Prepared Remarks
Stewart Butterfield, Chairman, Chief Executive Officer and Co-Founder

Thank you everyone for joining.

I want to highlight three key areas of continued execution against our highest priorities, those which you heard me talk about on the last two calls, along with comments on macro-related headwinds we are seeing in the installed base and what we are doing about it.

I'll discuss Slack Connect, where we're seeing the emergence of a genuine network effect which is already impacting new customer acquisition, along with the continued success of our enterprise business as highlighted through recent customer wins.

But let me start with what I'm *most* excited about and that's accelerating growth in new paid customers. This is the fundamental driver of the entire business, from compounding expansion on the self-serve side to the most valuable source of enterprise pipeline. Net new paid customer adds grew at a faster rate in June and July compared to April and May. That trend continued in August, even after the typical vacation-related slowdown for the month, indicating that paid customer additions are potentially finding a new baseline rate.

We attribute part of the uptick to the "work from home"-driven increase in the importance of the category, but we believe an even bigger portion of the impact comes from incremental product drivers. Those are, *first*, continued improvements to the self-serve experience for new team creators and joiners, leading to more successful teams, *second*, improvements to paid conversion driven primarily by new trial offers and, *third*, the emergence of inter-company collaboration as a new path into the product via Slack Connect.

The core product experience improves every quarter, with a particular emphasis on simplifying and removing friction from the process of creating or joining a new team. Our focus in this area has delivered results. Small changes create minor compounding tailwinds. We continue to invest here and expect Slack to get better and more obvious for new teams each quarter, driving increased yield from our self-service funnel.

It's worth noting that the full impact of this growth will show up over time: historically it has taken new cohorts of paid teams several years to hit their peak revenue contribution. We expect the strength you saw in Q2 to materialize in a more pronounced way at the end of this year and into the next.

Moving on, a quick update on Slack Connect: I mentioned it earlier as a driver of new paid customer acquisition, but we also believe it serves as a key product differentiator and an important factor in retention. Connect provides a very rare combination in Enterprise software: a giant leap forward in both end user experience *and* security and compliance. Whereas so often customers are asked to trade one off for the other, we can provide both.

In June, after an extensive open beta period, we officially launched Slack Connect and released "multi-org shared channels," which allows up to 20 organizations to share a single channel. This enabled a large number of new use cases and uptake was rapid. Marketing support and ongoing product improvements have added even more fuel to the fire.

We measure network adoption by the number of "Connected Endpoints" in the graph and, as the number of endpoints has increased, growth has accelerated: from 140% year on year growth in Q4, to 160% in Q1, and to over 200% in Q2.

Many of the endpoints are on teams that had not previously upgraded to a paid plan or even teams that are brand new to Slack. To encourage adoption and virality, in late March we introduced 90-day trials for teams that are invited by a paid customer, making the connection experience seamless. Those trials started to expire in late June and in just six weeks contributed over a *thousand* new paid customers, out of the 8,000 total paid customers added in the quarter. Trial starts are increasing as the network grows, so we expect Slack Connect's contribution to paid customer growth to increase substantially in the second half. We further expect that trend to continue, especially as we drive increased utilization inside enterprises with the launch of compliance and security features, such as author-aware encryption key management in shared channels.

This product-driven growth is very encouraging, providing us with a scalable way to sustain customer growth. Our pace of execution on the product side is accelerating; the new user experience is going to improve further and in the second half we'll announce a number of new features for Slack Connect. Stay tuned for more updates at Slack Frontiers, our user conference, on October 7-8.

Our continuing product leadership with features like Connect, our extensible platform and workflow integrations, and our significant architectural and scalability advantages, are all propelling growth in the enterprise segment. We added 17 new million dollar customers in the first half, ending Q2 with 87, up 78% year-on-year. New and expansion deals this quarter included Sony Network Communications, Shopify, IRIS Ohiyama, Kindai University, Peloton, LPL Financial, NTT Data Corporation and Al-nye-lum Pharmaceuticals.

Across industries, our value proposition is resonating with market leaders and companies at the forefront of digital transformation. For example, 4 of the 6 largest North American telecommunication providers are now million dollar customers on Slack. This echoes the pattern we see across many other industries where the market leader chooses Slack.

We are also achieving significant depth of adoption within verticals such as financial services. For example, HSBC doubled its investment. HSBC is one of the largest banking and financial services institutions in the world, serving millions of customers. The shift to remote work has accelerated HSBC's Slack adoption, providing them with a secure platform to drive internal alignment and deliver innovative solutions for their customers.

Northwestern Mutual ranks No. 111 on the Fortune 500 and offers life insurance, disability insurance, long-term care insurance, and financial advising services across the US. After an extensive evaluation of Slack against competing products, Northwestern Mutual chose Slack as its preferred collaboration tool. With Slack as an enterprise-wide tool, Northwestern Mutual plans to streamline their processes for innovation and meeting clients' financial needs.

Leading life, accident, and health insurer throughout the Americas, Pan-American Life Insurance Group, chose Slack and accelerated its adoption when employees were transitioned to remote work. Slack was able to meet Pan American's high standards of security and compliance, streamline communications with vendors and partners and maximize their technology investments. Pan American found Slack to be the best tool to bring its 2,000 plus employees together.

Also of note this quarter, the successful completion of the largest initial deployment of Slack ever to over 450,000 users.

We continue to deliver on our company priorities outlined at the beginning of the year: accelerate paid customer growth, grow the network, and win in the enterprise. I'm proud of our ability to execute, especially against the backdrop of a complex set of changes in the environment.

As I mentioned earlier, in Q2 we felt some macro-related headwinds in the installed base. We price on a per-seat basis and when our customers downsize, freeze hiring, or hire more slowly, net dollar retention is negatively impacted. That impact is direct, and because of our fair billing policies and the substantial number of smaller customers on monthly plans, it shows up much more quickly than it would for others in our industry.

On the Enterprise side there is also more budget scrutiny, especially for new categories with longer adoption curves. Even when leaders understand the deep impact that Slack can have for them, the urgency of the moment favors short term solutions that solve immediate problems. CIOs have a lot on their plates right now.

The pandemic has obviously had both positive and negative effects on our business. We believe the positive changes will have greater impact and will persist as part of a permanent structural shift in the way we work, on the other hand the negative effects will dissipate as we emerge from the pandemic and related economic uncertainty.

In the meantime, we have rapidly adapted our go-to-market tactics to the current environment, leaning into our product leadership as well as ROI-based, use-case specific selling and marketing oriented around distributed/remote work. We are also investing in CIO-outreach and using Slack Connect as a lever to drive broader deployment discussions. As IT departments begin their return to longer term strategic priorities, we see these messages resonating.

These sales efforts are complemented with new trial programs and new distribution partnerships, including the recently announced deepening of our partnership with Atlassian. Historically, where we focus we see results and this is certainly an area of focus.

To wrap up, I want to reiterate that the core driver of long-term growth, paid customer additions, accelerated meaningfully in the first half. We believe there are drivers in place that will sustain this momentum, including our rapidly growing network for intercompany collaboration, Slack Connect, which is accelerating as it scales.

Finally, I'd like to welcome the Rimeto team to the Slack family. The completion of the acquisition this quarter sets us up for some exciting future opportunities, especially for Slack Connect and the platform. We see huge potential in reimagining the enterprise directory and look forward to sharing updates on future calls.

With that, I'll turn it over to Allen.

Prepared Remarks
Allen Shim, Chief Financial Officer

Thank you Stewart, and thanks again to everyone for joining us.

I will go through our fiscal second quarter results, then discuss in more detail the impact from the COVID-19 pandemic on new customer and existing customer business and close with guidance for the third quarter and full year fiscal '21.

Total revenues in the second quarter were $216 million, growing 49% year-over-year.

Calculated billings were $218 million, growing 25% year-over-year. As discussed last quarter, to support distressed customers, we have continued to offer credits, installment billing and billing durations of less than one year. In Q2, calculated billings were impacted by approximately $4 million of COVID-related concessions and contract duration related headwinds. This brings the total concessions-related billings headwind in the first half to approximately $11 million.

Although we've seen a slowdown in concession requests over the past couple of months, it's still not possible to forecast the effects of the pandemic on our customer base over the next few quarters. We plan to continue to help customers manage through this unique time and expect calculated billings to be negatively impacted and less useful as a measure of underlying growth during the COVID-19 crisis.

Trailing twelve month calculated billings were $865 million and grew 38% year-over-year.

Remaining performance obligations were $388 million up 80% year-over-year.

Net dollar retention was 125%, versus 132% in Q1.

We ended the quarter with 985 customers with more than $100k in annual recurring revenue, up 37% year-over-year. We also ended the quarter with 87 customers with more than $1 million in annual recurring revenue, up 78% year-over-year.

We continued to show improved operating leverage in the quarter, with non-GAAP operating margins at negative 3% and free cash flow of $11 million.

I'll now provide more detail on the business with a focus on what we are seeing from new customer growth and what we are seeing in our existing customer base.

We continue to see healthy growth in Paid Customers. As of the end of Q2 we surpassed 130,000 Paid Customers, up 30% year-over-year and representing an addition of over 8,000 Paid Customers quarter-over-quarter, up substantially from the 5,000 Paid Customers added in the second quarter of fiscal '20.

The shape of Paid Customer additions in the quarter was encouraging, with June and July accelerating versus April and May. This acceleration continued in August.

While some of the acceleration in Paid Customer growth this quarter is likely due to work-from-home, growth is also due to some emerging product-related drivers that we believe will be more sustainable as the work-from-home tailwind normalizes.

First, in late June we started to see the results of the 90-day Slack Connect trials we launched in Q1. These trial conversions contributed significantly to paid customer growth in the last month of the quarter. Connect provides us with another driver of adoption, as our existing customers are starting to pull their vendors, partners, and customers into Slack for inter-company collaboration.

We have historically had two funnels for our business: the self-service funnel and the direct sales funnel. With Slack Connect, a third funnel is emerging and as Connect grows, we expect its contribution to paid customers to also grow.

Second, as we have discussed on the last two calls, we have been very focused on the self-service funnel and the new user experience. We are making significant progress here and that is driving better conversion rates.

Re-accelerating paid customer growth has been our biggest focus this year, as customer growth feeds the business over the longer-term. We are very encouraged by the progress observed in the first half notwithstanding the COVID impact.

Due to this progress, we expect paid customer additions in the second half of this year to exceed additions in the second half of fiscal '20.

I'll now provide some additional color on what we are seeing in the base of existing customers.

As discussed last quarter, our customer base looks a lot like the broader economy, with representation from businesses of all sizes, in nearly all geographies, and all verticals. We estimate less than 20% of our business is from industries most directly impacted by the COVID-19 pandemic. While these represent a minority of our business, these higher risk industries grew significantly slower in the first half versus non-impacted industries. We also price on a per seat basis and many of our customers are on a pricing model tied to usage with Fair Billing, so recessionary dynamics such as reductions in force, hiring freezes, and slower hiring are direct and immediate headwinds to growth within our installed base.

In the midst of those headwinds, customer retention remains very healthy, with retention for customers spending greater than $100k annually remaining flat in the mid-to-high 90s. Retention for customers spending between $1k and $100k was in the low 90s, and moved downward slightly. Engagement also remains very high. Customer churn has also largely stabilized over the last couple of months.

On the other hand, $100k customer contraction provides a good example of how headwinds like headcount reductions in our customer base impact metrics. In Q2, we had 50 customers move from the $100k to $150k bucket to the $50k to $100k bucket. This compares to only 10 in the second quarter of fiscal '20.

Net dollar retention was similarly impacted. Contraction was approximately three percentage points above normal in Q2. Some of the contraction in Q2 was due to what might be described as a hangover effect from the Q1 surge. In Q2, growth in many of our customers contracted or flattened versus normal seasonal trends. In August, growth began to trend at more typical seasonal levels.

In general there is more budget scrutiny, particularly for incremental investments, and we have seen sales cycles lengthen with some customers accordingly. This is particularly true in the Americas region. Close rates in geographies less impacted by COVID are similar to pre-COVID levels.

I'll now provide some direction on modeling Q3 calculated billings. As discussed, many of the headwinds we have observed in Q2 have stabilized and some parts of our business are beginning to accelerate. At the same time, the macroeconomic environment has created more uncertainty for our customers. Given this backdrop, we expect similar quarter-over-quarter percentage growth from Q2 to Q3 as we observed in fiscal 20.

Now, onto guidance.

For the third quarter we expect revenue in a range of $222 million to $225 million representing year-over-year growth of 32% at the midpoint.

We expect non-GAAP operating loss in a range of negative $27 million to negative $23 million driven by higher investments in our R&D and sales organizations.

We expect non-GAAP EPS in a range of negative $0.06 to negative $0.05. We are modeling Q3 basic shares outstanding of approximately 571 million.

For the full year, we are raising our revenue guidance to a range of $870 million to $876 million, representing growth of 38% at the midpoint.

We expect full year non-GAAP operating loss guidance in a range of negative $75 million to negative $70 million.

We expect full year non-GAAP EPS in a range of negative $0.14 to negative $0.13 We are modeling full year weighted average basic shares outstanding of approximately 567 million.

Finally, we continue to make substantial progress on our growth phase leverage targets and now expect to be free cash flow breakeven for the year.

With that, I'll turn it over to the operator for questions.