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Freshworks, Inc. (FRSH)

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CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

MANAGEMENT DISCUSSION SECTION

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Great. Good morning, everyone. Thank you for joining us at the Morgan Stanley TMT Conference. My name is Elizabeth Porter. I'm an analyst on the US software equity research team. And I'm very pleased to have with us today Freshworks' CFO, Tyler Sloat; and President, Dennis Woodside.

Before we begin, for important disclosures, please see the Morgan Stanley Research Disclosure website at www.morganstanley.com/researchdisclosures. And we are going to take audience Q&A, so at the end, there will be some mics going around.

With that, Tyler, Dennis, thank you so much for joining us.

Unverified Participant

Thanks for having us.

Unverified Participant

Thanks for having us.

QUESTION AND ANSWER SECTION

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. So, before we dive into the business, Dennis, you joined Freshworks in September last year as president.

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

A

That's right.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

And some investors here may know you from your operational and leadership roles at Google, Dropbox, Impossible Foods, also from your board membership of ServiceNow. And I wanted to just understand a little bit more of what attracted you to Freshworks.

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

A

Yeah.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

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What was it about the opportunity and what really compelled you to join?

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

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Yeah. So, I got a call from one of our investors, Sameer Gandhi who also was an investor in Dropbox and who I'd gotten to know quite well. And he said, look, I'm involved with this company, Freshworks. We're in some very big markets and we have this massive opportunity. We need someone to help come in and really focus on scaling the business, in particular, scaling go-to market. So, he introduced me to Girish and I was just blown away by the vision, right? Girish's vision is to provide software that's simple, easy to use, good value for the customers across a very broad range of products, IT, CX, CRM. And when I dug in and started trying to understand the actual product set, I was pretty impressed with how far the product had matured. So, my kind of thesis coming in was here's a business that's doing very well in SMB, has a good product like growth motion which Dropbox had as well. And it has a real opportunity to migrate upmarket.

I think what's been a surprise for me coming in is how much progress the company had already made in starting to move into mid-market which we look at as about 250 employees to 5,000. How much progress had already been made before I got there in terms of product maturity and growth? And as we shared in Q4 about 60% of our growth or 60% of our business now is coming from that mid-market segment.

So, so far it's been really exciting to work with the team, to get to work with Girish, to get to work on our customers. I've been to India twice. I've been to Europe twice. I've probably spoken with over a hundred customers in that time and our customers love our products which really is where how you can build a great business.

Q

Great. I definitely want to dig back into that moving up market piece in just a bit but before we go there, as President, you have really broad responsibilities across the organization. And what are you seeing in the business in kind of the six months that you've been there and where are you spending your time?

A

Yeah. So, the way we're – the way we operate and Girish and I were two in a box so we're co-leading the company. Girish is focused more on technology and where are we taking the product over a multiyear course. I'm focused very much on how do we execute, how do we create a world class go to market organization, how do we grow the business here and now?

So, I spent more of my time on the go to market side. I've spent a little bit – quite a bit of my time bringing people in who I like to say who have seen growth and who have seen great. So, we move Patty into the CRO role. He's done an amazing job, recently brought on a leader who Shafiq Amarsi who was the head of sales op at Amazon for eight years.

So, he saw – or AWS. He saw AWS go from small to very large, saw great. So, bringing those kinds of people into the organization I think that's super important for us to scale. We've been spending quite a bit of time with Patty and our CMO, Stacey on how do we we create a very efficient path to market and path into this midmarket? And then spending quite a bit of time with Tyler on what's the plan for the year and how we're driving growth efficiently over the course of this year and next year.

Q

Great. And I'd love to touch a bit on the demand environment. In Q4, just despite a difficult macro, Freshworks was able to deliver a really strong quarter of new business. And you mentioned earlier about the product portfolio really focused on great value and total cost of ownership and time to value. So, can you just touch on, how has demand evolved in recent months and just initial observations for the demand environment into 2023?

A

Yeah. So, I think a couple of things have come together to lead to that result in Q4, where new business really was the driver of our growth. In many SaaS businesses, they're harvesting their existing customers and that's where they're getting their growth. We're actually continuing to get new growth. And the reason for that is our products have matured very rapidly over the last couple of years, both on the IT side and on the CX side.

On CX, we've added conversational capabilities. So, integration with WhatsApp and Apple Business messages to enable modern customer support interactions and created a unified – basically a unified customer record that allows a customer to take advantage of single-pane-of-glass interaction. On the IT side, we've added ITOM. We've added an employee service management capability to enable us to serve customers outside of IT. And that's all happened in the last 12 months. So, the products have matured tremendously.

At the same time, our customers are increasingly looking for value. And you have customers who've had deployments with, let's say, a service cloud or sales cloud or ServiceNow. They're coming up for renewal. They're asking themselves, am I getting the value out of this product that I need to? They're being pressed to reduce their budgets, or at least not grow their budgets. And they're looking for an alternative. So, that's where we tend to do quite well. So, we had – and in larger and larger customers. So, we had an example of, you know, Carrefour's Belgium division, 11,000 employees, very sophisticated IT department going with us for IT over one of larger competitors. Addison Lee was an IT customer, went with us for CRM over a very large incumbent because they like the fast time to value, the ease of use, and the lower overall TCO. So, that tends to be why we're winning in the market at a high level.

Q

Great. And when we think about the core customer base, you know, a lot of it has been more of the smaller businesses. But you mentioned kind of where your priority is is go to market kind of scaling must bigger into those larger customers. You noted the success with 60% of new business actually coming from more mid-market, larger customers. So, when you think about what are the tactical things that you're changing, what are the drivers of that improved up-market activity, what would you call out and how do you view the longer term customer targets for Freshworks and how that's evolving?

A

Yeah. So, we have an inbound motion and an outbound motion. So, we started as a pure product-led growth company that was entirely focused on SMB as a company that was built in India serving organizations around the world. That motion, it turns out works for large organizations as well as small organizations. So, the example of Carrefour Belgium, they actually started through a trial that their IT department signed up for online with no sales interaction whatsoever. So, they started, they get a little bit of an idea of the product. We, of course, see that data. Then we can engage. We can develop that into a bigger opportunity. We can develop that into a sale. So, for us, we have to continue taking advantage of that, I would say, secret sauce of, you know, marketing and product advantage of that, I would say secret sauce of marketing and product that drive inbound leads that we can then develop into outbound sales when the customer is big enough.

So some of the changes that we made, I think there was an opportunity to clarify that and to say, the field is really supposed to be doing deals that we can't get through that product-like growth motion and then closed deals that come in through that product-like growth motion. So we clarify that in part by changing the line between what our SMB team focuses on, which was previously companies with under 250 employees to move that up to 500. And then we've focused our field teams on very much hunting and growing, right? So in the past, reps would have responsibility for both. We need people to develop the art of new customer acquisition. And again, that's partly what benefited us in Q4, and the art of true cross-selling, upsell. And cross-sell is a big opportunity for us. Most of our expansion in the past has been natural seat additions that happened fairly organically. We haven't leaned into the motion of okay, you're a IT customer, you're a CX you – let me tell you about CX, let me get in touch with the buyer for CX software, when's your contract coming up, all that stuff. So we're leaning into that big time now and I'm optimistic about that being a source of driver – a source of growth for years to come.

I mean, you asked about what's the ideal customer kind of down the road, I think there's a huge opportunity in where we're focused right now, which is pretty much up to 5,000 employee companies, but then we have multiple opportunities in larger ones as well. But our – the bulk of our kind of go-to market motion is focused in that 0 to

5,000 employee company where the big the big incumbents really are not focused there. They don't serve them well. The products in many cases are overbuilt for what those customers need...

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Yeah.

A

...and we've got a great solution.

Q

And moving on to the competitive environment a little bit, one of the differentiation pieces for Freshworks has been that over 80% of head count is based in India. And how has that just allowed you to differentiate kind of your platform from like the cost perspective? And how easy would it be for another vendor to come in and replicate?

A

Well, I think – so I've been to Chennai twice now. I think if you were to visit us in Chennai, we have – that's our biggest office in India, 4,000 people. That's where nearly all of our development occurs. And I don't think any company can rep – first of all, I don't think any company can replicate that kind of culture of, hey, this is a place where you can grow your career from entry level software engineer all the way up to product manager and product leader. Many other companies have a center in India, but it tends to be more back office, and the leaders – the leadership of the product organizations tend to be in the US.

So, that's a huge advantage for us longer term. And what that's resulted in is this more rapid innovation cycle. Two years ago, you wouldn't say that we were a viable competitor to a ServiceNow, right? But now, in the mid-market, we absolutely are. And that's because the product has gotten better and better faster than it could have had we been reliant on, let's say, a US-based team with a much higher cost per engineer.

Q

And when I think about the product portfolio, it's mainly the three segments we talked about, the customer service, ITSM, kind of sales and marketing, CRM. And you highlighted that a ServiceNow would be a competitor there. But between all of those markets, it does get pretty crowded. So, can you just help us understand a little bit more of where does Freshworks' Freshservice for sales, who you are actually competing with most? And second, have you seen any changes to the competitive environment as Zendesk has gone private and there may just be less funding out there for some of those newer businesses?

A

Yeah. So, we compete in three broad spaces, as you mentioned, in IT, in CX, customer support, and then in CRM. The first two are by far the largest businesses that we have. On IT, at the high end, you've got ServiceNow.

You know, they are very much focused on the top 2,000, 2,000 largest companies in the world. That leaves quite a bit of space. You then have incumbent like on-prem providers like [indiscernible] 00:12:17 And there they're focused very much on maximizing their revenue per customer driving price up not so much on value. So, we're very confident of our competitive position there.

How has competition changed in that segment? We are having getting more swings at the bat in bigger deployments. And we're winning more of those deals than we have in the past. And that goes back to the product maturity, the product getting more mature, and then us having the right message right now, which is we're all about TCO. We're about faster time to implementation because the software is simpler and not needing to hire an army of consultants to get the product to work and deliver. So, our time to value is much faster. Our TCO tends to be half as much.

On the customer support side, we compete at the high end against Service Cloud. And then, to some degree, I would say they're more mid-market as well. And then there's a bunch of point solutions that are doing one of the many things that we do. They might be providing just bots to for – to answer queries and deflect queries. They might be providing just the conversational layer on top of a – but not ticketing, right. So, we provide a full stack solution from, you know, second level ticketing to the actual conversational platform where agents can exchange in texts, emails, phone calls. It doesn't matter. All that information comes into a single pane of glass for the rep. Where we win there is again total cost of ownership, ease of use, ease deployment and feature completeness.

is, again, total customer ownership, ease of use, ease of deployment and feature completeness. So, gladly, it does not have a second level ticketing solution, like a haptic for some of these spot players, they don't offer anything other than that. So, if you have a customer who wants to go stitch that together, they can it gets very expensive, takes a lot of time, or they can buy our product and we offer that kind of full feature functionality. And then, how is competition changed there? I think, similar dynamic. We're getting more swings of the bat in bigger deployments and we're seeing that kind of win rate kind of creep up over time which is positive for us.

And then, the last area that we compete in is sales and marketing automation and classic CRM. That product set is kind of where ITFM was a couple of years ago, right? So, we've got some investment to make, some maturity to make. Very well-suited for up to 1,000 employee companies. And that's where we're having success, that primarily SMB-led motion that's primarily product-led growth, inbound-led growth, that's not where our field sales is. It's 100% focus now. But we're still seeing wins. We're seeing companies like Addison Lee which were IT customers. They love the IT product. They love the value that they're getting out of it. And then, they had their sales force contract come up for renewal and they said, hey, we want something that's more flexible, lower cost, and also faster time to value and doesn't require us to hire these consultants every time we want to change the product. And so they've migrated to our CRM solutions. So, I think that's a big opportunity for us down the road, particularly with this large CX space and large ITSM space.

Elizabeth Porter Q
Analyst, Morgan Stanley & Co. LLC

Great. And another area that you've kind of moved into more recently is application for HR and legal with Freshworks as a team...

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That's right.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

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And so, that's an enterprise service management application for functions that are outside of what you typically had served. So, why was that a natural extension that are outside of what you typically had served. So, why was that a natural extension for the product? And what are some of the synergies of expanding from more employee facing function to customer facing function similar to what you did with Freshdesk and Freshservice? And should investors expect this type of portfolio expansion more going forward?

A

Yeah. I mean, we're very excited about the ESM end product. So, Freshservice for Teams. The reason we leaned into that product, we had customers already like thousands of customers already using our IT product to serve HR, legal, et cetera. It's a workflow engine so that generalized – generalizable workflow engine is very effective in these other departments. And the IT department typically is the one who's asked to create a solution for onboarding as an example or contract management.

So, we created a product that's specifically around business teams where the information in that team, the management of that team is separate from the IT team management. The administration is actually separate which you need if you want to serve the HR department. So, it's very much a case of us following our customers and then we've had some early customers like there was a customer I'm talking to Friday in Europe, technology player. They have 1,700 employees. They have a thousand licenses with us.

And that's because they're – we started with IT and their IT department found more and more uses and they wanted to unify on a single platform. So, that EMS motion for us we think is going to be pretty exciting over time. I think in terms of the other cross-sell opportunities, the decision makers are different but if you start with IT, IT is typically is influencing what you buy and CX on what you buy in sales and marketing if – even though they might not be the decision maker.

So, if we start in IT, we think there's opportunities on the CX side as well. Remember of our top 20 accounts, half of them have a CX and an IT deployment. And that just shows that and most of those accounts started in one or the other and grew pretty substantially over time. They typically start small and grow large. So what we need to do now is to lean into that motion more systematically than we have in the past. I think, in the past, has been much more opportunistic and getting back to kind of creating a world-class go-to market organization. That cross-sell motion is not how we've typically expanded in the past. It's been by organic seat addition. So we see that as a big opportunity this year.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

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Great. And, Tyler, I want to get you involved in some of the financial questions. So when I think about where you exited 2022, you had constant currency billings growth of nearly 30%. And when I look out for 2023 revenue growth, constant currency revenue growth is in the about 17% range. So can you help us unpack what's included in guidance in terms of expectations around macro kind of the retention from existing kind of customers and that new business piece?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

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Yeah, we started talking at the end of Q1 last year that we were starting to see some things happen in the macro and pressure on our expansion motion. And expansion was a pretty big driver of growth for us where we had kind of mid-teens net dollar retention kind of we went public and really there was some FX tailwinds to that so we said, hey, think of this as kind of this low-teens business.

As we came out through the year, the expansion motion did fall off. We saw that and we knew that was happening. At the same time, we kept churn where we had been making progress on churn. We kept churn kind of flat in Q3 and Q4. What that led to is obviously a decrease in our net dollar retention. But what we talked about in Q3 and Q4 and Q4 in particular that we had a record new business quarter in terms of new logo ACV.

We expect that expansion promotion to continue to see pressure. And we talked about net dollar retention coming down to about 105% is our expectation for Q1. And we think there could be additional pressure in Q2, hoping and thinking it could be a trough at that point.

But in terms of our guidance, we've built in what we see. We built in the fact that we think there's going to continue to be pressure on expansion. We are looking at other ways to expand with our customer base outside of agent additions, which is really Freshservice for teams is a good example. It's really the first add-on product of Freshservice. So, we're actively going engaged with our customer base. We're looking at specific cross-sell motions from Freshservice to Freshdesk where that – historically, they're different buyers and we haven't really focused on that. And so we are focused on that now.

But in terms of our growth, a lot of it's going to be driven on new logos. I mean, we're still expanding with customers and we'd look at our greater-than-$50,000 customer base, which is growing at a really healthy rate. The biggest factor of growth in that greater than $50,000 in Q4 was still expansion. That's customers landing at $30,000, $40,000, and then growing with us. And that's still continuous. It's just not at the pace that it has been in – prior to 2022.

Q

Yeah. And excluding some of the macro headwinds that we're seeing now, how do you view the normalized growth algorithm in a more normal environment, especially as some of these things, like the cross-sell motion and the moving up market, really start to play into the model?

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Yeah. And I think – if we're coming to 105 in Q1, we're still guiding to 17% growth and churn is relatively stable. If expansion comes back, we're mid-teens net dollar retention business. And if you add that to kind of what we think is normalized growth, specifically in the three markets that we play in which these are massive markets with well over $100 billion in TAM, that we don't see any reason why we can't get back to that kind of 30% sustainable growth rate. We just need to have it coupled with expansion along with new business.

A

I mean, just to add to that, the products that we sell every company in the world over let's say 20 employees needs, right? Every company has an IT department. They need to manage their queries coming in and any kind of crises and outages. And that's what our product does. Every company has a customer support team. Most do. We have a customer support team. They need technology to enable them.

They need things like AI and bots to deflect queries and drive customer satisfaction over time. And everybody while the sales force needs to automate it. So, that's the big opportunity for us long term. We're not in a nice to have product category. I think that's why we're continuing to win in new business. We're in a pretty much a must have product category and that, that benefits us greatly.

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Okay. I'll ask another question and then we'll open up for audience Q&A. On operating margin so Q4 was notably above expectation and you gave guidance for operating loss to reach breakeven and in Q3 and turn positive in Q4 later this upcoming year. So, what are the key levers to achieving this goal? And in a scenario where macro gets a little bit worse, do you have less incremental levers to pull to protect some of that profitability?

A

Yeah. I think we've demonstrated last year where we still be revenue based on the initial year guidance for the year. It wasn't an incredible beat, but we'd be on the bottom substantially on operating margin. And we were able to do that because we're actually hiring very rapidly. And we did slow down hiring. We did focus on efficiency as we saw things start to change.

Because we're hiring, we thought we've really built out a lot of infrastructure so definitely come in and we're really focused in Q4 and a lot of tweaks that we're making to the model coming into this year but they weren't like substantial changes there. We were able to look at the investments that we had. And now we feel like we've made all those investments and we don't have to incrementally invest that much more. And I think you'll see our head count not grow substantially as it has in the past.

What that's allowed us to do is we're still growing our top line and really drive efficiencies, and we're going to continue to do that. We think of it as kind of a three-step process. So, just get sustainably free cash flow positive. We said we're going to be free cash flow positive in Q4 and then for the entire 2023, with some nuance on the quarters which we detailed out. And so we feel like we've done that. We kind of all got to go do it.

Second was non-GAAP operating margin. And great profit there, and we said, hey, we expect to be there kind of by the end of the year. And then third is GAAP. And the thing about Freshworks is that it's always been in the DNA of the company to be efficient. It is one of our competitive advantage. And in fact, for fiscal 2021, we produced cash that year. And so we made large investments and now we're going to digest them. And I think we're actually in pretty good shape.

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Great. Do we have any audience questions?

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One in the back.

Q

One in the back.

Q

Given that the macro is in flux right now, both positive and negative, when you talk to your customers on the puts and takes and kind of their initial budgets, is this kind of a quarterly review when you talk to your clients on whether they increased budgets or further cut budgets, or is it a kind of a second half kind of review process? Kind of how fast is kind of the feedback loop? Thank you very much.

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Can we take that?

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Yeah, I can.

A

Yeah, you can go ahead.

A

Yeah. So, I think there's two aspects to that. So, for new business, what tends to happen is there is some event, triggering event that leads to an evaluation that leads to an opportunity for us. And that could be a contract expiring or a merger where you need to integrate a number of solutions. So, that's one sense.

And there that's a point in time where we have to get in and win that kind of a deal.

On the existing customer side, it really varies. Some of our contracts are – many of our contracts are annual contracts. So at the renewal is both is an opportunity to upsell or cross-sell. And then some of our contracts like our SMB business tends to be much shorter duration. And there you can buy our product monthly. You can buy our product on an annual basis as well. So, it just depends on what segment you're talking about and whether you're talking about a new opportunity or new customer or an existing customer.

A

I should add that our sales cycles are smaller than most enterprise businesses. The SMB sales cycle is less than 30 days, right. So, it's a trial-based process. Even on the mid-market enterprise, we're not talking about year long sales cycles or even six months. In most cases there within a quarter. And so when we look at that, you know, they are pretty rapid sales cycles. When we talk about macro though, we've always had the strategy of building incredible software at incredible value. And when times are more difficult, we actually see that there is potential advantage for us when we are going and competing and be able to provide a customer a great software and a great value and being able to price something that's much more expensive for them. And so we do lean in to that. And we are leaning into it now. The new customer logos, you know, as we mentioned, best new ACV quarter ever in Q4. When expansion comes back because it will come back, those are the customers that are going to expand. So, I'd much rather be growing right now through new lower growth than expansion growth because that will be additive in the future for us.

Q

Go ahead.

Q

Yeah. I guess you've touched on kind of the third step being GAAP profitability. I know it's a topic that's top of mind for a lot of investors and stock-based compensation expense.

software space, the stock based compensation expense. I think Freshworks in 2022 is running at about 42% of sales. I guess the question is how does the company think about stock-based compensation expense normalized levels? What that's going to look like in the future dilution to shareholders? And, yeah, just how they think about that and the timelines over which you've got profitability?

A

Yeah. And so we haven't detailed out the time. I know we have to do some work with the investor base to model out the SBC that we have, but also to do dilution. I can say we're very focused on dilution right now. We had said kind of what the public think of us as between 3% to 5% dilution every year. Clearly we're hiring fewer people, right? You have fewer grants to make.

And you know that is going to happen. Most of the stock-based comp that we have today is not like we can make it disappear. A lot of that is being driven by the grants were made before we went public that has a tail for years that we have to actually live with now. And so what we need to do is be able to model that out for everybody to be able to show.

I can't say we are very focused on it. We spent about $170 million last year doing net exercises of [ph] RSUs 00:28:44. So, those RCUs never enter the market is just over 9 million shares. We're going to continue to do that. We think it's going to be high teens in terms of dollar value every quarter this year and we think it's a good use of capital.

It's kind of – it's essentially almost like a buyback without being a buyback because those shares don't enter the market. And we are focused on doing things like that and focused on dilution and probably I think better than stock-based comp is more free cash flow per share for the outstanding shares we're going to be looking at.

Q

Great.

Q

Just a couple of questions. Good thing that 150 and what, mid-teens [ph] ACR 00:29:20. can you break that down between how much you expect from sort of seat expansions versus modules or sort of cross-sell into different products? And then on your net new, great to see the strength. How much is greenfield great to see that strength. How much is greenfield or product excel really tool replacement versus you're going to be replacing a more relevant competitor? Okay. Two big questions there. On a net dollar retention is really two sides to a coin, right? Churn and expansion.

On the churn side, we're pretty open about, we went public, we're low-20s as a company. We've got it up to high, high-teens. We got brought it down to high-teens. I said Q3 and Q4, it's stable. So, then the – you can do the math on if it's going to be 105 this quarter, how you get to that? I can say that we don't break out where the expansion is coming for, but by far the majority of our expansion today is agent addition or seat addition and so you can think about it that way. And again, we're focused on that cross-sell motion.

Do you want to answer second piece?

A

I didn't quite understand the second question.

A

Repeat it? Oh, yeah, yeah. But it's different by product, right? And so in the CRM Freshsales and Freshmarketer...

A

Greenfield. Yeah.

A

Typically greenfield. They could be doing using Excel or some of those solutions. In our CX solutions, that does sell from the SMB all the way up. As you get to that mid-market and up, they typically have something and we're competing against Zendesk and Salesforce in that market. And in Freshdesk, I'm sorry, Freshservice which is actually really great. You have – there's a lot of legacy in there still, and we think that's a huge opportunity for us. And legacy, the BMC Remedy advantage share all kind of tools that are there.

Unverified Participant

Great. That brings us on our time. Thank you so much for joining us today and sharing your insights.

Unverified Participant

Thank you.