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CA, Inc. (CA)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the CA Technologies' Conference Call and Webcast of Third Quarter Fiscal Year 2018 Results. At this time, all participants are in a listen-only mode, and later we will conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] And as a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, Ms. Traci Tsuchiguchi, Vice President of Investor Relations. Ma'am, you may begin.

Traci T. Tsuchiguchi
Vice President of Investor Relations, CA, Inc.

Thank you and good afternoon, everyone. Welcome to CA Technologies' Third 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 Q&A session.

These prepared comments were previously recorded, and this conference call is being broadcast on Tuesday, January 30, over the phone 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, and is available on our website at ca.com/invest, as well as in our supplemental earnings materials, all of which are also available on our website.

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 a detailed discussion of potential risks.

Please note that our fourth quarter quiet period begins at the close of business on March 15, 2018. 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.

Michael P. Gregoire

Chief Executive Officer & Director, CA, Inc.

Good afternoon. Thank you for joining us. I'm very pleased to report strong fiscal third quarter results. Total revenue growth accelerated from the prior quarter, and organic revenue grew year-over-year. Quarterly revenue was the highest it's been in four years and resulted in the highest growth rate CA has delivered in six years. Importantly, we delivered a number of new innovative products to the market.

In terms of booking metrics, total new sales and organic new sales outperformed the year-over-year decline in the renewal portfolio. Our strong revenue performance combined with disciplined expense management resulted in solid operating income and margin performance, excluding the one-time impacts of the Tax Cut and the Jobs Act (sic) [Tax Cuts and Jobs Act] that was enacted in the U.S. during the third quarter, commonly referred to as the U.S. Tax Reform, earnings per share grew year-over-year.

Across our portfolio, we are positioning CA as the preeminent partner for customers in building a Modern Software Factory, one that is agile, built to change, and able to adapt to market disruption and customer demand. Its foundation is in an automation that is fueled by data and analytics that are protected by strong security to preserve customers' most valuable assets. It enables customer to save time and money and reduce errors so that they can deliver application experiences that delight their end users. This effort in building the modern software factory is the combination of developing innovative, organic products, acquiring strategic assets, and remaining focused on the customer's journey and customer success.

In the third quarter, we launched a number of new products. They represent the ongoing investments we are making across our portfolio and are great examples of the innovation CA is delivering to the market. One of our newest organically developed products is CA Continuous Delivery Director or CDD. This new SaaS-based offering integrates the DevOps workflow for end-to-end visibility and management of application development, test, release, and monitoring. CDD applies intelligence to the test planning and quality risk assessment. This enables developers to more easily assess pipeline progress and performance that provides a seamless way to eliminate inefficient spreadsheet-driven processes in release planning and management in a single pane of glass by orchestrating CA DevOps solutions, third-party solutions, and open source technologies.

Another new product, CA BlazeMeter API Test, is a light-weight SaaS-based testing solutions that enables developers and testers of agile teams to auto-generate and execute hundreds of API tests concurrently. This is a great example of a small acquisition that we made in FY 2017. Since the acquisition, we have ramped organic investment in the underlying technology and continued to expand its capabilities while knitting it into CA's broader DevOps and continuous testing set of solutions.

Globally, security continues to be a critical concern of our customers, and CA is uniquely positioned in the identity space to help customers that have hybrid cloud environments. In the quarter, we launched CA Trusted Access Manager for Z, which is essentially privileged access management for the mainframe. It eliminates the need for shared privileged credentials, and it works directly with mainframe security best practices, produces forensics in all the privileged user activities so that customers can maintain complete control of sensitive, mission-critical data.

Our largest mainframe customers continue to experience MIPS growth. Often, they view mainframes as just another enterprise server within their hybrid cloud environment. As the second largest software supplier for this platform and one of the only software companies making meaningful investments in the area, we are able to provide compelling and unrivaled solutions that address real business needs.

Our solutions are enabling customers to better manage storage needs while protecting the privacy of this data, helping them to achieve GDPR compliance. Our Dynamic Capacity Intelligence solution addresses the challenge of higher costs associated with increasing MIPS usage by optimizing capacity utilization. And we're addressing the engineering and technical skills gap by increasingly adopting artificial intelligence and machine learning.

All of this innovation is helping to drive sustained, long-term renewal yields and healthy new sales in our Mainframe business. We continue to be very pleased with the performance of the Mainframe business unit. Our third quarter revenue performance was no exception. Clearly, we continue to invest both in our Enterprise Solutions and our Mainframe portfolios.

On the acquisition front, we continue to be pleased with the strategic nature of both Automic and Veracode. The integration of both acquisitions is progressing well, and both are contributing to new sales and revenue growth. For example, the third quarter marked Veracode's largest bookings quarter in its history, strength was driven by expanded opportunities influenced by CA's relationships.

It also benefited from broader geographic distribution. In the quarter, Veracode experienced robust growth internationally, where it had little distribution prior to the acquisition. One of the core tenets of the fundamental improvements we've seen over the past few years has been our commitment to customer success. Our NPS or Net Promoter Score, which is an industry standard measure of customer loyalty, continues to rise on a positive trajectory.

In the quarter, our NPS improved 3 points from a year-ago period. All underlying drivers of the score, including product quality, product functionality, and ease of use, improved year-over-year. The percentage of customers who consider CA a strategic partner increased year-over-year. Our Customer Satisfaction Score also improved over last year with an average score exceeding 9 on a 10-point scale.

We are entering our fiscal fourth quarter with good momentum, which reinforces my confidence in achieving our full-year revenue, margin, and CFFO guidance. In many ways, CA is a very different story today than it was several years ago. We plan to host an Analyst Day here in New York on May 30 to provide a framework for what these changes mean as we look ahead to our FY 2019 and beyond. The timing of the Analyst Day will be shortly after we report our FY 2018 results, and before we report our first quarter FY 2019 results under the new revenue recognition accounting standard. It will be a great opportunity to refresh your perspective of CA, and to better understand the way in which we will measure and judge our performance going forward. We look forward to sharing more then.

With that, I will turn the call over to Kieran to review the third quarter financial and full-year guidance. Thank you.

Kieran J. McGrath

Executive Vice President & Chief Financial Officer, CA, Inc.

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.

We were pleased by our results in the third quarter, which was driven by improved top line growth and ongoing disciplined expense management. Importantly, organic revenue grew on a year-over-year basis both in our Enterprise Solutions segment and for the company overall.

Total new sales in the period were up high-single digits, both as reported and in constant currency. Notably, we delivered strong new sales growth despite a renewal portfolio that was down in the high teens as reported and down approximately 20% in constant currency.

As we stated previously, the year-over-year fluctuations in the renewal bookings vary on a quarterly basis due to the timing and duration of large transactions. Our renewal yield for the third quarter was in mid-80s. Year-to-date, our average renewal yield is slightly above 90%.

From a geographic perspective, new sales increased in all geographies except in North America, where new sales were approximately flat on a year-over-year basis. From a segment perspective, Enterprise Solutions new sales are up in the mid-teens as reported and up in the low teens in constant currency.

Mainframe new sales were down low-single digits both as reported and in constant currency. Strong new product sales driven by both established and newer products like Dynamic Capacity Intelligence, Data Content Discovery, and Mainframe Operations Intelligence were more than offset by lower capacity sales in the period, reflecting a smaller portfolio of renewals compared to the year-ago period.

Total revenue for the third quarter was $1.093 billion, up 9% as reported, and up 7% in constant currency. Acquisitions contributed approximately 6.5 points to total revenue growth in the quarter. From a segment perspective, Enterprise Solutions revenue was up 19% as reported, and up 16% in constant currency. Mainframe Solutions revenue was up 1% as reported, and was approximately flat in constant currency, slightly better than our longer-term expectation for the mainframe market. Services revenue was up 11% as reported, and up 9% in constant currency.

Total revenue backlog was up 1% as reported, and down 2% in constant currency, while current revenue backlog improved 8% as reported, and 5% in constant currency. Approximately 5 points of the current backlog increase can be attributed to the acquisitions of Automic and Veracode.

GAAP operating margin in the third quarter was 28%, and non-GAAP operating margin was 38%. Segment operating margins in the quarter were 64% for Mainframe Solutions, 11% for Enterprise Solutions, and 3% for Services.

In the third quarter, Mainframe segment margins benefited from reduced corporate overhead, while ES segment margins benefited from higher revenue and efficiency improvements. We believe that we will improve the margin of our Enterprise Solutions business over time. However, going forward, as our Enterprise Solutions revenue becomes a larger portion of our overall product mix, we expect it to also absorb more of our corporate overhead, which will partially offset the positive trends in our ES business.

GAAP and non-GAAP income taxes for the third quarter were $375 million and $71 million respectively. GAAP income tax expense included a $318 million tax charge from the preliminary estimates resulting from U.S. Tax Reform. We have excluded these one-time charges from our non-GAAP results. Of the $318 million, approximately $220 million related to the deemed repatriation of earnings held by our foreign subsidiaries, which is payable over 8 eight years, and approximately $98 million related to the remeasurement of deferred tax assets and liabilities for the change in income tax rates. We will continue to refine these estimates over subsequent periods.

As a result, our Q3 GAAP tax rate was 133%, and our non-GAAP tax rate was 18%. Currently, we expect our longer-term effective tax rate to be in the low 20% range, subject to further interpretation and clarification of U.S. Tax Reform. GAAP diluted earnings per share in the third quarter was a loss of $0.23 per share, down 146% as reported and in constant currency. Non-GAAP diluted earnings per share was $0.75 per share, up 19% as reported, and up 16% in constant currency.

Higher revenue coupled with solid operating margin drove our non-GAAP EPS performance. Our non-GAAP EPS also benefited from an otherwise lower than anticipated effective tax rate. Specifically, net favorable discrete items benefited our non-GAAP results by approximately $0.04 per share, and the lower statutory U.S. tax rate benefited our non-GAAP results by an additional $0.05 per share.

Our Q3 CFFO was $315 million, down 39% as reported, and down 41% in constant currency. The year-over-year decline in our CFFO is largely attributable to the timing of single installment cash collections, which were $36 million in the quarter and down $195 million year-over-year. The timing of single installments reflects a lower mix of bookings with financial services companies compared to the year-ago period. We ended third quarter with approximately $45 million in net cash. We paid $106 million in dividends, and repurchased $53 million worth of shares outstanding in the quarter. We have $507 million remaining of our original $750 million share repurchase authorization.

We'd like to provide some incremental disclosure with regard to our upcoming adoption of ASC 606. We have not yet finalized our assessment, as we still need to close our fiscal fourth quarter, and there are a number of factors that will still need to be analyzed. That said, we currently believe that upon adoption of the new revenue recognition standard, our total deferred revenue and revenue backlog will materially decline. As we mentioned last quarter, this reflects the license component of bookings recognized under the current standard. Under ASC 606, this will become part of a cumulative effect adjustment within retained earnings.

As a consequence of this adjustment, when taken together with certain U.S. Tax Reform provisions that accelerate the timing of U.S. income recognition for accrual method taxpayers, we currently expect an incremental impact of $100 million to $150 million of cash taxes to be paid on average per year for the next four years. We expect that this cash tax impact will be largely offset by the benefit from the reduced U.S. corporate tax rate enacted under U.S. Tax Reform. Taken together, we believe the incremental cash taxes resulting from the ASC 606 adoption and the enactment of U.S. Tax Reform will be approximately $25 million to $50 million on average per year for the next four years. As a reminder, we do not expect new revenue recognition standard to significantly impact billings and cash collections from billings.

Now turning to guidance. Guidance is based upon exchange rates on the last day of the preceding quarter, which was December 31, 2017. No material acquisitions are assumed in our guidance. For the full year, we continue to expect total revenue to increase by approximately 5% as reported, and approximately 4% in constant currency. This translates to reported revenue of $4.22 billion to $4.25 billion. We continue to 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%.

Given the impact from U.S. Tax Reform, we now expect our GAAP tax rate to be in the range of 55% to 58%. Our non-GAAP tax rate is anticipated to be approximately 25%. Our previous guidance was between 28% and 29%, both GAAP and non-GAAP. We expect our GAAP diluted earnings per share to decrease by 46% to 41%, both as reported and in constant currency. This translates to reported GAAP earnings per share of $1 to $1.10 per share. The change to the GAAP diluted earnings per share outlook primarily relates to the change to the full-year GAAP effective tax rate as a result of U.S. Tax Reform. We expect our non-GAAP diluted earnings per share to increase by 2% to 5% both as reported and in constant currency.

This translates to reported non-GAAP earnings per share of $2.54 to $2.60 per share. The change to the non-GAAP diluted earnings per share outlook primarily relates to the reduction in the statutory tax rate as a result of U.S. Tax Reform and other net discrete tax benefits realized. 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 continue to 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 take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question is from the line of Sterling Auty of JP Morgan. Your line is open.

Sterling Auty
Analyst, JP Morgan

Q

Yeah, thanks. Hi, guys. Kieran, a lot of discussion there on tax, I just want to make sure that we're clear. What is the net impact that you talked about in terms of the cash tax impact of the moving parts?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Hey, Sterling. So what we defined is that we think that the – as you know, as we do this flow-through into the retained earnings as part of the modified retrospective method, with that tax liability that we create, we get to pay that tax to the U.S. government over a four-year time period. We think that the impact could be anywhere from $100 million to $150 million a year related to that impact alone. However, as we move forward because of the benefit with our tax rates that as we said we expect to be in the low 20% range, we think we'll be able to mitigate most of that, and the likely impact will be – probably be somewhere between $25 million and $50 million on a net basis.

Sterling Auty
Analyst, JP Morgan

Q

So that's $25 million to $50 million higher than what we would have seen under the old accounting rules. But then again, after the four-year payments on the deferred, then you'll get the net benefit of the lower tax rate will really start to flow through.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Exactly, exactly.

Sterling Auty
Analyst, JP Morgan

Q

Okay. All right. Onto the business, it looked like a very solid improvement, especially in the ES part of the business. You announced a number of new products, but I want to make sure that we're clear in terms of what really resonated – what were the things that you saw the most improvement in that ES portfolio here in the quarter?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Well, Mike?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

So, hey, Sterling, it's Mike. I think it was a combination of things. As you know, when we move from quarter-to-quarter, we have some renewals that come up. But we had a nice uptick in selling outside of the renewal portfolio, and on the Mainframe, they had a very nice quarter. We had three net new products that we put out there: Dynamic Capacity Intelligence, Mainframe Operations Intelligence, and Data Content Discovery.

I think some customers, if they were getting ready for GDPR, were starting to think through how they're going to go take a look at their data. So I think that was a bit of an uptick for us. The products are really – the newer products are really starting to take off, very nice quarter with Veracode, PPM, Agile Central, and strong performance from API Management. So when we take a look at the number of organic and acquired products that we put a lot of R&D into and how they're being sold and marketed into our customer base as well as net new customers, it was significantly better than Q2.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

And if I might add in addition to obviously the SaaS products that Mike referenced with Veracode, PPM, and Agile Central, what really helped us as well was – and again, part of that benefit is of a smaller renewal quarter than a year ago, as part of selling outside the renewal, we actually saw an increase in our upfront revenue recognition as well in areas like PAM and API Management that were also much better than what we'd experienced in Q2.

Sterling Auty
Analyst, JP Morgan

Q

Got it. Thank you.

Operator: Thank you. Our next question is from the line of Raimo Lenschow of Barclays. Your line is open.

Mohit Gogia
Analyst, Barclays Capital, Inc.

Q

Thanks, guys. This is Mohit Gogia dialing in for Raimo. So guys, so on the top line seems like a solid performance on revenue. If you look at it, and it's good to see the company going back to organic revenue growth, delivering organic revenue growth, but can you just provide more color on the bookings performance, some of the puts and takes there? Thank you.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Sure, Mohit. Yeah, a good question. So, as a reminder, and you know this pretty well, our bookings are obviously heavily influenced by our renewal portfolio overall, and the renewal portfolio, depending on duration and timing of when we sign big customer events, can vary from quarter-on-quarter. In the quarter, our renewal portfolio was down 20% versus a year ago.

So when we look at it and we see that our total new sales are up in the high-single digits, well, obviously, that's benefiting from both inorganic as well as organic participation, particularly with the Mainframe business, our new sales from a Mainframe perspective were down in the low-single digits. Our ES new sales in aggregate were up around 10%; however, if I look at that on an organic basis only, it was down around 10%. However, I still see a lot of selling outside the renewal because my renewal portfolio was down 20% in total. So, we definitely saw a lot of sequential improvement quarter-on-quarter with that, even though overall organic ES new sales were down.

Mohit Gogia
Analyst, Barclays Capital, Inc.

Q

Thanks, guys.

Operator: Thank you. Our next question is from the line of John DiFucci of Jefferies. Your line is open.

John DiFucci
Analyst, Jefferies LLC

Q

Thanks. Mike, a question for you, then one for Kieran. I guess, Veracode, sounds like it really benefited from working under the broader reach of CA. I guess, trying to give a sense of how sustainable this is, I guess how are sales to sort of traditional customers outside of CA's, what I would say, somewhat limited core customer base?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

Yeah. I think that's a great product, that is probably one of our easier products along with API Management to sell standalone to net new customers or customers that might have some of our more mature products and are looking to engage in a relationship with CA outside of the core, because it's such an important product with respect to protecting the assets of a company and being able to run it in the cloud, and it's a very low implementation cost, so it's a very approachable product.

The other thing is to your second question, Veracode had a very small distribution engine especially outside the United States. It's a product that sells well in Europe. We're starting to see some traction in both Latin America and APAC. The other thing is, we've continued to pour R&D dollars into Veracode, and as they continue to enhance the product and also bring out net new products under the Veracode platform, I think it's going to sustain for the next foreseeable future, John.

John DiFucci
Analyst, Jefferies LLC

Q

So you are seeing sales, continued sales outside your traditional customer base?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

That is correct. It's probably...

John DiFucci
Analyst, Jefferies LLC

Q

Okay.

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

...as I said, it's one of the easier products to sell because it fits the mantra of easy to sell, easy to install, easy to run, and it's got a very interesting and quick ROI.

John DiFucci
Analyst, Jefferies LLC

Q

Okay, great. Thanks, Mike. And Kieran, if I can just go back to Sterling's question because that's important, you guys, you've been great about this, this is something that's all new for us too, CA's been sort of front and center in trying to help explain all this. But I just want to make sure I understand. ASC 606, I was always under the impression that that would have a net neutral effect on cash flow, although you pointed out early that it would affect the timing, it could affect the timing of cash flow. But according to what you just said, is that still a hold? I mean, to have $100 million to $150 million negative impact over the next – per year, over the next four years, is that all due to ASC 606? That sounds like – that doesn't sound like a shift, a little shift in timing.

Kieran J. McGrath — A
Executive Vice President & Chief Financial Officer, CA, Inc.

Yeah, so John, it's a great question, and I think it is worth spending a little time on it. So two things have occurred, we always knew that ASC 606, if you have a change in the timing of your revenue, obviously the government is going to have [ph] a change (00:27:18) for change in the timing of the taxes that you're supposed to pay to them. So we always knew that was coming. And quite frankly, we originally – we were originally estimating that would hurt us on a 35% statutory U.S. tax rate.

The good news is, U.S. Tax Reform in terms of the Tax Cuts and Job (sic) [Jobs] Act is signed, reduces the statutory U.S. tax rate down to 21%. So any of that hit that you're going to take as part of the ASC 606, you'd take it at a cheaper tax hit. However, the government also had a clause in there, I think they called it the means test, the all-events test. And especially, they expanded their reach beyond to just what was in your deferred revenue as well, but actually wanted to see everything that was in your total backlog. And essentially, it went with the same reaction that once you sign the contract, you are going to recognize that revenue in its entirety, they were entitled to take the tax and all of that.

What we're talking about is purely the profits that we would recognize sometime in the future being accelerated to a point in time, and we have the opportunity to pay that tax over four years. But it's purely, John, a timing. There was no incremental tax hit related to it, it's all related to timing.

John DiFucci — Q
Analyst, Jefferies LLC

Okay. Kieran, we really – thank you. We really appreciate. This is new for all of us, and...

Kieran J. McGrath — A
Executive Vice President & Chief Financial Officer, CA, Inc.

Yeah.

John DiFucci — Q
Analyst, Jefferies LLC

...it's somewhat complex, and you've been very, very helpful. So thanks. Appreciate it.

Kieran J. McGrath — A
Executive Vice President & Chief Financial Officer, CA, Inc.

Yeah. And what we just wanted to be clear was, and we'll emphasize it again, so yes, we'd had the ASC 606 haircut that come along, but because of the benefits in terms of the reduction in the U.S. statutory rate as well, it really is a net modified hit of only between, in our estimate right now, $25 million to $50 million a year.

John DiFucci
Analyst, Jefferies LLC

Q

Yeah. I got it. Okay. Thank you.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Thanks, John.

Operator: Thank you. Our next question is from the line of Abhey Lamba of Mizuho Securities. Your line is open.

Abhey Rattan Lamba
Analyst, Mizuho Securities USA, Inc.

Q

Yeah. Thank you and good performance, guys, congrats. Mike, can you talk about the drivers behind sales outside of renewal cycle? Clearly, we saw pretty good results here. And you highlighted Veracode doing really well due to geographic expansion, what are the other products that can benefit from similar type of geographic expansion?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

Sure. I think selling outside the renewal, first of all, this is something that we've been working on for an awful long time, I would say it's been top of mind's focus, believe it or not, for about eight quarters, and we did have a very nice quarter. I still think there's work for us to do to become more consistent with respect to that. But I do like the pattern recognition that I saw in the quarter, and I like the way that the sales team called their forecast and stuck to their forecast pretty much throughout the backend of the quarter, which means that they're really getting in and digging in deep and understanding the buying patterns of their customers.

And that's about being a professional, that's about being diligent and having a little bit of grip. And I think that had a lot to do with selling outside of the renewal. And as you could remember, I was less than flattery about the sales force in Q2 for what I thought was less than diligent performance with respect to selling outside the renewal and understanding the process at each and every customer, which is not necessarily the same, you have to really go in and understand who the economic buyer is, who the economic user is, and who is the approver is. I think I saw signs that the sales force did a really nice job this quarter being able to do that. Now...

Abhey Rattan Lamba
Analyst, Mizuho Securities USA, Inc.

Q

Got it.

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

...if you have products that – I can't stress this enough. If you have products that are easy to use, easy to install, have a tangible ROI, I mean, it's easier to sell those products than it is to sell a product that's got a long sales cycle, a perpetual license, which means it's got to have a probably a more complex install, now there are some products in the world and some products definitely at CA that add an incredible amount of value, but they're complex because they're solving complex problems.

But to the extent that our portfolio has more SaaS, easy to use, well-designed products, where we've been able to articulate the ROI in very easy to understand business terms, I think you have a shortened sales cycle plus a more impactful sales cycle. Now the products that fit that more easily, obviously Veracode, PPM, Agile Central, API Management, while it's more or less a lot of perpetual, it is a product that is more easy to install and easier to use.

And I would argue that PAM, well, if you get into a multi-country, multi-data center, multi-platform environment, that could get awfully complex, but we do have a lot of customers that are looking for Privileged Identity Management, whether it be on a single node of mainframes with the new product we put out that does that for System Z, or just in one particular data center with homogenous servers. So, I think it really depends on what the customers – the problem that a customer is trying to solve. But we definitely have a much bigger portfolio of solutions that hit a modern software performance agenda.

Abhey Rattan Lamba
Analyst, Mizuho Securities USA, Inc.

Q

Got it, thanks. And Kieran, you talked about North America being flat versus – while other regions are extremely well. Can you just compare and contrast the dynamics in the regions? That's it for me.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Sure. I mean, so just as a reminder, for the North America respective, obviously it was heavily influenced because of the renewal portfolio declining on a year-on-year basis. Actually, we are pretty happy with – we're actually very happy with their selling outside the renewal portfolio. APJ, inside of APJ, Japan did pretty well. Honestly, we could have done better on the sales outside of the renewal and the upfront revenue there.

LA, LA just had a really a gangbuster quarter for us in terms of new sales and revenue growth. And EMEA, obviously they did well with new sales especially with a lot of the help from the Automic acquisition. We'd like to see a little bit more consistency across all the regions within EMEA, North, South, West, et cetera. But I would take a step back and say, all of our geographies actually seen revenue growth in the current quarter, so that was a real positive.

Abhey Rattan Lamba
Analyst, Mizuho Securities USA, Inc.

Q

Thank you.

Operator: Thank you. Our next question is from the line of Walter Pritchard of Citi. Your line is open.

Walter H. Pritchard
Analyst, Citigroup

Q

Hi, Kieran. Wondering first just on the software fees and others, that number was up quite a bit, I think, [indiscernible] (00:34:20), a market jump versus what we've seen in the past, that $228 million. What drove that?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

I'm sorry, one more time again, I didn't – which one?

Walter H. Pritchard
Analyst, Citigroup

Q

The software fees and other lines...

[indiscernible] (00:34:31)

Walter H. Pritchard
Analyst, Citigroup

Q

...fees was up a lot – yeah, up a lot, I'm just curious what the driver was there.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Right. So as we talked about in the past, within there, we have both our upfront revenue, as well as our SaaS revenue, and I'm happy to say that both contributed very strongly sequentially and in a year-to-year basis in the quarter. So both our SaaS business as well as our on-prem business that's recognized in an upfront basis both did quite well in the quarter.

Walter H. Pritchard
Analyst, Citigroup

Q

Okay. And then I guess if I sort of parse through just on a high level, total revenue grew 9%, you're talking about 2 points of currency impact, 6.5 points to the M&A, the organic growth more like 0.5 point, which is pretty different than the headline number. But your – I'd say your rhetoric sounds a lot better in terms of how you're feeling about the business. I guess I don't – if I look at that 0.5% kind of organic constant currency growth on the revenue side, I don't necessarily – with a little bit more upfront, I don't necessarily come away thinking this was a much better quarter. But could you help me understand just in your tone, why you'd sound like you're much happier with the result than that would indicate?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Sure. So in the last quarter in Q2, ES revenue was down organically, I think it was 5% or 6%, we were up organically in ES revenue in Q1, really driven by the strength in our SaaS revenue, recovery in the upfront, and then strength in the SaaS businesses. Mainframe, which have been down 3% in Q2, actually was flat on a constant currency basis in the quarter. And the Services business, which has been a real drag on my business for many, many quarters now actually was organically up 1%.

So I would say I saw very strong sequential improvements across all three of our business segments in Q3 that made me actually quite happy in the performance overall. Can always do better, but in terms of sequential improvement, it was quite strong.

Walter H. Pritchard
Analyst, Citigroup

Q

And then just last quick one on the renewal rate in the mid-80s. What was the – I think that's been little lower than it's been normally. What was the driver there?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Yeah, I mean, listen, it was – we're down 20% in our renewal portfolio overall, it only takes a couple of deals that are challenged to heavily influence renewal portfolio like that, and that's kind of where it is. On a year-to-date basis, I don't see any trends here that I'm worried about, we're still over 90% in total. But again, a few deals and a smaller renewal portfolio in aggregate can influence it.

Walter H. Pritchard
Analyst, Citigroup

Q

Okay, great. Thank you.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Thanks, Walter.

Operator: Thank you. Our next question is from the line of Mark Moerdler of Bernstein Research. Your line is open.

Mark L. Moerdler
Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you for taking the question, appreciate it. As you mentioned, Mainframe revenue was flat, constant currency, but new sales in Mainframe were down low-single digits. Can you give me a little more color to understand that? And then I have a follow-up.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Well, remember, the Mainframe model is a ratable business model, and the performance in the current quarter is predicated upon the new sales that we've been driving, as well as the renewal rates that we see in the Mainframe business for all of the preceding quarters. So, as you've heard Mike talk about all of the new product that we've been bringing to market here for the Mainframe perspective, it's having an effect along with the business that's quite sticky.

So we saw that really come to a fruition here in the quarter, where our revenue in aggregate was flat on a year-over-year basis, and I might add actually against a pretty difficult compare with our Mainframe business from Q3 of the year ago as well.

Mark L. Moerdler
Analyst, Sanford C. Bernstein & Co. LLC

Q

That makes sense. I really appreciate. That's very helpful. Second, just to confirm on the tax implications that have changed in ASC 606, you're saying that the IRS looks at your total backlog basically hit you now with the charge for what's sitting in the backlog. Does that simply mean that they're pulling for the tax payments, and if so, I guess, you won't see those tax made in the future, and does that mean – and as well that's fully included in the 20% tax rate going forward that you guided here?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Yeah. So I think you have to separate the thought process, Mark. One thing is, it's actually the difference between [indiscernible] (00:38:33) where we're going to [ph] wash (00:38:36) the backlog and the deferred revenue into retained earnings. That's going to create a taxable transaction. That's what I talk about in terms of spending $100 million to $150 million a year over the next four years, we spread that payment out. That's the one-time event.

Prospectively, our new revenue recognition, the ASC 606, is going to require that you take revenue at point in time when you deliver it, and that will also accelerate revenue, but it's not going to be nearly as substantial, and that's the piece that's captured in the low 20s rate as we go out through time.

Mark L. Moerdler
Analyst, Sanford C. Bernstein & Co. LLC

Q

Excellent. Very helpful. I really appreciate. Thank you very much.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Yeah.

Operator: Thank you. Our next question is from Brad Zelnick of Credit Suisse. Your line is open.

Brad Alan Zelnick
Analyst, Credit Suisse

Q

Great. Thanks so much. Mike, a lot of indicators suggest the industry is in the midst of a strong spending cycle in the data center. Can you talk about the extent to which you think it benefits CA on both sides of the business and specifically what you're hearing from customers relative to their optimism and propensity to spend?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

Sure. I think that there is an awful lot of optimism. Last week, I was in Davos and pretty much across the board, there's two big themes. One, just in general business optimism, and secondly, a big, big focus on jobs and how jobs are being affected by digital footprint, and every company really understanding that they've got to have a digital persona regardless of what industry they're in. And as they accelerate their ability to understand their customers taking advantage of artificial intelligence, taking advantage of big data, they have to put systems in place that are very close to their customers to collect that data and also serve those customers.

So I think that this combination of better than average synchronized growth on a global basis coupled with this notion that they have to get more digital, that puts us in a great spot. If you're going to be building products, you're probably going to want to manage that product in that project, you're going to want to use PPM. If you're going to be building software, you're going to want to do it through Agile. If you're building software, you're going to have to test that software. If you're going to test that software, you're going to want to do it in an automated fashion. And as you move from unit test to integration test to system test to performance test, you're not going to want to do that by hand or write custom scripts, you're going to want to automate that whole continuous delivery process.

And then, by the way, if you're taking on a much more digital footprint, you'd better make sure you've got security, you're going to want to have that code go through code scan, and as developers are starting to write their code, you're going to want them building in the security functions into the code before it's flipped over to operations.

When this is running, you're going to want to be able to monitor it, you're going to want to be able to monitor disk drives, you're going to want to be able to monitor cloud functions, whether you put the application in AWS or Azure in your own data center on a mainframe, we're the only company that can monitor that completely heterogeneous platform. So, when I see high GDP growth driven by a company's desire to have a bigger digital footprint, I'm very bullish about our opportunity to participate in that.

Brad Alan Zelnick
Analyst, Credit Suisse

Q

Awesome, Mike. And Kieran, just a follow-up for you. How do you think about your cash balances in offshore subsidiaries now post-Tax Reform and possibly using the cash to buy back more stock?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Sure. Well, I mean, the first thing I'd say is obviously we're still permanently invested with our cash overseas. We'll obviously use this as a great opportunity now to revisit with Mike and with the Board our capital allocation strategy overall, we do that with the Board on a fairly regular basis anyway, so there's nothing new about that. But obviously, this has the potential to potentially free up more cash for CA to access. And as always, we're going to look for the best geographies and the best places to make our investments to drive the most optimum shareholder value that we can.

Brad Alan Zelnick
Analyst, Credit Suisse

Q

Excellent. Thank you.

Operator: Thank you. Our next question is from the line of Kirk Materne of Evercore ISI. Your line is open.

Kirk Materne
Analyst, Evercore Group LLC

Q

Hi, thanks very much. Mike, maybe just a follow-up on Brad's comment around sort of the economic cycle, when you look at sort of the execution this quarter, are there any metrics you look at in terms of win rates or sort of the pipeline build that makes you feel good that the execution is really sort of more organic CA getting better versus sort of just being able to tag along on a better economic cycle? I know obviously [ph] you hope that (43:31) both, but as this is sort of selling outside the renewal cycle has been ongoing process, what makes you feel good that this is – you have two steps forward and not one step back as we look out over the remainder of this calendar year?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

Sure. I don't think I've got enough data to say that we've got repeatability on a consistent basis to be able to sell outside the renewal quarter every quarter. Now, part of that is just systemic from what does the renewal portfolio look like to the extent that we've got a big renewal portfolio, it's going to be harder. If we have a smaller renewal portfolio, it's going to show up more that we were not able to do that because [ph] it left at that (00:44:16).

But from a metrics perspective, we look at a handful of very important metrics. We look at every single product every quarter, win-loss, and we take a look very diligently once a week as a whole management team on pipeline and pipeline progression. We take a look at it split between digital and direct sales. So when we see the pipeline and we have heuristics on some of these products because we had them for a while, we know what kind of pipeline we need to get to the kind of numbers that we're looking for. Most products, like you'll see in most software companies, it's about three times.

We also take a look at each and every sales professional, each sales territory to understand how much pipeline they've added and what their close rates are and how well they performed against their forecast. I think if you are calling a number especially midway through the quarter and are able to hold that forecast, that means you intimately understand the buying patterns of your customer. That was much, much better in Q3 than it was in Q2.

So, we are constantly looking at ways to improve – I saw quite a bit of improvement as Kieran pointed out across each and every segment, but make no mistake about it. We still have work to do here, and we are going to be on it all day, every day. We think that we have a great opportunity, we got great products. It's a complex industry, it's a competitive industry. I think if we let our guard down at all and don't seek for continuous improvement, I think you'll fall the wayside of every software company that got over their skis with respect to their performance. We had a good quarter. I was real happy with it. We got another one coming up and another year and another year after that, and customers change, personnel changes, products change. I think we have to stay on this all the time, and that's kind of an agile mindset which we've adopted.

Kirk Materne
Analyst, Evercore Group LLC

Q

That's great. I really appreciate the color. And then just, Kieran, just you mentioned on your prepared remarks just in terms of the margin mix shift as ES gets bigger. Can you just talk about the opportunities for where the opportunities, I guess, exist to take margins up in the ES business understanding the business itself will be taking on some of the overhead or more of the overhead? I'm just – specifically I'm wondering around your sales and marketing efficiency, R&D efficiency, where may be some of the opportunities in that part of the business?

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

Sure. Well, I think first and foremost, nothing has changed in terms of our overall view as terms of the opportunity for our ES margins. We really believe that the business should be capable of operating in the high teens, and I think our on-prem business certainly has plenty of opportunity to get there.

I think when you think about those businesses, we want to make sure we do the appropriate level of investments and we're not looking to start those, I think from a SaaS business perspective, scale is what you find. As you grow the scale and a lot of these are businesses that we've acquired – that we acquired and they were not profitable, so scale is critically important.

I think where you'll see most of that benefit will literally be on the sales and marketing side, where did you start to scale through that. What we're seeing are businesses that we're acquiring, while we are doing orders of magnitude, more transactions, but we're doing these transactions at a much smaller average selling price, and that takes different sales motions and things like that than what we've historically done, and we're always looking to fine-tune our go-to-market, our go-to-market motions, and our go-to-market spend in total, and I think that's one of the areas where we'll see the improvements as we go through time.

Kirk Materne
Analyst, Evercore Group LLC

Q

Great. Thanks, guys. Congrats on the quarter.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

I think it's just important to reemphasize really, we don't see any change in either the Mainframe profitability or the ES opportunity for profitability. We just wanted to point out, especially in a quarter where you see ES's revenue growth so dramatically. It actually pulls more of the kind of the general overhead from the Corporation as well. So it's a little bit of a – as they make progress, just still having to absorb a little headwinds, if you will.

Kirk Materne
Analyst, Evercore Group LLC

Q

Understood. Thank you.

Operator: Thank you. [Operator Instructions] Our next question is from the line of Matt Hedberg of RBC Capital Markets. Your line is open.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Hey, guys, thanks for taking my questions. Mike, you mentioned GDPR in your prepared remarks, and we think your identity's assets could certainly be well-positioned in that regard. I was curious though, throughout the quarter, throughout the December quarter, did you actually see GDPR conversations drive sales, or is it still a little too early to say if that influence is influencing sales behavior?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

No, it's definitely driving sales. We have to go live with that all, all of us do in – did operate in the European Union in May. So, especially in large companies that have mainframes in particular, like 70% of the world's business data is on a mainframe, almost every company that we deal with that has a mainframe is a multinational. And they're looking for ways to be able to deal with the regulation, and they want to make sure that they get it right and this is a tool that can help.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Got it. That's helpful. And then I know there is always a question about the lag effect here, but how should we think about the potential benefit from the IBM Mainframe refresh cycle?

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

A

Sure. We're seeing obviously MIPS increase, so that shows up a little bit in our capacity. And one of our products, Mainframe Operational Intelligence, I mean, every customer is looking – they wake up in the morning and say, I want more MIPS, but I want to pay the least amount possible. So if they're going to drive more MIPS, they're going to want to run those machines as efficiently as they possibly can. And Mainframe Operational Intelligence is a way that they could take advantage of getting the right applications run at the right times and in the right partitions, and it gets a little bit complex. But it really does save on their MIPS usage when they're using those general purpose MIPS that are – that could be quite expensive, you're running complex heavy transaction processing.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

And if I may...

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Great.

Kieran J. McGrath
Executive Vice President & Chief Financial Officer, CA, Inc.

A

If I just might add. So obviously, we're thrilled to see the quarter that the IBM hardware had in terms of all the MIPS that they put out there. What we normally find is our customers tend to buy increased capacity when their renewal cycle naturally comes up. So we had a down renewal cycle this quarter, and we would expect to be moving into a heavier renewal quarter here in Q4 that we have an opportunity to sell incremental capacity as well.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Thanks, guys. Super helpful.

Operator: Thank you. And at this time, there are no further questions. I'd like to turn the call back over to Mike Gregoire, CEO, for closing remarks.

Michael P. Gregoire
Chief Executive Officer & Director, CA, Inc.

Well, thank you very much, and thanks, everyone, for joining us tonight. I know everyone's super busy. At the end of the day, I think we delivered really strong third quarter results. I'm very pleased that it was the best revenue growth rate we've delivered in six years. And organic revenue grew year-over-year. Although as Walter pointed out, relatively small, it's definitely a step in the right direction. The revenue performance combined with disciplined expense management drove solid operating income and margin in the quarter, and over the long term, we believe that CA will benefit from the recently enacted U.S. Tax Reform. Looking ahead, we will continue to optimize our business and drive long-term sustainable growth in shareholder value. Thank you once again, and good night.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, you may now disconnect. Everyone, have a great day.