F2Q18 Earnings Conference Call Script

Final

Traci Tsuchiguchi:

Thank you and good afternoon everyone. Welcome to CA Technologies' Second Quarter 2018 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 will open up the call for a Q&A session.

These prepared comments were previously recorded and this conference call is being broadcast on Wednesday, October 25th, 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 U.S. 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 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 statements. Please refer to our SEC filings including our annual report on Form 10K for a detailed discussion of potential risks. Please note that our third quarter quiet period begins at the close of business on December 15th, 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:

Good afternoon. Thank you for joining us.

I am pleased with the healthy operating margin and strong CFFO growth we delivered in our second fiscal quarter. We are very pleased that the contribution from our SaaS business continues to grow at a rapid pace. Total new sales, Enterprise Solutions new sales, and Mainframe new sales all outperformed the year-over-year decline in the renewal portfolio. This, combined with our revenue backlog, gives me confidence in our full year guidance.

That said, it is not lost on me that we have work to do.

Our sales execution in Q2 was disappointing and revenue came in below our expectations. In particular, velocity in sales outside of the renewal cycle of Enterprise Solutions products was short of our expectations. There are a few primary factors underlying this.

First, the renewal portfolio was smaller in the second quarter than in the year ago period, as we expected. This lighter renewal portfolio creates a natural headwind to all of our bookings-related metrics.

However, our expectation is that we should be able to consistently sell outside of our renewals, regardless of the timing of the renewal portfolio. Any failure to do so erodes opportunity to recognize up-front revenue that directly ties to our quarterly revenue results. After demonstrating success in selling outside of our renewal portfolio, we got complacent. Growth in our ES free-standing new sales requires a level of sales leadership and focus across the team that did not materialize in Q2. We expect to return to a more consistent level of performance in the second half of our fiscal year.

Another factor that impacted our Q2 organic revenue performance was the result of a conscious decision we made to prioritize new sales of the Automic automation platform. Unifying CA's organic automation solutions onto an integrated CA Automic ONE Automation platform negatively impacts our organic revenue in the near-term, particularly in the Enterprise Solutions segment. We believe the long-term benefit to all of our stakeholders more than offsets the organic headwinds this creates in the near-term.

Over time, our customers will benefit from the clarity of a single platform with robust integrations across our product portfolio. For our customers, this decreases their development dollars, integration efforts, and simplifies their broader IT environment. We will continue to make decisions that are in the best interest of our customers and long-term shareholders, even if at the expense of near-term optics.

We remain pleased with the strategic nature of our recent acquisitions.

The importance of our Veracode acquisition, which elegantly bridges our Security portfolio to our DevOps portfolio, could not have been more evident this quarter with very well publicized recent data breaches. Security continues to be top of mind among business leaders and individuals. Looking back at the breaches that have happened in the recent past and looking ahead to GDPR, or the EU's General Data Protection Regulation which goes into effect in May of next year – it's clear that security continues to be critically important.

Today, there's an extraordinary amount of code that's written. This proliferation accelerates the need to ensure that code is written securely to prevent hacks and compromises that can severely impact consumers, tarnishing the reputation of corporations and their executives. Fixing faulty code earlier in the cycle with a SaaS-based tool, before it's released, is efficient, cost-effective, and in everyone's best interest. Veracode's value proposition is precisely this sweet spot.

When I look at our identity-centric security portfolio, I am incredibly proud of CA's partnership with customers like Nasdaq and the State of Louisiana Office of Technology Services. With the latter, we are implementing identity and access management solutions across government agencies to further digitize and better protect state and citizen information. It is working to modernize and standardize IT services across the state's 16 government agencies in order to streamline processes and enable engineers to more efficiently and more securely run services and applications across networks.

In the second quarter, we announced the release of CA Privileged Access Management, or CA PAM, 3.0. It gives companies and organizations the ability to scale their PAM deployments across multiple departments, and provides Managed Service Providers a helpful way to manage multiple instances of the product for their customer base across platforms and infrastructures. The scalability of a PAM solution is critical to ensure organizations can address and control cyber risk coming from trusted users in any environment. Customers need to manage access across departments, geographies, heterogeneous IT environments, and consider complex architectural requirements. CA PAM supports these needs with enhanced features that enable greater control across the spectrum of user access points.

Last month, we announced “Day One” support for IBM z14 for our key mainframe solutions. Our continued investment in the mainframe and partnership with IBM helps to ensure the mainframe remains a system of trust with its elevated level of encryption and security. In addition, our solutions, which leverage the new z14 platform, greatly decrease the risks of data breaches that can arise from the degradation of performance associated with increased encryption needs. We are collectively providing unified enterprise security that helps to increase an organization’s compliance structure across new and existing mainframes. This is of increased importance as organizations prepare for the implementation of new regulations that focus on data privacy, like GDPR.

Strength in mainframe new sales, despite a smaller renewal portfolio in the quarter, was driven by our newer products, including Mainframe Operations Intelligence , Data Content Discovery, and Dynamic Capacity Intelligence.

Across our product portfolio, we continue to earn the recognition of third party industry analysts. CA was recently named a leader in the IDC MarketScape: Worldwide Agile PPM 2017 Vendor Assessment – Enabling Adaptive Planning for Emerging Markets, DevOps and IoT. CA was also named a Leader in the Forrester Wave for Continuous Delivery and Release Automation, Q3, 2017. And, CA was positioned as a Leader in the 2017 Gartner Magic Quadrant for Application Release Automation.

We are well positioned in great markets, and our solutions are solving real problems for our customers. This feeds my optimism as I look ahead.

In the near-term, we believe we are on-track to achieve our fiscal year 2018 guidance. Additionally, we are working on an on-going plan to improve the efficiency of our opex spend across the organization.

Longer-term, we are working on a plan to drive accelerated improvement in our organic revenue trajectory. Concurrently, we are putting in place improvements to drive sustainable growth and expand profitability over time. We are optimistic that we have a path to improve the long-term health of the company and our shareholder returns.

I look forward to seeing many of you at CA World next month. Our financial analyst track will take place on November 15th. There is no better place for you to see the breadth and depth of CA's portfolio of solutions and hear firsthand from our customers how they are deploying CA's solutions.

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

Kieran McGrath:

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.

Bookings

Q2 total new sales were up mid-single digits as reported and low single digits in constant currency, and organic new sales were down approximately 10% as reported and low teens in constant currency. As Mike mentioned, while we were pleased by the continued strong performance of our SaaS products, we were disappointed by our overall slower sales velocity in the quarter.

The total renewal portfolio was down mid-single digits as reported and high single digits in constant currency compared to the year ago period. As we have stated on prior earnings calls, the year-over-year fluctuations in our renewal bookings vary on a quarterly basis due to the timing and duration of large transactions. Our renewal yield for the quarter was greater than 90 percent.

Organic new sales declined year-over-year across all regions due to the lighter renewal portfolio in the quarter.

Within our segments, Mainframe new sales were up in the low-20s and were positively impacted by both product and capacity sales in the period. Specifically, we saw strong demand for new products such as Dynamic Capacity Intelligence which optimizes mainframe capacity utilization. New sales contributions from Mainframe Operations Intelligence, which embeds machine learning to improve operational performance and Data Content Discovery which addresses security and compliance challenges were also drivers in the quarter.

Enterprise Solutions new sales were down in the low-single digits, and organically were down approximately 20%. As mentioned, we were very pleased by the performance of our SaaS products, which continued to grow at a rapid pace in the quarter. Our recent acquisitions also contributed meaningfully to our results in the quarter.

Revenue

Total revenue for the second quarter was $1.034 billion, up 2% as reported and up 1% in constant currency. Acquisitions contributed approximately 5 points to total revenue growth in the quarter.

From a segment perspective, Enterprise Solutions revenue was up 7% as reported and 6% in constant currency. Mainframe Solutions revenue was down 2% as reported and down 3% in constant currency, in-line with our longer-term expectation for the overall Mainframe market. Services revenue was flat as reported and in constant currency.

Total revenue backlog was up 2% as reported and 1% in constant currency while current revenue backlog improved 7% as reported and 6% in constant currency. Approximately 4% of the current backlog increase can be attributed to the acquisitions of Automic and Veracode while the remaining balance was driven by organic factors. In general, the size of the renewal portfolio coming due in the next twelve months is a driver of our current revenue backlog.

Operating Margin and EPS

Q2 GAAP operating margin was 27% and non-GAAP operating margin was 38%. Segment operating margins in the quarter were 65% for Mainframe Solutions, 10% for Enterprise Solutions, and 1% for Services.

Our Q2 GAAP tax rate was 28.7% and our non-GAAP tax rate was 28.5%.

Q2 GAAP diluted earnings per share was $0.44, down 12% as reported and down 10% in constant currency. Q2 non-GAAP diluted earnings per share was $0.62, down 7% as reported and down 6% in constant currency.

Cash Flow

Our Q2 CFFO was $37 million, up $90 million compared to the year ago period. Single installment cash payments were $80 million in the quarter, and up meaningfully over the prior year. Recall that in the year ago period, single installments were unusually low.

We ended the second quarter with approximately $100 million in net debt. We paid $108 million in dividends and repurchased $90 million worth of our shares outstanding in the quarter. We have $560 million remaining of our original $750 million share repurchase authorization.

We continue to expect that we will at least offset dilution with our share repurchase program.

ASC 606 Update

Consistent with what we've said in the past few quarters, we'd like to provide some incremental disclosure with regard to our upcoming adoption of ASC 606. Upon adoption of the new revenue recognition standard under the modified retrospective method, we expect that a significant portion of deferred revenue and revenue backlog booked in accordance with the current standard – ASC 605 – will not be recognized as revenue following our adoption of ASC 606. Instead, it will become part of a cumulative effect adjustment within retained earnings.

Said another way, the license component of bookings recognized under the current standard will fall out of deferred revenue and revenue backlog. Instead, it will be captured in retained earnings on the balance sheet.

As a consequence of this adjustment, we expect to see an acceleration of the timing of income taxes payable. We are still evaluating the amount and timing of those payments upon adoption and awaiting updates from regulatory agencies. As a reminder, we do not expect the new standard to significantly impact billings and cash collections from billings.

Guidance

Now, turning to guidance. Guidance is based upon exchange rates on the last day of the preceding quarter, which was September 30th, 2017. No additional material acquisitions are assumed in our guidance.

As a reminder, please keep in mind that our renewal portfolio for the year is heavily weighted toward the fourth fiscal quarter. Typical seasonality for CA implies bookings and revenue to be stronger in the fourth fiscal quarter as well. Operating margin in the third quarter will be impacted by the timing of spend related to CA World, and therefore should be the lowest operating margin of the year.

For the full year we expect total revenue to increase by approximately 5% as reported and 4% in constant currency. This translates to reported revenue of $4.22 to $4.25 billion.

We also expect our full year GAAP operating margin to be between 26% and 27% and our non-GAAP operating margin to be between 36% and 37%.

We expect our GAAP and non-GAAP tax rate to be between 28% and 29%.

We expect our GAAP diluted earnings per share to decrease by 8% to 5%, both as reported and in constant currency. This translates to reported GAAP earnings per share of $1.70 to $1.76.

We expect our Non-GAAP diluted earnings per share to be down 2% to flat, both as reported and in constant currency. This translates to reported Non-GAAP earnings per share of $2.42 to $2.48.

At the end of the year, we expect approximately 412 million shares outstanding, and a weighted average diluted share count of approximately 415 million shares.

We expect cash flow from operations to be up 2% to 6% as reported, and flat to up 4% in constant currency. This translates to cash flow from operations of $1.10 billion to $1.15 billion.

With that, we’ll open it up for questions.