So, see, we all know that customer service automation is something that businesses want, and it's not today after Gen AI. It's been something that businesses want right from the day they started putting in IVRs and call centers, right? So, this has been a journey for us, and of course, Gen AI is accelerating that. And our Freddy Self Service is also built to capture and leverage that.

And as you clearly stated, for the customer, it's a win-win because by investing in technology, they're saving a lot more in terms of overall not having to hire so many people, and that translates into a better revenue realization potential for Freshworks also. That's exactly true.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

And so, are you able to increase the size of the contracts overall on the renewals?

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

A

Yes.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

Okay.

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

A

So, again, it's early days, but what you're describing is exactly what we're pursuing, and that's what you're talking about with respect to reduced agent count. Where that happens, we're basically replacing human costs with software costs. And so, our customers are on that exact same wavelength. Not all of them are looking to reduce staff. But for those who are, there's absolutely a business case to be made for spending more on the software. And remember, we have a consumption product. That's what Freddy Self Serve (sic) [Freddy Self Service] is. You pay by session, which is basically the equivalent of a ticket. And they understand that language. They understand how to monetize the ticket or what the ticket costs them. So, they're willing to pay on a consumption basis for avoiding that human interaction.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

All right. Great. Thank you both.

Operator: Our next question comes from the line of Elizabeth Porter with Morgan Stanley.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you so much. I wanted to ask a bit on more of a macro question. The macro headwinds deal hesitancy has been an impact really across software. So, I wanted to get your view on how conversations are trending with customers as it relates to just how long deals can be pushed off? And how does that balance with this rush to invest in AI and not wanting to be left behind? Kind of any sort of view on kind of when that pendulum and shift back to customers being more willing to engage in deals, would be super helpful for your view?

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

A

Well, as I said earlier, we're seeing two different trends. In the larger account space, which for us is in that 500-and-up cohort, we're seeing good momentum, we're seeing a lot of interest, we're seeing a lot of deals, and you're seeing that in our numbers overall. As our customer base continues to shift into larger relationships with us, higher ARPA, that tends to be on the IT side of the house, but not exclusively, because some of the deals that we talked about this quarter, like Stitch Fix, are customer support deals. It's SMB where, at least for us, we're seeing the kind of headwinds that you're talking about, the prolonged decision making, the no decision, et cetera.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Thanks. And then for the Device42 acquisition, kind of wondering if you could give us any sort of additional color on how the deal sizes might compare relative to your current ITSM deals, any sort of revenue or growth that we could think about as it relates to the asset that you're willing to share.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

I'll take the back part of that. So, as we mentioned, we've been a partner with Device42 for a while. We've actually been reselling their product, but it's really more on a limited basis. But we do know that it works with our customers, and it's integrated. We said at our Investor Day, we've got over 8,600 Freshservice customers paying us greater than $5,000 a year, and Device42 has about 800 customers. And of the 8,600, very few of them actually are using Device42. So, we think there's going to be great synergies there, and that's the purpose of this deal. We really think this is an investment in Freshservice, which that product has been doing really, really well and positioned really well.

But we also know that not having the capabilities of Device42 has made us less competitive in the upper enterprise. And so, our expectation is that this is going to fill that gap, that we know that there's deals that we've lost because we haven't had that. And so, our expectation is that this is going to be revenue accretive. We don't have the numbers yet to share. We'll do that after we close the deal. But we did say in the script that revenue accretive for the year, and also we think it's going to be cash flow neutral.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you.

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