Atlassian Corporation Plc

Second Quarter Fiscal Year 2019 Earnings Conference Call

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Ted Lin, *Goldman Sachs*

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PRESENTATION

Operator:

Good afternoon, ladies and gentlemen. Thank you for joining Atlassian's earnings conference call for the second quarter of fiscal 2019. 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 Ian Lee, Atlassian's Head of Investor Relations.

Ian Lee:

Good afternoon, and welcome to Atlassian's Second Quarter Fiscal 2019 Earnings Conference Call. On the call today we have Atlassian's Co-Founders and CEOs, Scott Farquhar and Mike Cannon-Brookes, our Chief Financial Officer, James Beer, and our President, Jay Simons.

Earlier today we issued a press release and a shareholder letter with our financial results and commentary for our second quarter of fiscal 2019. These items were also posted on the Investor Relations section of Atlassian's website at investors.atlassian.com. On our IR website, there's also an accompanying presentation and data sheet available

We'll make some brief opening remarks and then spend the rest of the call on Q&A.

Statements made on this call include forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. 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. Further information on these and other factors that could affect the Company's financial results is included in filings we make with the Securities and Exchange Commission from time to time, including the section entitled Risk Factors in our most recent Form 20-F and quarterly report on Form 6-K.

In addition, during today's call we will discuss non-IFRS financial measures. These non-IFRS financial measures are in addition to and not as a substitute for or superior to measures of financial performance prepared in accordance with IFRS. There are a number of limitations related to the use of these non-IFRS financial measures versus their nearest IFRS equivalents and they may be different from non-IFRS and non-GAAP measures used by other companies. A reconciliation between IFRS and non-IFRS financial measures is available in our earnings release, our shareholder letter and in our updated investor data sheet on our IR website.

I will now turn the call over to Mike for his brief opening remarks before we move to Q&A.

Mike Cannon-Brookes:

Good day, everyone. Thanks for joining us today. Q2 was a beauty, a great way to cap off 2018, as we surpassed $1 billion in calendar year revenue for the first time. In Q2, we had $299 million in revenue, up 39% year-over-year. For the quarter, we also generated more than $122 million worth of free cash flow.

In October, we closed the acquisition of Opsgenie, a leader in incident alerting and on-call schedule management. We're tremendously excited to have them join the Atlassian family as we double down on IT teams this year. IT organizations big and small are becoming more service driven and agile-oriented, and as technology becomes the key ingredient for growth and survival of (inaudible) business, we're excited about the role we play in helping IT drive that transformation, and Opsgenie plays a key role in strengthening the service and response muscle for IT teams across the Fortune 500,000.

During Q2, we also acquired Butler for Trello, one of Trello's most popular integration. Butler gives Trello users the ability to work smarter and faster by bringing the power of workplace automation to their Trello boards. Individual users can shrink multiple steps into one, will have things like user assignments or status change based on triggers or rules that they set up themselves. It's a super power that we're excited to bring to the millions of daily Trello users.

I'm also excited to share that Jira Software recently surpassed 65,000 customers. This is more customers than the entire Company had when we went public just three years ago. Including Opsgenie, we ended Q2 with a total customer count of more than 138,000.

We've provided more detail on these announcements, along with many other updates, in our earnings release and shareholder letter that was issued earlier today.

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

Operator:

Thank you. We will now begin the question and answer session. To ask a question, you may press star, then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two. At this time, we'll pause momentarily to assemble our roster.

The first question comes from Bhavan Suri with William Blair. Please go ahead.

Bhavan Suri:

Hey, guys. Congratulations, that was a spectacular quarter, so great job there. I guess I just wanted to touch on a couple of quick things, just one question, but with two small parts. When you think about the quarter specifically, I'd love to understand sort of the impact pricing changes had in terms of pull-forward and sort of what the impact of that might have been, just some quantitative, and also quantitative commentary on sort of how that played out to the customer behavior you've seen in the past year, given the pricing increase, what they thought, shared, etc., and then the pull-forward. Thank you.

James Beer:

Thanks, Bhavan, for that question. The first thing that I'd really like to emphasize is that our key top line metric that we focus on to measure our business continues to be revenue, and that's because we are not like most traditional enterprise software companies, in that the significant majority of our business is made up of either monthly or annual subscriptions or annual maintenance contracts, and we expect this to be increasingly the case as our customers continue to choose our cloud and data center offerings.

To further emphasize this point, again, unlike many other software companies, multi-year deals are only a tiny fraction of our business, while pull-forward activity by our customers ahead of a server price increase drives really just a timing difference, rather than a change in the scale of our relationship with that customer. So, as a result, we very much believe that revenue is a better reflection of the underlying customer demand for our business when you consider our performance over time.

But, more specifically, to address your question around pull-forward activity, as we indicated on the call last quarter, we did see a significant volume of Q2 transactions coming in ahead of the server price increases taking effect, and this activity came in the form of both early annual renewals and multi-year renewals. So, this pull-forward activity, in essence, replaced what would otherwise have occurred in the second half of our current fiscal year, or the following two fiscal years, as well.

In terms of the part of your question around the customer behavior and so forth, again, as expected—and I must say I'm pleased by the overall reaction to the price increases that we've had from our customer base, and I think that's illustrative of the way we roll out price increased, we give lead time, and of course the companies, with those price increases are very significant improvements in the product. We're investing heavily in our product every month, and this comes through in terms of the value we create for our customers.

Bhavan Suri:

That's really helpful. Thanks, guys, I appreciate the color there. Thank you and congrats.

Operator:

The next question comes from Nicolay Beliov with Bank of America. Please go ahead.

Nikolay Beliov:

Hi, thanks for taking my questions, and congratulations on the results here. I have a pretty basic question for the team. You highlighted 65,000 Jira Software customers. Can you please remind us, Scott, roughly, the spread between Jira Core and Jira Software, and right now where do you think is the penetration of the potential market for Jira Software, are we in the second inning, the fourth inning? I just wanted to get your thinking (inaudible)?

Scott Farquhar:

Thanks for the question. It's Scott here. We don't break out Jira Core and Jira Software, but I think—you know, Jira Core is a relatively recent offering for us and it's still growing, so it would be safe to say that the majority of our revenue in the broader Jira family comes from Jira Software and Jira Service Desk, but still the majority is Jira Software.

What was your second question? It was around are we in the first, second, third or fourth innings. I think that's an American term. I think I'd have to translate that to like a cricket term. We're in the third day of the test, I guess. The way I think about it is the software market is growing incredibly fast. Every company is becoming a software company. So, the market itself is growing very fast. We are growing, continue to grow our customer base within that market incredibly well, and then we're also growing our share of wallet within our customer base as we do more things for them, such as Opsgenie, which we've talked about, the Jira Service Desk, and we also, as we start going adjacent into more IT Teams, we're seeing that as sort of a new market opportunity for us, as well. So, I feel very good about both the TAM and the relatively small penetration we have within that TAM today.

James Beer:

Just to add one point on to what Scott was saying there, the U.S. Bureau of Labor Statistics recently came out with some data estimating that the number of software developers in the world is going to be growing 24% annually through 2026, so a very interesting illustration of the future potential.

Nikolay Beliov:

Got it, and then a quick question for you. Long-term deferred revenue increased sequentially quite a bit. We haven't seen that in a while. What drove that and what do you think the forward trends will be in long-term DR over the next couple of quarters?

James Beer:

Yes, well, as you say, long-term deferred revenue sequentially was up around $14 million, and that certainly is a larger bump than we would usually see from one quarter to the next. That was very much driven by this pull-forward activity that I was referring to earlier, in particular, obviously, the multi-year part of that pull-forward activity, because the long-term deferred revenue represents activity that will be earned into revenue beyond 12 months from now.

Nikolay Beliov:

Thank you.

Operator:

The next question comes from Heather Bellini with Goldman Sachs. Please go ahead.

Ted Lin:

Hi, this is actually Ted Lin on for Heather. Thanks for taking my question and congrats on the strong quarter. I was wondering if you could just give us an update maybe on your overall philosophy on pricing. Historically, it seems like you've gotten a lot people in at a very low price to help improve willingness to pay, and so for a lot of your customer base it's pretty high value to cost products. So, how do you capture more of the value that your customers are getting longer term?

Jay Simons:

Yes, hey, this is Jay. So, I think you captured the philosophy in your question, that we believe in providing incredible product at the most affordable price. That's been consistent through the Company's history. We also believe in creating opportunities to land inside of customers, where we remove prices as part of the friction, and so in Opsgenie, you'll notice that in October, shortly after close, we lowered pricing, introduced a free plan. We are transparent with our pricing. So, across the spectrum of what customers can buy and how they grow with us, we basically share those price points, so they don't have to ask. That's effectively the philosophy.

Where we work to participate in greater share of wallet is in adding more capability and more premium features that support enterprises as they scale with us. We've done that in the context of the data center product family, which we've talked about as growing nicely and continues to grow. In the cloud, we've done that in the context of access, which is effectively a premium capability that supports stronger identity and security management for customers.

Ted Lin:

Great, thanks for the color, and I guess on the quarter, given the strong outperformance and the strong pull-forward that you saw, how should we think about kind of that impacting the shape of the seasonality of deferred revenue and billings kind of for the rest of the fiscal year? Thanks.

James Beer:

Well, I would just sort of reconfirm that that pull-forward activity would have come from both the second half, both quarters of the second half of this fiscal year, as well as the two subsequent fiscal years, fiscal ’20 and ’21. You’re right, by looking at that sequential path of both short-term and long-term deferred revenue, you can get something for a steer as to the balance of where that pull-forward activity came from.

Ted Lin:

Makes sense. Thanks for the color.

Operator:

The next question comes from Ittai Kidron with Oppenheimer. Please go ahead.

Ittai Kidron:

Thanks, and congrats, guys, great quarter. A couple questions for me. First of all, since you know how many people pulled in revenue, can you roughly tell us what was billing growth without this pull-in effect? Then, the second question, more on the competitive front, now that GitHub is part of Microsoft—you haven’t talked much in your prepared remarks about BitBucket, but can you tell us if anything is changing competitively, how’s momentum in that business, is anything changing out there in the marketplace?

James Beer:

Yes, just briefly to the first point, I’d just sort of re-emphasize our focus on revenue as the top line metric that we try to really understand the underlying relationship with our customers over time. Scott, are you going to take the second one?

Scott Farquhar:

Yes, on Github’s acquisition from Microsoft, we haven’t seen any material change this quarter in the competitive market. We believe what we said previously, which is that Microsoft’s primary goal in acquiring GitHub was to get more of their developers into Azure, and that’s what we continue to see to be the Microsoft focus. So, there’s no real change in the last quarter on that front, even with the changes in how they price GitHub.

Ittai Kidron:

Very good.

Operator:

The next question comes from Keith Weiss with Morgan Stanley. Please go ahead.

Keith Weiss:

Thanks a lot, and thank you, guys, for taking the question, and a very nice quarter, indeed. I was hoping to sneak in two questions, one on Opsgenie and kind of the competitive environment that you see out there, where kind of like the combined offering that you guys are bringing to market is going to sort of be able to gain some competitive advantage; and then on—maybe one for James on the operating margin side of the equation. Also, a really impressive quarter for operating margins, you saw some real nice year-on-year improvement. The guidance doesn’t have that, the guidance is a kind of more muted on year-on-year compare in terms of operating margins. Can you talk to us a little bit about sort of where those areas in investment are and sort of why, on a year-on-year basis, it would be a so much lower kind of improvement on operating margins in Q3 versus Q2?

Scott Farquhar:

It's Scott here, I'll take the question about the opportunity and the competitive market. We feel incredibly bullish and excited about the market for incident management. For those of you who are sort of new to the story, as developers move their workloads to the cloud and as companies become more like a software company, developers are increasingly being on call. They're responsible for making sure that their code stands up through production and performance, and when it's not, then companies need a way sort of alerting their developers and co-ordinating responses, and those responses could be around downtime, they could be around security incidents. All these things are involved when you're running a code at scale in the cloud, and Opsgenie is a response and plays in that site, and we feel really very bullish about that. We have Opsgenie that does the incident alerting part, we have Jira which handles a lot of the tasks before and after, and we know Jira is the way that work gets done in organizations, and so putting those two things together is very powerful, and we also have StatusPage, which is the leading provider of—StatusPage is on the web to communicate with your customers if you're having downtime. So, when customers have problems, they want to know if there's something up with the provider, and we use StatusPage for that. So, the combination of those three products is, in my opinion, unmatched out there in the market and we're really bullish about bringing those together.

Keith Weiss:

Excellent, thank you.

James Beer:

Keith, on the margin side of things, let me handle that. In Q2, obviously, we did see a strong operating margin, really driven by some nice performance on the revenue line, and then on the spending side of things, both in the cost of goods sold, we saw some nice benefits there as we continue to work on the efficiency and effectiveness of our hosting expenditures, and on the operating expense side, I'd point to some timing issues around the arrival of additional headcount, and also some lesser than expected spending around certain professional services. So, all of that combined to drive the Q2 result.

As you note, we are expecting margins to be lower in the back half of the year, and so as we think about the Q3 story, there are a few different things driving that. First of all, Q3 is when we issue additional salary increases to our team, and so that begins to kick in, and also Q3 represents the calendar year, obviously, and therefore the payroll tax reset associated with our employee expenditures.

In addition to that, as we talked about on the last call, we've really been putting effort and investment into our hiring engine, if you will, and we're pleased with the progress that we're making in that regard. So, while we increased our employee count substantially in Q2, I would expect—obviously about half of that was driven by Opsgenie—I would expect the organic level of headcount to continue to increase in Q3, as we particularly invest in our R&D-centric model. Within the R&D area, we see a lot of different opportunities, obviously, right across our business, but I would particularly point to our cloud products as a whole, to our work on our cloud platform, which you can think of really as us developing common componentry that we'll utilize across the different cloud services. Of course, this will allow us to build cloud services more efficiently and more quickly, as well as helping us adjust our ability—improve our ability to deal with larger deployment sizes, while continuing to enhance our security and privacy, compliance requirements, that sort of thing. We've talked a lot about the IT market opportunities, so we'll be particularly investing there. I'd call out Opsgenie as one clear example in that arena. Then, I'd also point to the data center offerings for our on-premise customers. We've been very pleased with the growth rate in recent quarters there and I would expect that to continue into the future.

Keith Weiss:

Excellent. Thank you, guys.

Operator:

The next question comes from Richard Davis with DG Financial. Please go ahead.

Richard Davis:

Okay, thanks. C.G., but that's okay. I think it was like 85% of your new customers came on as cloud subscribers. Is there any difference in lifetime customer value for cloud customers versus on-premise? I'm sure there's a different shape in the profitability, but I've just always wondered about that. Thanks.

Jay Simons:

Hey, Richard, this is Jay. Not materially. I think, as we've mentioned before, cloud is a little more expensive than server. We also have the ability to operate cloud a little differently than we can in serve, because we have kind of visibility into how the product is being used and we have kind of different avenues that we can leverage for cross-sell and expansion and kind of connecting to the customer kind of in-product to open up different paths and avenues for cross-selling other products. But, from a lifetime value, I think they're pretty comparable, and that speaks to the strength. I think that the products provide themselves in the value they provide to customers.

Richard Davis:

Great, thanks.

Mike Cannon-Brookes:

Richard, this is Mike. When Jay says the customer lifetime value is comparable, he means on a customer potential basis. We tend to calculate, for example, if someone is a 50-person company, you know, going wall-to-wall in that company, we can sell 50 seats; if someone is a 50,000-person company, we can potentially sell 50,000 seats. So, for the size of the company, our potential return or lifetime value is equivalent. Generally, the larger the company, the less likely they are to choose cloud today, but obviously that's changing on a timescale basis, if that makes sense.

Richard Davis:

No, that's super-helpful. Thanks very much.

Operator:

The next question comes from John DiFucci with Jefferies. Please go ahead.

Zach Lountzis:

Hey, guys, this is Zach Lountzis for John. Could you talk a little bit about the Stride partnership, how it's going, the transitions from Stride and HipChat, and then any changes there competitively with Microsoft or anyone else?

Mike Cannon-Brookes:

Yes, hi, Zach. I can talk to that—it's Mike—sure. Look, it's going—I'd say the partnership is going very, very well. We have a great relationship there. We continue to work together and build out features and functions that help our joint customers across our product portfolios to have the best experience that they can. We continue to move through the transition and migration period for HipChat and Stride customers. Again, there's about a month and a bit left of that, so we continue to work with big and small customers to help them migrate and to get into that future world. I don't know if we have anything else to call out on the go-to-market side there, but it's been going pretty well so far.

Zach Lountzis:

Okay, thank you very much, and then, James, if I could. You guys raised that convert a few quarters ago for $800 million, or something, in net cash today. I was wondering how you guys think about the positioning there going forward, any additional raises that you might be looking to make, and what the ideal balance is, really?

James Beer:

Yes, I think the converts, as well as our ongoing free cash flow generation, provides us with substantial financial flexibility, so we're very pleased by that, given the scale of the market opportunity that we have in front of us. So, obviously, we're very pleased with, in particular, the continued progression of our cash flow results.

Zach Lountzis:

Okay, great, thank you. Thank you, guys, very much.

Operator:

The next question comes from Michael Turits with Raymond James. Please go ahead.

Michael Turits:

Hey, guys, good evening. Good quarter. On the upside on the billings, how much of it was, in addition to pull-forwards, may have been (inaudible). Was there any particular shift to more data center and multi-year contracts either on data center or on maintenance?

James Beer:

Yes, Michael, I wouldn't point to anything in particular, other than what I've already commented on already. Remember that the price increases really applied to our server business, we did not increase prices on the data center business, so it was really much more that part of the overall platform that we offer that was driving the pull-forward.

Michael Turits:

Got it, and then also a strong quarter on the other line, which includes marketplace. Anything that suggests any particular inflection there?

James Beer:

Yes, we were very pleased with the marketplace performance, as we have been now for a number of quarters. One additional accounting element, in terms of a technical issue, is the pull-forward activity related to our customers buying marketplace apps, our portion of those purchases dropped straight into revenue in the quarter that they occurred, since we've already satisfied any conditions that we need to be able to execute on at that point.

Michael Turits:

Okay, thanks very much.

Operator:

The next question comes from Rishi Jaluria with D.A. Davidson. Please go ahead.

Rishi Jaluria:

Thanks. Hi, guys, thanks for taking my questions, two quick ones. First, just the stat you gave around cloud customers—that's definitely really impressive, it's nearly 75% of total customers—can you just give us a sense for how this number has either directionally trended over time and where do you think it'll end up over time, especially given that 85% of net new customers were cloud customers, and then I've got a follow-up?

Mike Cannon-Brookes:

Look, I can answer that. I mean, directionally, it's clear in the numbers. As we've said, it's more than 85% of new customers coming into the cloud. I would say we expect that to continue to trend upwards as companies increasingly—fundamentally, the cloud can provide a better offering than I think most companies can run themselves, right? It can be more secure, it can be faster. It takes away the operational management hurdles, you don't have to upgrade it. So, there's inherent obvious advantages in the cloud. I believe this is going to be a decade-long transition and the majority, the vast majority of software will be run in the cloud. We're seeing 85% plus of new customers coming in choosing that. It's logical that our overall customer base would trend to that, and then continue to trend up, as that's the case. At the same time, we don't force migrate customers, it should be very clear we are pro-customer choice, and there's a significant number of companies for whom that's not their choice. That is a distinct advantage of us (inaudible) over a pure cloud vender, is that we can provide a better, more holistic offering as companies go through that transition internally over the next decade.

Rishi Jaluria:

Got it, thanks, that's helpful, and then one follow-up for James on the gross margin guidance. I guess just how should we be thinking about why implied Q4 gross margins should be dropping from where they are, and then with the AWS migrations being done, what should the longer impact on gross margins be? Thanks.

James Beer:

Yes. So, in the back half of this fiscal year, we'll continue to be investing in some of the data center infrastructure in Asia-Pacific, in particular, so that will drive some additional COGS for us. Over the longer term, obviously, as Mike was just pointing out, we would expect cloud to continue to steadily grow as an overall proportion of the business, and we know cloud comes with lower gross margins than the behind the firewall platform offerings that we have, because obviously we're doing the hosting work, whereas behind the firewall, our customer is paying for that activity.

Rishi Jaluria:

Okay, got it. Thank you.

Operator:

The next question comes from Keith Bachman with BMO Capital Markets. Please go ahead.

Keith Bachman:

Hi, thank you very much for taking the questions. I had two quickies and a longer term question, but was there any organic help, or was the inorganic help in any way material in the quarter you just reported? In addition, Europe looked like it had some strength there. Was there anything that you wanted to call out in Europe as being unusual, or what was the driver of strength? Then, I'll wait to ask my follow-up. Thanks.

James Beer:

Yes. So, in terms of inorganic activity, we closed the Opsgenie transaction at the start of the quarter, and when we announced that transaction, we indicated that it would drive around a point of revenue growth for us during fiscal '19. That would be the only factor. We would have got a full quarter effect of Opsgenie on the revenue side there.

In Europe, what I would point to there is that our channel is a very important component of our distribution generally, and, indeed, around half of our channel partners are in Europe, so it's a particularly important part of our European distribution business. Those channel partners in Europe, in particular, worked effectively with our customers around some of the pull-forward activity that we spoke of earlier, and some of that activity—I mentioned the marketplace activity earlier on—does drop immediately in the quarter to revenue. So, that would have also benefited that EMEA growth rate that you see.

Keith Bachman:

Okay, fair enough. Then, the question I wanted to ask, again, directional and philosophical, is when you're thinking about your revenue growth profile, there's a few things that impact it, one is prices, the other is mix, but I'm also just trying to understand how we should be thinking about subscriber growth as being a driver of future revenue growth, and is there any kind of metrics that we should be thinking about, is it the key driver of your growth going forward, or just any kind of categorization of how that impacts the top line? Thanks.

Mike Cannon-Brookes:

Yes, I can talk about that, I guess, philosophically. Look, we've been very clear that we have a lot of different growth vectors in our quite unique business, and that's a constant challenge, intellectual challenge for us to manage between the different leaders, but I think we've done—we've got a history of a pretty good job so far. When we talk about that, obviously, you get the headline customer number, which was past 138,000, which is a great number, but that only means that that is a singular domain, and think of it as a singular company that's become a lifetime customer. They then have a lot of different ways to grow. As you've seen us over time build out the portfolio, as we add more products, there are more things that that particular customer can buy.

Secondly, obviously, the customer, themselves, can grow inside the product that they're already in. So, as they land in Jira Software, they land in Trello, they land in Confluence, they can just literally add more of their company to that. So, if they've got 10,000 employees, they might start with a 50-person team somewhere, and our job is to continue to deliver value to them over time, so that they will grow into a 100-person customer for us, then a 1,000-person, and hopefully to a 10,000-person customer. That's just within our stable.

The other thing, obviously, is things like the marketplace, which has been called out a couple times on the call, which is an ability for that customer to grow outside of things that Atlassian builds, and we provide the platform for that to connect those vendors and the great ecosystem we have with those customers in a transactional way.

Then, lastly, you've seen us, obviously, judiciously exercise our acquisition model over time as another way for the business to grow.

The headline customer number, 138,000, is a very good one, but we have a lot of ways to grow those customers within that number.

Keith Bachman:

Okay, all right, thanks very much. Good luck.

Operator:

The next question comes from Jonathan Kees with Summit. Please go ahead.

Jonathan Kees:

Great. Thanks for taking my questions. Hey, guys, it was, indeed, a ripper of a quarter, and that's impressive given the gloom and doom you see in the headlines, you read in the headlines, in the news. I guess my question is more what concerns you in terms of the macro issues, or are you not seeing much. I would think you at least encounter stuff like the government shutdown. You do have exposure to the government, the federal business. There are indications of an IT slowdown, and that would impact software. You obviously don't manufacture stuff in China, so that doesn't impact you. But, in general, what are the macro issues that you are seeing that concern you?

James Beer:

Yes, Jonathan, I'll take that one. We aren't seeing anything specific in terms of macro weakness. As you point out, our exposure to China is really immaterial. While we certainly wouldn't say that we're immune to a recession, we also believe that, as was quoted back around the IPO time, that our business is very much built for stormy weather. So, the Company has been able to very nicely weather the last two recessions. I think our low-cost, high-value model is a big driver of that. Another thing to consider, of course, is that the way we distribute our product, it's really chosen by the end users, rather than sold top-down and pushed onto those users, and so feel good about the business model's ability to withstand a dip economically.

Jonathan Kees:

Okay, all right, that's helpful. If I can ask one other question? You've mentioned, James, that obviously margins are going to be going down in the second half, specifically, operating margins. Sales and marketing ticked up substantially on a sequential basis there, and actually over the last several quarters. Is this going to be the new norm? I know that in the past you've talked about initiatives to try to promote Trello, focus on that first, launch across the world and then focus on monetization later. Are we talking about we're going to be seeing increased levels of sales and marketing going forward even beyond second half?

James Beer:

On the call last quarter, we spoke about the fact that we were going to enter into a specific marketing campaign around Opsgenie in combination with, as Jay was discussing earlier, the price reductions that we rolled out into the marketplace, and you may have seen some of that activity around the country. So, that was a big focus of Q2. I would say that we do have some plans for the balance of this year to continue to push on that IT market opportunity. The other thing that I would point to is Jira Software Cloud was relaunched just back in October and Jay and his team have been putting considerable marketing effort behind that, as well. I wouldn't necessarily draw a long-term trend around the current level of activity in the sales and marketing arena, but we're very pleased with the investments that we've been making there and expect to make for the balance of this fiscal year.

Jonathan Kees:

Okay, great, that helps, thanks a lot. Congrats, guys.

Operator:

The next question comes from Derrick Wood with Cowen & Company. Please go ahead.

Derrick Wood:

Great. Thanks for taking my questions. I guess, on that comment, the relaunch of the Jira Software Cloud and the increase in the user scale capabilities with Jira and Confluence, I'm curious, are you seeing increased interest from your on-premise base looking to migrate to the cloud, or you generally see kind of the cloud versus the data center base swimming in two different lanes?

Jay Simons:

Hey, Derrick, I'll take that. Migration between server, from server to cloud, you know, has been kind of ongoing, as different segments to the market, to the point that Mike made earlier, move to cloud for all of the advantages that Mike described. We also kind of open the aperture on cloud to support larger companies, where we moved kind of—as you noted, the user limit increase from 2,000 to 5,000 for Jira Software and Confluence. As we do that, it'll open up the opportunity for larger customers to move. The data center business continues to grow for companies that, for reasons of their choosing, want to remain on server, but run our products at scale to support thousands to tens of thousands of users. So, I think the way we think about server and cloud still is celebrating the choice of a customer to run the product where it best fits them, but provide incredible value in both server and cloud to support where they want to go and where they want to move to.

Derrick Wood:

Great, thanks, and then can you give us some color on what the reaction has been from your install base on the Opsgenie acquisition, and I guess, given the price reduction, are you already starting to see transaction volume move significantly higher, or is there some time needed to digest the offering?

Scott Farquhar:

Derrick, we've been—it's Scott here—we've been very pleased with the response to all the things we've done. We've acquired Opsgenie, we've rebranded it, we've changed pricing, we've put advertising dollars behind it, we've improved integration to the rest of our products, so, we've been happy with all the results that have come from all those things. We do have examples of many people in the base who have moved from competitive products to Opsgenie purely on the basis of our acquisition and knowing that the increased integrations will come over time, so we're already seeing some of that earlier on. So, overall, we're very happy with how that's working out.

Derrick Wood:

Great, thank you.

Operator:

The next question comes from Jack Andrews with Needham & Company. Please go ahead.

Khanh Ngo:

Hi, gentlemen. It's Khanh Ngo filling for in for Jack today. Congrats on the great quarter. It seems that a majority of the IT first responders are still relying on legacy tools, like Excel, to manage their loading system, so what gets IT users to shift behavior to next-gen tools, like Opsgenie, and how far away are we from seeing like a critical mass of users rely on software to automate their loading processes?

Scott Farquhar:

I'll take that again. It's Scott here. Look, you know, we've experienced this over a long time, you know. The majority of people 10 years ago were using spreadsheets to manage their software development process, too, and as people have to move at a faster pace and as people have to be more collaborative, we see the shift to tools dedicated to this purpose. We are seeing that today with IT first responders. There's a large number out there. If you have to be quicker in response, as you have to run more cloud services, and increasingly you become more of a software company, producing software for your customers, those things need to change. So, I would say there's two areas of this. One area is still moving from spreadsheets. I would say there's a huge opportunity also from people that aren't first responders today. Many corporate ITs, they don't make change very often, only once a quarter or once a year. Internally, it's a very convoluted release process, (inaudible) cloud. As a result, when things don't' change, they break less frequently, but we all know that these days the pace of change in the environment is increasing, people are using cloud products, and so whether you're internal IT teams or you're producing software for your customers, that pace of change means that you're releasing more often, you're going to have more downtime, and all those things drive the need for products, like Opsgenie, to help responders. So, there's lots of different areas that are going to be growth opportunities here, even for people that aren't using spreadsheets today.

Khanh Ngo:

Okay, that makes sense, and as the features and integration between Jira Ops and Opsgenie kind of converge, how does the messaging around IT change? Do you guys go to trying to sell more of a platform solution, kind of emphasizing the synergies that having multiple products brings to the IT user?

Scott Farquhar:

Yes, that's a really great question. We've been known for 15 years now as being amazing for software teams and providing all the proactive software teams' need to get their job done, from Confluence that handles requirements and documentation all the way through, and over time we've seen IT teams start adopting those products, as well, particularly in the software area of the business, but also they use Jira Service Desk across their, you know, help desk environment, they'll use Confluence, Jira Software. So, we've had a deep presence in IT for a long time, but what we're seeing now is as we provide more of the solution, we're becoming more of a trusted vendor at a high level of the organization, you know, CEOs and down, so we're now also acting as a trusted vendor to provide most, if not all, of what they need in their IT teams. But, that's the sort of market shift that we're seeing at the moment.

Khanh Ngo:

Okay, great. Thanks, guys.

Operator:

Again, if you have a question, please press star, then one. The next question comes from Patrick Walravens with JMP Securities. Please go ahead.

Patrick Walravens:

Oh, great, thank you, and congratulations. Can I step back and ask how you guys think about when you should build it yourself and when you should buy it, and maybe you can use Opsgenie as an example?

Scott Farquhar:

I'll take that one. It's Scott here. We have a strong bias to building things. We have a long history of building and bringing products to market. We brought Bitbucket Server to market, we brought Confluence, Jira, Jira Service Desk, Jira Ops. There's a lot of products we bring to market. But, that's our strong preference. Beyond that, if there's a time-to-market aspect, it's really the reason we're able to bring something in there, we want to move faster if there's an existing product out there. We also have a very strong marketplace. Where there's an existing solution in the marketplace, where we believe it's something core to our customers, we lean towards acquiring something from the marketplace, rather than trying to compete with them. So, we sort of have a preference there to make things, you know, rather than competing with our marketplace. (Inaudible), yes, if there's a time-to-market area, we will look to acquire something.

On the acquisition side, we've got a very strong track record of success there in terms of products and making sure that they're successful inside the organization, and that comes from our strong bias on acquiring companies that have a strong cultural fit with Atlassian, a strong business model fit, in terms of bringing a high-volume, low-price products, and also having a fit with our customer base. Opsgenie, specifically, that fits very strong in all three of those, great cultural fit, perfect business model alignment, and fits right into the customer base and the next thing they need to buy.

Patrick Walravens:

Great, thank you, and do you guys have—are there still major gaps sort of functionally for IT ops, or do you have most of what you need now?

Scott Farquhar:

I'd say there's a—it's an interesting question. I'd say we provide a huge amount of what IT do today. If I think internally the areas we're focused on, one is that we're changing that perception, so people do turn to us and look to stable products and see what we already have to serve them, but we are still building and investing. We have a huge R&D investment to tackle the areas we don't have at the moment, and some of those are very small adjacencies, you know, on top of the platforms we already got. With Jira, you know, Jira is an incredible platform and Jira handles a lot of workflow, and often it's the case of just targeting specific workflows in IT on top of the platform that we've already built.

Patrick Walravens:

Okay, great. Thank you.

Operator:

This concludes our question and answer session. I would like to turn the conference back over to the Management Team for any closing remarks.

Mike Cannon-Brookes:

Thanks, everyone, for joining the call today, we appreciate the time, and look forward to keeping you updated on our progress. Thanks a lot.

Operator:

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.