OVERVIEW:
None
Well, good morning, everybody. Thank you for joining us for day 1 of Baird’s Global Services -- Consumer Services Technology Conference. My name is Rob Oliver. I follow the SaaS sector here at Baird. And it’s my pleasure to have Ingo Friedrichowitz here with us. Ingo is here because David Barter is out of the weather CFO. So you’ve been entrusted to relief duty here. Apologies to everyone who is expecting David, but force majeure, but we’re very happy to have Ingo at the company. Ingo, thanks for joining us.

Ingo Friedrichowitz

Well, Rob, thank you so much for having us here. Very excited about the conference, looking very much forward to great meetings and a great chat this morning. Thanks so much for including us.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Great. The session is going to be interactive. You should have instructions to put questions here. There’ll be a break out after as well, but please send questions and we’ll try to get many as possible.

So New Relic is a turnaround story in the public markets and one where we’re seeing rising interest in marketing meetings from client calls. So let’s start there. It can take a while to change the narrative for companies that are turnaround stories. But let’s start with what you guys have done, which is a lot because I’ve done a lot of different things through this turnaround to get the company into the position where it is right now. Maybe just if you can step back and level set the room and talk about some of those major steps you’ve taken to get where you are right now.

Ingo Friedrichowitz

Yes, that’s a great start for this there. Really 3 transitions I would want to cover. One is on product, one is on go-to-market and one is on business model. And for those of you who have been on the Analyst Day last -- 2 weeks ago here in New York, there’s maybe a bit of a recap, but just to level set everyone on some items. So on the product transition, we started in 2008 as a cloud-only APM company where Lew Cirne, our founder was a pioneer in that space and in that category. And over time, we added more and more capability to our overall platform. And then the capability are all under one by user experience. So that customers can do everything within the context of each other.

So application performance context of what’s going on in the infrastructure, what’s going on with devices, what are the logs telling us of what’s going on? What’s really becoming the need to see things in context of all the different applications and IT environment elements. And so we re-pivoted from having multiple products like (technical difficulty) and create a single platform -- we call it the all-in-one observability platform that stores all the data from that IT environment in one place, gives you one API and one query language to analyze it. And then the capability are all under one by user experience. So that customers can do everything within the context of each other. At the same time, we transformed from not just the product, but we also moved everything from our own data centers to hyperscalers who would get true scalability of our product for our customers.
And now we are at a stage where GigaOm tells us that the overall technology from us (technical difficulty) leadership or we are seen as a leader by GigaOm, we are closest to the center of the GigaOm observability radar from back in February. We are also pretty efficient on the platform running at (technical difficulty) margin, gross margin that is, and it also helped us actually accelerate our innovation velocity. So we moved from one or so major release per year to 6 or more major releases. So that’s transition #1 from a single product to platform company all in the cloud (inaudible).

Second transformation was on the go-to-market side. We heard from our customers and know our audience, Bill Staples our CEO as a developer, that developers and engineers don’t enjoy to be Go To. They want to explore the product at their own pace, at their own velocity in order to [fall in love with it!] And that led us to create an additional motion in our go-to-market called product-led growth.

That is -- it starts with a free tier, where people can explore all the capabilities we have, all 30 capability platform, play with them, explore them, instrument their environment prior to using the product. They love it. They will ask their (technical difficulty) manager or the procurement department to buy it. And that’s been pretty -- has a good motion and velocity behind it as well. We have been adding more than 800 customers every quarter, [8] customers in the last year, have more than 40,000 free customers now. And altogether, I think we are probably the most ubiquitous used platform for customers (technical difficulty).

The thing I want to call out here is it’s not just customers that are small, there’s often a (technical difficulty) a small customer. We actually have a lot of large customers as well, Fortune 500, Fortune 1,000 and public sector named public sector customers and all coming from that product led [growth].

The third transition is on the business. Here, the challenge was that as I mentioned earlier, there was 2 proliferation with 5 or more tools that more than 75% of customers are using, customers need to buy all these different tools, go through a purchasing process, budgeting process separately. And that created complexity by itself. And we thought the consumption model here may help break down that barrier and allow customers to use all 30 capability, (technical difficulty) [simple meters], data users.

And now a couple of weeks ago, we were highlighting query as a [meter] as well to (technical difficulty). We love the consumption model because we think it’s a better aligned with the value that customers are getting from our product. That growth (technical difficulty) out of transition and transformation as well. And we are now at a stage where last quarter, 84% of our revenue are now in consumption. We’ll have 16% to go. So our work is cut out for the next 4 to 6 quarters to transition that as well, but we think it’s with (technical difficulty). So yes, so netting it out 3 major transitions, all very fundamental to the company, if you will, while still running the company, but we think it sets us up for profitable growth.

QUESTIONS AND ANSWERS

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Great. Great. So a lot to dive into there, but I want to talk first about the Analyst Day since it’s so fresh in people’s minds that was just here in New York a couple of weeks ago. You guys set some long-term targets there of 20% to 25% revenue growth and 20% to 25% margin growth. I guess first question is, can you help maybe give us a better sense of what constitutes long term for you guys? And then what are some of the key assumptions that were sort of implicit in those targets?

Ingo Friedrichowitz

Yes. So let me break it out maybe into -- as you do into growth and profitability. So growth, we -- I want to point towards the consumption growth because that’s really (technical difficulty) for New Relic. And the consumption revenue growth in the past has been in excess of 30% in last couple of years, excluding the impact of any migration from the subscription.

This fiscal year, FY ’24, we had indicated it to be at around 20% plus or minus a few for consumption revenue growth, excluding migration. And so as our consumption revenue continues to grow and subscription revenue continues to step down. So by the middle of next year, we should be a
pure consumption business. And then the revenue growth of the company is aligned with consumption revenue growth. So once we are through the transition (technical difficulty) out as well, we are then targeting consumption revenue growth that is strong.

The second part on profitability here is that we moved from negative from loss-making a few years ago to profit in FY '23. We're guiding now to 14% to 15% of this year and especially in the second half, we expect to exit the second half or be in the second half at around mid-teen, high-teen profitability. So a major, major trend (technical difficulty) of profitability really has become a strength of the company. So adding these 2 together, growth and increased profitability, we think we're well on our path to achieve those goals. First hurdle will be really a rule of 40. So revenue growth plus operating margin profitability (technical difficulty)

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

On the consumption side, you guys have had a lot of success with that transition to date. You set out some -- at least what seem to people in the room to be some fairly aggressive concrete targets about sort of getting end of life of subscription. And that's the next 4 to 6 quarters. I guess, what gave you the confidence that, that was the right approach to take. I mean presumably, you guys have had a lot of strong enterprise relationships for a long time, presumably some of those folks are on subscription. And while your software is sticky, durability is a competitive space. So what gave you the comfort that, that's the right time frame and the right approach to be that [aggressive]?

Ingo Friedrichowitz

Yes. Well, first of all, we -- as we looked at the expiration of the remaining contracts of our largest customers, we saw that they are expiring in the next 4 to 6 quarters. So there is a compelling event to engage with the customer on the discussion to move consumption. And if we're engaging with them anyways, we thought why not engage all the way, thus the integration to a consumption contract. If you remind, they're already on the technology platform, [new] technology platform.

So it's only "only" the migration of the contract. We've been putting together incentives for these customers in order to make it easier for them to switch over. And we now have probably 2.5 years of experience under our belt in these migrations.

So we thought this is sort of the right time given this compelling event to do that. There's also a benefit for us at the end of all this, we think running one business, the consumption business is more profitable than running 2 businesses, consumption and subscription business. And we incentivized (technical difficulty) customer consumption model. We also think it creates more value for our customer, the mature pricing model as well as the backup shelf where with the consumption model (technical difficulty)

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

When you guys issued your full year guidance, David, sort of went out of the way. And I think underscore the point at the Analyst Day that you guys assumed probably a higher level of churn going into this period, just in case there were customers that did churn off of that. Can you talk a little bit about how you guys got to those assumptions and where -- how you felt you landed at something that felt like it was something you can achieve because there's got to be some uncertainty around that, what customers will do.

Ingo Friedrichowitz

Yes. Yes, for sure. And we -- the way we think about the customers is really like a pyramid, as Dave offered. The top 100 to 200 drives the majority of the revenue. And then you've got 2 tiers below that, a couple of thousand at the middle tier, a couple of thousand at the bottom tier. In terms of revenue, we offered on the call that there would be -- sorry, we've seen in Q4 a subscription revenue decline, excluding migrations of minus 8%. And we think we've modeled for the guidance that, that may double this year as we go through that final inning of transformation to the consumption model.
In terms of customer count churn, we may see higher numbers given that probably the bottom tier of that customer pyramid may be better served through a free tier, which we then have the opportunity to nurture again and drive to be copay customers at the end of the day. So we think we have a middle of the fairway estimate here baked in, in terms of the churn. Obviously, we don't like churns, so we'll work hard to avoid as much as possible. But right now, this is our best guess of what's going to happen.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. So we follow a handful of product-led growth companies and some of them have free tiers and some of them don't, some of them have free trials. So you guys are contemplating maybe at that low end that some of that churn will be churned to you. Is that correct?

Ingo Friedrichowitz

Correct, yes. Exactly.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Okay. Great. Questions are already rolling in, and please send some more, and I'm going to try to get to a few of them, and there's a break out afterwards. So you'll have an opportunity to ask more. I just wanted to step back as one of the first questions we get from investors when we talk about New Relic (inaudible) stated is just how competitive this space is. And I was hoping, Ingo, you can frame this for us the way you guys think about it. Because on the one hand, it seems like observability is a very competitive area. We all know a lot of vendors. On the other, it seems like it's an area that seems to be one of the more rapid growers within the software sector. So can you maybe touch on how you guys view the competitive environment? And maybe what is differentiated about New Relic within that?

Ingo Friedrichowitz

Yes, absolutely. So the market itself is actually really exciting. The -- I know everybody talks about the competitiveness. But if you think about the secular growth that sits in the observability market, it's mind blowing in my mind. It's driven by public cloud growth and public cloud migration growth. I think one of the analysts estimate that there will be public cloud spend in the order of magnitude of $2.5 trillion in the next decade. So at 17% CAGR. That's a massive growth that's going to happen.

Digital transformations fuel observability growth. There's more than $2 trillion spent on that category alone. And then complexity is constantly increasing with new applications, even Gen AI based applications now coming in and the IT environments become bigger and more complex and require a more sophisticated way of doing observability.

So we think the market itself is growing really well and fueled by secular drivers. And we think there is enough space for multiple vendors in that market. It's not a winner-takes-all market. And the way we are positioned here is truly along those 3 dimensions of transformation that I mentioned earlier. One, it is highly scalable, all-in-one single data store platform that allows people to analyze and see everything in context of each other. And that's -- as GigaOm called out, we're leaders in that space. The go-to-market motion that's efficient from a cost perspective, still getting us very strong industry-leading customer gains here. And then thirdly, the consumption model, which we think is very compelling, especially in times like this, where the economy is a little bit uncertain that customers are getting better -- the best value for their investment.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. Let's talk about some of the other areas within observability that seem to be contested like AI Ops and security, AI Ops, -- maybe talk a little bit about the differentiated value that New Relic brings to the market in AI Ops. I know PagerDuty is going after that market. You've got big (inaudible) private companies that are also going after that market and talk about your approach to that.
Ingo Friedrichowitz

Yes. I think on AI Ops, one of the great innovations that’s coming down the pipe is the generative AI capabilities. And we have -- we sort of think about that in 2 angles or 2 use cases. One is the obvious one, which is more and more applications require generative AI or have generative AI included. We came out back in March with a capability to actually observe Gen AI based applications as well. But more specifically to AI ops, which is the capability of the observability stack, we have announced Grok a couple of weeks ago. And here, really, the concept and the idea is to make it easier for any engineer to use an observability platform. It breaks down complexity and barriers for more and more people to use the observability capabilities.

If you have a moment to take a look at the demo we shared at the Analyst Day, it might be interesting to see that visualized. But at the same time, it’s also a way of getting not just more usage of the platform, but also make it faster to resolve problems given the capabilities that generate of AI as part of Grok can really help there.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

And part of what -- as a New England Patriots fan, I keep calling it Gronk. So I’m sorry. But -- so part of what Grok sort of, I think, wowed people in the demo at the Analyst Day, but I think more importantly, at FutureStack the day before, was around getting down to the developer level around some of the capabilities down there about solving some development problems even before they can arise. Maybe talk a little bit about what you saw in the demo or what you guys are doing there?

Ingo Friedrichowitz

Yes. Yes. So the demo was doing really 2 things. One, taking natural language like English to convert that into instrumenting more and more capabilities within the IT environment to be observed. And so that helps customers to get faster ramped in their observability journey. Two, once in the scenario of finding issues and fixing issues, a developer can now use Grok, which is also integrated with our CodeStream capability to help suggest like how to fix the issue that got surfaced by the Observability tool.

And maybe to call out here is the one unique thing of New Relic is based on an acquisition we did a couple of years ago called CodeStream. We actually are able to surface issues from observability in the IDE -- in the developer environment that developers are using. Visual studio, Eclipse, you name it. And that’s a unique capability because ultimately, everything gets fixed by the developer through the code. And that would need to -- and making that faster, that surfacing of issues and resolving those issues, whether that’s through Grok or through the actual developer is a big value that customers see in the New Relic platform.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. A few questions coming in from the audience. So thank you. One on consumption-based pricing. There’s been a fair amount of variability in the reported results of companies that have consumption-based pricing. Clearly, good for the customers, but can you give us a sense of why it’s good for New Relic and why it’s good for investors?

Ingo Friedrichowitz

Yes. Yes. So I get that a lot around predictability. We can forecast our consumption based on how we see customers using the product. And so we think it is forecastable pretty clearly. Now are there more variants based on the economic environment? Yes, but it’s still predictable and forecastable from our perspective. We think that trade-off is reasonable because it does create longer-term relationships and deeper relationships with our customers, given the lack of shelf or given the better alignment with value overall.
And it's not a new model. I mean successful companies, AWS, Azure, Snowflake, all high-caliber companies or businesses have been using the consumption model for many years and have been, I believe, appreciated by investors too.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. Great. Another question that came in was about -- you mentioned query-based pricing earlier that you guys talked about at the Analyst Day that you're sort of in a pilot, I think, now with that. Can you talk a little bit about what early feedback has been on that and what your ultimate plans might be there?

Ingo Friedrichowitz

Yes, sure. Yes, Early feedback has been encouraging because that's what we thought it would do. It would enable more users to query the data and use the data that we provide in our observability platform. And some of the customers have been now expanding the users because of that. And so it would have the potential to break down barriers of usage across the organization. And so we're encouraged by that early feedback. We'll need to digest it and analyze it and see what that truly means for our business and how we go to market with that.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. Great. I still have time for a couple of questions if you want to send them in. I asked this question at the Analyst Day, too, and I'd love to go to hear your take, but it seems like historically, like you had Splunk that was really good logs and New Relic that was really good at APM and you had a data dog that was really good at infrastructure and (inaudible) a bunch of things. And then it seems like it's moving from the sort of best of breed to suite market with this single pane of glass on observability.

But for you guys in consumption, how do you -- what constitutes success? Like how do you know that your customers are -- how do you drive your customers to use the AI ops and infrastructure and other elements of that platform? Because at the end of the day, big companies are often running you guys side-by-side with other vendors and not putting their eggs all in one basket. So how do you drive that consumption of those use cases or what do you guys call them capabilities -- does that internally weren't necessarily viewed as the New Relic Spring? How do you drive that?

Ingo Friedrichowitz

Yes. That's a great question. So I agree with you. We've moved from a best-of-breed market to a suite all-in-one platform market based on customer needs to bring all these capabilities together and see them -- see applications in the context of infra and logs and all the other parts of the IT environment.

Now we have a few angles here on how we help customers discover these additional capabilities. One is through our product-led growth motion where within the product, it's instrumented to see like check this out or try this in order to see what else is possible. We also have Mark Dodd's team and the sales-led growth motion, our CRO, who has a framework that he engages with customers to show them what's possible with our platform. And that has led to some great expansion examples that he shared at Analyst Day a couple of weeks ago of customers, driving more capability usage beyond APM to infra, logs, CodeStream, mobile browser, you name it, as well as helping customers conduct their digital transformations, go through the cloud migrations that they're planning to.

So it's a 2-angle approach that we help customers in order to grow beyond what they are using right now. That's why I'm so excited about the foundation of customers. We've got more than 57,000 customers paid and free, and that's a well we can go into in order to drive more growth in the future. We shared, I think, a couple of weeks ago that our existing customer base itself could generate up to $3 billion of revenue if we were to get them to their full potential.
Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Got it. We have time for one more question. And I had a bunch of financial questions teed up for Dave and you’ve had to fill in for him in a pinch, which we really appreciate, and this is [reverse] fireside. So I really appreciate it. It’s going great.

But I’ll ask one on profitability because, I mean, it’s been a tremendous success story in terms of you guys were a very unprofitable company for a while. And in a couple of year period, you ramped to a guide of 14% to 15% margin for this fiscal year. Clearly, you saw a lot you could leverage you can pull, model change, go to market, a lot of efficiencies. What’s driving those increased margin efficiencies and confidence over the next couple of years? What gives you the comfort? And what are the levers you can pull then?

Ingo Friedrichowitz

Yes. Yes. So maybe let me step through the P&L to answer that. So on gross margin, we are currently last quarter at 79%. We think in the long-term model, we can get to 80% to 82%. In fact, our AWS instance itself is already operating at an 80% level. We think we can still invest a little bit here while we scale down our own data centers and move continue to hyperscalers, we are planning to add more geographic footprint on hyperscalers in order to address more customer needs.

Going further down in the P&L on sales and marketing. We have, I think, in the last 5 quarters, had more than 8 points of improvement on expense as a percent of revenue, again, helped by the product-led growth motion but also by an efficient allocation of the resources that we have. And we continue to make progress here in terms of sales efficiency. And then last but not least, on G&A, we restructured part of our real estate portfolio to reflect the reality of hybrid work. and that should trickle through in terms of our efficiency there as well. So multiple levers to pull in order to drive more profitability.

Robert Cooney Oliver - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Great. A lot of exciting things going on in New Relic. I’d like to thank everybody for joining us today. And Ingo Friedrichowitz, thank you very much for joining us. Really appreciate it. And up next in this room will be exponential fitness. Thanks very much.

Ingo Friedrichowitz

Thank you so much for having us.