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CA - Q3 2017 CA Inc Earnings Call

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OVERVIEW:

Co. reported 3Q17 total revenues of $1.007b and GAAP diluted EPS of $0.50. Expects 2017 reported revenue to be $4.01-4.03b, reported GAAP EPS to be $1.80-1.85 and non-GAAP EPS to be $2.42-2.47.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CA Technologies 3Q 2017 earnings conference call.

(Operator Instructions)

I would now like to turn the call over to Traci Tsuchiguchi, Vice President, Investor Relations. Please go ahead.

Traci Tsuchiguchi - *CA Technologies - VP of IR*

Thank you, and good afternoon, everyone. Welcome to CA Technologies' third-quarter 2017 earnings call.

Joining me today are Mike Gregoire, our Chief Executive Officer, and Kieran McGrath, our Chief Financial Officer. Mike and Kieran will offer some prepared remarks, and then we'll open up the call for a Q&A session. These prepared comments were previously recorded, and this conference call is being broadcast on Tuesday, January 24 over the telephone and the internet.

The information shared in this call is effective as of today's date and will not be updated. All content is the property of CA Technologies, and is protected by US and international copyright law, and may not be reproduced or transcribed in any way without the express written consent of CA Technologies. We consider your continued participation in this call as consent to our recording.

During this call, both GAAP and non-GAAP financial measures will be discussed. Reconciliations of non-GAAP financial measures to the most directly comparable GAAP financial measures are included in our earnings release, which was filed on Form 8-K earlier today, as well as in our supplemental earnings material, all of which are available on our website at ca.com/invest.

Today's discussion will include forward-looking statements, subject to risks and uncertainties, and actual results could differ materially from these forward-looking statements. Please refer to our SEC filings, including our annual report on Form 10-K, for our detailed discussion of potential risks.

Please note that our fourth-quarter quiet period begins at the close of business on March 15, 2017. Please note that all comparisons are year over year and as reported, unless otherwise indicated. So with that, let me turn the call over to Mike.

Mike Gregoire - *CA Technologies - CEO*

Good afternoon. Thank you for joining us. I am pleased with the strong CFFO growth, and healthy operating margin and EPS, we delivered in Q3.

On a constant-currency basis, our revenue in the quarter came in as expected. Foreign currency headwinds negatively impacted reported revenue by an additional 1.5 points in Q3 relative to the September 30 rates.

As discussed last quarter, we faced a difficult year-over-year compare due to the timing of upfront revenue realized in the year-ago period and the continued attrition of our Services revenue. This continued attrition of our Services revenue is due primarily to our ongoing efforts to develop products that are easier to install and easier to manage.

The cadence and quality of our product releases continues to improve. While we are making progress across a number of our key strategic imperatives, we are continuing to work to improve the consistency of our performance across business units, customer groups, and geographies. For example, our Mainframe business is performing very well, and our North American Platinum team delivered solid results in the quarter. However, performance in our Named and Growth, or partner-led, business was inconsistent.

Total new sales and ES new sales declined in the quarter. This was due to a variety of factors, including very large deals in areas like Privileged Access Management, or PAM, and Service Management that closed in the year-ago period, which created a difficult compare. In addition, the pipeline for some of our products, like Project and Portfolio Management, or PPM, is more heavily weighted towards Q4 than it was for Q3.

Mainframe performed very well in the quarter, reflecting the combination of key competitive wins, healthy renewal performance, and our successful partnerships with global service providers. This is a result of our ongoing organic innovation and commitment to customer success.

This dedication to customer success extends beyond our software. There is no doubt that we live in a highly integrated world, where various systems are interdependent. Our solutions are known to be mission critical: highly reliable and zero down time.

Our net promoter score, or NPS, which is an industry standard measure of loyalty, continues to rise on a positive trajectory. Our customer satisfaction score continues to increase, and our customers are rating our product quality higher.

With this backdrop, we are pleased, but not surprised, by the performance of our Mainframe segment, both in Q3 and through the first three quarters of the fiscal year. Our zero net new defect policy has resulted in considerably lower customer support issues and higher customer satisfaction. In the quarter, 12 new Mainframe releases went into GA, including new SKUs for CA Development Environment for zSystems, Mainframe Operations Intelligence, and CA Release Automation Connector for z/OS.

We have demonstrated a long-standing commitment to innovating on the Mainframe. Due to the value and quality of our systems, customers continue to rely on the Mainframe for mission-critical applications, which continues to drive MIPS growth. And there is an increasing number of customers choosing to standardize on our solutions. All of these factors are driving our success in this market.

At CA World in November, we introduced the concept of Built to Change. Companies and organizations used to be built to last. Now they must adopt the mindset of Built to Change. New opportunities and new threats are emerging in an accelerated pace. This requires a more agile approach which provides the framework to pivot quickly and results in more robust, higher-quality solutions.

The adoption of Agile across our development organization is enabling us to develop integrations across a number of our product families, improving the seamlessness of our broad portfolio. For example, at CA World we released new integrations between our APIM and APM solutions with CA Precision API Monitoring. We introduced new Application Lifecycle Conductor, or ALC, integrations with CA Agile Central. And our latest release of CA Identity Service, our new Security SaaS offering, incorporates new integrations with CA's Single Sign On solution. Users can now access all of their cloud and on-premise applications from a single system.

There is no question that our end-to-end vision is resonating with customers. Our solutions enable customers to plan, develop, test, manage, and monitor with seamless security across all environments.

Our APIM business, for example, delivered the largest quarter in its history in Q3, with strength across most geographies, products, and routes to market. In the quarter, CA was positioned highest for ability to execute in the Gartner Magic Quadrant for Full Life Cycle API Management. CA was also named a leader in the Forrester Wave: API Management Solutions, Q4 2016.

In addition to the number of new releases announced at CA World, the APIM team also demonstrated CA API Gateway for Microservices. It also demonstrated industry vertical use cases, including a healthcare mobile app on top of our Healthcare Portal, and a Finance mobile app with Payment Services Directive and open banking.

Customers like Service NSW, or New South Wales, in Australia are using our API Management Solutions to connect millions of citizens to hundreds of services running on different processes and platforms. Our solutions enable every company to be a software company. We are really excited about our position in the APIM space and the opportunities we see going forward.

Similarly, our overall portfolio of continuous delivery solutions had the best new sales quarter in its history, driven by continued strength in Test Data Management. And all product lines in the business unit released new versions in the quarter. The innovation engine at CA is alive and well.

Code.org, the organization driving to ensure every student has the opportunity to learn computer science, used CA BlazeMeter to synthetically test its site for over 25 million users at its global Hour of Code campaign. The event offered tutorials on more than 30 languages and had the capability of reaching tens of millions of students in more than 180 countries. We are passionate about the need to encourage and expand computer science education to reach a broader population of students. We are very proud of our ability to help ensure the success of Code.org and its events.

Across our portfolio, we are continuing to focus on developing products that are easier to install and easier to manage, without compromising functionality for the sake of simplicity. Agile Central, which also experienced new sales growth in the quarter, is a good example of this. In the quarter, we launched significant enhancements, simplifying the user experience with personal navigation. We are also working within and across business units to encourage cross-functional collaboration, which should result in unique differentiation in our solutions and frictionless experiences for our customers.

Consistent with our strategy of moving our portfolio of solutions forward and creating opportunities to best serve our customers, we are pleased to have closed the acquisition of Automic last week. We had been in conversations with Automic's management team for well over a year. It is an asset that we had targeted for strategic, operational, and financial motivations. So we are excited to welcome Automic employees and customers to CA.

Strategically, Automic expands our Workload Automation and DevOps portfolio with its cloud-enabled platform, and gives us an end-to-end automation solution. Operationally, it elevates our presence outside North America and strengthens our footprint in the Germanic region where we were underpenetrated. Financially, the acquisition meets our rigorous hurdle rates and was a great opportunity for us to utilize off-shore cash.

As I look towards the end of our fiscal year and into FY18, I am pleased with the progress we are continuing to make. Increasingly, we are a company that is Agile and Built to Change, and we continue to pivot to make thoughtful and strategic adjustments to optimize our position.

While we are proud of our progress, we are by no means satisfied. We know that we must continue to evolve in order to achieve our potential and consistently deliver long-term sustainable growth.

With one quarter left to go in the year, we believe we are on track to achieve our objectives in FY17. To provide some insight into how we're thinking about FY18, including Automic, we expect the level of growth to be in line with what we're experiencing in FY17. This assumes that Services continues to be a headwind to revenue and that Mainframe performance is consistent with our expectation of low single-digits revenue decline year over year. Taking a longer-term, holistic view of the Business, including both organic and inorganic contributions, we believe that we can deliver low single-digit growth in the medium term. With that, I'll turn the call over to Kieran to review our third-quarter financials and full-year guidance. Thank you.

Kieran McGrath - *CA Technologies - CFO*

Thank you, Mike. Before we get started with the quarter review, please note that all comparisons are year over year, as reported, unless otherwise indicated. This afternoon, I'm going to focus my comments on the key business drivers and performance indicators for the quarter. The balance of our financial details can be found in our supplemental and press release.

Our Q3 total revenue was $1.007 billion and was down 3%, and 2% in constant currency. Our constant-currency revenue performance in the quarter was consistent with our expectations, due to higher level of upfront revenue recognized in the year-ago period and the decline in Services, as Mike has mentioned.

The strength of the US dollar negatively impacted our reported revenue by 1.5 points compared to September 30 rates, the last day of the preceding quarter. For year-over-year comparison purposes, the strength of the US dollar negatively impacted our reported revenue by 0.5 points.

Q3 Enterprise Solutions revenue declined 2%, Mainframe Solutions declined 1%, and Services declined 12% as reported and in constant currency. Q3 total new product and capacity sales were down in the mid-single digits as reported and in constant currency. Q3 renewals were up in the mid-single digits, both as reported and in constant currency.

As we previously stated, the year-over-year changes in our renewal bookings can vary on a quarterly basis, due to the timing of large transactions. We continue to expect the renewal portfolio in FY17 to increase in the high teens year over year, both as reported and in constant currency. Renewal yield for the quarter was in the low 90%s, in line with our longer-term target.

Turning to geographies, new sales were down in North America, due primarily to uneven performance in Named and Growth, or partner-led, accounts. New sales in Latin America declined due to ongoing macroeconomic challenges in the region. New sales were flat as reported, and increased in constant currency, in EMEA. New sales in APJ were down, reflecting the timing of the renewal portfolio in the region.

Revenue increased in APJ as reported and in constant currency. In Latin America, revenue increased as reported, but was down in constant currency. In EMEA, revenue decreased as reported, but was up in constant currency. Revenue declined in North America as reported and in constant currency.

Within our segments, Mainframe new sales were flat as reported, and increased in the low-single digits year over year in constant currency. Mainframe new sales performance in the quarter reflects the combinations of competitive wins and customer consolidation onto the CA platform, continued traction with newer organic products like Data Content Discovery, or DCD, and our ongoing successful partnerships with System Integrators, or SIs. Overall, we continue to expect our Mainframe revenue to be down in the low-single digits over the medium term, which we believe is in line with the mainframe market.

Enterprise Solutions new sales decreased in the high-single digits year over year as reported and in constant currency. Areas such as API Management and Continuous Delivery saw positive new sales growth in the quarter. However, as we've discussed in the past, within Enterprise Solutions there are products in our Enhance portfolio that are more mature and not growing but contribute to margin and cash flow.

Services revenue decreased 12% as reported and in constant currency. We expect Services revenue to decline, as we design our products to be easier to install and as we leverage partners. We continue to expect this headwind in Services to have a dampening effect on our overall revenue growth in the near term.

Total revenue backlog was up 3%, and up 4% in constant currency. Current revenue backlog declined 1% as reported and was flat in constant currency. As we've said in the past, current revenue backlog will likely grow after we demonstrate multiple quarters of new sales growth while maintaining a low 90%s renewal yield.

Q3 GAAP operating margin was 31%, and non-GAAP operating margin was 38%. GAAP operating margin increased 3 points compared to the year-ago period and is consistent with our medium-term target.

Segment operating margins in the quarter were 61% for Mainframe Solutions, 14% for Enterprise Solutions, and negative 4% for Services. Q3 Services margins reflect actions taken during the quarter to rightsize the segment, given our expectation that Services revenue will continue to be a headwind.

Our Q3 GAAP and non-GAAP tax rates were 29%.

Q3 GAAP diluted earnings per share was $0.50, down 4% year over year, and down 8% in constant currency. Q3 non-GAAP diluted earnings per share was $0.63, flat year over year, and down 2% in constant currency.

Our Q3 CFFO was $517 million, up $185 million year over year. CFFO increased relative to the year-ago period, primarily due to the timing of single installment collections. Single installment cash payments were $231 million, and up $106 million year over year.

As we discussed last quarter, we have entered into an agreement in principle to settle a longstanding matter brought against us by the DOJ and an individual plaintiff relating to our GSA schedule with the government. We have accrued for this liability, and expect to pay the $45 million in cash during the fiscal fourth quarter.

We ended Q3 with approximately $739 million in net cash. During the third quarter, we paid $107 million in dividends. We did not repurchase shares in Q3, due to the timing uncertainty related to our payment of the GSA settlement, combined with the rate and pace at which we had executed share repurchases in the first half of the fiscal year. Generally, we expect to offset dilution with our share repurchases. We have $650 million remaining of our original $750 million share repurchase authorization.

Now turning to guidance, guidance is based upon exchange rates on the last day of the preceding quarter, which was December 31, 2016. The guidance also includes the impact of our acquisition of Automic. As described at the announcement of the acquisition, given the timing of the close, which occurred on January 18, we expect Automic to contribute 0.5 points in revenue as reported and in constant currency.

The acquisition is expected to adversely affect GAAP and non-GAAP total Company operating margin by 1 percentage point, and be dilutive to CFFO, as well as GAAP and non-GAAP diluted earnings per share, both as reported and in constant currency. The impact of the Automic acquisition, combined with the higher level of expenses typically incurred in our fourth fiscal quarter, are expected to meaningfully depress ES margins in our fiscal Q4.

For the full year, we expect told revenue to be flat as reported, and flat to up 1% in constant currency. This translates to reported revenue of $4.01 billion to $4.03 billion.

We expect a full-year GAAP operating margin of 28% and a full year non-GAAP operating margin of 37%. We expect our GAAP and non-GAAP tax rate to be between 28% and 29%.

GAAP diluted earnings per share is expected to increase in a range of 1% to 4% as reported, and flat to up 2% in constant currency. This translates to reported GAAP earnings per share of $1.80 to $1.85.

Non-GAAP diluted earnings per share is expected to be in a range of flat to up 2% as reported, and down 2% to flat in constant currency. This translates to a non-GAAP earnings per share of $2.42 to $2.47.

At the end of the year, we expect approximately 413 million shares outstanding and a weighted average diluted share count of approximately 415 million shares.

Cash flow from operations is expected to be in the range of a 5% decrease to a 1% decrease as reported, and a 3% decrease to a 1% increase in constant currency. This translates to $990 million to $1.03 billion, and includes the anticipated settlement of legal matters relating to the agreement in principle for the GSA litigation previously discussed.

As we look ahead to FY18, we'd like to provide some preliminary headlights into our current view. Including Automic, we expect FY18 growth to be similar to the level of growth we're experiencing in FY17. We expect Services to continue to be a headwind to revenue and, consistent with our longer-term view, we expect Mainframe revenue will decline in the low-single digits year over year. Now with that, we'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Raimo Lenschow, Barclays.

Raimo Lenschow - *Barclays Capital - Analyst*

Thanks for taking my question. I had two quick clarification questions and then one more underlying fundamental. First, Kieran, if I look at the guidance, and I assume Automic is about 0.5 point of benefit for 2018, as well -- and maybe that's the first clarification you need to give me -- then you're looking for a decline of revenue of 0.5% to growth of 0.5%. Is that math correct, just to start with that one?

Kieran McGrath - *CA Technologies - CFO*

So Raimo, I think for 2018, we're expecting Automic to contribute probably closer to 2 points of growth overall. What we're saying is in terms of why we think it will be in sync with where we were this year, the higher end of where we're expecting this year, is really because we're continuing to see Services being a headwind, probably up a point. And from the Mainframe perspective, Mainframe has actually operated, I'd say, on the high end of our guidance all year long. I think consistent with how we view the market over the long term, declining in the low-single digits, that's going to contribute an impact to us, as well, next year. And just from a clarification perspective, we also think that if FX remains consistent with where we ended in 12/31/16, we think that probably represents about another full point of headwind to us next year, as well.

Raimo Lenschow - *Barclays Capital - Analyst*

Okay. Because FX was my next question, in terms of the impact there for Q4 and the full year. It's both talk what you just talked about, Kieran.

Kieran McGrath - *CA Technologies - CFO*

That's a fair point. So we expect it to be, it was 0.5 point, the guidance was 0.5 point, the impact was 0.5 point year-to-year in Q3. It will represent a full point on the year-on-year in Q4. And then obviously, 1 point, as well, for next year, presuming the rates stay consistent to where they are right now.

Raimo Lenschow - *Barclays Capital - Analyst*

Okay. Perfect. Okay. Thanks for that. And then one for you, Mike. So if I look, the Named and the Growth accounts were the ones that this quarter where you were kind of inconsistent. But that has been going on for a while. Did you guys do any kind of root cause analysis to see what's going on there, what needs fixing? Thank you.

Mike Gregoire - *CA Technologies - CEO*

Thanks, Raimo. Yes, especially this quarter, I was really disappointed in what happened, primarily in Named North America. I think that when we look across the board on a global basis, what we're seeing is that the high end of the Named look a lot more like our Platinum customers, and that's a little bit of a different selling motion. And the lower end of Named, we put a lot of that into growth, is much more like a reseller.

So when I take a look at our staff and the way that we've trained them and the way that we've positioned them on a global basis, I think we can do a little bit more to match the accounts to the buying patterns that we're seeing in the market. And it took us several quarters to really understand this motion. It's not as fluid and predictable as you would expect. And it wasn't until we looked at the data over four or five quarters that we saw that.

The other thing is that we were probably masked a little bit, because we've had pretty good traction in the ESTG space over the last five quarters. This is the first quarter in five that we haven't grown revenue in ESTG. So a combination of maybe a little too optimistic about our progress and then not fully understanding the buying patterns of these distinct customer patterns.

Raimo Lenschow - *Barclays Capital - Analyst*

Okay. Perfect. Thank you.

Operator

Matt Hedberg, RBC Capital Markets.

Matt Hedberg - *RBC Capital Markets - Analyst*

Sure. Thanks, guys, for taking my questions. I've got two, one a modeling question and then a follow-up for Mike. Kieran, at your Analyst Day, you talked about your renewal portfolio. I think it's expected to be down in FY18 versus FY17. And considering your initial guide for FY18 on revenue, I'm wondering, can you give us some color on how we should think about cash flow growth next year? Should flat to down a little bit be the right way to think about it?

Kieran McGrath - *CA Technologies - CFO*

I think we might have even touched on this a little bit at CA World, as well, Matt. But truthfully, our customers are going to pay us fairly consistently. While sometimes we'll see spread out over a three-year deal, the customers might actually pay 40% up front in a particular year, in generality, it's fairly linear in where it comes. And I guess the one thing that you should think about is that whole GSA payment that we're going to make here of about $45 million in Q4, that's actually going to be a tailwind for us in the CFFO next year.

Matt Hedberg - *RBC Capital Markets - Analyst*

Got it. Okay. And maybe one other follow-up from Analysts Day. Mike, you guys talked about the CA Accelerator program. I'm curious, can you give us an update on some of the innovation? I know there's a lot of cool technologies percolating in that. Maybe an update there would be helpful.

Mike Gregoire - *CA Technologies - CEO*

Sure. There's a number of them in there. Some of them we want to try to hold that a little tight to the vest, because we're still playing around with it. We think it's a competitive advantage. But the ones that are progressing along, we're very happy with. One in particular, called 42IO, the initial idea of what we were going to use it for didn't work out, but the underlying technology ended up being our whole analytics platform, which we code named Jarvis. And that's been used in a couple of the products as we went out to market in Ayman's group, our Chief Product Officer.

We have another one that we've been working on called WhoZoo, which is one that really takes a look at matching skills. We have another one that's doing some very interesting work in machine learning, really understanding how an application functions in the context of the environment it's in. So there's quite a few things going on in there that I'm very pleased with. It's a high performing team that really takes advantage of Agile, and they are truly disciples of Lean and really work hard to make sure that they pivot very quickly and go through our process in very quick form.

And also, since you're asking about innovation, I think the Products groups, which is run by Ayman, has done a phenomenal job. They put 12 relatively meaty releases out this quarter. And I can think of several, in particular, like Identity Services, which is a great application, so that you can come to CA, that is number one in identity access management, especially for high volume on-prem, but now you can go and use the same system and do all the cloud-oriented authentications. There's no company that has that ability to bridge between all of these on-premise systems and a robust cloud set of services.

Agile Central did a big release this year -- or this quarter -- where they've really trimmed up the user interface and made the whole Agile methodology much, much more approachable. And I think that's going to drive a lot more usability. And if you think about how a modern software company runs with land and expand, making it easier to use gives you an opportunity past the land to start expanding.

One on the Mainframe that I think was extraordinarily impressive was Intelligent Mainframe Management and Automation. This is, once again, only a CA product. We are one of the few companies that are really investing in the Mainframe. And this is using machine intelligence to really understand what's happening in a Mainframe environment, whether that be the network, the disk structure, the CPU power.

And it's also built that you don't have to be a Mainframe expert to use it, which is driving this whole notion of ease of use. So I'm very bullish on what's happening in our products organization. Code quality is high, customer satisfaction is up, and the innovation engine is clearly humming here at CA.

Matt Hedberg - *RBC Capital Markets - Analyst*

Thanks, Mike.

Operator

John DiFucci, Jefferies.

John DiFucci - *Jefferies LLC - Analyst*

Thank you. My question was for Mike.

Mike, I'm looking at revenue, I'm looking at new bookings, and it's not so much that new bookings are down year-over-year, because I remember last year you had a great quarter for new bookings. But it looks like it's really that new bookings don't seem to be able to offset attrition. And when I look at -- forget about the Professional Services for a minute -- but when I look at Subscription, that Subscription line has been negative in every quarter for, I think, five years now.

And I know some of it may have shifted to software fees and others, and I know there's some constant currency effects in there, too. But I look at that and I think about all the things that you've done and your team has done, on the sales operations side, which I think are very positive, and on the products side, and there's a question Matt asked, and I think that's really cool and positive.

But maybe given what CA is, or half of what CA is, is Mainframe, this slowly melting iceberg, maybe trying to grow it isn't really going to work. And maybe there are other ways to return value to shareholders. And I'm just wondering if that is anything you're considering, especially given that next year's guidance now implies that organic constant currency growth is going to be negative again.

Mike Gregoire - *CA Technologies - CEO*

Well, I would challenge your assumption. As you know, CA's model is a little bit more awkward, it's not as straightforward as many software companies. When you've been around for 40 years, you have multiple revenue streams. And if you take a look at your first assumption, we have grown bookings 2% this last quarter. So the opportunity to grow is clearly there.

And if you take a look at ESTG, we've had revenue growth in five consecutive quarters, except for this particular quarter. When I take a look at the number of products that are out there and I take a look at our ability to penetrate the market, I take a look at what customers are looking for. With more stability in a software provider, they're looking for a vendor that is heterogeneous with respect to platforms and not tied to selling services or selling hardware, I think we're a very unique property out there.

And we are definitely seeing growth. We will grow this year. The guidance we've given for next year, we've given you an indication that we have an opportunity to continue to grow. We kick out a great dividend. We are very careful with our capital structure. All of the acquisitions that we've done have been accretive to revenue. So I'm not in the same place you are, John.

John DiFucci - *Jefferies LLC - Analyst*

Yes. No, Mike, I hear what you're saying. But even next year's guidance, if you take out -- and I think making these acquisitions makes sense -- but just trying to measure you the way we measure every company, on an organic constant currency basis, you aren't going to grow, if you do what you guided to, if you take out Automic.

And I believe you've added a lot of value and CA's a much better company today than it was five years ago. But I just wonder if it's just -- I mean, you are trying to make this thing grow and there's some expenditures that go into that and maybe, maybe, I don't know, people ask me all the time, can they increase the dividend if this doesn't work, things like that. And I'm just wondering if now's the time to start to think about it. But it sounds like that's not what you're thinking.

Mike Gregoire - *CA Technologies - CEO*

Well, we review our capital structure every year and we look at multiple opportunities to drive shareholder value. And when we think about the long-term of CA and the value we drive over a longer period of time, we're very comfortable with our strategy.

John DiFucci - *Jefferies LLC - Analyst*

Okay. Thank you.

Operator

Mark Moerdler, Bernstein Research.

Mark Moerdler - *Bernstein - Analyst*

Thanks. I appreciate it. Two questions. First, how should we think about the use of cash if what's being discussed in the government occurs, in terms of the ability to return cash efficiently from a tax point of view? And then a follow-up question.

Mike Gregoire - *CA Technologies - CEO*

Sure. First of all, we don't know what the policies are going to be. Right now, we return about 65% of our cash back to shareholders. We have been relatively consistent on that for several years. So we will take a look at it in the context of that framework.

And I'm sure that when you take a look at all the discussions that have happened, that I don't think it's going to be a just take the money off and do whatever you want with it. There's probably going to be some strings attached with any kind of program that they put in place. And until we see what that program is and evaluate that against all of the opportunities we have to drive shareholder growth, it's hard to really think about what could happen. We're going to wait and see what the programs are.

Mark Moerdler - *Bernstein - Analyst*

Excellent. And then Mike, as a follow-up, given the size of the Automic acquisition, how should we model and think about on a going forward basis the spend on acquisitions?

Mike Gregoire - *CA Technologies - CEO*

Yes, we've been -- once again, we try to be as consistent as we possibly can. You can take a look at what we've done here with Automic, we haven't done a large acquisition for about 18 months. We try to do $300 million to $500 million per year, on average.

And as we said in the opening comments, we've been talking to Automic for a year. So we don't know when we're going to be able to transact. We're extraordinarily disciplined. We do a great deal of due diligence. And at any given time, we're looking at multiple opportunities with respect to acquisitions. We just really can't control the closing times of those acquisitions.

So we still like those tuck-in type applications, and the $40 million to $60 million range. But when we see an opportunity to get something that's a little bit more meat meaty in the $300 million to $500 million, or in this case, $600 million, at the right valuation, we feel that those are good fits for our company and to drive our long-term strategy.

Mark Moerdler - *Bernstein - Analyst*

So you still figure on a $3 million to $5 million on a year-over-year basis going forward is a fair estimate?

Mike Gregoire - *CA Technologies - CEO*

You know, I'd take the timing out a little bit. And once again, that's how we kind of think of it. But I don't have complete control over how these things work.

Kieran McGrath - *CA Technologies - CFO*

It's an average, right?

Mike Gregoire - *CA Technologies - CEO*

It would be an average.

Mark Moerdler - *Bernstein - Analyst*

Right, over a long time. I appreciate it. Thank you.

Operator

Michael Nemeroff, Credit Suisse.

Michael Nemeroff - *Credit Suisse - Analyst*

Thanks for taking my questions. The Service margins this quarter were negative. I'm just curious what the drag was there. We haven't seen the Services margin negative in several years. Can you get that back to breakeven over time and keep it there? And then I have a follow-up, please.

Kieran McGrath - *CA Technologies - CFO*

This is Kieran. Certainly, we've been telegraphing that with our Services revenue declining, we obviously look to keep our Services business not really contributing a lot of profit to us, but neither do we want it to lose a lot of money. What you saw this quarter, and I actually referred to it in my script, was actually the cost that we took to really try and realign our resources with what we project the future revenue to be.

This will probably play out over several quarters and things like that. But it's really more of right sizing it. Over the long term, I think we feel pretty comfortable that we can drive a business here in low- to mid-single digits. We want to ensure that the services that we put in place are there for deployment and to help our customers make the best use of our software.

We're not trying to gouge anyone. We just think that's the right use of it. So yes, absolutely, we can recover here once we get through the next quarter or two of just trying to realign our resources.

Michael Nemeroff - *Credit Suisse - Analyst*

Thanks, Kieran. That's helpful. And then on the ES solutions, if I may, maybe this is wishful thinking, but could you give us maybe the growth mix of the legacy versus the new products, so we can determine how much longer those legacy businesses are going to be a drag on that unit's growth?

Mike Gregoire - *CA Technologies - CEO*

Yes, it's a complicated question. We don't break it out by product. But the best way to think of it is three distinct buckets. We have a group of products which we call Enhance. And those products we don't sell a lot of net new. We sell a little bit of capacity. But they're very profitable products and our customers use them all day, every day. And part of our relationship with them is the fact that we continue to invest in those products. Mind you, we're very careful with respect to our R&D spend and very limited marketing spend.

The next bucket are Scale products. These are the ones you see us do a lot of advertising on, a lot of marketing on. They still get a healthy R&D budget. These are products that we are actively selling across the board. We're selling them into our Platinum accounts. We're selling these into our Named business, and we're selling them into our Growth business.

And then we have the third bucket, which is high growth products not yet mature, very high R&D cost, scaling marketing costs. And the mix of all three of those buckets, we have various products that move back and forth. Once a product gets to a certain level of scale, where it's primarily a capacity sale, then it will move into Enhance. A product that is new and is starting to ramp up and scale, we put into the Scale bucket.

And the spend and the management of that looks a little bit different than you would manage a team that is going for a net new product with net new innovation and really working on getting customers into the Agile scrum teams, rather than working heavily on deploying. Does that give you a little bit of context for how we think about it?

Michael Nemeroff - *Credit Suisse - Analyst*

It definitely does, Mike. But if you could put maybe some quantitative meat on those bones, that would be a little bit more helpful. Thanks. In terms of the mix --

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Mike Gregoire - *CA Technologies - CEO*

It's one of those things where it's really hard to do. The segmenting we have is in the three segments that we have.

Kieran McGrath - *CA Technologies - CFO*

I would say that we did attempt to try and give a broad level segmentation in our CA World slides, where we at least gave a sense as to what's the overall mix would look like and what the changes would be over time. No doubt about it, the Scale product is where the focus, as Mike points out, and that's where the real growth is. But some of the Enhance products will growth on unique quarters, as well. So it is difficult to specifically quantify it. But I do think the charts that we put into CA World at least give you some sense as to how big it is.

Michael Nemeroff - *Credit Suisse - Analyst*

Okay, guys. Thanks very much. Appreciate it.

Kieran McGrath - *CA Technologies - CFO*

Thanks, Michael.

Operator

Walter Prichard, Citi.

Walter Pritchard - *Citigroup - Analyst*

Hi. I'm wondering, Kieran, if you could just clarify the comment on -- or I guess it was Mike that answered the question on Growth and Named account issues. It sounded like it was a customer segmentation issue, and that was really the issue that you feel like the sales motions in those various buckets are working, it's just a matter of getting the customers in the right area. Is that the right interpretation of, I think it was your answer to Raimo's question?

Mike Gregoire - *CA Technologies - CEO*

Walter, it's Mike. We've been paying close attention to this for several quarters. And you're always trying to optimize your sales force. And we do pay pretty close attention to customer satisfaction, as well as cost of sales. And a Platinum customer does behave different than a net new customer that we've never done business with before. I think we get those two extremes.

When it comes into the middle, I think we need to take a harder look at some of the customer segmentation. Because I think there's a lot of very large customers that actually look lot more like a Platinum customer, they expect a dedicated sales rep, they expect a different type of service, they are going to competitive bid pretty much all of the work that's out there, and the Platinum team is very good at these long, multi-country bids that they've been doing for a number of years.

On the flip side of it, there's a whole segment of customers that are looking for point solutions. And four years ago, or three years ago, we didn't really have point solutions, we had very complex on-prem solutions that required high services and a lot of configuration, if not customization.

We don't have a lot of those products in the portfolio anymore. We really have pivoted to SaaS, cloud, on-demand, easy to use, easy to install. And there's a whole segment of customers that are looking for a try-and-buy and a much more digital footprint.

And I think we can take a harder look at that, do a little bit more work on customer segmentation and get the customers that look like Platinum to be sold to like a Platinum customer, and then take advantage of this growing group we've built in handling our partnerships. Our partnerships did a very nice job multiple quarters in a row, and we're starting to scale that out on a global basis. So I think we can leverage that, as well.

Walter Pritchard - *Citigroup - Analyst*

Got it. And then just on ES, is it possible to help us understand the impact, the magnitude of the impact of tougher comps that you saw with large deals from a year ago and then the execution issues in that new product growth rate?

Kieran McGrath - *CA Technologies - CFO*

Clearly, from a revenue perspective, it was worth about 4 points on the year-on-year basis to the ES business, the upfront revenue, as we talked about. So from a new sales perspective, I'd say it actually constituted a fairly substantial portion of the new sales, if I just think about our PAM product and probably our IT Service Management product, in particular, all of which had some big deals with upfront type of characteristics a year ago. That was probably really responsible for all of the ES decline in its aggregation.

Walter Pritchard - *Citigroup - Analyst*

Okay. Great. Thank you very much.

Operator

Sterling Auty, JPMorgan.

Sterling Auty - *JPMorgan - Analyst*

Yes, thanks. Hi, guys. I just wanted to do follow up on that line of questioning around ES. Was there anything in that ES segment in terms of some of the newer growth initiative products that had a tougher quarter? Or when you looked across, was it primarily stuff that was in your more mature bucket that you talk about that maybe saw some additional headwinds, beyond the examples that you gave in terms of issues like tough compares, et cetera?

Kieran McGrath - *CA Technologies - CFO*

So not to be redundant, but the payoff in the Xceedium business really was the one that really faced the big headwinds on a year-on-year basis, both from a new sales and from a revenue perspective. And that was one of the items that I had mentioned to Walter before. Most of the other stuff that we really think about is our scale products, like API, Continuous Delivery, all actually did quite well in the quarter and all had some really good growth.

Sterling Auty - *JPMorgan - Analyst*

Got it. And then you talked about the improvement in Net Promoter Score. Is there any sense you can give us in terms of where your Net Promoter Score sits relative to the peers that you compare against?

Mike Gregoire - *CA Technologies - CEO*

Sure, we take a look at the whole software space and we try to focus directly on the enterprise space. And we've had a lot of growth in the Net Promoter Score over the last two years, and I would put us in the mid to upper quartile with respect to the software industry and definitely in the upper quartile with respect to the enterprise subset of the software industry.

Sterling Auty - *JPMorgan - Analyst*

Got it. Thank you, guys.

Operator

Abhey Lamba, Mizuho Securities.

Abhey Lamba - *Mizuho Securities Co., Ltd. - Analyst*

Thank you. Mike, you talk about low single-digit growth in the near term. What's your time frame to get there on an organic basis? Or will acquisitions be a key part of that strategy on a continuing basis?

Mike Gregoire - *CA Technologies - CEO*

Yes, it's going to be a combination of both using acquisitions. We've got a very solid balance sheet, and being able to use that balance sheet is a competitive weapon for us. Secondly, I do think that there is a little bit of a misunderstanding with respect to organic and inorganic. For example, if you take a look at our purchase of Xceedium, that was a very, very small acquisition, and it was a great starter set with respect to security and privilege identity management. But if you take a look at the rapid revenue growth, that's been done because of our enterprise sales capability which didn't exist. So that's not -- that is a complete organic capability that we brought to a great product set.

Secondly, when you're starting to sell to the Fortune 500 and some of the biggest governments in the world, a small company needs a lot of R&D help. And our ability to help that team with our own resources that really understand what a large complex customer is expecting, that's all organic, as well. So when we take a look at the kinds of things we buy, we don't buy things just because we want to get revenue.

We buy things because we think we can really add value to their product roadmap and we can add a lot of structure with respect to distribution. So it's a combination of those two things that you put them together, you're able to drive the kind of growth we're looking for.

Abhey Lamba - *Mizuho Securities Co., Ltd. - Analyst*

Got it. Thank you. And Kieran, you gave us a marker for top line for FY18. How should we think about your OpEx and margins next year? I know you don't want to give guidance right now, but any qualitative commentary on how we should think about your priorities for next year would be very helpful.

Kieran McGrath - *CA Technologies - CFO*

It is a little premature, as you say, Abhey. Clearly, you have to take into account that even though Automic will be contributing to us next year, with all of the purchasing accounting, the deferred revenue haircuts, and a lot of the integration costs that we're going to spend, it is going to be a headwind and probably an impact to us from an overall margin perspective. I think from a profit perspective, it probably won't be from a profit perspective, but from a margin perspective, probably will be.

Abhey Lamba - *Mizuho Securities Co., Ltd. - Analyst*

Got it. Thank you.

Operator

Michael Turits, Raymond James.

Michael Turits - *Raymond James & Associates, Inc. - Analyst*

Hello, guys. A couple questions. First, just a small clarification, but the level of growth that you talked about being the same next year, is that on the USD or on a currency basis? And was it 1 point of FX headwind total or incremental that you expected next year?

Kieran McGrath - *CA Technologies - CFO*

I think right now, we're thinking it's about 1 point in aggregate, assuming no change with the rates.

Michael Turits - *Raymond James & Associates, Inc. - Analyst*

Okay. And you said that you thought it would be the same level of growth on a USD or constant currency basis next year?

Kieran McGrath - *CA Technologies - CFO*

On a constant currency basis.

Michael Turits - *Raymond James & Associates, Inc. - Analyst*

Okay. And as to the weakness in ES, Mike, one thing that you didn't mention this time that we've talked about before is the ability to, quote, sell outside the renewal cycle. I know it's tough, given especially the Platinum customers, that they're so tuned to that, but that's been a long-term project for CA and I'm wondering where you are there.

Mike Gregoire - *CA Technologies - CEO*

It's a constant work in process. I was disappointed for sure with how the Named group worked this last quarter, but I was encouraged by the transaction volume that we saw. Now when you take a look at the products that we're building, the business model, that's not just us, but every software company's moving towards, which is try-and-buy and land-and-expand, getting that volume up is a precursor to being able to expand those accounts. So that was a definite bright spot. But I do think we can do better in selling stand alone outside of the renewal portfolio. It's an imperative.

Michael Turits - *Raymond James & Associates, Inc. - Analyst*

And last question for Kieran, if I understand right, you mentioned in the original press release that Automic was profitable. So it seems like if you do the math that you're expecting at least this year, more expenses than revenues. So why so much dilution if it was profitable? What are you doing there?

Kieran McGrath - *CA Technologies - CFO*

In the short term here, you've got a lot of one-time costs that you're taking, just related to transaction costs, legal fees, bankers' fees. And then obviously, you can't underestimate the deferred revenue haircut. It's all part of the purchase accounting.

So that's the type of stuff that impacts us. When you think about what I said, actually, or what our guidance said when we announced it, we believe that it will be accretive in FY19. So we get there fairly quickly. It's a good entity. But you have to get through all of these purchase accounting issues and then the integration costs.

Michael Turits - *Raymond James & Associates, Inc. - Analyst*

Okay. Thanks, Kieran. Thanks, Mike.

Operator

Gregg Moskowitz, Cowen and Company.

Gregg Moskowitz - *Cowen and Company - Analyst*

Okay. Thank you very much. First question, for Mike. How did Security do overall this quarter? And within that, what was strong and which product area didn't grow as much as you would have liked, perhaps?

Mike Gregoire - *CA Technologies - CEO*

Security did pretty well. Our flagship product continues to impress and continues to do well, which is the Privileged Identity Management product. And that was well pretty much across the globe. Some of the older products that are in the Enhance category didn't have a whole lot of capacity this particular quarter, and that does ebb and flow. This was a quarter where we saw some of that behavior.

Gregg Moskowitz - *Cowen and Company - Analyst*

Okay. And then just a clarification on M&A, getting back to Mark's question. So as you noted, Automic was above your guidance of $300 million to $500 million per annum. Are you still looking at potential M&A beyond tuck-in acquisitions, in case an opportunity presents itself, or is any significant M&A off the table over the next several months as you digest Automic? Thanks.

Mike Gregoire - *CA Technologies - CEO*

Yes, we'll continue to look at what's available in the market. We have the capacity and the ability to do multiple acquisitions, whether they be a handful of small ones or a couple ones the size of Automic. But as I said earlier, we can't control the closing of these transactions. There are things we obviously would like to buy and sometimes the seller doesn't want to sell.

Trust me, there's not a banker that isn't trying to get in my office every week trying to sell something. And we listen to a lot of conversations, and every now and then, one will make sense to us and hit the valuation criteria that we have. It also have the cultural fit, as well as the financial performance that we're looking for.

Gregg Moskowitz - *Cowen and Company - Analyst*

Okay. Great. Thank you.

Operator

Kirk Materne, Evercore ISI.

Kirk Materne - *Evercore ISI - Analyst*

Thanks very much. Mike, can you talk about the Automic integration in terms of the sales and go-to-market strategy on that front in terms of what you're doing (Inaudible). They have a good presence in Europe? I was just wondering how you're going to start to integrate that in with the broader CA sales force.

Mike Gregoire - *CA Technologies - CEO*

We have a methodology for doing that, much like what we did with Rally. And the first principle is do no harm. And when you take a look at this particular transaction, the primary focus that they have had has been in Europe, and that's one of the things that was very attractive to us, and they have a relatively small presence here in the US.

I think we'll take our time making sure that we don't lose any of the pipeline that they've built and the strength that they've built in Europe, and we'll initially start augmenting our ability to transact here in the US. There's also a lot of work we can do with respect to our own products and driving some synergies on a global basis that we want to make sure we capture, and that will happen over the course of the next six months.

We've put a very experienced integration lead. He used to run all of Asia for us. And prior to that, he's been international in LatAm, been with the company for an awful long time. And I think that that level of experience and that experience in operating in international theaters will help us not make mistakes.

Because, as you think about a company that's primarily based in Europe, does think a little bit differently than a company that's based in the US. We want to make sure we have the right cultural fit. We want to make sure we take care of customers. And we also want to make sure we get the appropriate fit within the overarching context of CA.

Kirk Materne - *Evercore ISI - Analyst*

Okay. And then just one follow-up on M&A in general and a little bit more philosophical. But when we listen to you, you guys are obviously very excited about Privilege ID Management, Rally, API Management. There's a number of products that I think you guys are very excited about. You've mentioned that you feel like your internal development engine's backs are cranking out really good products and better code than it ever has. But it's really arguing that.

On the other hand, you guys continue to talk about buying things. And I guess my question, Mike, is, how wide do you want this portfolio to get before you lose focus potentially Your Named Growth accounts, it sounds like it's more segmentation than focused on a product perspective. But I think we're all wondering, you have a lot of good things going on, when did those organic growth engines start to stand on their own feet, versus having to go out and continue to bolt something else on.

It seems that you guys have a big enough base of product, and especially with Automic coming out, to let those run by themselves and see how it plays out. What am I missing there? Because it seems the internal development engine should be able to take over at some point versus the inorganic acquisition strategy. Thanks.

Mike Gregoire - *CA Technologies - CEO*

I agree with you 100%. As you know, it takes time to take a product from scratch, build a product, get it through, system test, unit test, performance test, integration test, market it, get it out to customers. We've been at this for a couple years and we're just starting to see some of those products come off.

Now if you take a look at the organic, net organic products that we put into the market, our cloud identity service product is an organic product, just went out this quarter. When you take a look at the Intelligent Mainframe Management and Automation, that's a completely organic solution.

AXA, which is tagged onto -- it's a pure SaaS solution, it's one of our fastest growing products right now. And that's attached to our APM business. We also have the work and the amount of engineering that we've put into our APIM solution. Most of that solution now is organic. So there's a lot that's been done. And I think to your point, we should be impatient, but we're just starting to see the fruits of that organic activity now.

Kirk Materne - *Evercore ISI - Analyst*

Okay. Thanks.

Operator

Philip Winslow, Wells Fargo Securities.

Philip Winslow - *Wells Fargo Securities - Analyst*

Thanks for taking my question. Most of my questions have been asked, but I wanted to focus on the medium term guidance that you talked about on the Mainframe side. And you are obviously, a declining Mainframe revenue business. And you've done a very good job keeping the margins high there, but as you continue to have a decline in the revenue, what are the levers that you can pull to keep that margin flat?

Because that's the question I've been getting, is that you think about scale on a software business model on the way up or leverage on the way up, isn't there inverse leverage on the way down. How do you manage that? Because you obviously have done a good job managing the past couple years. But is that sustainable?

Mike Gregoire - *CA Technologies - CEO*

Thanks, Phil. If you take a look, we've been talking about ES a lot tonight, so let's start with that, because I think that's where the focus needs to be. I don't think you're going to drive Mainframe operating margins up any higher. I think that that's the right mix at that particular space. And if you drive those margins up any higher, I think you isolate yourself from customers.

When you take a look at the ES business, we did 14% operating margin this last quarter. It's been hovering in and around the teens. We need to get that business in a steady state up into the high teens. And we are investing a lot, obviously, in marketing, we're investing an awful lot in R&D. And over time, I think you're going to see that portfolio move up into the high teens.

Now the other thing that's working a little bit against us, but that's our job to go figure this out, is everything we're building is SaaS and it's ratable. So we don't have the luxury of getting that big upfront revenue kick, which is usually a sweetener to operating margins.

On the other hand, we're getting a much more predictable revenue stream in our SaaS revenue. So between the mix of that business model and our focus on getting those products to market and making sure that those products are sold, I think you'll see the leverage stay with respect to the ES side of the house.

Kieran McGrath - *CA Technologies - CFO*

And I just read I think where, I think with our Mainframe, I think what we found and discovered over the last year in particular, that many of our partnerships, many of the large SIs, give us a lot of flexibility and fungibility in our go-to-market, as well, where we can continue to drive our footprint without a very heavy sales and marketing, as well.

Mike Gregoire - *CA Technologies - CEO*

That's a great point.

Philip Winslow - *Wells Fargo Securities - Analyst*

Got it. Thanks, guys.

Operator

Thank you. And I'm showing no further questions. I would now like to turn the call back over to Mike [McGuire] for any further remarks.

Mike Gregoire - *CA Technologies - CEO*

Great. Well, thank you very much for joining us this evening. I'd like to leave you with a few closing thoughts. We're very pleased with our third quarter operating margin, earnings per share and CFFO performance. And as we enter into the fourth fiscal quarter, we believe we're on track to achieve our FY17 objectives. We continue to make progress across a key number of areas, a lot of them which we have talked about tonight. We are releasing higher quality products at a faster cadence and we're building integrations across a broad product portfolio, and we believe this is a significant competitive advantage for CA. With that, I'll thank you and have a great evening.

Operator

Ladies and gentlemen, thank you for participating in today's conference. You may all disconnect. Everyone have a great day.
