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Freshworks, Inc. (FRSH)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

I will hand the call over to the Head of Investor Relations, Joon Huh. Please proceed.

Joon Huh

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

Thank you. Good afternoon, and welcome to Freshworks' second quarter 2024 earnings conference call. Joining me today are Dennis Woodside, Freshworks' Chief Executive Officer and 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 2024 performance and our financial outlook for our third 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 to improve operating efficiency. For a discussion of additional material risks and other important factors that could affect our results, please refer to today's earnings release, our most recently filed Form 10-K and our other periodic filings with the SEC. Freshworks assumes no obligation to update any forward-looking statements in order to reflect events or circumstances that may arise after the date of this call, except as required by law.

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

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

Dennis M. Woodside

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

Thanks, Joon, and thank you, everyone, for joining us on the call today. I'm pleased with our results this quarter, which demonstrated continued growth, financial discipline, and innovation. We are well positioned for the expansive opportunities that are in front of us.

In Q2, we delivered results that met or exceeded each of our previously provided financial estimates. We grew revenue to $174.1 million and delivered another quarter of strong free cash flow of $32.8 million, resulting in a free cash flow margin of 19%. This represents more than 600 basis points of year-over-year margin improvement and is reflective of our increasing operating leverage and discipline.

We also welcomed notable customers into the Freshworks' community, including Kayak, Davidson Kempner Capital Management, Paul Smith UK and many others. Lastly, we completed the strategic acquisition of Device42, which adds advanced ITAM capabilities to our Freshservice solution, in early June.

During my first quarter as our CEO, I spent extensive time in India with our product and engineering teams, digging into our product roadmap and upcoming anticipated innovations. I also met with customers, partners, and other key stakeholders in New York, Boston, Chennai and Bangalore, gathering feedback and better understanding what we do well and what we can do better. From those conversations, it's clear that customers are making buying decisions based on four criteria.

First, they want to automate workflows with AI to increase efficiency across IT, customer support, sales, marketing and beyond. Second, they want uncomplicated solutions that are simple to implement and to own. Third, they want to see rapid impact of their investments. And fourth, they want the flexibility of a platform they can modify and scale over time. Freshworks meets those needs.

In addition to these external meetings, we've conducted our annual strategic review of the business with our leadership team. This review has confirmed our belief that we have a significant opportunity right in front of us across multiple markets. And by focusing on three strategic imperatives, we will continue to drive durable, profitable growth for years to come.

The first imperative is that we play to one of our biggest strengths, IT and employee experience solutions, which includes ITSM, ITAM, IT operations, and ESM. Even without taking Device42 into account, this is our largest business group with over $340 million of ARR and over a 30% growth rate year over year.

Including Device42, we have over 17,000 IT customers with 670 customers spending more than $100,000 with us. More than two-thirds of our IT ARR is from the mid-market and enterprise segment. Our net dollar retention rates for this business exceed 110%, and we are seeing growth across the board for both small and large businesses.

To capture the expansive IT and employee experience opportunity, we intend to prioritize investments of product and engineering resources to these solutions. This will allow us to create richer ITSM capabilities for the enterprise, capture the ITAM opportunity with Device42, and expand our business with a focus on ESM and automated workflows as we build for business teams beyond IT.

For our IT and employee experience solutions, we continue to deepen our GTM capabilities to serve the mid-market and enterprise. We are now replacing incumbents whose companies were founded with a primary focus on the IT function for enterprise customers. In Q2 alone, we won 19 new and expansion deals of over $100,000 and we also saw a six-quarter high win rate in IT against our largest competitor.

Against our two largest competitors, we won deals with a major software player, a large California state agency, a major real estate company, and many more. We have momentum in the marketplace for customers wanting an enterprise-grade workflow solution for IT without the high cost and hassle they're seeing with our competitors.

In Q2, we saw continued momentum across all segments, including enterprise, mid-market, commercial, and SMB, as companies achieve high-value benefits without implementation and ownership complexities, while delivering rapid impact at a competitive price. Large industry-leading organizations like Nucor Steel, Carrefour, Bridgestone Tires, [ph] Weissman, Qualthon (00:08:01), and Riverbed Technology are using our employee experience software to digitize their work and enable productivity gains, leading to more efficient processes and happier employees.

For example, America's largest omnichannel specialty [ph] meet – (00:08:19) mattress retailer replaced their existing ITSM solution because the legacy software could not scale to meet their needs as they grew head count across several functions. We won this deal over one of our top competitors. Since going live with Freshservice, the company has seamlessly onboarded staff across departments and reduced workflow changes from months with the incumbent to a single day with Freshworks.

As another example, an iconic fashion retailer chose our Unified platform to manage all internal requests, approvals, and ticketing throughout the inventory planning, buying, and merchandising processes. Freshservice helped unify multiple inventory management and merchandising teams on a single centralized service management platform, reducing operational costs by 10%, improving gross margins, and yielding a 20% improvement in ticket resolution time.

Our third customer example is Creditsafe, the most used provider of business credit reports, serving 430 million businesses worldwide. A longtime Freshdesk customer, Creditsafe was seeking a modern ITSM solution that could easily integrate with their existing tools. They evaluated Freshservice against one of our top two competitors. Freshservice proved to be easier to use and more cost effective than the competition. The native integration with Freshdesk and our historically strong partnership made selecting Freshservice a natural choice for Creditsafe, as they more than doubled their account value with us.

These successes demonstrate that we have the opportunity to become the digital platform that enables mid-market and enterprise customers to compete at global scale.

On capturing the ITAM opportunity, Device42 provides a more comprehensive, up-to-date view of assets across an organization's entire IT infrastructure. We're excited about going to market with our joint solution as we see a lot of upside and strategic value from the acquisition.

We now have both the opportunity to upsell advanced ITAM capabilities into our existing Freshservice customers and the opportunity to cross-sell Freshworks' products into the Device42 customer base. With deeper enterprise capabilities, this also expands our addressable market, as we're now able to win deals in a broader group of large, mature companies.

Device42 is primarily an on-premise business today. So, our first goal is to deliver an improved seamless integration between Freshservice and Device42 by Q1 of next year. Second, we're working on turning Device42 into a cloud-native solution, which we anticipate could be ready by the end of next year. But we already see the great product market fit with larger customers that use both Device42 and Freshworks, like Kaiser Permanente, the State of Indiana, the University of Alberta, Hewlett Packard Enterprise, and HD Supply.

Let me share an example of how Freshservice plus Device42 is delivering value for our customers. A regional bank in the US, operating 230 branches, was looking for a long-term partner to support their IT needs cost effectively. We beat a large competitor and replaced the legacy incumbent based on our ability to provide visibility into assets and apps, which was a key priority in the highly regulated risk-averse industry. This bank chose a multi-product solution consisting of Freshservice, Freshchat, and Device42, based on the scalability and sophistication of the solution and time to value.

The final component of playing to our IT business strength is expanding the business by focusing on ESM and automated workflows. We are seeing strong demand for our enterprise service management offering of Freshservice for Business teams, which allows teams like HR, finance, and facilities to automate employee service delivery and benefit from the same uncomplicated solutions and rapid time to value as ITSM. We're seeing great traction in this category and expect that with continued focus on this area, it can be a meaningful contributor to ARR in the coming years.

Texas A&M, a top-ranked public university with world-class business, agriculture, and engineering programs, initially implemented Freshservice for IT Service Management. After seeing improvements in productivity and ticket resolution, they expanded Freshservice to include ESM, supporting both internal IT needs and external transit-related inquiries, which was particularly important during the football season when they needed to scale operations. Freshservice enabled Texas A&M to manage complex game-day logistics, supporting up to 150,000 visitors and handling over 600 tickets daily with a 30% faster resolution time.

Our second imperative is to build out our AI capabilities and bring them to market to thousands of customers. Customers are already seeing the value in the two Freddy AI products that are in the market today with Freddy Self Serve bots and Freddy Copilot. We are encouraged by the results we've seen since Freddy Copilot became generally available in mid-February.

In Q2, we saw significant momentum in adoption with now over 1,200 customers, as Copilot numbers for both customers and ARR nearly doubled from the prior quarter. We're seeing over 40% attach rates for new deals of $30,000 or more. Customers are seeing on average a 30% productivity lift with the help of Freddy Copilot. We have thousands of licenses from Freshservice customers with power users of Freddy Copilot seeing more than 40% improvement in average resolution time for IT incidents.

I'm pleased to say that we are monetizing ahead of our internal targets for Freddy Copilot as this thing is now a core part of every sales conversation. We are seeing customers like European travel company, Digitrips, choose Freshworks as a scalable foundation for end-to-end cloud operations. Using Freddy Copilot, they improved their response times to customer inquiries by nearly 300% even as ticket volume doubled during the same period.

Gen AI is rapidly transforming how agents and customers are leveraging technology in customer service. The world's largest operator of open-top sightseeing tours in 26 cities globally, serving 6 million tourists each year, recently transitioned to Customer Service Suite powered by Freddy Copilot, which has resulted in an improved agent satisfaction score by 12 points, with a nearly 20% reduction in resolution time for their customers.

Freddy Self Service for customer support continues to be another strong area of value for our customers. We're starting to see traction on customer adoption with over 900 customers for bot sessions, doubling from a year ago, and realizing an average deflection rate of around 40%. One example is Hinge Health, a virtual clinic that serves more than 200,000 patients. They chose Freshdesk with Freddy Copilot, Self Service and Insights for its all-in-one customer service solution.

Hinge Health started with eight seats and has since expanded to hundreds of seats on Freshdesk. With Freddy Self Service, they've increased their ticket-handling capacity by more than 30-fold, achieving an impressive 85% CSAT score and lowering their first-response time from hours to minutes. Today, we're focused on driving broad customer adoption and usage, so they can realize value from our AI products and we believe meaningful monetization will follow over time.

Our third imperative is to accelerate growth for our customer experience solutions, which includes our customer service and sales and marketing products. SMB and commercial companies continue to be the most significant consumers of these offerings, which make up approximately $350 million in ARR with a combined year-over-year ARR growth rate in the mid- to high-single digits as of the end of last quarter. To accelerate this growth, we are further simplifying the product experience to increase the ease of implementation and maintenance and improve time to value.

We are also streamlining our go-to-market processes to be more customer segment focused, including recruiting more partners that focus on the SMB and commercial space. Partners are driving meaningful growth for SMB and commercial new business today and we are optimistic about the added growth our new partners will deliver.

As mentioned previously, we are seeing increasing momentum for Freddy Copilot with our customer experience solutions. Among our SMB and commercial customers, we're achieving double-digit attach rates on new deals for Freddy Copilot. Leveraging the benefits of AI, our customers in all segments are able to deliver higher levels of customer satisfaction, while enjoying improved efficiencies. Customers like Total Expert and Ashley Furniture have invested and are realizing immediate value.

Another example is Canada's British Columbia Lottery, which selected Freshchat over our largest competitor to improve its customer experience. They chose Freshchat with Freddy Copilot for its easy-to-use interface that provides the team with analytics to help identify and solve challenges in the customer journey. Since implementing Freshchat with Freddy Copilot, British Columbia Lottery has seen an uptick to their customer experience scoring and an agent productivity increase of 20%.

In Q2, customers continued to expand usage across our customer experience solutions portfolio with multi-product adoption ticking up to 27%. One example is a global leader in the logistics and transportation industry who has been a Freshdesk customer for eight years. Recognizing the value that Freddy AI delivers, they expanded their usage to include Freddy Copilot and Freshchat to maximize their service delivery at an affordable cost, while simplifying their processes.

Overall, it's been a tremendous first quarter as CEO, and with our strategic priorities in place, we believe we are well positioned to seize this massive opportunity in front of us and accelerate growth. I'm excited to lead our company of 5,000 talented employees into the next phase of Freshworks' growth journey as we work towards delivering innovative solutions that customers want and scaling the business to $1 billion in revenue and beyond.

Now, I'll hand it over to Tyler to discuss the financial details.

Tyler Renwick Sloat

Chief Financial Officer, Freshworks, Inc.

Thanks, Dennis, and thanks to all of you joining on the call and via webcast. As Dennis mentioned earlier, we met or exceeded our key financial estimates in Q2, even without the Device42 results. Now, with the addition of Device42 as part of the Freshworks' family, we're excited to go after a broader set of customers in the mid-market and enterprise.

We are sharpening our strategic focus to lead with the IT and employee experience business, as we see strong customer demand and more attractive opportunities for this part of the business. We plan to fuel additional growth and better capitalize on the huge IT opportunity and other adjacent markets. At the same time, we're maintaining our focus to drive operational efficiencies that we expect will lead to durable and profitable growth in the business over time.

For our call today, I'll cover the Q2 2024 financial results, provide background on the key metrics, and close with our forward-looking commentary and expectations for Q3 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, we closed the Device42 acquisition on June 6, so our Q2 numbers include partial Device42 results for the quarter.

Where there is meaningful contribution from the acquisition, I will break out specific metrics on a one-time basis to help provide a better understanding into our business performance. 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 Q2 increased to $174.1 million, growing 20% for both as reported and on a constant currency basis. Professional services revenue contributed $2.5 million for the quarter, which was similar to Q1, as we continue to shift services revenue to our partner network.

Device42 revenue contribution was approximately $3 million, as we recognized revenue for the partial quarter. We closed large IT opportunities with the upmarket customers, and this, once again, drove the majority of our ARR growth. We saw meaningful strength for our new business in the US and won a number of competitive six-figure deals in the field.

Moving to margins, we maintained a strong non-GAAP gross margin of 85%, similar to Q1, as we remained diligent in efficiently scaling the business. This represents an improvement of nearly 100 basis points compared to the prior year.

Our non-GAAP operating income came in at $13.1 million, representing a non-GAAP operating margin of approximately 8% and ahead of prior expectations. Most of the outperformance was a result of certain expenses pushing out to the second half of the year and lower personnel-related costs. As a reminder, the Device42 results and associated transaction costs are included in these numbers, but these were not meaningful to the total operating results.

Moving to the operating metrics, our two key business metrics are net dollar retention and customers contributing more than $5,000 in ARR. From a macro and demand environment perspective, Q2 trends were generally similar to what we saw in Q1, as gross expansion continued to see pressure, while overall churn remained steady quarter-over-quarter.

Net dollar retention was 106% in the quarter, both as reported and on a constant currency basis and in line with our expectations. Looking forward, we estimated net dollar retention of approximately 105% for Q3, as we expect to see ongoing pressure on the expansion part of the business.

For our second key business metric of number of customers contributing more than $5,000 in ARR, this metric grew 14% year-over-year to 21,744 customers, representing quarterly net adds of nearly 1,200 customers, with 631 of these customers coming from Device42. This customer cohort now represents 90% of our ARR.

For our larger customer cohort contributing more than $50,000 in ARR, this cohort grew 30% year-over-year to 2,839 customers, representing quarterly net adds of 246, with 145 of these customers coming from Device42. This cohort now represents 50% of our ARR.

For total customers, we added approximately 1,300 net customers in the quarter and ended with over 68,800 customers, with just over half of the new customers coming from Device42. Excluding customers from the acquisition, we added approximately 600 net customers in the quarter, pointing to signs of improvement for customer adds compared to 400 in Q1.

Now, let's turn to calculated billings, balance sheet, and cash items. Our calculated billings grew 17% on an as-reported basis and on a constant currency basis to $185.9 million in Q2. Device42 billings contribution was $7.7 million for the quarter. So excluding the impact of Device42, calculated billings grew 12%.

Looking forward to Q3 2024, our initial estimate for calculated billings growth is 16%, which includes Device42 results. For the full year 2024, we expect calculated billings growth to be approximately 16%, with approximately 1 to 2 percentage points coming from Device42.

Moving to our cash items, our largest use of cash during the quarter was $214 million for the acquisition. We generated $32.8 million in free cash flow for Q2, outperforming our estimates as we continue to drive our operational efficiencies in the business. Given our strong cash flow performance again this quarter, we are increasing our full year 2024 estimates to $132.5 million, with approximately $32.5 million expected in Q3.

We continue to manage and offset share count dilution by net settling vested equity amounts by using approximately $15 million during the quarter. This activity is reflected in our financing activities and is excluded from free cash flow. As a result of these activities, we ended the quarter with cash, cash equivalents and marketable securities of $1 billion.

We plan to continue net settling vested equity amounts going forward, resulting in expected Q3 cash usage of approximately $13 million at current stock price levels. For the year, we expect to use approximately $63 million to net settled vested equity amounts. With our ongoing focus on operational efficiency and financial discipline, we expect to end the year with cash of well over $1 billion, maintaining a strong balance sheet and financial flexibility for the business.

Turning to our share count for Q2, we had approximately 328 million shares outstanding on a fully diluted basis as of June 30, 2024, representing a share reduction compared to the prior year. The fully diluted calculation consists of approximately 301 million shares outstanding, 24 million related to unvested RSUs and PRSUs, and nearly 3 million shares related to outstanding options.

Before providing our financial estimates for Q3 and full year 2024, let me provide background on how we're planning for Device42 results in our consolidated financials going forward. First, Device42 is primarily a term license business today, which creates less predictability for our reported revenue quarter-to-quarter. Second, we expect specific partner business involving competitors to decline and ultimately go away.

These factors may cause quarterly fluctuations to our total revenue, so we want to be prudent in our forecasting models. As we go forward, we will provide breakouts for metrics as required for disclosure or if they're meaningful to understand the underlying business fundamentals.

Now, on to the specific numbers for our forward-looking estimates. For the third quarter of 2024, we expect revenue to be in the range of $180 million to $183 million, growing 17% to 19% year-over-year; non-GAAP income from operations to be in the range of $13 million to $15 million; and non-GAAP net income per share to be in the range of $0.07 to $0.08, assuming weighted average shares outstanding of approximately 304.2 million shares.

For the full year 2024, we expect revenue to be in the range of $707 million to $713 million, growing 18.5% to 19.5% year-over-year. This includes estimates of approximately $11 million for Device42 for the year; non-GAAP income from operations to be in the range of $60 million to $66 million; and non-GAAP net income per share to be in the range of $0.32 to $0.34, assuming weighted average shares outstanding of approximately $306.4 million. Our forward-looking estimates are based on FX rates as of July 26, 2024, so any future currency moves are not factored in.

Let me close by saying that we believe we have the right strategy in place to capture the market opportunity in front of us and drive durable long-term growth at Freshworks. We are prioritizing investments to our business that we believe will position us for better execution in IT and employees experience. We remain focused on product innovation, delivering on our AI initiatives, and improving the growth of our customer-facing solutions to deliver scalable solutions for our customers. We look forward to updating you on our progress, and we're excited for what's ahead.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment for our first question, and it comes from the line of Brent Bracelin with Piper Sandler. Please proceed.

Brent A. Bracelin
Analyst, Piper Sandler & Co.

Q

Thank you. Good afternoon. Great to see the IT and employee experience business now the largest segment. Dennis, for you, I wanted to double-click into Freddy AI momentum. I think you talked about customer adoption nearly doubling sequentially. I know it's still early to see AI show up in the application layer, but it sounds like you're starting to see it. Can you just walk through what is driving that? We're getting a lot of questions on ROI around AI. Can you just help us understand why you're seeing strong adoption there? And then a quick follow-up for Tyler, if I could.

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

A

Sure. So, first of all, we are seeing tremendous interest amongst all of our customers in, at the very least, a discussion of AI and a trial of AI, and in particular, our Copilot product. So, we are finding all of our customers are comfortable with the idea that AI can make their agents more productive. And when they see the value of the AI suggesting answers to customers for deeply technical questions that often take time for agents to research and resolve, the agents don't have the answers at the tip of their tongue, they see the value.

So, typically, a customer will do a small deployment during an evaluation phase, and they'll measure the actual productivity impact in terms of response rate, customer satisfaction with the response. And they'll quantify what that does for overall productivity. That will lead them to have conviction about actually paying for our Copilot add-on. So, that's what's driving our growth there. And like I said, we're seeing attach rates around 40% for large deals. Those are deals for us over $30,000 a year.

Every conversation in a meaningful deal involves Copilot, and we're going back to all of our existing customers, and this is both on the CX and the IT side, and having that same conversation with our existing account. So, we launched our product a year ago in beta. We went through beta for about six months. We went into GA in mid-February, so we've only been selling for a quarter and a half, but I'm really pleased with how the teams performed in Q1. And I think that's going to be a driver of growth for some time to come.

Brent A. Bracelin
Analyst, Piper Sandler & Co.

Q

Very interesting color there. And then, Tyler, for you as a follow-up here, it looks like you added, what, 600 net new customers, ex-Device42. That's up from 400 last quarter. Can you talk through what drove the improvement there? Was it just sales productivity? Did you see a stronger close rate exiting the quarter? Just help us understand the uptick in net customer kind of lands here this quarter.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah. I mean, we were really pleased that we had a little bit of a turnaround on the customer side. It's still not to the levels that we saw a couple of years ago, but a little bit of top of funnel on the SMB side, some stabilization on churn, where churn had actually driven some of the lower customer numbers in the prior quarter. Again, it wasn't as much dollar churn, but really logo churn for really that long tail. And then, yeah, execution. But again, the SMB, there's a little bit of noise in there. [ph] We've got (00:33:50) the pressures we talked about in terms of overall SMB kind of macro pressure as well as expansion still persist, but we were really pleased in Q2 with that uptick on the customer number.

Brent A. Bracelin
Analyst, Piper Sandler & Co.

Q

[indiscernible] (00:34:02).

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Next question, please.

Operator: Yes, I'm sorry, I was muted, sir. It comes from the line of Pat Walravens with Citizens JMP. Please proceed.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

Oh, great. Thank you. And congratulations, Dennis, on the start to the first quarter as CEO. It's great. One of the big questions that investors have is just this whole tradeoff between seat-based pricing and consumption-based pricing as AI kicks in and increases the productivity of the agents. Can you just talk a little bit about what you learned over the last quarter or so about that?

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

A

Sure. So, I would start by saying a lot of our focus has been on Copilot, although Self Serve, we're seeing adoption grow there as well. And as I mentioned, we nearly doubled the number of customers that are paying for our Self Serve bots. The dynamics are quite different. For bots, of course, they're paying for bot packages, which is a consumption-like model. The more bot sessions that they buy, they're paying as-they-go, so to speak; whereas the Copilot is a per-seat adder. For both, we're not seeing meaningful changes in seat dynamics. In fact, we're seeing many customers are coming on board to us for the AI itself. But for existing customers that are adopting, we do not see meaningful changes in our overall seat counts, which is promising.

In some cases, customers are redeploying or freeing up time for agents to handle higher-order work, or work that is more complex, requires more of a human touch. And in other cases, we have some customers who are trying to move their support teams into more of a revenue center. So, they're adding tasks to the agents that are more about generating new business, not just addressing questions from existing accounts. So, I think it's still pretty early to see how this is going to play out. But for now, we haven't seen any change in the overall dynamics of our business.

Pat Walravens
Analyst, Citizens JMP Securities LLC

Q

That's super helpful, especially the part about the support teams moving to revenue centers is interesting. Thank you.

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

A

Thank you.

Operator: Thank you. One moment for our next question. And it's from the line of DJ Hynes with Canaccord Genuity. Please proceed.

David Hynes
Analyst, Canaccord Genuity LLC

Q

Hey, guys. I'll stick with the common thread here. Dennis, I guess based on the adoption trends and ROI efficiency you're driving with AI capabilities, do you feel like you've set Copilot and Self Service pricing in the right spot?

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

A

Yeah. So, I think we have better data right now on Copilot. On Copilot, we're very pleasantly surprised with how the pricing has held up. So, as a reminder, our Copilot [ph] edition (00:37:12) is $29 a seat per month. We're seeing really positive pricing for that product. And again, I would go back to the impact. The impact is very measurable through a beta test or through pre-post, through a holdout of agents that are and are not using Copilot. So, our customers are seeing the impact either during a trial pre-sale, or if they're an existing account, during a trial with a subset of their agents, and that's really driving the pricing.

They're seeing the value in the AI. And again, it's only been one full quarter, but that's quite promising for us. And we're leaning into it. The entire sales team, whether you're talking about field sales and selling into the larger accounts, or our teams in India that are working on our existing business or selling into smaller accounts, everybody is pitching in Copilot, and it's getting a really positive reception.

David Hynes
Analyst, Canaccord Genuity LLC

Q

Yeah, that's great. And then, Tyler, maybe a follow-up for you on the guidance. So if you got $3 million from Device42 in a month, that annualizes to about $21 million for the year. But the full-year guidance increase is about $10 million at the midpoint. So if my math is right, are you trimming the outlook for the core organic business, or is that more the cushion you're adding for less predictability that comes with Device42? If you could just talk through the dynamics in the guide, that would be helpful.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah. So, the $3 million for the month, it's not quite that clear, right, DJ, because they are a term license business and they are relatively back-end-loaded in terms of – because they're selling to larger customers. And so, depending on, say, if it's a one-, two-, three-year deal, could have a little bit more revenue, that $3 million doesn't actually equate to that many deals. And so, you can't take a linear assumption on that to get to your $21 million. We built in the $11 million.

We did say, hey, we do expect some of that business to see disruption, and a lot of it is because they had a decent amount of their business through partner channels that are with competitors. And so, naturally, we would expect some of that to go away and we'll clearly learn more about that business as we go through the back half. So, kind of in an eye of prudence, we built an $11 million for the whole year, inclusive of the three.

David Hynes
Analyst, Canaccord Genuity LLC

Q

Okay. Understood. Got it. Thank you, guys.

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

Scott Berg
Analyst, Needham & Co. LLC

Q

Hi, everyone. Thanks for taking my questions. I'm going to follow up on DJ's last question there, and not trying to get into the weeds on contract terms on this call necessarily, Tyler. But how much of the customer base of Device42 had multi-year contracts versus kind of singular, annual? I think a common question [ph] I was (00:40:06) trying to understand what that annualized number looks like in terms of consistency, in terms of how to view that business. Thank you.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah. We haven't broken out, [ph] contract, because (00:40:16) they do have a mix of, I would say, one-, two-, and three-year deals. And they also have a portion of – a pretty [ph] immaterial (00:40:25) amount of what we call periodic revenue, which is more usage-based. So, it's not actually under a full multi-year contract. Scott, as we learn more, because we're also – as customers come up for renewal, we'll have opportunities to craft those renewals in terms of the terms, right? And the real goal here, we outline kind of what the product roadmap is for Device42. The first is to build a really deep integration. But the second is to really move it to a pure cloud offering. And that will do away with the term license to get it back to pure subscription, but that's probably towards the end of next year. And so, we'll have to provide some color each quarter going forward if it is kind of a material impact one way or the other.

Scott Berg
Analyst, Needham & Co. LLC

Q

Got it. Helpful. And then a question for Dennis. I know you're looking to have this cloud version ready next year, I'm sure a more tightly integrated solution at that point next year as well. But when you think of the go-to-market there and the partner base that [ph] "42" (00:41:26) is using, you mentioned that some of your competitors, that partner dynamic probably dissipates over time. But does this help you potentially unlock more partner opportunities, whether that Device42 is using those channel partners exclusively by themselves, or maybe the combined opportunity is even more appealing to more partners out there?

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

A

Yeah, absolutely. And I think there's a couple different vectors that we're exploring. We have some partners that are already working with Freshworks that are familiar with Device42, because we've already been co-selling with them, but there's a number of partners that are not. So, introducing them to those partners, getting those partners to actively bring Device42 to deals is an opportunity. And then Device42 has built a partner-centric business, and a number of those partners are not as familiar with Freshworks. So, we're systematically going to all those partners and introducing ourselves, our offering, and trying to get earlier into the sales cycle, because typically in many of those deals, a customer is considering an ITSM right alongside an ITAM offering. And now, we can get in front of those deals that we weren't even seeing before.

So, a lot of the early work has been understanding the pipeline on both sides, partner pipeline as well as our self-generated pipeline, and then making sure that we are bringing Device42 into every possible opportunity that we have and vice versa.

Scott Berg
Analyst, Needham & Co. LLC

Q

Very helpful. Thank you.

Operator: Thank you. Our next question comes from the line of Ryan MacWilliams with Barclays. Please proceed.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Q

Hey, thanks for taking the question. Dennis, great to hear about your meetings with key stakeholders across the business, along with like the acceleration in ARR for Freddy Copilot in the quarter, has your priorities changed here at all from either product or go-to-market side, or anything now after the last quarter that you think you want to double down on from here?

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

A

Yeah. I think – as I stated in the remarks earlier, I think it's really about optimizing our investment profile and making sure we're investing where we see the greatest return. And as I outlined in the prepared remarks, the first imperative is to win in that IT and employee experience business. That's where we have really solid product market fit, a lot of momentum. Like I said, most wins we've ever had against our biggest competitor over the last six quarters in Q2, just seeing a lot of traction there and a lot of opportunities. So, areas like managed service providers or MSPs, we have hundreds of MSPs using our product today, but we don't have a real full-fledged MSP offering that would enable them to scale faster, manage their accounts much more effectively. So, we're going to go build that.

ITAM or ESM, we have an ESM product today that's doing really well, but it's not really deep. So if you think about like ESM for HR, there's a lot more we could be doing if we deepen our capabilities there. So, we're going to invest there. Now, we're going to do that by really optimizing within our existing resource profile. We've got well over 1,000 super-talented engineers. They're conversing and up to speed on how we develop products. So, making sure we've got the right balance across our products is super important for us.

I think the second big imperative is AI, because we spent the last year building out our AI offerings, deepening them, testing them, ensuring that the quality of results is high. Now, we're seeing it pay off and really putting the pedal to the metal on monetizing that AI opportunity, starting with Copilot, but we've got some exciting innovation coming around Freddy Self Serve as well that'll make deploying bots much easier towards the back half of this year. So, those are the two really big priorities that we're leaning into.

I think the customer experience products of CX and sales and marketing, that's more of an SMB-oriented product today, as you know. And potentially if SMB comes back, that business comes back. In the meantime, what we're trying to do is figure out how do we make those products work together better? So if I'm a CX customer, I can seamlessly upgrade or add a sales and marketing seat. Right now, that's harder than it needs to be. So, there's work to be done there, but those first two priorities are real here-and-now opportunities and we're really leaning into them.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Q

I appreciate that detail. And then, Tyler, two quick housekeeping questions on the net dollar retention rate. For the first quarter net dollar retention rate, was that inclusive of Device42?

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

For the first quarter, you mean...

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

A

Q2.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

...for Q2?

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

A

Yes.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Q

Q2, sorry. Yeah. So, what would that look like ex-Device42? Sorry.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

The impact wasn't super-significant. It helped slightly in Q2, but it wasn't off of what our expectations were, which we had set 105% to 106%.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Q

Perfect. And then on the 3Q guide, what's [ph] this one (00:46:37) that's influencing this? Is there something you've seen in July so far or there are changes in linearity throughout the second quarter that influence this guide? Thanks.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

So, not a lot of change in linearity. Our field business has become more and more back-end-loaded, which is as expected, and that's been happening for a while. And I think in terms of SMB and expansion, it's still kind of the same pressures that we've talked about for a long time now. And so, there's no significant changes.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.

Q

Appreciate it. Thanks, guys.

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

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you so much. I wanted to just follow up on the guidance questions. And excluding the benefit from Device42, it looks like the revenue and billings guidance suggests the back half outlook on core growth is a bit softer than the prior guide implied. So, it would be helpful to really understand where you're taking a more conservative view on the back half of the performance for the core business, even if it doesn't really sound like macro change too much from Q2 to Q1. Thank you.

Tyler Renwick Sloat
Chief Financial Officer, Freshworks, Inc.

A

Yeah. I mean, the prior guide was at $710 million. We built in an estimate of $11 million for all of Device42 for the year. We said that, hey, that business we expect to have disruption there, so that is an estimate. In terms of the $710 million at the midpoint, kind of minus $11 million, but $713 million at the high, it's really nothing significantly different. Right? We still see expansion pressures, and that is agent addition, which it has been, but primarily affecting our CX business, and still SMB pressures. Right? And these are the same kind of things we've been talking about for a little while. So, there hasn't been a dramatic change. We're adding a little bit of prudence into that number for the back half. But outside of that, there's no significant change [ph] was there (00:48:45).

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And then on the SMB side, understanding that's still a challenge from the macro perspective, you guys have been making a lot of investments just to modernize that inbound motion. So, any updates on the progress you're seeing there and when we could start to see those investments benefit the model?

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

A

Yeah, I think you did see a tick up in total customer growth, excluding Device42 of around 600 net adds compared to, I think, under 400 net adds in the prior quarter. And so, you're starting to see some impact, but I think we still need to continue to improve that experience for customers. And part of that is also making it more seamless to – if you're a customer of our support product to buy into sales and marketing or vice versa, and that's some of the things that we're working on. So, we did see some improvement. But again, we're continuing to find ways to make incremental changes to our process to drive greater conversion of leads into customers.

Elizabeth Porter
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you.

Operator: Thank you. Our next question comes from the line of Pinjalim Bora with JPMorgan. Please proceed.

Noah R. Herman
Analyst, JPMorgan Securities LLC
Q

Hey. this is Noah on for Pinjalim. Thanks for taking our questions. So, Dennis, in your remarks, you mentioned that you'll be streamlining the go-to-market at least for the customer experience and sales and marketing products, to be a little bit more customer segment focused. Just wanted to see if you could provide more color on that, and how long do you think some of these go-to-market initiatives would take, especially for those two segments?

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

Yeah. So for that specific change, the team – the way our model works, we market our products on a global basis and we have leads coming in by product. So, let's say a Freshdesk lead. That lead previously would go to a geographic-oriented or aligned sales team, North America or EMEA or Asia-Pac, and they weren't product aligned. And what we were finding is that our products are so different that the product depth really mattered a lot more than the regional specificity. So, we reoriented – and this is just for that inbound team, we reoriented that inbound team to be product-centric.

So, a Freshservice lead goes to a Freshservice team, regardless of geo, and Freshdesk to Freshdesk, regardless of geo. And our thinking is that that over time will drive greater specificity, greater expertise, and, ultimately, benefit in improved conversion rate in that inbound business, in particular. Those changes are finished. They've been made, and that's how we're going to market as of this quarter.

Noah R. Herman
Analyst, JPMorgan Securities LLC
Q

Great. And maybe for Tyler, just quick housekeeping, but I think last quarter you mentioned like [ph] was churn (00:52:01), I guess, was sort of in the mid-teens. I'm curious if there was any material change in Q2.

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

No, no material change. It's relatively stable.

Noah R. Herman
Analyst, JPMorgan Securities LLC
Q

Thank you.

Operator: Thank you. Our next question comes from the line of Brent Thill with Jefferies. Please proceed.

Luv Sodha
Analyst, Jefferies LLC
Q

Thank you. This is Luv Sodha on for Brent Thill. Thank you, Dennis and Tyler, for taking our questions. Maybe the first one for you, Dennis, if you could parse out maybe the customer experience side of the business, obviously it's underperformed over the past year. I guess, as you look at that business, could you talk about what the impact of AI has been in terms of seat degradation and how much of it is macro impact at this point?

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

Thanks for the question. So, we have not seen impact attributable to AI of seat degradation. In fact, we're seeing pretty strong attach rates both in SMB, which tends to be more [ph] CS customer rates (00:53:11) and to be more SMB, in new customers coming in and in our larger customers, and I'm talking specifically about Copilot, which is a net adder to expansion. What we're seeing is that the rate of seat addition over the last 18 months has come down as businesses are not expanding at the same rate. They're under pressure, because the cost of financing expansion is meaningfully higher.

But the reason that I have confidence that it's not AI driven is we look at customers that have and have not adopted AI, both Self Serve and Copilot, and we don't see material differences in expansion rate, churn rate, or retention rates between those who have and have not adopted. So, we don't think it's AI. We think it's continued macro pressure on the SMB. And that is more reflected in the CX business, because our business skews more SMB in CX.

Luv Sodha
Analyst, Jefferies LLC
Q

Got it. That's perfect. And then a quick follow-up for Tyler. Tyler, last quarter you'd obviously guided billings to about [ph] 15% (00:54:27), and this quarter now it's 16% with 1 or 2 points from Device42. I guess, could you just talk about the framework there in terms of the guide, what are you baking in in terms of expectations for billings growth in the back half of the year?

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

Yeah. I mean, we built in – we said 16% for the year, but we said 1% to 2% for coming from Device42. So, we do think that will impact. Again, the Device42 business is a little bit less predictable for us right now, as we just closed it, and we do expect some disruption, so we'll obviously update that at the end of Q3 based on what we're learning. But the billings growth, essentially we've taken into account everything we know on billing. And Luv, as you know, we don't think billings is a great metric, but we understand that it's important.

Luv Sodha
Analyst, Jefferies LLC
Q

Got it. Perfect. Thank you so much.

Operator: Thank you. Our next question comes from the line of Rob Oliver with Baird. Please proceed.

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

Great. Good afternoon. Thanks for taking my questions, guys. Dennis, on Device42, can you just talk a little bit about how you plan to go to market on that and just refresh us on is it rolling in – the plan to roll it in to the core Freshworks sales force? And then, I think – and I might have misheard you versus Tyler relative to when it will move to a cloud-native solution. I thought I heard you say Q1. And what are you guys assuming? Like, are customers going to be forced to move to the cloud-native solution at that point? Is there a potential for incremental churn? And I guess, a follow-up question to that is, do you have to wait until the cloud-native solution to fully integrate your two products? So, a lot there. I apologize, but thank you very much.

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

Yeah, let me just – so thanks. Let me just walk through again our plan for Device42 from a product standpoint. So, today, we have a lightweight integration between Freshservice and Device42. That allows an agent to switch from the Freshservice experience into Device42, if they have to or they want to understand the assets of the organization that they're working in. That said, it's not seamless and it comes across and feels like a different product experience.

The first product initiative that's underway right now is to create a better integration, a more seamless integration of the two products with D42 remaining on-prem and obviously Freshservice remaining in cloud. That's what is available early next year. The second product milestone is to create a cloud-native version of Device42, and that is a plan for the latter part of next year.

Now, in terms of migration and all the ins and outs, that we're going to have to work through, but that's the product plan. In terms of how we're going to market now, we've been going to market with Device42 as a partner for some time where we see a customer with an advanced IT footprint, a mix of lots of assets on-prem and in cloud that they want to track, and we've had success selling them into many deals.

Now, that we've acquired the company, it's just an accelerated version of that. So, we've gone through our entire pipeline of new business. And wherever there is a prospect that could possibly benefit from advanced ITAM, we are introducing and bringing Device42 in. When we have expansion opportunities, same thing. And then we're also looking at Device42's pipeline for any opportunities to bring Freshservice in, where they previously may not have considered us.

So, that's all underway right now. We've seen a couple of successes already. A large public university in Canada, with 15,000 faculty, took both Freshservice and Device42. We've got a lot of deals, where Device42 is part of the mix. And so, it's a great opportunity for us to upsell D42 into our existing base as well as bring them into new deals, and to bolster our overall position.

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

Great. Super helpful. Thanks guys, I appreciate it.

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

Yeah.

Operator: Thank you. And our last question comes from the line of Alex Zukin with Wolfe Research. Please proceed.

Ryan Krieger
Analyst, Wolfe Research LLC
Q

Hey, guys. This is Ryan Krieger on for Alex. Thanks for taking the question. Just going back to the Freddy Copilot and Freddy Self Service customer metrics you provided, are there any segments or verticals where you're seeing increased or slower rate of adoption? And then, on the NRR metrics, you talked about the macro being stable quarter-over-quarter, but you do expect to see further NRR compression in 3Q. So, any solutions where that's a particular drag on that metric? Thanks.

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

I'll take the net dollar retention, Ryan. Yeah, we haven't seen change or reversal in expansion pressure in SMB. And I think just the net dollar retention – a number kind of to 105%, which is not dramatically different than this quarter, is really just how the year-over-year numbers work on [ph] ARR (01:00:00) on what we can see. Every quarter, we kind of annualize the prior quarter so we have a little bit more data. And so, I don't think there's any big change we're expecting on net dollar retention. I think it's just the way the numbers are flowing.

Churn is relatively stable, and expansion is kind of where it is in terms of the pressures in terms of agent addition. That being said, the work we have to do is to figure out – number one, Device42, to use that as a new expansion motion and how quickly we can get that going; and then things like ESM, selling into our Freshservice space, that has got great traction, along with continuing to sell Copilot.

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

So on Copilot, the promising – another promising aspect of where Copilot is, is we're getting traction across our two largest products, both customer service and IT. So, agents in both categories are finding value in the product. And it's not limited to any one industry or segment of our customer base. We're seeing traction in small business as well as in larger businesses. We're seeing traction in customers that are brand new to us, buying right off of our website and deciding to add Copilot after trialing it for just a few weeks, as well as larger customers that are doing much more sophisticated testing.

So, we think it's going to – it is a core part of what we're selling now. We think that over time, every customer is going to benefit from what Copilot does for their agents, and that's going to be a big story for us over the course of the next year.

Ryan Krieger
Analyst, Wolfe Research LLC
Q

Great. Thank you.

Operator: And thank you. This concludes our Q&A session and conference for today. Thank you to all who participated. And you may now disconnect.