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CA - Q2 2017 CA Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 total revenues of $1.018b and GAAP diluted EPS of $0.50. Expects FY17 reported revenues to be $4.03-4.07b, reported GAAP EPS to be $1.88-1.93 and non-GAAP EPS to be $2.49-2.54.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to CA Technologies second-quarter 2017 earnings conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded. I would now like to turn the conference over to Ms. Traci Tsuchiguchi, Vice President of Investor Relations. Ma'am, you may begin.

Traci Tsuchiguchi - *CA, Inc. - VP of IR*

Thank you and good afternoon, everyone. Welcome to CA Technologies second-quarter 2017 earnings call. Joining me today are Mike Gregoire, our Chief Executive Officer; and Kieran McGrath, our interim Chief Financial Officer. Mike and Kieran will offer some prepared remarks, and then we will open up the call for a Q&A session.

These prepared comments were previously recorded, and this conference call is being broadcast on Thursday, October 27th 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. Reconciliation to the most directly comparable financial measures are included in our earnings release, which was filed on Form 8-K earlier today, as well as in our supplemental earnings materials 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 statement. These upper to our SEC filings, including our annual report on Form 10-K for a detailed discussion of potential risks.

Please note that our third-quarter quiet period begins at the close of business on December 15, 2016. 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, Inc. - CEO*

Good afternoon. Thanks for joining us. I am pleased to report solid Q2 results. We delivered another quarter of revenue growth with strong margins and earnings. Our performance in the quarter improves our confidence in our ability to cross over into modest revenue growth from the full year of FY17.

We are making progress across a number of our key initiatives. Our product development and innovation engines are beginning to gain traction, and I am very pleased with our customer experience metrics. We know that we are moving the ball in the right direction, while we recognize that there are areas in which we still need to continue to improve. As expected, new sales declined in the quarter, driven largely by the very difficult year over year comparison as a result of the large system integrator deal we closed in the year-ago period.

Importantly, as we mentioned last quarter, we now have agreements in place with our three largest SI customers for the largest several years. This reflects our position as a trusted technology partner to the largest global system integrators and provides us with good visibility into our longer-term customer commitments.

In terms of sales execution, I am happy to report that our freestanding new sales increased year over year. While the overall portfolio of deals for us to renew was smaller in Q2, I am encouraged by our healthy attach rates to renewals.

In the quarter, MetLife, one of the largest global insurance companies; FedEx, a global transportation and business service leader; and Cerner, a healthcare delivery solution provider, expanded their relationships with CA to include a number of solutions across our portfolio. New sales in our named and growth or partner-led accounts also grew nicely. Continued progress in freestanding new sales and penetration into named and growth accounts are key to driving long-term, sustained growth.

Q2 CFFO was negatively impacted year over year by the combination of a lower level of single installment collections and a higher level of cash tax payments in the quarter. As we've said before, we remain focused on and committed to developing products that are easier to install and easier to manage. A byproduct of this can be seen in the decline we are experiencing in our services revenue.

We continue to expect that as our portfolio of more user-friendly products grows and we increasingly leverage partners, our services revenue line will be impacted. Our Q2 services performance reflects this ongoing trend.

Results were also impacted by a lower level of prior-period services bookings and some nonstrategic projects that have come to close. We expect these collective factors will continue to be headwinds to our services revenue.

We remain committed to cultivating and nurturing the spirit of innovation at CA. While there is always more work to do, and we acknowledge that real systemic change within a large product organization takes time to bear fruit, we are making considerable progress. We are continuing to innovate within our existing portfolio and now have a more disciplined process in place to invest in future areas of growth for CA.

I'm very pleased that our efforts are recognized by industry analysts and, most importantly, by our customers. We look forward to providing more color on our progress at CA World next month.

I would like to highlight our overall portfolio of continuous delivery solutions, which had a great quarter with significant customer wins across a number of sectors, including financial services, telecommunications, media, government, and healthcare IT. We are committed to helping our customers become more agile in the application economy.

Our continuous delivery portfolio is central to this strategy, as it enables customers to rapidly develop, efficiently test, and reliably release applications. The result is more higher-quality applications delivered to the market at a faster pace.

We continued to invest in innovations across the continuous delivery portfolio. Our latest version was made available in July and focuses on an improved security model for customers. It also provides dependency management for complex deployments involving multiple applications.

We are pleased that CA release automation was positioned by Gartner in the Leaders Quadrant in its inaugural Magic Quadrant for application release automation. It helps customers manage their complex continuous delivery pipelines, and it is a critical element of a dev-ops strategy and executing many small releases in quick succession.

In August, we released the latest version of CA Agile Requirements Designer and end-to-end requirements gathering test automation and test case design tool that reduces manual testing effort. And just last month, we announced a small but strategic acquisition of BlazeMeter. While not meaningful in terms of its immediate financial impact, BlazeMeter adds a next-generation open source, SaaS-based performance and [load] testing platform to the portfolio.

Within security, I am particularly pleased with privileged access management, advanced authentication, as well as payment security, which all delivered very healthy new sales growth. In the quarter, we closed multiple seven-figure transactions, including very good competitive wins for CA Privileged Access Management. We have released a number of enhancements across the portfolio, and we continue to view security as one of the key pillars in our strategy to grow in the years ahead. Security is a critical component for our customers and their digital transformation strategies.

We are pleased with our performance of our mainframe business from a revenue perspective for the second quarter and for the first half of our fiscal year. We recognize that this is a market not in secular growth unlike the rest of our markets. As such, there is no doubt that size matters.

We are in a unique position as the largest independent software vendor in this market and really the only other Company outside of IBM making meaningful investments to support, sustain, and innovate for our customers with a mainframe footprint. This means that we are able to organically innovate on the mainframe with solutions like CA data content discovery, or DCD. With more than 70% of enterprise data on the mainframe, DCD enables customers to data-exposure risk onto the system by automatically scanning through the data on the mainframe infrastructure for regulated or sensitive data.

Data discovery, classification by security level, and comprehensive reporting enables our customers to mitigate risk. We are the only vendor in the market that does this on the mainframe, and we are very pleased with this performance and rate of market adoption.

The breadth and scale of our portfolio, our focus on integrations across the enterprise, and our dedicated efforts to continually improve customer experience are the foundations of our ability to support end-to-end dev-ops on the mainframe. We have flagship solutions like CA Endevor, which provides source code management and archives versioning of code development, including Java and parallel development. We also provide newer solutions like CA application lifecycle conductor, or ALC, which helps customers automate and manage the software development lifecycle, spanning mobile to mainframe environments.

CA provides one of the broadest portfolios of mainframe solutions in the industry, and we are leveraging our R&D across our developmental organizations For example, CA Agile Central users can create a new Agile story and then drag and drop so that ALC and Endevor create all of the associated code on the mainframe and move the code from development to test and then to production.

Other examples of enterprise solutions in mainframe synergies include CA release automation, test data management, and service virtualization. These are all tangible proof points of CA's commitment to an investment in providing value to our customers across mainframe, distributed, cloud, and mobile.

This leads me to an area in which everyone across every level of CA's global workforce is focused, customer experience. Perhaps the best way to illustrate what this means to us is to provide a few specific customer examples. TomTom, the Dutch navigation, mapping, GPS, and now sports and fitness company implemented CA Agile Central in its transition from traditional waterfall software development to Agile. Through this experience, TomTom viewed CA as much more than a software provider; CA is a trusted partner that provides access, demonstrates responsiveness, and engages in continuous product collaboration.

The Royal Bank of Scotland is implementing the bank's vision of delivering a seamless, omni-channel customer experience using CA risk analytics. CA solutions and partnership enable RBS to be agile and adaptive to the needs of its customers in an ever-changing financial services industry.

These are the types of stories that motivate us every day. From the earliest point of contact with customers through the many years that follow, we have vastly improved how we are showing up. From our CNN partnership for its election coverage to the tens of thousands of customers we've reached out to on customer experience day last month, and the ongoing contact our development and sales teams have with our customers on a daily basis, we have made considerable improvement.

CA's brand familiarity and consideration continues to move higher, particularly among business decision makers. Our customers are giving us higher scores on product quality, and customer satisfaction continues to trend positively.

We are proud of the great progress our team has made across the organization, but we are not satisfied. We still have work to do to further refine and optimize and really be agile, so that we can continue to evolve and achieve the type of long-term sustainable growth we know we have the potential to achieve.

Looking ahead, I'm optimistic. When I look at our Company holistically in terms of the markets we're in and the opportunities we have, both organically and inorganically, I believe that we are on track. Overall, we believe we can deliver modest low single-digit growth over the medium term.

We look forward to welcoming many of you at CA World next month through keynotes, guest speakers, and technical and best practice sessions, we'll explore and demonstrate how software has risen from a supporting role to the lead actor in driving business strategy and philosophy. We will host an analyst session on November 16th that will provide a great opportunity to speak with our executive team and to hear what our customers are saying firsthand.

With that, Ill turn the call over to Kieran to review our second-quarter financials and full-year guidance. Thank you.

Kieran McGrath - *CA, Inc. - Interim CFO*

Thank you, Mike. Before we get started with the quarter review, please note that all comparisons are year over year and 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 Q2 total revenue was $1.018 billion, and was up 1% and up 2% in constant currency. This was the second consecutive quarter we've grown revenue year over year as reported and the third in constant currency.

Q2 enterprise solutions revenue increased 7% and increased 8% in constant currency. Mainframe solutions decreased 1% as reported and in constant currency. Services declined 10% and declined 9% in constant currency.

Q2 total new product and capacity sales were down in the mid-20s as reported and in constant currency. The decrease in Q2 total new sales was due primarily to a difficult year-over-year compare driven by new sales associated with the large system integrator renewal transaction we signed in Q2 last year. Excluding the large SI transaction, total new product and capacity sales were down low teens, routinely as reported, and in constant currency.

Q2 renewals were down in the mid-50s, both as reported and in constant currency. Excluding the large SI transaction, renewals were down high single digits, both as reported and in constant currency.

As we previously stated, the year-over-year change in our renewal books 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 90s, in line with our long-term target.

Turning to geographies. New sales were down in North America, due in part to the difficult year over year compare resulting from last year's large SI transaction, as well as a small newer portfolio even outside of this large SI transaction. New sales in Latin America declined due to ongoing macroeconomic challenges in the region. New sales were up in India, due to strong performance in (inaudible) growth while partner-led accounts. To this point, we have seen minimal impact from Brexit on new sales.

APJ was up sharply more normalized levels, following a difficult quarter in the year-ago period. Revenue grew across all geographies as reported, except in India. Revenue grew in North America and APJ, was flat in Latin America, and declined in EMEA constant currency.

Within our segments, mainframe new sales declined in the mid-40s year over year as reported and in constant currency. Excluding last year's large SI transaction, mainframe new sales declined in the mid-20s and in the low 20s in constant currency. Mainframe new sales performance reflects lower levels of mainframe capacity due to the composition of the renewal portfolio, outside of the large SI renewal in the year-ago period.

Overall, we continue to expect our mainframe revenue 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 teens year over year as reported and in constant currency. Excluding last year's large SI transaction, enterprise solutions new sales decreased high single digits as recorded and in constant currency, in line with the renewal portfolio.

Areas such as continuous delivery and security saw positive new sales growth in the quarter. However, as we've discussed in the past, within enterprise solutions, there are products in our enhanced portfolio that are more mature and not growing, but contribute to margin and cash flow.

Services revenue decreased 10% and 9% in constant currency. We expect services revenue to decline, as we design our products to be easier to install and as we leverage partners. Services revenue is also impacted by a lower level of bookings in previous quarters and the conclusion of the some non-strategic services engagements. As Mike mentioned, we expect this headwind in services will continue to have a dampening effect on our overall revenue growth.

Total revenue backlog was up 4% as reported and in constant currency. Current revenue backlog declined 2% as reported and 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 90s renewal yield.

Q2 GAAP operating margin was 31% and non-GAAP operating margin was 40%. Operating margin improved year over year due to improved operating efficiencies and the impact of the acquisition-related expenses in the year-ago period.

This was partially offset by an increase in legal expenses related to us entering into an agreement in principle to settle the long-standing matter brought against us by the DOJ and individual plaintiff related to our GSA schedule with the government. This litigation was previously disclosed by us and relates to time periods as far back as 2002.

The proposed settlement is for $45 million and admits no wrongdoing. While it is still subject to finalization, we are pleased to have ventured into this agreement in principle in an effort to put it behind us. We look forward to continuing our long-standing relationship with the government as a trusted and valued customer and partner.

Segment operating margins in the quarter were 62% from mainframe solutions, 18% for enterprise solutions, and 3% for services. Our Q2 GAAP and non-GAAP tax rates were 31% and 29% respectively. Q2 GAAP diluted earnings per share was $0.50, up 28% year over year, and up 31% in constant currency. Q2 not GAAP diluted earnings per share was $0.67, up 20% year over year, and up 18% in constant currency.

Our Q2 CFFO was negative $58 million, down year over year as reported and in constant currency. CFFO declined relative to the year-ago period, primarily due to a lower level of single installment collections in the quarter, as well as higher cash tax payments.

Single-installment cash payments were $59 million and down $70 million year over year. The lower level of single-installment cash payments resulted from the mix of renewals in the quarter, which had fewer large financial institutions. Single-installment cash payments typically come from large financial institutions.

We ended Q2 with approximately $496 million in net cash. During the second quarter, we repurchased $50 million in shares and paid $107 million in dividends. We have $650 million remaining of our original $750 million share repurchase authorization.

As Mike said, we are pleased with our Q2 performance and it gives us improved confidence in our ability to cross over into modest revenue growth for the full-year in FY17. We are making progress across key imperatives and are continuously evaluating opportunities to improve our ability to sustainably grow. However, there is still work to do.

Our performance in some product areas and in (inaudible) growth in partner-led opportunities continues to improve but remains uneven. Also, our strong revenue performance in the quarter and the first half was aided by a relatively low proportion of upfront deals in the year-ago periods, making for easier compares.

As we indicated last quarter, the large SI deal we signed in Q1 substantially shifted the renewal portfolio, such that FY18 renewals are expected to decline year over year. To overcome this headwind, we are working to drive continuous improvement in the sales organization to increase consistency and velocity, independent of the renewal cycle. We are continuing to work to improve the efficiency and productivity within our development organization and continue to evaluate M&A opportunities to supplement our portfolio.

As a Company, we expect modest revenue growth in the medium term. This is the result of our three-pronged capital allocation of quarterly dividends, share repurchases, and acquisitions.

Now turning to guidance. Guidance is based upon exchange rates on the last day of the preceding quarter, which was September 30, 2016. The guidance also assumes no material acquisitions.

For the full year, we expect total revenue to increase in a range of flat to up 1% as reported and in constant currency, consistent with our prior expectations. This translates to reported revenue of $4.03 billion to $4.07 billion. We expect full-year GAAP operating margin of 29% and full-year non-GAAP operating margin of 38%. We expect our GAAP and non-GAAP tax rate to be between 28% and 29%, consistent with our prior expectations.

GAAP diluted earnings per share is expected to increase in a range of 6% to 8% as reported and 2% to 5% in constant currency, consistent with our prior expectations. This translates to reported GAAP earnings per share of $1.88 to $1.93.

Non-GAAP diluted earnings per share is expected to increase in a range of 2% to 5% as reported, and 1% to 3% in constant currency, consistent with our prior expectations. This translates to non-GAAP earnings per share of $2.49 to $2.54.

We'd like to provide some additional color regarding our expectations for the second half of FY17. While there is no change to our full-year revenue guidance, I would like to provide some headlights into how expect Q3 to play out.

In terms of the year-over-year compare, the tailwind of the upfront revenue mix that benefited the first half of the fiscal year is expected to become a headwind in the second half of the fiscal year. As such, we expect revenue to decline 2 percentage points year over year in Q3. This was largely due to the timing of the mix of upfront deals that closed at year, in addition to a lower level of services revenue. As discussed earlier, the upfront mix was particularly low in the first half of FY16 and then rebounded in the third quarter.

With regard to non-GAAP operating margins, we expect the lower revenue level to impact to Q3 operating margin when compared to the year-ago period. As indicated earlier, there is no change to our full-year 2017 revenue or operating margin guidance. At the end of the year, we expect approximately 411 million shares outstanding and a weighted average diluted share count of approximately 414 million shares.

Cash flow from operations is expected to be in the range of a 3% decrease to a 1% increase, both as reported and in constant currency. This translates to $1.01 billion to $1.05 billion. Previous quarter guidance was an increase of 2% to 6%, and an increase of 1% to 5% in constant currency. This change is due to the anticipated settlement of legal matters related to the agreement in principle for the GSA litigation previously discussed. With that, we'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Raimo Lenschow, Barclays.

Unidentified Participant - - *Analyst*

Hi guys. This is Andrew on for Raimo. Could you dig in a little more to that GSA settlement? And are we going to see any more impacts maybe this year or next year?

Mike Gregoire - *CA, Inc. - CEO*

Hi Andrew. Thank you. Yes, the GSA settlement, this is a long-standing complaint that was filed sometime in 2009 and it goes back to transactions that reach all the way back to 2002. And we've been working with the DOJ since 2014 trying to understand their complaint and how the best resolve it.

We're pretty pleased to be able to resolve this at $45 million. We'll pay that $45 million off some time in Q3 our Q4 as we get through the normal process of the settlement.

This has been a boat anchor that's been in every K and Q since I've been here. And working through this process is long and arduous, and I think both us and the government are happy to have this behind us.

The government's a great customer of ours. We do a lot of different transactions with a lot of different agencies, and this has been something that we've both been working in earnest to try to get to a reasonable settlement.

We don't have anything of this magnitude on the books for the rest of the year, and the way we're running the railroad here, we've got enough controls in place that I think that being very clean with respect to how we transact, especially with the government, we've really stepped that up over the last couple years. Hopefully that's helpful.

Unidentified Participant - - *Analyst*

Yes, maybe I could just sneak in one more, just to cross the Ts and dot the Is on this. Anything in the next few quarters of any particularly large deals that might be coming up that we should look out for?

Mike Gregoire - *CA, Inc. - CEO*

With respect to selling deals or respect to settlements?

Unidentified Participant - - *Analyst*

For booking deals.

Mike Gregoire - *CA, Inc. - CEO*

We're always trying to find the big ones, but our renewal portfolio is pretty set between now and the end of the year. And we don't see anything that we have in the pipeline that would be of the magnitude of Q2 of last year. But as we saw in the first quarter of this year, sometimes, customers decide that they want to make a strategic decision to consolidate their data centers and/or consolidate the relationships with fewer vendors. And we really can't control that.

Kieran McGrath - *CA, Inc. - Interim CFO*

Just to follow up, obviously you know that we have our three biggest SIs now locked up for the next 4.5 years, plus, so we wouldn't anticipate any other big SIs coming in.

Unidentified Participant - - *Analyst*

Great. Thanks, guys.

Operator

Matt Hedberg, RBC Capital Markets.

Matt Swanson - *RBC Capital Markets - Analyst*

Thanks. This is Matt Swanson on for Matt. I'd like to dig a little into the enterprise solutions operating margins in the quarter, coming in at 18%, it's higher than we've seen in some time. Can you talk a little about what drove that, and then just as a reminder, how the products within enterprise solutions vary from a profitability standpoint.

Mike Gregoire - *CA, Inc. - CEO*

Sure, I'll give a little bit of color, and then I'll have Kieran weigh in on some of the financial metrics. Well, the first thing is that I was super pleased about is of the growth portion of the enterprise segment of the 8%, 4% of that was from our SaaS solutions, and these are solutions that didn't exist 18 months to 24 months ago. So I'm very happy to see tangible metrics that our innovation engine is working.

With respect to the higher margin, a lot of that has to do with just timing. If you take a look at the cyclical nature of our business and when acquisitions have hit, we're on the year anniversary of Rally, and with the Xceedium acquisition being relatively small and the amount of capital we had to put in to make Xceedium ready for large-scale customer usage, we've had some savings.

This will be a blip in enterprise margin. Eventually we'll get up to the high end and be repeatable there, but I don't think 18% is going to be consistent for the next little while. Kieran?

Kieran McGrath - *CA, Inc. - Interim CFO*

Mike, I agree. If we go back and take a look at last year when we are at pretty 36% margins for the Company as a whole and where ES was extremely low, that's obviously the quarter when we brought in both the Rally and the Xceedium acquisitions. So there was a significant amount of one-time costs associated with that.

And for the Company as a whole, if you look at those one-time costs that we didn't incur this year, basically think of it offset with the GSA impact. So the real impact in the margin improvement for the Company as a whole, as well as for ES, was a lot of the upfront revenue that we talked about.

You heard me describe that we had a very weak compare in terms of our upfront revenues, and that's all in the ES segment a year ago. The growth that we had in upfront revenue in Q2 was worth about 3 or 4 points of margin expansion on a year-on-year basis.

And as Mike said, longer-term plans, we expect to get there. And just keep in mind Q3, we always have the seasonality of our -- of CA World, which incurs some big costs, and then obviously in Q4 when we're finalizing commissions and payouts, it's usually our seasonally lowest quarter of the year.

Matt Swanson - *RBC Capital Markets - Analyst*

All right. Thanks for the thorough answer, guys, and for taking my question.

Kieran McGrath - *CA, Inc. - Interim CFO*

Absolutely.

Operator

Kirk Materne, Evercore.

Kirk Materne - *Evercore ISI - Analyst*

Thanks very much. I had just a question about the mainframe business. Is it mid-single-digits decline that you're seeing. Mike, when you go out and talk to people, is there any concern that that decline could accelerate as people start thinking more and more about public cloud?

I think the mainframe has been somewhat of a stalwart and it doesn't get brought up that much. I'm not sure if that's just because we don't talk about it enough in general. I'm just trying to get a sense on whether or not that you feel like that is a pretty good glide point from here.

And then secondly, around mainframe, obviously, very high margin business. Do feel like there's enough margin expansion in the ES business to offset the margin contribution mix shift there just to maintain margins where we see them, just generally, when we look at a year or two from now? Thanks.

Mike Gregoire - *CA, Inc. - CEO*

Sure. First on the mainframe deceleration, we don't see high single-digit mainframe deceleration; we've consistently seen low single-digit mainframe deceleration. So it hasn't -- I wouldn't characterize it in the higher end of single-digit deceleration.

And when we're talking to customers, customers that have made an investment in the mainframe continue to invest in the mainframe for a variety of reasons. I think the biggest reason is that's where the applications are. And to report those applications onto a different platform to do the exact same thing, the amount of calories to do that and the amount of risk, especially if you're in a regulated environment, there just hasn't been a whole lot of appetite to do that. They'd rather spend their net new development dollars building net new products and services that get to devices that customers want.

Secondly, there's been a great set of technologies. One of them that we're one of the primary suppliers of is ATI management. So a lot of mainframe customers want to serve up that mainframe data that's very protected, very secure and put it onto a tablet, put it onto a smartphone. And the way that they're doing that is using ATI technology.

So they get to keep the high-volume transaction processing engine that is currently working, keep the applications, the data structures in place, and then be able to serve their customers in a way that customers want to be served. So I think that's the stability argument for the mainframe, and we haven't seen anything really change with respect to that.

With respect to margins, as you know, we break out our business in three segments: mainframe, ES, and services, with mainframe always being in the low 60s and services fluctuating in the mid-teens. As we continue to get better and have better efficiencies in our enterprise business and the higher volume of revenue, we are able to get a blended margin in the high 30s, and we feel pretty confident about that for the foreseeable future. Kieran, maybe you have a couple comments with respect to the margin?

Kieran McGrath - *CA, Inc. - Interim CFO*

Right, so just a couple points. For starts, from a services perspective, mid single digits is where we expect the margin to be over the longer haul. We think that there is a lot of opportunity, as Mike pointed out, as you start to scale the revenue, especially in the SaaS. So, and you start to achieve some scale. We really think we can improve the low teens that we've been operating at in ES, certainly to get to the high teens over the [technical] and midterm time horizon.

From a mainframe perspective, we think as long as the growth continues to decline in the low single digits, as Mike pointed out, we can manage both the cost profile in that business as well as improving the cost profile in the ES business to maintain ourselves in that high 30s that we've been staying at for the last couple years.

Mike Gregoire - *CA, Inc. - CEO*

Kirk, just to finish up your question -- when you go take a look at the transcript, I specifically put a lot of commentary in with respect to the mainframe. Because the other thing that's helping the mainframe is we've been able to blend innovation from the ES segment onto the mainframe, and that makes the customers more attracted to the platform because they're constantly think innovation. And to the extent that they can work with their mainframe solution, they're on-premise enterprise solution, and the cloud solution, we have products that scale across all three, it just makes less of an argument to move off of a platform that's already working and spend your precious R&D resources on net new innovation that's going to drive your customer segment further along.

Kirk Materne - *Evercore ISI - Analyst*

Thanks guys. I appreciate the color.

Operator

John DiFucci, Jefferies.

John DiFucci - *Jefferies LLC - Analyst*

Thank you. Guys, I'm just trying to reconcile, I know your model has a lot of moving parts here, but bear with me for a second because excluding that large deal last year, I'm just trying to figure out how new business could be down greater than renewals. And especially if new business attached to renewals was good and new business standalone was good, was it good, but just last year it was even better, and that's why new business growth or new business declines were greater than renewal declines this quarter? I don't know.

Kieran McGrath - *CA, Inc. - Interim CFO*

John, let me take a shot at that. From a renewal perspective, total renewals were down in the mid-50s. If you adjust for the big SI that we had in Q2 of last year, we were down in the high single digits.

From -- when we go and think about the mainframe business, really the mainframe business without that big adjustment, adjusted for the big SI, was down in the mid-20s. And quite frankly, that's capacity. We're seven years -- seven quarters now into the mainframe -- the latest mainframe cycle. Its not unusual for that to start to drift off a little bit over time And it is so highly dependent on our renewal cycle.

So this Q2 was just a very, very seasonably low renewal cycle for us, just based upon the number of large deals that we're going to close. And normally, that's where we would expect this to drive incremental mainframe capacity.

If we take a look at the ES business, we think the ES business, which quite frankly, we were very pleased with a lot of the freestanding sales that we saw across the spectrum, as well as the attach rates on the small amount of renewals that we did do. And we think overall, the ES business was down at that mid-single digit, up high single digit number, consistent with what the renewals would have been if you adjusted for the big acquisition from last year.

John DiFucci - *Jefferies LLC - Analyst*

Okay, so it's all the mainframe. That's just something we just have to live with, that is what it is.

Kieran McGrath - *CA, Inc. - Interim CFO*

Yes especially from a capacity perspective.

John DiFucci - *Jefferies LLC - Analyst*

Okay. And Kieran, you made a statement. You said you expect modest revenue growth in, quote, in the medium term. And I just want to -- can you give us little bit of more color on what you exactly mean by the medium term?

Kieran McGrath - *CA, Inc. - Interim CFO*

Well, I think we've always been pretty consistent in defining the medium term as our three-year strategic plan cycle. We have not changed. Anything we've seen, we have not changed our view of that at this point in time.

John DiFucci - *Jefferies LLC - Analyst*

Okay. That's all very helpful. Thank you.

Kieran McGrath - *CA, Inc. - Interim CFO*

Thanks, John.

Operator

Walter Pritchard, Citi.

Walter Pritchard - *Citigroup - Analyst*

Hi. Thanks. I think, Kieran, I have a similar question on the -- just making sure I understand what's going on with the upfront business. My interpretation of what you had last year was a lot of the Rally business, and some of the new product success was showing up in SFO. And it sounds like now -- are you actually looking for that business to decline year over year or flatten out? And why wouldn't we see better growth there if that's where some of the new product business is going?

Kieran McGrath - *CA, Inc. - Interim CFO*

Walter, I hate to revisit a subject that you and I were just on when we had our panel discussion along the whole world of accounting and [BSOE] and all the rest of that stuff, but sadly we have to get into a little bit of that. What you normally find is a year ago, it was very large renewal cycle quarter. And in that renewal cycle quarter, when you have a lot of renewals and you're selling the new product, that product is going to be taken ratable by -- from the BSOE that we have, that's forced to take ratable.

But we were at really extremely low levels, as we said, in the first two quarters of last year and that really rebounded very nicely to actually quite high levels of upfront recognition in the third quarter of last year. Where we actually had a deal related to our Xceedium business that we sold into a government agency, the largest deal they had ever done, and that was all taken on an upfront basis.

So what we've seen this quarter, very low renewals. Again, nothing unusual about it except that we just didn't have a lot of big deals expiring at this particular point in time. And any of the freestanding sales that we sold outside of that renewal cycle for those qualifying products, we were able to take the revenue upfront. So hate to get [gorpy] with that BSOE and accounting world of it, but it was a little bit of that complicated with the mix of just when our renewal cycle was naturally ebbing and flowing.

Walter Pritchard - *Citigroup - Analyst*

And then relative to the services business, that business has been anywhere from flat to down 10%. And I understand strategically what you're doing with pushing more of that to -- or having the partners pick up more of that to given them some business in your ecosystem. But can you talk about, do you expect that actually to steepen in terms of the declines you've seen? Do you expect it to flatten out over time? Any direction there would be helpful.

Kieran McGrath - *CA, Inc. - Interim CFO*

I think in the near term, we are anticipating declines pretty consistent what we saw this quarter. As I think about it, mid to high single digits, and probably for the near to mid term, until we reach a certain level. We've gotten ourselves out of some businesses that we didn't think as necessarily strategic. We really want our services businesses to be there really to help with adoption of our software.

In all honesty, long term we expect that we will have a level of service that's required. One, to drive transformation our customers like we would do at a rally or something like that, as well as to help continue with adoption. We don't think the business is going to totally evaporate, but I do think in the near and the midterm, we'll probably see rates of decline pretty consistent to what we saw this quarter.

Walter Pritchard - *Citigroup - Analyst*

Great. Thank you.

Operator

Abhey Lamba, Mizuho Securities.

Unidentified Participant - - *Analyst*

Thanks very much. This is [Partov] in for Abhey. The 32% growth on the software fees line, can you give us a sense of what the drivers behind that were and how sustainable that is in -- over the next few quarters?

Kieran McGrath - *CA, Inc. - Interim CFO*

Well, from a categorization perspective, the first thing I need to point out is in that SFO line, we have a combination of the upfront revenue that we take, which as we said was significantly stronger in Q2 this year that it was last year. It's also line item where we've been putting our SaaS business. As Mike mentioned earlier, that we had about half of our overall ES revenue contribution from our SaaS businesses. So it's really a composite of both.

Unidentified Participant - - *Analyst*

Okay. Thanks, and as a follow-up, when you look at your portfolio today, and with your growth goals in mind for FY18, do you think you have all the pieces in place to achieve that growth? Are there any product areas that you don't have exposure to but are currently evaluating?

Mike Gregoire - *CA, Inc. - CEO*

So, we always have an opportunity to trim the portfolio in areas that are not growing, and we also have opportunities to build new organic product. And we also try to look for opportunities to use our balance sheet and buy adjacencies that we think will help us grow in the future.

So to answer your question -- I think we're in a very good position to achieve the kind of growth we gave through in guidance, but we're always going to be taking a look for new technologies on the buy versus build analysis. If you take a look at just this last quarter, we bought a relatively small company called BlazeMeter, which is very strategic for us.

We've had a lot of growth in our testing market. This is an additive to the testing market, but gives customers another opportunity to protect their code as it goes into production. And this is a foray into another SaaS product, and it's also using a significant amount of open-source technology. So it hits all of the things that we think are important as to what customers want to buy. And to the extent that we see opportunities like that, what it does is it gives us an opportunity to accelerate growth and it also derisks our plan going forward.

Unidentified Participant - - *Analyst*

Okay, great Thanks very much.

Operator

Michael Nemeroff, Credit Suisse.

Michael Nemeroff - *Credit Suisse - Analyst*

Hi, guys. Thanks for taking my questions. Mike, I just want to follow-up on some of the comments you had in your prepared remarks around the innovation on the mainframe. Specifically, you mentioned DCD. I'm curious, are you using DCD in some of the other innovations on the mainframe as a retention tool on renewals? Or are you selling those products to customers discreetly? And if discreetly, what would the -- is it meaningful and what would the decline in the mainframe look like without it?

Mike Gregoire - *CA, Inc. - CEO*

Yes. It's a [step] a single product, and I think in my prepared remarks, I had three or four different products that we profiled. This is one that's done both ways, Michael. For example, I know of an insurance company that bought that particular product outside of the renewal cycle, because they thought it had value and they wanted to be able to use that to scan their data logs to make sure they're following the regulatory procedures that that particular industry has.

Whenever we're pitching a renewal, our sales force is trained to use that as an opportunity to keep the renewal yield high. So we're constantly shooting for something higher than a 90 in our renewal cycle. What it does is it takes some of the pressure of that renewal yield away.

The over-arching thesis of what we're trying to do there is to help that deceleration, that secular deceleration of the mainframe, dampen it down by offering customers both net new solutions. And also, psychologically, show them that we're still investing in the mainframe. We're one of only two companies that are still making significant investments in R&D on the mainframe. And to the extent that we're able to package that up and show the value, I think it protects the franchise.

Michael Nemeroff - *Credit Suisse - Analyst*

That's great. That's all I have. Thanks very much.

Operator

Michael Turits, Raymond James.

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

Hi guys. Two questions. One, I don't know if you addressed 0- obviously the next 12 months revenue backlog. Again, I realize that we're far away from it turning, or at least we're not at the point where it turns positive. But it did tick down, so what was the issue there?

And then also, can you square up the growth year over year in freestanding sales. Could the fact that ES was down with the renewal portfolio, ex the SI deal? Because my understanding is that the big push has been to work on what you're doing in terms of selling outside of the renewal portfolio.

Kieran McGrath - *CA, Inc. - Interim CFO*

Let me take the last one first and then we'll get back to the backlog. As I think I've said before, the opportunity when you're not selling with the renewal, per se, just the opportunity to take that revenue upfront, and so that ends up happening is you have a much higher yield in that which you sell from a new perspective that you'll actually recognize upfront, and that does, in fact, play a part. But why the revenue backlog comes down a little bit as well, because the license portion of that revenue you're taking in the current time period.

Additionally to that, similar to the list that we were getting inorganically over the past several quarters as we added revenue from our acquisitions last year, there was a modest current backlog help there as well, and now that that's -- we've wrapped around and we've flat-lined on that, I think what you're seeing is probably, I would say, it's actually relatively flat quarter on quarter when you take those things into consideration.

Now from a freestanding sales perspective, clearly, long term, that is absolutely the objective. The objective is, over the long haul, to ensure that our business is always going to look for opportunities to sell and not have to wait until an annual or tri-annual contract expires.

I think our teams are getting better at that. We've seen, actually, some good performance over the last year and several quarters happening in our named and growth accounts. But surprisingly, it happens actually quite frequently in our platinum accounts as well.

Mike Gregoire - *CA, Inc. - CEO*

The other thing I'd add to that, Michael, is we are seeing a change in how customers buy. Up until even two or three years ago, enterprise software companies were constantly selling in and around renewals for these large ELAs, because that's how the customers have been trained for 20 years to buy from us. And breaking that mold has taken some time.

So even though we have the best intentions and we'd prefer to be able to sell solutions when customers need them, there is a lot of procurement teams that hang on, waiting six, nine months before they buy, thinking that they're going to get a better deal if they package it up into an ELA. I'm seeing some of the frost break on that particular model, but when I take a look at the mainstream, large, Fortune 200 companies, there's are still a lot of decisions made by procurement teams that I think is shifting to line of business buyers.

When we're selling to a line of business buyers, they don't care about ELAs. They have a problem, they want that solution solved, and they're buying it with a capital budget, with an operational budget, rather than the capital budget. And a lot of times, they're buying it outside the context of a general CIO procurement team. Still some work to be done in our industry with that, but I don't think that's a unique CA phenomenon.

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

Okay thanks Mike. Thanks, Kieran.

Operator

Thank you. At this time, I'd like to hand the conference back over to Mr. Mike Gregoire for closing comments.

Mike Gregoire - *CA, Inc. - CEO*

Thank you very much for everyone joining. I know it's a big evening with a lot of companies reporting tonight. But I'd like to leave you with a few closing thoughts. First of all, we are very pleased with our second-quarter revenue, operating margin, and earnings performance and remain on track to achieve modest revenue growth this fiscal year. We're making progress across a number of our key imperatives, including product sales and customer experience.

I look forward to many of you at CA World next month, when we host a track for financial analysts on November 16th. Thank you very much for your time and good night.

Operator

Ladies and gentlemen, thank you for participating in today's event. This concludes our program. You may all disconnect, and have a wonderful day.
