Computer Associates – A Good Business Model Gone Awry

by Mohnish Pabrai

In 1997 James O'Shaughnessy wrote a wonderful book entitled "What Works on Wall Street". S&P Compustat, for the first time, gave an outsider complete access to their entire proprietary database of stock prices on public securities going back over 40 years. He "back tested" the returns generated by various classes of stocks (large cap, all stocks etc) with various valuation metrics (high P/E, low P/E, high Price to Sales Ratio, low Price to Book Value Ratio etc.)

His conclusions were very interesting. All stocks as a group from 1954-1994 had an average annualized return of 12.45%. However one of the best performing strategies was to invest in all stocks with Price to Sales Ratio (PSR) less than 1 and rebalance annually on January 1 of each year. This yielded an annualized return of 18.14% - a substantial out performance over the broad market. The PSR of a stock is arrived at by taking the sales of a company per share and dividing it by the price of its stock. To get a ratio less than one means that the company's annual revenues are higher than its market cap.

One of the major reasons that PSR has proved to be a far better metric of valuation than P/E ratios is because earnings are an "accountant manufactured" number. It is very difficult in most companies for accountants to "edit" sales numbers. The top line is much harder to fiddle with than the bottom line. There is a very high level of integrity in the PSR ratio for most companies.

One company that has successfully doctored both the top and bottom lines is Computer Associates (CA). When software is usually sold to large companies, most software companies charge a license fee for first year use and maintenance fees for subsequent years. Per GAAP, only the license revenue can be treated as income during the current year. Maintenance revenue must be recognized annually. When CA signs a multiple-year deal with a customer, it has considerable discretion on what it calls license revenue and what it calls maintenance.

According to a recent New York Times story, when CA buys software vendors, it tries to persuade their existing customers to "reroll" or extend their license and maintenance agreements for as long as 10 years. Sometimes it throws in other CA products (such as Unicenter), which the customer may not ever use. However when the revenue is booked, most it is classified as license revenue (for Unicenter) versus maintenance. There is also a huge divergence between cash collection and revenue booked. CA's booked revenue has little correlation with cash coming into the company.

As an investor, when I start looking at a company the first few financial questions I have are:

1. What are its revenues and market cap? (This gives me the PSR ratio)
2. What is its expected future free cash flow?

With CA, I can't even begin to answer the revenue and free cash flow questions. In a given year, I read well over a thousand annual reports, 10-Ks and 10-Qs. When I looked at CA's most recent 10-K and 10-Q, I got a headache. Trying to predict the company's revenue or cash flows (or even understand past real revenue and cash flow is very hard). Warren Buffett has a great quote that came to my mind as I was going through CA's financials. He says that "The only reason that one may have difficulty understanding a company's financial statements and notes is because the writer does not want you to understand them." Faced with such a situation, Buffett abandons any further research and will never make an investment in such a company. Mr. Sanjay Kumar and Mr. Charles Wang do not have an overly complicated business. If they choose to, they could make it simple for shareholders to understand.

At its core, CA has elements of a wonderful business. CA has grown dramatically over the years to become the 4^{th} largest software company in the world by acquiring tens of software companies that were typically either in decline or financial difficulty. CA's modus operandi was typically was to terminate virtually all senior management and dramatically curtail expenses. It typically pulled the plug on new products and focused on maintenance revenues. This vulture business model as applied in the software business is very powerful. Software sales to large Fortune 2000 companies have recurring revenue streams and it is extremely painful for companies to change vendors. Thus CA had locked in future revenue streams. They strip theses companies to the bone, raise maintenance charges on existing customers and milk the installed base for all they can get from them.

The flaw in their execution is the heavy-handed tactics used with customers. Most CA customers hate them, but have no choice but to be with them. Very few Fortune 500 companies begin a relationship with CA by buying a product directly from them. They suddenly find themselves in CA's ironfisted grip. A few years ago, when I ran a systems integration company, one Fortune 500 CIO told me that he had had so many tough negotiating sessions with CA that whenever he buys software now, he makes the vendor put in a clause that if they ever get acquired by CA he gets reimbursed for all his investment in the software so he can change vendors less painfully!

As much as we hate them, vultures pay the critical role in our ecosystems and every industry needs at least a few good vultures. CA is the best vulture I've come across in any industry.

I think the CA model can work well without alienating customers. My two cents of advice to Mr. Kumar and Mr. Wang is to nurture their installed base, simplify the accounting and get revenues and cash inflow to be in alignment. Revenues, earnings and the stock price will drop in the near term, but they'll reflect the realities of the business long term.

Texas billionaire, Sam Wyly, is in a proxy fight to wrest control of the business away from Mr. Kumar and Mr. Wang. Sam sold two software companies he founded to CA in the past. He must have bitterly watched from the sidelines the usual vulture carnage that follows a CA acquisition. Even if he fails in his proxy battle, Sam will almost surely serve as a wakeup call to CA to start mending its ways.

Finally, with a current PSR ratio north of 4 on possibly inflated revenue numbers, CA is a long ways off from being a great O'Shaughnessy value buy.

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