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Atlassian Corp. (TEAM)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and thank you for joining Atlassian's Earnings Conference Call for the Fourth Quarter of Fiscal Year 2023. As a reminder, this conference call is being recorded and will be available for replay from the Investor Relations section of Atlassian's website following this call.

I will now hand the call over to Martin Lam, Atlassian's Head of Investor Relation.

Martin Lam

Head-Investor Relations, Atlassian Corp.

Welcome to Atlassian's fourth quarter of fiscal year 2023 earnings call. Thank you for joining us today. Joining me on the call today, we have Atlassian's Co-Founders and Co-CEOs, Scott Farquhar and Mike Cannon-Brookes; our Chief Revenue Officer, Cameron Deatsch; and Chief Financial Officer, Joe Binz.

Earlier today, we published a shareholder letter and press release with our financial results and commentary for our third quarter of fiscal year 2023. The shareholder letter is available on Atlassian's Work Life blog and the Investor Relations section of our website, where you will also find other earnings related materials, including the earnings press release and supplemental investor datasheet.

As always, our shareholder letter contains management's insights and commentary for the quarter. So, during the call today, we'll have brief opening remarks and then focus our time on Q&A.

This call will include forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and assumptions. If any such risks or uncertainties materialize or if any of the assumptions prove incorrect, our results could differ materially from the results expressed or implied by the forward-looking statements we make. You should not rely upon forward-looking statements as predictions of future events. Forward-looking statements represent our management's beliefs and assumptions only as of the date such statements are made and we undertake no obligation to update or revise such statements should they change or cease to be current.

Further information on these and other factors that could affect our financial results is included in filings we make with the Securities and Exchange Commission from time to time, including the section titled Risk Factors in our most recently filed annual and quarterly reports.

During the call today, we will also discuss non-GAAP financial measures. These non-GAAP financial measures are in addition to and are not a substitute for or superior to measures of financial performance prepared in accordance with GAAP. The reconciliation between GAAP and non-GAAP financial measures is available in our shareholder letter, earnings release and investor datasheet on the IR website.

Please keep in mind that we'd like to allow as many of you to participate in Q&A as possible. To facilitate that, we'll take one question at a time. Please rejoin the queue if you have another question or a follow-up, and we'll do our best to come back to you later in the session.

With that, I'll turn the call over to Mike for opening remarks.

Michael Cannon-Brookes
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

Thank you all for joining us today. As you've already read in our shareholder letter, we delivered a strong quarter financial results. We closed out FY 2023 with great momentum in cloud migrations, in enterprise and across all our three markets. We generated over $3.5 billion in revenue this year and over 250,000 customers now power their collaboration on our world-class cloud platform. Amidst a challenging year, we're extremely proud of all that we've accomplished. We said we'd play offense in FY 2023, and that's exactly what we did. We migrated millions of users to our world-class cloud platform. We built game-changing innovations such as Atlassian Intelligence, launching new products like Jira Product Discovery, delivered increased scale on our cloud platform and unlocked data residency in new locations like Germany and Singapore for our global customer base.

Working deeply with our customers, we're more and more excited about the value Atlassian Intelligence will deliver by leveraging the latest advancements in large language models combined with each customer's unique data and our world-class cloud platform with our two decades of data-driven insights into how teams work, we'll be able to further unleash each of our customer's potential across all our three markets. Today we're seeing our bets pay off and that's strengthening our conviction in our strategy. As we enter FY 2024, we're eager to get after those large opportunities and believe we're well-positioned to come out of the year even stronger.

With that, I'll pass the call to the operator for Q&A.

QUESTION AND ANSWER SECTION

Operator: We will now begin our question-and-answer session. [Operator Instructions] Your first question comes from Michael Turrin from Wells Fargo Securities. Please go ahead.

Michael Turrin
Analyst, Wells Fargo Securities LLC

Q

Hey. Great. Thanks. Appreciate you taking the question. Joe, given it's your first full year guide, maybe you can start by walking us through the process there, the visibility into and confidence in framing those cloud targets for fiscal 2024. And there's some commentary in the letter just around the proportions you're expecting between data center and cloud and just some details in there I think it's useful to bring to the front of the call. So anything on just the signals you're watching and how the end-of-life event is taken into account, all very useful. Thanks.

Joe Binz
Chief Financial Officer, Atlassian Corp.

A

Great. Thanks for the question. I think I'd just start with our cloud revenue guide of 25% to 30%. That assumes the macro headwinds in FY 2023 persist into FY 2024 and that migrations from server and data center will continue to be strong contributors to cloud growth, approximately 10 points. So we do expect the momentum that we've seen in 2023 on that front to continue. The low end of our cloud guidance range assumes continued macro weakness throughout FY 2024, as well as some macro impact areas that have held up really well in FY 2023, like churn, upsell and migrations. Finally, we do expect cloud revenue growth rates to gradually improve throughout the year, driven by the easier prior-year comparables that we have in the second half of the year.

Now, you mentioned data center. In terms of data center, we do expect decelerating revenue growth rates in FY 2024 driven by a few things. First and foremost, lower migration from server following the server end of support.

We do expect greater migrations from data center to cloud as we remove migration blockers and enhance our cloud offering. And then of course, data center has difficult prior-year comparables in the second half of the year.

And then finally, we expect a steep decrease in our server revenue up to end of support in February 2024, at which point we'll no longer recognize any further revenue. So that's a general outline of how we're thinking about that for next year.

Operator: Your next question comes from Keith Weiss from Morgan Stanley. Please go ahead.

Sanjit K. Singh
Analyst, Morgan Stanley & Co. LLC

Q

Thank you for taking the questions. This is Sanjit Singh for Keith. One of the challenges of the last couple quarters is really the – this free-to-paid conversation, the letter suggests that was still sort of an impact again, this quarter. As we go into next year, just wanted to get a sense of what it would take to sort of reignite growth in that segment of the customer base. Is it simply just a better macro or there's things on the funnel side, the sales side and the execution side that could help reinvigorate growth in that side of the business.

Cameron Deatsch
Chief Revenue Officer, Atlassian Corp.

A

Yes. This is Cameron. I'll speak to the new customer number. So in Q4, we definitely saw that continued downward pressure on our free-to-paid conversion that we've been speaking about largely through the last four quarters or so. Although we do continue to increase the total number of free customers out there in the pool and serve those customers year-on-year, simply those customers are slower to take up the credit card and purchase our software, which is fine. We can be patient and convert them over a longer period of time.

The bigger shift that we saw between Q3 and Q4 was actually due to something that we had full control of as we look to our budgets, and we're very diligent with all of our budget this year, but we really went into our marketing campaigns then and marketing campaign budgets and looked at ROI of those investments. Based off a deep dive of that analysis we were actually able to redirect some of our top-of-funnel spend towards higher value, longer-term customers. The result here was that we got less customers overall in the funnel and converted to paid customers in Q4. But the customers we did bring in will be by the higher, longer-term value, higher ROI customers for that marketing spend.

Going forward, as Joe already mentioned, we do continue to believe that the macroeconomic pressure against the free-to-paid will continue. But we will always be optimizing our marketing spend for the highest ROI possible. And where we see good ROI, we will put more investment behind it.

Operator: Your next question comes from Arjun Bhatia from William Blair. Please go ahead.

Arjun Bhatia
Analyst, William Blair & Co. LLC

Q

Hey. Thank you guys for taking the questions. Maybe one for Cameron or Joe. Just as you're thinking about how fiscal 2024 plays out, how should we think about the cadence of the migrations that are left as we approach the February end of life? And maybe this one's more for Cameron, but who are the customers that are still left on server, do they tend to skew smaller or larger? Anything you can give us there would be super helpful. Thank you, guys.

Joe Binz
Chief Financial Officer, Atlassian Corp.
A

Yes, Arjun, this is Joe. I'll take it first, and then Cam can chime in at the end. As you mentioned, we had support for our server products in February 2024. Our focus there is obviously on migrating our remaining server customers to either our cloud or data center offerings. We expect that there will be uncertainty in quarter-to-quarter variability based on when and how our server customers ultimately choose to migrate. For now, we are assuming the trends we saw in FY 2023 with respect to how many server seats migrate and where they migrate to will continue in FY 2024 directionally through end of support. And that at end of support, we expect most of the remaining server seats that migrate will migrate to data center and we've also built appropriately prudent assumptions for customers who will choose not to migrate in FY 2024 into our guidance. And we'll be able to share more on quarter-to-quarter assumptions related to that server end-of-support dynamics when we provide our Q2 guidance next quarter. Cam?

Cameron Deatsch
Chief Revenue Officer, Atlassian Corp.
A

Yeah. Just adding to that, I just want to highlight that this entire transition since we announced the end of server support almost three years ago has been a multi-year journey and a multi-year investment across all factions of Atlassian, whether it's go to market or getting closer to our customers, whether it's R&D teams, eliminating cloud blockers, delivering scale, certifications, you name it. And of course, the variety of programs we've rolled out from price changes to loyalty discounts and of course this large compelling event with the end of service support coming up in February.

So like I said, it's been a multi-year journey and as we've been saying, we're very consistent and very happy with our performance along the way. We were able to retain a very large portion of our server customers while getting our customers to choose cloud or data center appropriately.

That said, we have about six months more as we come up to February. We have a significant server customer base still out there. They are of all shapes and sizes, I have to say. But they're the ones who waited the last – to the latest to make this choice, which is perfectly fine. The good part there is we are in a better position than we've ever been to help those customers make the right choice for their company and transition as quickly as possible. Obviously, we'll incentivize our customers to choose cloud first and foremost in all those conversations, but data center of course is there and honestly a great option for some customers out there who simply are still not ready to move to cloud.

As far as who will choose what, as Joe said, we largely see that customer choice falling in line with what we've kind of seen over the last year. And of course, the customers who wait for the last minute definitely will have data center as a easy migration path for them if they want to stay on prem.

Operator: Your next question comes from Ryan MacWilliams from Barclays. Please go ahead.

Ryan MacWilliams
Analyst, Barclays Capital, Inc.
Q

Thanks for taking the question; two part question here on 4Q cloud results. Could you maybe provide some context around what the contribution was from migration to cloud growth in the quarter? And how should we also think about the contribution from the expiration of the loyalty discount program to that fourth quarter cloud growth? Thanks.

Joe Binz
Chief Financial Officer, Atlassian Corp.

A

Yeah. Thanks for the question. The first part of the question in terms of migrations, the migrations contribution to growth in the quarter was very consistent with what it's been in the past. I think we've talked about it being approximately 10 points in FY 2023. That was a similar outcome in Q4.

In terms of outperformance to the revenue guide, the outperformance was driven by stronger than expected purchasing in June and primarily in enterprise ahead of the expiration of our loyalty discount program. And that came in the form of both more deals and higher contract value per deal, and it drove strong results in migration, seat expansion and upsell to premium and enterprise versions of our products across both our cloud and data center businesses. And that drove the outperformance there.

The server outperformance in the quarter was driven strictly by stronger than expected renewals and larger deal sizes. And then finally, marketplace outperformance was driven by our pull-through on the stronger cloud and data center sales I noted earlier; hope that helps.

Cameron Deatsch
Chief Revenue Officer, Atlassian Corp.

A

Yeah. And this is Cameron. Just from a customer perspective, I just want to say that none of this was really a surprise for the customers. We've been very open along the way for over the last few years about how the loyalty discount program would be staging down over three years and going away entirely on July 1. And it's that openness that these customers – largely we've been working with them for many months, sometimes with these bigger customers for years knowing that this date was out there and giving a large, compelling event to make that choice. Of course, as I already mentioned, we still have another big date out there with next February, and we'll continue to work with our customers who still remain on server between now and then.

Operator: Your next question comes from Kash Rangan from Goldman Sachs. Just go ahead.

Kash Rangan
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thank you very much. I was curious if you could just comment on the transition. We've had a transition of sorts in the company and with the CRO transition, how are you approaching the next year's planning? Are you looking for a new leader within the company, are you hiring somebody outside? What are the considerations on that transition? Thank you so much.

Scott Farquhar
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

It's Scott here. I just want to say a huge thank you to Cameron for his 11 years at Atlassian. And Cameron's done every job at Atlassian. He's done marketing presales and now eventually, what he's at, running all of our sales and marketing, and he's done an incredible job. And when we chatted about this, it's been the right time for Cameron to step back because the cloud migrations and end of life of server are going so well. So it turns out that's the right time for Cameron to spend a bit of time on skiing given he lives up in Tahoe at the moment.

In terms of what happens going forward, Cameron has some really strong leaders under him inside the business, particularly on the sales side, he's got a leader that runs most of the sales organization at the moment and so we expect there to be a strong continuity of that leadership.

At this stage, we're not saying exactly how that role will be replaced or refilled, but I don't expect there to be significant changes from what we've done in the past.

Operator: Your next question comes from Gregg Moskowitz from Mizuho Securities. Please go ahead.

Gregg Moskowitz
Analyst, Mizuho Securities USA LLC

Q

Okay. Thank you for taking the question and best wishes to Cameron. For Michael or Scott, you were very clear at the Atlassian summit in April that Atlassian Intelligence would be embedded in all of your cloud additions and be free of charge. But since that time, we've seen several software companies, GitLab, to name one of them, announce specific pricing for their Gen AI tech. And so, I'm curious to hear your thoughts on the direct monetization plans that are developing in the industry. Also, if Atlassian Intelligence delivers the value to customers that you think it can, could all of this potentially make you rethink your approach at some point?

Michael Cannon-Brookes
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

Yeah. Hi, Gregg, it's Mike here. Thanks for the question. Look, I would start with our philosophy here and long-term thinking as a company. We clearly believe that Atlassian Intelligence and AI and new models are a huge opportunity for us. We think that software is supply-constrained, not demand-constrained, that will enable the creation of far more software. We are a content, text-based business and anything that allows you to manipulate, generate, parse, understand text is very good for us as a company that targets collaboration and knowledge workers. We have a huge amount of data across our set of products and connections to third-party products and the best-of-breed products in the world.

That is incredibly value for us.

So we are huge believers in AI and the potential of Atlassian Intelligence to drive significant value change for our customers. Secondly, our philosophy is to lead with R&D, to build and then customer value before thinking about monetization. I know there may be others in the industry who go the other way around it and announce a price, then build something, then work out if customers care. We don't work that way. We go in the other direction.

So you've seen us execute that plan and that play many times over two decades, and that's exactly what we're doing in terms of the Atlassian Intelligence. We are super excited and I believe you're at TEAM 2023, one of the best feature set customer resonances we've had at the announcement and the launch of what we demonstrated to customers, huge customer excitement. Our job now is to turn that into actual customer usage in a huge manner first, and that is exactly what we're doing. Those features are now in the hands of the order of thousands of customers, and we are working every single day to make sure that those features deliver customer value and are actually used first.

We do believe they'll drive significant product competitiveness and unleash the potential of every team, which is what we're here to do. There are a number of ways we believe, as we've said before, that we gain economically from the Atlassian Intelligence feature set. Again, first and foremost, we do believe it will continue to drive significant momentum in migrations of customers from server and data center products to the cloud. Atlassian Intelligence features only exist in the cloud and can only exist in the cloud. So anything that is a carrot to further improve that migration flow is a good thing for us economically as a business.

Secondly, we do believe it'll drive product competitiveness and improve our new to new customer conversion rates and our win rates against competitors in all markets. Worth saying that we have built Atlassian intelligence leveraging our cloud platform, which is both world-class and quite unique. It is a great example of why we spent 5 to 10 years building this cloud platform, because we can ship Atlassian intelligence features in every product, in every category that we're in, every market, to improve our competitive standing across the board. And we think that will come back in new customers and competitive wins over the medium to long term.

And thirdly, some Atlassian intelligence features enhance and leverage features that are packaged into premium and enterprise editions. So we do believe that it will drive some additional movement as customers go from free to standard and standard to premium and premium to enterprise. Some features do exist in enterprise levels. For example, the Atlassian Analytics features that exist in the enterprise edition, very powerful set of features to be able to use Atlassian Intelligence to generate queries for you is one of the resonant features, but that will hopefully drive more enterprise edition upgrades.

So we do believe there is monetization opportunities for us in Atlassian Intelligence in summary, but philosophically we're starting with R&D and building a deep set of core capabilities we believe we can scale for the next 5 to 10 years as this wave takes over all software. And secondly, we are focusing on delivering customer value first. We are doing it every single day and we remain incredibly bullish about this area of the company.

Operator: Your next question comes from Brent Thill from Jefferies. Please go ahead.

Brent Thill
Analyst, Jefferies LLC

Q

Thanks. Joe, on the operating margin, you're guiding down 200 basis points year-over-year and I think in the shareholder letter, you expect that trend to reverse. Can you just walk through that the next couple-year cadence and how you're thinking about the investments you're going after and then maybe tie that into that expansion and how you're thinking about how that plays out. Thanks.

Scott Farquhar
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

It's Scott here, I'll take the first part about that and Joe can get in with the details. And just to remind those who might be new to Atlassian's story, well, I think we've run a very successful and highly profitable business over a really long period of time [indiscernible] (00:22:11) free cash flow, has great margins. And about 18 months ago, we identified a set of opportunities where we wanted to invest heavy arm behind those opportunities than we had historically. And the three opportunities we articulated to you, our investors – at our Investor Day, were investing heavier in enterprise cloud, investing heavier in our cloud migrations and investing more in our ITSM set of products.

And on all three, I mean super happy with the returns we've been getting, migrations were – continuing at the pace that we thought. We were – ITSM, particularly in this time of consolidation and people looking to get off high-priced legacy vendors, we've seen a lot of competitive switch-outs, and in enterprise cloud, you're seeing now some of the numbers now $0.5 million, $1 million deals in our shareholder letter like we're seeing a great uptick in our enterprise segment as well. So all three of those are going really well.

Now, you, as investors have rightly asked, well, what does the shape of that investment look like? How many years are we doing that for? And in our investor letter this year, just that we – just came out today, we shared that we expect the FY 2024 margin profile to be the sort of lowest point in our margin and we expect them to climb over the coming years back to towards our historical norms. Joe, do you want to add any more color to that?

Joe Binz
Chief Financial Officer, Atlassian Corp.

A

Yeah. Thanks, Scott. Brent, I'm just going to walk you through some of the mechanics. So in the FY 2024, we do expect operating margins of approximately 18.5% as Scott mentioned. That's lower than this year and it's driven by the strategic high-priority areas we're investing in that Scott and Mike have both highlighted, including the areas of innovation like AI. Keep in mind, in FY 2024, we'll also be lapping the H2 benefit of restructuring savings and lower bonus expense that we had in FY 2023.

In terms of FY 2025, what's happening there is we do expect continued healthy revenue growth in FY 2025 combined with our expectation of improving operating leverage as operating expense growth moderates, as Scott mentioned, particularly in the big areas of investment like cloud migrations. And we will continue to drive general efficiency improvements with scale. So that's some of the mechanics underneath the philosophy that Scott articulated.

Operator: Your next question comes from Ari Terjanian from Cleveland Research. Please go ahead.

Ari Terjanian
Analyst, Cleveland Research Co. LLC

Q

Thank you for the question and congrats on the results, Cameron. I know you're leaving at the end of the year, but congrats on a great run. I guess, question for you, a lot of strength here in the quarter on enterprise size. If you could double click, what do you think has changed from a go-to-market perspective, investments into enterprise advocates and the partner side that helped drive some of these larger deals and do you feel like Atlassian's at a steady state now in terms of the investments on a go-to-market side or is there more to come here as you think about the future? Thank you.

Cameron Deatsch
Chief Revenue Officer, Atlassian Corp.

A

Thank you for the question. And yes, we're very happy with the results we had in Q4 and the strength we continue to see in migrations and enterprise. But like I said, none of this happened overnight and none of this was specifically just because the go-to-market tends to focus more on enterprise. This really has been a multi-year investment from Atlassian, largely with the commitment to get closer to our largest customers and deliver – honestly to become the strategic partners that they want us to be.

Now, this starts with R&D, and you see us deliver massive investments in scale. We have 50,000 users in our cloud products today, certifications, extensibility, and largely just understanding our enterprise customers' unique needs much more closely. And then of course, we match that investment and go to market by including our enterprise advocates, our technical account managers, our customer success managers and so on. And as we got closer, we've been able to get larger deals, longer term commitments, and become the strategic partner that customers want.

However, we've been able to do this all through evolution, as we said, not revolution. And you see that today in our sales and marketing spend. So we've been able to actually get closer to our largest customers to do these larger enterprise transactions, all while maintaining largely-industry leading sales and marketing expense, something that I'm exceedingly proud of and something that I'm very happy with my team will continue to do going forward is have that great balance of understanding our flywheel and product-led growth and all those great principles that Mike largely laid out earlier of how we're even thinking about AI. But then, of course, when we're ready, go to our largest customers and bring those solutions to them. And of course, get value in return for that.

So we will continue to get closer to our largest customers but we will absolutely continue to maintain our incredible efficient go-to-market structure going forward.

Operator: Your next question comes from Michael Turits from KeyBanc Capital Markets. Please go ahead.

Michael Turits
Analyst, KeyBanc Capital Markets, Inc.
Q

Thank you. Hey, guys. Good evening. So you said in a couple of places that migrations are strong, but you talked about them both to data centers as well to cloud. I was wondering if you could drill down specifically on the migrations to cloud. Scott mentioned things like data residency that were obstacles that were being removed. But are we in a position where whether it's because macro feels better people are okay on TCO or some other reason that the actual migrations from let's just call it on-prem whether it's from data center or server to cloud are improving at this point, s that sustainable?

Cameron Deatsch
Chief Revenue Officer, Atlassian Corp.
A

This is Cameron here. So the migration plan like I said is a multiyear program we put in place and as the customers choosing cloud choosing data center has been very much in line with what we've expected as we eliminate cloud blockers, whether that's data residency, scale, extensibility and to be perfectly honest, we have a public roadmap where we show all of our customers, here's all the things that we are shipping down the road so they can make the appropriate choices going forward. It's a combination of all those things that have allowed us to get these large customers choosing to move to cloud.

Of course, as we've said, there are still plenty of customers out there that aren't ready for cloud, would prefer to stay on premises and are choosing data center. And we will continue to see, I think a large portion of customers going over the next year choosing data center as that option. But that's not a dead end. We largely see that investment in data center as a further commitment into Atlassian and we've proven again and again that we can move data center customers to the cloud with half of our migrated seats coming from data center customers. So once again, we provide the optionality for the customers throughout, if they choose data center, that's great. We'll continue to work with them on moving them to cloud and getting the most value from Atlassian long-term. Mike, you got anything to add?

Michael Cannon-Brookes
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.
A

Nothing Cameron. I think you nailed it. Just re-emphasizing that half our migrated seats coming from data center is a really important milestone for us as we continue this long-term journey.

Operator: Your next question comes from Alex Zukin from Wolfe Research. Please go ahead.

Alex Zukin
Analyst, Wolfe Research LLC
Q

Hey, guys. Thanks for taking the question. Maybe just first, if we look at the cloud revenue growth number and we look at – we try to decompose net new ARR into net new versus migration versus expansion, you've talked a little bit about the migration dynamic, but how much – like if we look at the – if we just ask you like a cloud NRR metric and how much was coming from expansion, it'd be great to understand that particularly as we're getting into the later innings of the migration. And then maybe just as a follow-up, you talked about healthy top line growth for fiscal 2025, you gave the 25% to 30% growth range for 2024, which we really appreciate, by the way.

Is that a durable kind of growth rate? It's obviously a wider range, given the macro uncertainty, but is that growth rate likely to stay durable, particularly as maybe the migration tailwinds start to add a little bit as we get past the server end of life?

Joe Binz
Chief Financial Officer, Atlassian Corp.

A

Yeah. Thanks for the question, Alex. I'd say starting with your last question, in terms of FY 2025, we're obviously not giving any guidance on that. To your broader question, I do believe it's durable. The value that we're adding to the products that cloud brings, it's very specific, the value it delivers to customers, I think there's a lot of opportunity for tailwind in that business. And so, directionally speaking, we should continue to see very healthy growth as I mentioned for FY 2025 that will be driven primarily by cloud as the server revenue base goes away and increasingly data center customers migrate to the cloud.

In terms of your first question on net retention rates, I would just say paid seat expansion and free-to-paid conversions continue to be impacted by the economic headwinds that we've seen that would impact that area of the business. In terms of a specific expansion rate, as you know, we don't share quarterly retention and expansion rates. Having said that, we've talked about the macroeconomic pressures and the underlying fundamentals in our business outside of that remain very strong, however, and we see no change to our structural competitive position. So we do expect those retention rates to improve once the macro picture stabilizes and begins to improve.

And then as you talked about earlier, I'd also highlight other key aspects of our business, like migrations and cross-sell and upsell and monthly active usage. Those all remain very healthy and speak to the highly valuable and mission-critical nature of our products. And those will also feed future expansion rate improvement. So our outlook is very positive on that going forward.

Operator: Your next question comes from Fred Havemeyer from Macquarie. Please go ahead.

Frederick Havemeyer
Analyst, Macquarie Capital (USA), Inc.

Q

Hi. Thank you very much for the question. Firstly, actually, another thank you for introducing a dark theme as well to – for people like me is greatly appreciated, especially when I'm on with some of my colleagues in Australia late at night. The question right now is really focusing on the migration tooling that you have as you're looking at and kind of reviewing the learnings that you have and the investments you've made into your migration tooling, just how confident are you that at this point you have the server to either data center or a cloud migration tooling on ramp capabilities really solved versus are there any significant risks you still see for some of those larger enterprise customers post server end of life to need to wait a little longer to have additional tools built out. Thank you.

Michael Cannon-Brookes
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

Hey, Fred, I can take that. It's Mike. And thanks for the kudos on dark theme in Jira. It's actually a good example of the amazing R&D team we have. It's done properly with design tokens and all sorts of things across our cloud platform using Atlaskit. So it will be coming to other products shortly. It's already in a handful of products but you'll see it all across the area. We have a huge focus on accessibility, which has kept us into migrations. Dark theme is quite challenging to do in an accessible way that works to meet all of the standards required for people who have accessibility issues when it comes to software.

Gets to some of the migration tooling questions that you've asked. Our migration tooling continues to improve quarter-on-quarter. We work really hard on the tools to make that as self-service as possible. And largely what we are doing is continue to work on the scale and speed of the tools to move huge amounts of data faster and faster. The repeatability of those tools, our customers don't do one-shot migrations, especially the larger ones. They will migrate their data across, test it, migrate it again, and do that multiple times so the tooling becomes incredibly important to be repeatable and reliable.

And lastly, we work with customers who have lots of edge cases. Some of them have 10 to 20 years of JIRA family or Confluence data on prem. They may have edited their own database. They may have done a whole lot of things that we have to take as edge cases to move them across. We continue to work on how to do that as we get bigger and bigger customers and we encounter more and more edge cases, more of the tooling is self-service and repeatable. And lastly, we are continuing to work with app vendors and our amazing marketplace community to make sure that their app data and the apps themselves can be migrated as they move from our on-premise extensibility and plugin systems to connect and forge in the cloud. That's quite a unique migration challenge.

I would say, every quarter we get better and better at doing this. We can use less human power to do migrations. We can do bigger migrations. And really proud of how the team is going on managing all of that tooling. So continuing to improve. I don't know, it's – your question was around, is it solved? It will get better every single quarter as it has done for the last three years and we will continue to do that as we migrate more and more server and data center customers over time.

Operator: Your next question comes from Peter Weed from AllianceBernstein. Please go ahead.

Peter Weed
Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you and great to see IT service management growth called out in the note. It was top of mind for us too. We see it as a really large opportunity for you going forward. Obviously it already is a large business. Really impressive to see the 45,000 customers and 80% year-over-year growth. Kind of looking forward how should we think about the total upside from here? Like, what are the profiles of the companies that are the largest opportunity going forward that will drive more growth? And how much additional headroom do you see in this over the coming kind of three-ish years?

Scott Farquhar
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

Thanks, Peter. Scott here. Look, I think we have a huge opportunity for durable growth over such a long period of time. We operate in three very large markets. And so, take them one by one. You talked about Jira Service Management and ITSM, the opportunity there is we're the challenger in that particular market and, there's plenty of large incumbents there and plenty of unhappy customers in those large incumbents. And so there's just massive opportunities for us to take market share in that particular space.

In our migrations – well, actually let me talk about work management's role, there's definitely huge opportunities there, that's a very large market. And if you look at the stronghold we have around developers and around development teams and when I talk to CEOs these days around the world, like the biggest asks – one of the biggest issues is how do they make the development teams productive, how do they get more out of development teams? And when we look at customers consolidating around what work management for all items, they throw out other vendors, but they can't get rid of the tools that power their engineering teams. And so we have a huge opportunity for consolidation in our work management for all market.

And then if I look at the innovations that we're bringing to our traditional Agile and DevOps market, we're a large player there, but there's just so many different customer problems that we can be solving for them. And you saw us launch Jira Product Discovery to target product managers. So if we start tackling more and more personas across there, there's just so much customer value that we can produce. And so I'd say huge opportunities in every market that we have at the moment. And so I don't really see any limit there. Migrations of our customers from server to the cloud is just a stepping stone for us to be able to keep delivering huge value and increased cloud revenue.

Cameron Deatsch A
Chief Revenue Officer, Atlassian Corp.

Yeah. And Cameron here, I'll follow up just speaking with customers as well, the IT service business – as we mentioned, 80% growth in our largest enterprise customers with Jira Service Management last year, which shows that, hey, we've struck a vein here with the customers where you look at the trends in the market, customers are trying to consolidate vendors and save money. Jira Service Management for existing Atlassian customers is a great opportunity. Customers also want their development teams and IT teams to come closer together to work on a common platform. Jira Service Management provides that absolute capability, and customers want more flexibility, quicker time to value of their investments. They don't want to spend 6 to 12 months rolling out these tools. They want to be able to purchase software, get it running and start delivering value to their end users, in days, weeks at most and Jira Service Management once again delivers value here.

So, in the IT service management market broadly, I think we have a very unique offering with a very unique value prop at a very unique price point. And all three of those reasons are the reasons why customers continue to look to us and invest in Jira Service Management.

Operator: Your next question comes from Derrick Wood from TD Cowen. Please go ahead.

Derrick Wood Q
Analyst, Cowen & Co. LLC

Oh, great. Thanks. I guess, Joe, this is for you. I wanted to ask about some of the expansion headwinds being felt upmarket. I think with your smaller customers, I know a lot are on monthly contracts. So, perhaps, net expansion rates normalize quicker, but within your enterprise customers, you often have multiyear contracts. Customers would historically buy seats for growth to take advantage of pricing. And we've heard from other seat-based models that as growth in the tech world has slowed, expansions on renewals can be a lot more challenging. So just curious, is that something you're seeing and do you think we still need some time quarters ahead to fully cycle through this with kind of longer enterprise contracts?

Joe Binz
Chief Financial Officer, Atlassian Corp.
A

Yeah. Thanks for the question. Let me just talk a little bit about the differences between SMB and enterprise, and I think it will get to your question. The SMB segment of our business is the most sensitive to macro, and it has been the most impacted over the last year by the macroeconomic headwinds. We also do see the impact of changes in SMB in our cloud revenue sooner than in enterprise, simply given the mix of monthly cloud billings that we have in SMB. So I do expect SMB to be an area that will most benefit in our portfolio if macro improves and we'll see that impact in a fairly timely way in our revenue and P&L when it occurs.

Now, as you point out, enterprise has slightly different dynamics. It's been less macro-sensitive over the last year, still impacted by macro, but not to the same degree as SMB. And as you pointed out, enterprise also benefits from the investments we've made to unblock cloud migrations and improve enterprise capabilities, including premium enterprise SKU value. And they purchase that value through a higher percentage of annual and multi-year contract billings, and that reduces the quarter to quarter revenue variability to some degree. So you will see that play out over time and it does take longer for us to see that goodness from enterprise fully reflected in the P&L as a result of that.

Operator: Your next question comes from Austin Cole from Citizens JMP Securities. Please go ahead.

Austin Cole
Analyst, JMP Securities
Q

Yeah. Thanks for taking my question. Congrats on the results. So just cash now exceeds $2 billion on the balance sheet, kind of a milestone there. I was wondering if you guys could share anything on how you guys are thinking about M&A strategy at this stage.

Joe Binz
Chief Financial Officer, Atlassian Corp.
A

Well, yes, thanks for the question. I'll talk a little bit just in general about our capital allocation philosophy, which really hasn't changed. The first priority is investment to drive the long-term growth of our business, both from an organic R&D and sales and marketing perspective, as well as, as you point out, mergers and acquisitions and strategic investments. And from there, we typically look to opportunistically return capital to shareholders as we're currently doing through the share repurchase plan.

So Atlassian has always done M&A as part of its growth strategy and that continues to be part of it going forward as well. Scott?

Scott Farquhar
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.
A

I don't think there's any change to our philosophy irrespective of what our balance sheet numbers look like, we've always been a company that thinks about the long term in terms of our investments. And it's not going to change as a result of having a large or a small cash balance out there. We look at the right things – [indiscernible] (00:44:01) from a acquisition perspective [indiscernible] (00:44:06) we're willing to sit around and wait for something that really fits us and really provides value to our customers. And so, for us, we're always on the lookout for great value assets and we'll do them when the time is right, not irrespective of our bank balance.

Operator: Your next question comes from Fred Havemeyer from Macquarie. Please go ahead.

Frederick Havemeyer
Analyst, Macquarie Capital (USA), Inc.

Q

Hey, I'm back. Thank you. I wanted to also ask on the ITSM side of the business as well in Jira Service Management, just the enterprise growth in particular, I think you noted about 80% year-over-year is looking quite impressive. Just hoping to better understand what's really started to work there to be able to turn on that enterprise growth within service management?

Joe Binz
Chief Financial Officer, Atlassian Corp.

A

Cameron here. I'll call out the bits – what's driving the enterprise success and IT service management; largely comes off the back of many of our enterprise investments [ph] broadly (00:45:08) at the Atlassian Cloud platform level, whether that was data residency, whether that's certifications, all the same benefit that we had for driving migrations in large enterprise automatically gets translated to Jira Service Management.

However, the Jira Service Management team has also been exceedingly focused on knocking down the specific IT requirements of those larger customers and you see that largely show up the validation of that as we are in the leadership quadrant in the Gartner IT Magic Quadrant, which basically shows that, hey, yeah, we check all the boxes that those customers require while maintaining that unique value of bringing dev and IT together at a get a relatively competitive price point. So it's really the investment across the board in IT service management, as we said a few years ago, now we're going to double down this area. And as we've paid off those R&D investments and focused our go-to-market efforts, as we reach out to our larger customers and we talk to them about migrating the cloud, we're not just talking about getting what they already have over to the cloud, we talk about expanding the overall Atlassian value prop as we move to the Atlassian Cloud platform. And that's also helped us expand the Jira Service Management offerings. Mike?

Michael Cannon-Brookes
Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

A

Yeah. I just wanted to add on one thing I was talking to an enterprise customer maybe a month, month-and-a-half ago, and one of the things that was coming through to them was the value of the Atlassian platform and one of the reasons why they opted for JSM. In particular in this case they used Atlassian in their Agile and DevOps, the Jira software and other products. The combination of development teams and IT change is increasingly important. We have an incredibly unique value advantage there as every customer, every company becomes a software company, that connectivity between development teams and IT teams is incredibly important. That's powered by our investments in the Atlassian platform over time. You're seeing that come through in Atlassian Intelligence and a whole host of other ways. But it's really gratifying to us to see that resonating with customers, especially the large customers and it's a big differentiator.

The same actually applies on the connectivity between IT and service teams in an organization and the work management space. So on the other side of our market combinations, as enterprise service management continues to roll out, our virtual agent technologies using Atlassian Intelligence, I think will be a huge boon to larger enterprises in trying to take service management more broadly from IT into HR, finance, marketing and other capabilities. This all relies on the power of the Atlassian Cloud platform. It'll continue to drive migrations of our largest customers there and I think be a differentiator in the ITSM space.

Operator: Thank you. That's all the questions we have time for today. I will now turn the call over to Scott for closing remarks.

Scott Farquhar

Co-Founder, Co-Chief Executive Officer & Director, Atlassian Corp.

Thank you everyone for joining our call today. As always, we appreciate your thoughtful questions and continued support and a special thank you to the Atlassian team for your resilience and closing the year with strong momentum. Also want to say a special thank you to Cameron; that was his last earnings call. I want to say a huge thank you for the revenues you've given to Atlassian so far. Thank you all. And I'll see you next quarter.