

HubSpot

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Stan Zlotzky: Good morning, everybody. Thank you for joining us. My name is Stan Zlotzky from the Morgan Stanley software research team, and with us this morning we have the pleasure of hosting JD Sherman, the COO of HubSpot. JD?

JD Sherman: Thank you. Great to be here.

Stan Zlotzky: So, before we get started, very quickly, disclosures. Please note that all important disclosures, including personal holdings disclosures and Morgan Stanley disclosures, appear on the Morgan Stanley public website at www.morganstanley.com/researchdisclosures, or at the registration desk.

With that out of the way, JD, so HubSpot has really evolved as a company, right? When you first got started, you just had the marketing products, but then back in 2014, you really started to build out a much broader product suite, right? You built out sales, you built out customer service. As we fast-forward into 2019 and beyond, maybe give us a recap where you were and where you are going now.

JD Sherman: Yeah, sure. So, by a little bit of background, HubSpot's mission is to help millions of organizations grow better. We really target that midmarket and try to help them max their marketing, sales and services with the way modern human beings live, work, shop and buy. And we started with the marketing problem, which was that people have changed the way that they consume content, live and work. They're online instead of -- they're hard to interrupt, and so we built a marketing tool to help with that. And then we added to that the sales tool and now the services tool. Our observation is that people continue to change the way that they live, work, shop and buy, and the way that our customers need to market and sell to them continues to evolve.

So, moving from an app to a suite was really part of that recognition that the customer journey continues, and the way that people have to sell has to change as well. And now as we think about becoming a platform, there's sort of another realization that comes with that. You know, we always had this vision that HubSpot would be the all-in-one platform for midmarket companies to run their front office. The fact is that you can be all-in-one, but you're not -- I mean, more and more companies are using lots and lots of different software platforms, lots and lots of different software tools to meet their customers' needs, and we're never going to be the all-in-one. In fact, what we think we need to do is help our customers sort of orchestrate all of the software tools that they're

using onto one platform. And so that's really the effort and initiative that we've been focused on sort of beyond delivering on sales and services.

Stan Zlotzky: And so staying with the theme of, you know, helping customers really orchestrate everything, how do you do that?

JD Sherman: Well, I think part of it is, and it's a different answer for midmarket than it is for some of the larger companies who have sort of unlimited resources, where you can take big software tools and tie them together. You can use your IT resources; you can use implementation consulting around that. So, the midmarket companies, that has to be super simple. You have to make it really easy to both use the software and integrate other tools with it. And the key is for our customers to have sort of a center of gravity for them, and that center of gravity is really our CRM, our free CRM that we then build tools out on top of. What we want to be able to do is allow our customers to integrate what they have so that when things happen outside of the HubSpot software, it can get pulled into that center of gravity and our customers can act on those cues; they can use HubSpot to trigger automation workflows; they can use HubSpot to trigger activities in other applications that they use, etc., but it all sort of works together, and we want to help our customers orchestrate that.

Stan Zlotzky: And what role do partners have in that orchestration?

JD Sherman: That's a great question. So, part of this is we kind of have a new persona that we've talked about for a while. You know, we started really with a very simple persona. We called her Marketing Mary. She was VMO of, say, a 50 to 100-person company, and she was not very technically proficient, inclined, and so we had to, like, basically make software super easy for her to use. Now, first of all, Marketing Mary has become much more technically astute. In fact, we changed her name to Marketing Michelle, because we want to recognize that she's changed so dramatically. But, also, there's a new persona out there that we have to deal with, a developer, right? Somebody who wants to be able to use our platform and develop with it, and tie in integrations and be much more sophisticated with the platform. So, we want to approach that persona much the same way we thought about Mary and Michelle. We want to make sure that we're providing the right sort of level of support and experience and tools and capabilities for that developer.

Our partner ecosystem is a big part of that. A lot of our partners have evolved to sort of help their customers do exactly that. And we've seen a lot of our partners really grow from that and benefit from that by becoming more technical, by helping their customers not just with developing a website or a content campaign, but sort of running the entire flywheel of their business, tying in how their entire business operates using HubSpot.

Stan Zlotzky: So, one interesting things that investors might notice, especially the ones that have been following HubSpot for some time is even the language that you're using as far as describing HubSpot, if we back up to when you were going out -- I mean, back in 2014, you described HubSpot as, hey, we do marketing products for SMBs, right? Now you're doing this much broader platform of products that you describe as midmarket, right? And even same thing, Marketing Mary versus Marketing Michelle, right? Your partners have evolved from just being very basic marketing agencies to now they are agencies, but they also have these developer and these technical aspects.

JD Sherman: Um-hum.

Stan Zlotzsky: So, what I think all of this is playing to is you've been making very slow but steady and persistent steps upmarket, right? How are you thinking about HubSpot's trajectory going forward?

JD Sherman: Yeah. I think -- I don't want to -- so, there is the Enterprise, the Fortune 500 or Fortune 100, or whatever, and that's not our target market. We made a very big decision as a company before our IPO, probably in 2013. We had a marketing app that was starting to get pretty decent, and we decided, we said we could run the sort of standard playbook and take that app and take it upmarket, try to sell it to bigger companies, try to go from a \$10,000 ARPU to a \$100,000 ARPU, very natural playbook. But we looked at that, that top of the pyramid, if you will, and we said, boy, there is just a red ocean there. There's a lot of competition, and there's some pretty entrenched competitors that are, you know, doing very well and geared towards that. And we looked at what our sort of secret sauce was, and it was really a couple things. One is our software was really easy to use. It was about making, solving Marketing Mary's problem in the day, and that was a real value-add for the small and medium business, or the midmarket. I use those terms sort of interchangeably, to be honest, number one; and, number two, the thing that people don't like about that SMB, or what makes it difficult is it's really hard to reach those millions of customers. Once you've reached them they're great customers. They have very good margins and all this kind of stuff, but they're really hard to reach. We have kind of cracked that nut with our inbound marketing and with our partner channel. Layer on that what we've done since, we've made that decision, therefore, to go broad in the midmarket rather than go deep upmarket. We've layered on a premium approach to getting our customers to start using our software for free, so effectively try before they buy, to add value before we try to extract value. And I really think that that's the way, the modern way people are wanting to buy software, and it gives us tremendous reach into the midmarket. So, I think given that that was our special sauce, our capabilities, made it kind of sense for us to really focus on that market.

Now, we have, I would say, you know, this year we are -- or, last year at our INBOUND event in September, we announced a new Enterprise tier across all of our hubs, and that's gone really well. And that's really geared towards making sure that companies at the high end of our market don't ever feel like they have to leave HubSpot, because our capabilities will grow with them. We also introduced, you know, a more robust starter tier across all of our hubs so that people can start with us and start touchlessly and get going. That's really geared, I think, towards making sure that we're targeting the high end of that midmarket. But I do not think we're going to go after the big enterprise.

Stan Zlotzsky: Inasmuch you have these different pricing tiers now, at the low end there's a very big step function in pricing.

JD Sherman: Yeah.

Stan Zlotzsky: There's a starter package and then everything else. Does there almost need to be something in between, because you used to have an in-between.

JD Sherman: Yes, sir.

Stan Zlotzsky: And then you took it away.

JD Sherman: That's a great discussion and debate, actually. We had a basic product that was \$200, and it had a lot -- the problem with the basic product was, it was just as expensive to sell, but the unit -- the economics weren't good because customers would get stuck at that level,

and it didn't -- it was sort of -- it was an odd product to be in. So, when we finally developed that starter tier with a little more capability, plus, in addition, we launched our standalone CMS, so that customers who were on the basic product paying \$200, we could buy the Marketing Starter and the CMS, which was \$350, then it started to make sense that we could sunset the basic. We left any customer that was using basic and wanted to stay with it, we allowed them to stay with it. But the way I always think about it is two things: one, that example I just gave you. For a customer who just basically needs a website that's integrated with their marketing and sales tools, they can buy our CMS and Marketing Starter and Sales Starter, and they're probably talking about \$400 or \$500 a month. That's a good fit for that small customer, number one.

Number two, the way I think about that starter business, if you will, that \$50 product is, I really think about it as part of the conversion funnel, if you will, to get people into our professional and enterprise tiers. So, what we want to do is we want to get lots of people starting to use our free software. As they start to want to use more of those capabilities, like email or some of the more advanced CRM functionality, they'll -- without talking to any of our sales reps or anything, they'll start to -- they'll buy the starter deal tier, and then we can engage with them, which starts to add value to them, and we can explain to them and help them figure out the value of automation, which comes at the professional level, and customization, which comes at the enterprise level. So, we're not trying to build necessarily a big starter business that customers at \$50 or \$100; we're trying to use that as a mechanism to get good traction in that midmarket.

Stan Zlotzky: And what kind of success have you had in actually converting the \$50 starter to customers up to the \$800 pro users?

JD Sherman: Yeah, I think we're starting to have some good success there. As I was saying earlier, today about two-thirds of our customers, our paying customers start with the free software. So, they've started to use our software before they buy. And a big part of that sort of process, a big chunk of those will buy the starter product as their first lever. And we've started to build a really nice, I guess I'd call it flywheel, a nice spirality around people starting to -- you know hearing about HubSpot being able to start for free; you know, going from one firm to another and starting to do that and build that up. I feel like we're getting really good traction there. I do feel like there's a lot more opportunity for us to improve on that conversion funnel from free to starter to the professional and enterprise tiers. I think there's a lot more that we can do there.

Interestingly, what that takes is not an investment in sales and marketing so much; what it takes is an investment on the product side. It's really the investment we're making on our product growth team and getting them to start thinking about how can we help our customers with cues inside the product to want to experience some of these more advanced features.

Stan Zlotzky: It's almost like, you know, putting in like teaser features into the products and say, hey, you know, if you wanted this level of automation, this is why you should move up?

JD Sherman: Yeah. So, one of the things we're kind of testing is, like, actually having trials inside of the product, you know, where you're using our starter product and having some success, maybe you want to try the workflow automation features, and try that for 14 days, or whatever. We're really starting to -- like, I think a big -- we talked about the transition of being -- going from an app to a suite to a platform, I think the other big transition, evolution that's going on in HubSpot is the transition from an inside salesforce or gets a lead from the website, hopefully a very well qualified lead, but still calls that customer,

explains to them what inbound marketing is, convinces them to buy the product, and then hopefully they buy it and stick around, to a model where the customer finds out -- finds HubSpot, starts using the software, maybe even buys the software at some level, and then engages with either the salesperson or a customer success manager and moves up-- both up the stack and across the stack, and maybe buys sales, marketing and services.

Stan Zlotosky: This may be a little bit of a rhetorical question, but it sounds certainly like having these free and basic -- I mean, and the starter packages, it actually improves the productivity of your sales organization.

JD Sherman: That's one way to look at it for sure, absolutely.

Stan Zlotosky: Now, one thing they introduced at your user conference, you mentioned, was Enterprise package.

JD Sherman: Yep.

Stan Zlotosky: And what has been some of the -- you always had an enterprise package on the marketing side, right?

JD Sherman: Sure.

Stan Zlotosky: You introduced the Enterprise package for the first time with a newer product, but it wasn't just, hey, we're going to jack up pricing; there was actually some product changes and additions into the Enterprise. Maybe just walk us through what those product changes were and what the customer feedback has been.

JD Sherman: Sure. Yeah, just to step back. Like, we always had in marketing, in particular, a basic version, a professional version and an enterprise version. I would say that if you really looked at it with a jaundiced eye, you would give us an A in terms of that professional version targeting, call it 100- to 200-person firm. Like, we had an A, our product was perfectly suited for that. The enterprise product was kind of like a B- and C. What we've done with the Enterprise, with the launch that we've done is move that to more like an A-, I would say. So, I think we still have some work to do, but for the most part, that's a really good product now. It's a legitimate enterprise-level product. And what was missing from that product was mostly, if I grouped it all into sort of one category, the customization, the ability to customize things for our more advanced customers, whether that was reporting, whether that was commissioning and how you managed teams, and partitions inside the product, or whether that was in the way you trigger workflows and events. So, it was really about customization. Overall, I think about sort of our packaging as we want you to get started with the basic features, then when you need automation you're at the professional level; and then when you want to start customizing your marketing, sales and services, you're going to move to the enterprise level.

Stan Zlotosky: Back before, you know, going back a few years, I don't remember -- I don't recall where these numbers came from, but I feel like something like 20% of the install base was on the enterprise product. I don't remember if that's something that we came up with or you actually told us that number, but it was a small subset of your customer base.

JD Sherman: Yeah.

Stan Zlotosky: How are you thinking about your customer base going forward and what the new enterprise SKUs actually do to help customers actually move up into that product?

JD Sherman: Yeah. I think if you do it on a dollar basis, it's more than 20 -- it will be -- it's more than 20% now; I think it's like almost a third, and I do think that would grow. If you do it on a customer basis, it's much smaller than that, particularly with our starter customers. In one of my one-on-ones, I was joking about how we basically have a humidifier and a dehumidifier in the same room here. Like, we are advancing our features and adding enterprise levels, and that's going to drive ASPs up. At the same time we're acquiring lots and lots of customers at the starter level, and that's going to drive ASPs down, and we just let them battle it out and see which way it goes. But that's why I think you see our ASPs bouncing around as you do. If you peel that back and you look to just the Marketing product, just the Sales product, just the service product, you would see that the ASPs of those products are drifting up nicely as we're investing in the product and moving folks there. And then what's really driving it down is both the mix, because, you know, the Services and Sales product tend to have lower ASPs and they're growing faster, and the Marketing product, we've introduced a starter feature to that, which is just a \$50 product.

Stan Zlotzky: Got it. So, we'll touch on the Sales product in a little bit, but Service is something that's been the most recent product area. What has been some of the feedback, not just from customers, but from I think even more importantly, what has been the feedback from your partner, Ecosystem around the Service product?

JD Sherman: It's been very good, and in part is because that sort of initial target market or use case that we went after. Basically, we went after -- unlike with the Sales product, where we did kind of a startup within a startup and we created a whole new go-to-market, and we went after a whole new sort of customer set, with the Service product we really looked and said our existing customers kind of need a few basic things, and they're trying to do it with HubSpot anyway, and those things were like the idea of a ticket inside the HubSpot system, a knowledge base, you know. And all of these things sort of -- we have a CMS, so that's sort of your knowledge base; ticket's an object. You know, you can build all that together. So, we really built a product that would help our existing customers extend their use of HubSpot, and that's been really well received by them and it's going really well. And it's great for our partners, too, because what it allows our partners to do is what we've done as a company, which is take their customers and cross-sell them, and add more value as a partner to that. So, that's gone super well.

We've just started with some of the announcements that we had at INBOUND to acquire customers initially on the Service Hub, and I think that strategy is going to play out a little bit like we saw in the Sales side, which is the simpler use cases. Like the beauty of that product is it's really easy to use, particularly easy to use if you're already using HubSpot, because the pieces all work together. And I think our long-term differentiation on that product is going to be the way it all ties into the HubSpot suite and the HubSpot platform, and the way you can orchestrate across the entire customer experience.

Stan Zlotzky: So, for the partners, right, what is actually -- what needs to happen at a partner level in order for them to be able to say, okay, well, we used to be a marketing agency three years ago, but now we're also a -- you know, we help our customers with sales and now we're going to help them with customer service, too.

JD Sherman: Yeah.

Stan Zlotzky: What kind of transformation needs to happen there?

JD Sherman: Kind of the same transformation that's happening inside of HubSpot. And, by the way, we had some partners who are web design agencies, and they're going to be web design agencies, and that's what they want to do. And I think that's great. We should be really happy and enthusiastic about that. We're obviously investing in marketing and our CMS, and all that kind of stuff.

Our other partners, like, we started to talk with our partners about, hey, the world's changing. You know, you can't just think about marketing in a silo; it's really about this flywheel concept. And we've started to help them understand that, and they've really taken that mission to heart, because it is a big chance to basically help their customers make this transformation with them and grow their businesses inside of their own client base, something they really hadn't been able to do. The way our partners had to grow before, the only way they could grow is sign up more and more customers. We loved that, they loved that, that's great; now, in addition to that, they can go to their existing customers and say, you know, you should really extend this way and we can help you do that and, you know, we'll be able to show you the benefit of that. So, that's been really effective.

It's a little bit lagged what we've been able to do with our own direct sales force because, you know, obviously we can direct them very specifically. We've had to provide a lot of tools and capabilities to our partners to get there. I really see us starting to get traction with that now.

Stan Zlotzky: One interesting aspect of your product strategy, something called the Growth Stack, which is masters have been working -- looking at HubSpot; they're very familiar with it. But for those who might be newer to the story, Growth Stack is something that's about 35% of your customer base now?

JD Sherman: Yes.

Stan Zlotzky: And what are the products that go into the Growth Stack? And when you think about Growth Stack, is that a way for you to sell more into distant customers or is it more of a better way to acquire new customers?

JD Sherman: So, the Growth Stack is basically -- we actually changed the name to Growth Suite.

Stan Zlotzky: Do you know why?

JD Sherman: Actually, because Growth Stack sounded a little too much like growth pile, which it didn't sound good. But basically it's using more than one of our hubs, more than one of our software tools, and that's exactly what it is. You think about it in the midmarket, one of the things about the midmarket is, you know, you have lots and lots of customers but a relatively high attrition rate, because the customers are smaller and they go out of business or sort of just slow down and give up. What we've been able to do is sell more into that customer base, initially by our contact tier pricing. As customers grew their contacts, they spend more money with us. Now, in addition to that, we can sell them more software and grow inside of that footprint, and that's been really effective. It has a knock-on benefit, too, which is when customers use more than one part of our software, more than one hub, their retention is much better, like almost 10 points better. So, you know, obviously, they're stickier, particularly because we've really become the center of gravity for those businesses. So, there's a knock-on benefit of being able to do that as well.

Stan Zlotosky: So, we'll open up the floor to questions in a minute, but I wanted to throw one more out. On the Growth Stack, right? What does that have -- what's the battle going on here between Growth Stack from coming in with customers essentially having a large land versus having a bunch of products where you can have the expand after the initial customer? What are the puts-and-takes there and how it translates into your net revenue retention rate?

JD Sherman: Yeah. Yeah, that's a good question. I mean, it's not something we're trying to actively manage. I guess we would just assume that every -- we would love it if every customer would come in and buy everything from day one, and then what you'd see is retention metrics would look a little craftier because of what's upside. And certainly our sales force is obviously incentivized to the bigger sales that they make the more commissions they make, so there's a little bit of that. The flip side of it is, I think the way people -- modern people buy software is they want to start trying before they buy, and they'll try pieces of it, and they'll sort of naturally, organically add the various pieces. And, honestly, I don't know which way is going to -- you know, how that balance is going to play out. We're frankly comfortable sort of like letting that balance manage itself. We want to make it -- basically, what we want to try to do is take the friction out of the buying experience for our customers. And sometimes that customer is looking to buy a platform, and we want to make sure they can do that. Sometimes they're looking to buy pieces, and we want to encourage them to grow with us.

Stan Zlotosky: Got it. All right. Well, let's see if there are any questions in the audience. I think everybody is busy with lunch.

JD Sherman: We're not busy eating lunch.

Stan Zlotosky: We'll eat lunch later. Maybe switching gears slightly. The international part of your business growing very, very quickly. Walk us through some of the investments that you're making internationally and, more broadly, how do you think about the balance of investing internationally versus investing in the US? Why are you investing more internationally versus in the US?

JD Sherman: So, basically, our international playbook was initially take our US playbook to English-speaking people in countries all over the world, and that worked super well. It just scaled naturally, and because it was a green field, we kind of invested and it grew superfast. Phase 2, which we're kind of in right now, was take that same playbook, localize it, and when you say localize it, it's obviously not just the product but it's the marketing, the sales, the support, all the knowledge base, etc., and take that to markets similar to the US, or mature markets, and really run the same playbook with partners, with an inside sales team. And that's where we are now. And, again, lots of green field there, so we've been investing heavily and growing faster than the US. And I think we're still in the early innings of that. Next year we're going to open an office in France and be more aggressive in the French-speaking market, for example.

I think there's another phase to come that we're starting to experiment with, particularly now that we have a premium lighter touch going to market model, which should allow us to have some success in emerging markets, where the LTV, lifetime value of a customer, the price point is going to be a little bit lower. But if we can get to the right customer acquisition model, that can work as well. I think that's still to come, an investment for us still to make. We're just sort of experimenting with it this year. But, basically, over the last four to five years we've been investing more heavily in international as we sort of rolled out that playbook.

Stan Zlotsky: Got it. And maybe just a quick point -- oh, we have a question.

Unidentified Participant: I'm guessing on the marketing side it's a bit more green field for you guys. I'm just curious on the sales and service, who are you replacing and who are you kind of competing against for those opportunities, and if you could just confirm on marketing, was it just sort of more green field?

JD Sherman: Sure. I think there's still a lot -- one of the things that's interesting about the midmarket and what we've been able to do there is kind of bringing CRM to the midmarket. We're not really replacing anybody there. You know, I don't think the play for us would be to go in and replace the big CRM incumbents. They -- it's a hard thing to do to replace your -- particularly if it's well integrated and implemented and everything, it's really hard to do. What we've been able to do in the midmarket is sort of democratize CRM, make it so that it's easy to use, it's affordable, and more and more midmarket companies are starting to roll out CRM. So, I think that's really what's happening in, particularly in the sales space. We're not really replacing anybody.

The way I see the sort of competitive landscape is there's a lot of competition above us, like battling it out there in the midmarket, and we run into those guys at the high end, and we run into those guys in our marketplace, you know, if they're looking for -- if it's a considered purchase of a marketing automation system or what-have-you, we see a lot of competition there. There's plenty -- there's competition below us that's really going after the sort of solopreneur or the very small shop with, you know, you start with your website and then maybe you add a few more features, or you start with email marketing and add a few more features. We don't really compete with them. We run into them a little bit when we have a starter product that has a relatively low price point. But in our target market I feel really good about our competitive position. Obviously, there's competition, but I feel like we're in really good shape there.

Stan Zlotsky: All right. Maybe I'll just throw out one more question. JD, you recently did a big \$300 million equity offering. What's the rationale for the raise? You obviously had a lot of cash on the balance sheet before. What are you hoping to do with the money?

JD Sherman: Yeah. So, we're a growth company, obviously. We've to date gotten basically 100% of our growth organically. We're a build-first company. We've gotten really good at building software. I actually think building software has actually gotten easier with a lot of the tools that are out there and everything, and we've gotten really good at it. We sort of built this purpose-built platform that allows us to do that, and I think we'll continue to be a build-first company. We have not -- you know, one growth vector that we have not been able to -- we haven't sort of cracked is doing some M&A, you know, some inorganic growth. I feel like we're at a point now as a company, both size-wise and maturity-wise, in terms of our ability to do that and execute on it, as well as technology-wise. Now we have a platform, you know, we could snap in some acquired technology to that platform, and I think that would work.

So, we want to be open to that opportunity. It's not something we're going out and rushing to do. We have some ideas, but, you know, not committing to any of those ideas. What we wanted to do was if the idea -- if the opportunity availed itself, we wanted to be able to do that. We felt like we're ready technology-wise, ready as a company, we want to be ready from a balancing standpoint as well.

Stan Zlotsky: Any hints as to where you guys might be looking to --

JD Sherman: I could tell you, but then you couldn't tell anybody else.

Stan Zlotsky: All right. Fair enough. Well, that's a great place for us to stop. JD, thank you so much again for your time today.

JD Sherman: My pleasure.