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PRESENTATION

Operator

Good day and welcome to the Blackbaud, Inc. Q3 2018 earnings call. Today's conference is being recorded. (Operator Instructions)

At this time, I would like to turn the conference over to Mark Furlong. Please go ahead.

Mark Furlong ***Blackbaud, Inc. - Director of IR***

Good morning, everyone. Thanks for joining us on Blackbaud's third-quarter 2018 earnings call. Today we will review our financial and operational results and provide commentary on our performance in the context of our four-point growth strategy.

Joining me on the call today are Mike Gianoni, Blackbaud's President and CEO, and Tony Boor, Blackbaud's Executive Vice President and CFO. Mike and Tony will make prepared comments and then we will open up the call for your questions.

Please note that our comments today contain forward-looking statements subject to risks and uncertainties that could cause actual results to differ materially from those projected. Please refer to our most recent Form 10-K and other SEC filings for more information on those risks.

We believe that a combination of both GAAP and non-GAAP measures are more representative of how we internally measure our business. Unless otherwise specified, we will refer only to non-GAAP financial measures on this call.

Please note that non-GAAP financial measures should not be considered in isolation from or as a substitute for GAAP measures. A reconciliation of GAAP and non-GAAP results is available in the press release we issued last night and a more detailed supplemental schedule is available in our presentation on our investor relations website.

Please also note that unless otherwise specified, we will refer to 2018 results and comparable 2017 results as adjusted to reflect our adoption on January 1 of ASC 606 related to revenue from contracts with customers.

Before I turn the call over to Mike, I will briefly cover our upcoming investor marketing activity, which is available on our investor relations website. During the fourth quarter, our team will be attending the Stifel Midwest one-on-one conference in Chicago; Credit Suisse 22nd annual technology, media, and telecom conference in Scottsdale; 21st annual Needham growth conference in San Francisco, Raymond James technology investor conference in New York, and NASDAQ investor conference in London. We will also be holding meetings with investors in New York, Dublin, and Edinburgh.

With that, I will hand the call over to Mike.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Thanks, Mark. Good morning, everyone, and thanks for joining our call today. We have continued transforming the business towards a reoccurring revenue model, with our recurring revenue comprising 90% of total in the third quarter. And we continue to gain momentum in our aim to deliver digital transformation across the social good community and all the markets we serve.

As many of you know, we held our annual user conference, bbcon, earlier this month. And it is clear that the progress we've made is resonating with the individuals that use our solutions every day. We had a packed agenda and introduced more than 80 new product and innovation updates to a record-high attendance.

Roughly 3,000 attendees joined us in Orlando, which included hundreds of first-time attendees, representing our community of new and existing customers. There is no question that our customers are excited about the new Blackbaud and accelerated pace of innovation, which was evident by the overwhelming positive audience reaction to the long list of mainstage announcements and lineups at our customer showcase for product demos.

Our bbcon attendees are part of a growing Blackbaud community of over 40,000 customers and millions of software users that collectively represent 80% of the top 50 most influential nonprofits, over 90% of higher education institutions with billion-dollar campaigns, 26 of the largest nonprofit hospital systems in the US, and a third of the Fortune 100 companies.

We are the only cloud software company in the world uniquely positioned to serve and connect the entire philanthropic ecosystem, which includes nonprofits, foundations, corporations, education institutions, healthcare organizations, faith-based organizations, and individuals. IDC ranks Blackbaud as the 24th largest cloud software company in the world and Forbes listed us as one of the world's most innovative growth companies.

We estimate that each of the verticals we serve are larger than $500 million in TAM, our market share is less than 15% across each of these markets, and our total addressable market is roughly $10 billion in total. This is a considerable opportunity for us, which we will continue to expand over time through acquisitions and new solution development.

We are enabling the digital transformation, not only through our software services, data intelligence, and expertise, but newly formed partnerships and expansion of other existing relationships, like with Microsoft.

Also, our focus on the industry extends beyond our cloud software technology and solutions. A great example is the newly formed partnership we announced at bbcon with Points of Light, the world's largest organization dedicated to volunteer service. We are a key partner with them, defining new uniform standards that will help the social good community measure and understand the impact of volunteerism, enabling organizations to collect and manage data and provide actionable insights to yield improved performance and outcomes in volunteer programs.

I'm going to cover the quarter in the context of our four-point strategy. The first of our four strategies is integrated and open solutions in the cloud and we continue to aggressively drive this. As you will recall, we made a major announcement in July, introducing our comprehensive Cloud Solution for Faith Communities.

We are now bringing our proven strength in financial management, fundraising, marketing, payments, and analytics together with completely new Church Management capabilities. With this move, we will now provide integrated end-to-end cloud capabilities that enable churches to digitally transform their operations through a single connected experience.

This means churches will finally have our comprehensive modern cloud solution built for the way they work from a single accountable provider who can help them reduce their IT footprint by eight or more systems and vendors. We have several early adopters using the Church Management system today in close collaboration with our product team.

Because of our Blackbaud SKY platform, we are incorporating real-time customer feedback and quickly advancing changes in the platform. No one in this industry has taken this approach, has a modern engineering platform like Blackbaud SKY, or has these cloud application assets to even do so. To be clear, meaningful revenue will take some time, but we believe this solution is a game-changer in a very large addressable market.

In concert with these engineering efforts, we are ramping up our go-to-market resources as well. Additionally, we continue to rapidly innovate in the other vertical markets that we serve. At bbcon, we announced our Cloud Solution for Higher Education, introducing a new Education Management portfolio along with stewardship management and guided fundraising capabilities tailored for higher education.

This is another exciting next step forward in our continued commitment to provide comprehensive, purpose-built cloud solutions that drive digital transformation. This new cloud solution will enable customers to manage the complete student lifecycle, from admissions to alumni engagement, student enrollment, classroom scheduling, and a student information system.

It's a solution offering that we have been building for quite some time. It is a massive opportunity for Blackbaud to deliver innovation with a connected cloud in a market that's comprised predominantly of disparate legacy point solution software.

We began a few years ago by extending our K-12 school solutions with a significantly enhanced set of functionality for universities. The good news here is we have an entirely new addressable market in the higher education space with a very proven commercial-grade scalable platform with a broad customer set in the K-12 space. This means universities can now have access to digital transformation in a very new way on a proven platform.

We announced our Cloud Solution for Higher Education institutions mainstage at bbcon and our associates were flooded by customers excited about the potential of our comprehensive cloud solution to transform the way they manage their operations. Calvary University, for example, is a private four-year institution and one of our early adopters.

Calvary told us that they saw a massive opportunity to automate manual processes, influence the development office, and add seamless integration with their Raiser's Edge and Financial Edge NXT separated Blackbaud from the competition.

In a similar fashion, St. Louis College, another private four-year institution, was looking for a solution to connect admissions, academics, finance, marketing, and advancement operations. Blackbaud's cloud solution for higher education institutions takes full advantage of the rapid innovation, modern user experience, and enhanced capabilities made possible by our Blackbaud SKY platform.

Just like our Cloud for Faith Communities, our development didn't start from scratch. And we moved quickly by leveraging pre-existing capabilities available in Blackbaud SKY, like our Blackbaud ID single-sign-on capability and SKY UX user interface component library.

We have a high-velocity engineering environment, leveraging a mature ecosystem of existing and ever-evolving software services and components. The new higher education cloud is another great demonstration of our ability to rapidly build new solutions to further address customer needs and grow our addressable markets.

We also took mainstage at bbcon with Microsoft to share a major step forward in the nonprofit partnership we announced last year with the announcement of the Integrated Cloud Initiative for Nonprofits, which is a joint investment to accelerate cloud innovation in areas that address critical market needs across the mission lifecycle of nonprofits.

As part of this initiative, we announced our first jointly developed solution called Nonprofit Resource Management, which is a breakthrough in helping nonprofits effectively source, track, distribute, and measure the impact of their resources across core business processes for managing the distribution of material goods to financial and human capital distribution.

We are in an unprecedented era of humanitarian need. It's becoming more costly and complex to respond due to global conflicts, natural disasters, and localized challenges. Whether it's urgently needed medical supplies, disaster response equipment, or essential needs like food and clothing, every dollar saved and every supply more efficiently distributed has a power to transform and save lives.

The Nonprofit Resource Management solution suite is currently in development in collaboration with early adopters. The first capability set, called Goods Distribution, will be released the summer of 2019, with program design and other capabilities to follow.

The solution will be sold jointly through Blackbaud and Microsoft partner and sales channels and will work seamlessly with Blackbaud Solutions, providing a connected experience for the customer. This is another step forward in an evolving partnership between Blackbaud and Microsoft to jointly develop, co-market, and co-sell innovative software technology that will propel the industry forward.

This leads me to our second growth strategy, which is to drive sales effectiveness. Selling integrated cloud solutions that are purpose-built for our customers' needs, like our cloud solution for K-12 private schools, for example, is a key competitive differentiator for our sales teams.

Our sales account executives now lead with total solution selling strategy by vertical, focused on reoccurring revenue and driving more products per customer, higher ASPs, and increased customer retention over the long term. We know that attaching training, analytics, and payments improves the cloud experience, drives customer outcomes, improves retention, and increases customer lifetime value. We continue to innovate and acquire solutions that create greater value for our customers.

We have poured the foundation to develop a highly productive and scalable direct sales model. And we are now underway ramping our sales hiring more significantly than past trends, with over 100 openings underway with good progress in filling the positions.

Let's turn to our third strategy, which is TAM expansion. We are continuing to expand our TAM into new and near adjacencies with acquisitions and product investments. We have been executing this strategy for several years now and have primarily expanded our TAM through acquisitions until now.

With the introduction of the Blackbaud cloud solution for faith communities, our expanded cloud for higher education, and integrated cloud initiative for nonprofits, we are now in a position to organically build and not just acquire incremental TAM. These solution introductions will add approximately $2 billion to our TAM, which now stands at roughly $10 billion in total.

Our final strategic initiative is a focus on operational efficiency to strengthen the business and deliver improved profitability. We continue driving towards a more scalable operating model that creates efficiency and consistency in how we execute through infrastructure investments, productivity initiatives, and organizational realignments.

In 2018, we have been executing a cohesive workplace strategy to better align our organizational objectives with our geographically diverse workforce. In Q2, we moved into our new global headquarters and the employee feedback has been overwhelmingly positive.

For employees outside of Charleston, South Carolina, we are leveraging a more flexible office strategy to replace and upgrade some of our existing offices and expand our footprint into new locations. We have already successfully transitioned seven of our offices, moving our employees into highly modern and more collaborative facilities that are more centrally located for our employees and closer to our customers.

Overall, the key for us is optimizing our office utilization, improving our geographic sales coverage, and enhancing our employees' daily experience to improve productivity and effectiveness.

Overall, I'm pleased with the continued transformation in the business and shift towards reoccurring revenue. And I'm particularly excited about the accelerated pace of innovation that we are delivering for our customers and the reaction in the market.

Our announcements of new cloud solutions have significantly expanded our addressable customer IT spend and our TAM. Our commitment to developing fully integrated end-to-end clouds, like the newly introduced Faith Cloud, Higher Ed Cloud, and the Integrated Cloud Initiative with Microsoft are game-changes for the industry and a massive opportunity for Blackbaud.

Although we recently reset our guidance for this year, as previously explained, our future long-term opportunity has expanded over the last few months, given our TAM expansion announcements and solutions.

I will now turn the call over to Tony to cover our financial performance in greater detail before we open it up for Q&A. Tony?

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Thanks, Mike. Good morning, everyone. Please refer to yesterday's press release and investor materials posted to our website for the full detail of our Q3 financial performance. Today I will focus on key highlights so we can get to your questions.

Our third-quarter revenue was $210 million, an increase of 1.2% on an organic basis over 2017. Recurring revenue represented 90% of total revenue, which is 390 basis points higher than Q3 of 2017 and 4.9% growth on an organic basis.

We continued reducing the mix of one-time services and other revenue, which is positive for us long term, but creates a significant drag on our total Company revenue growth in the near term. One-time services and other revenue represented 10% of total revenue mix and declined 23% versus Q3 of 2017. The primary drag on recurring revenue was driven by consumer behavior associated with our transactions-related business lines.

Turning to profitability, our gross margin was 60.5%, which is a 40-basis-point decline versus Q3 of 2017. We generated operating income of $40 million, representing an operating margin of 18.9%, and diluted earnings per share of $0.59.

It is important to note that operating margin performance is inclusive of our investments into innovation, like our entirely new Faith Cloud, expansion of our Higher Education Cloud, Integrated Cloud Initiative with Microsoft, acquisition of Reeher, and investment to ramp in sales hiring that we began in the third quarter.

Moving to the cash flow statement and balance sheet, in Q3 we generated $58 million in free cash flow. We continued making necessary innovation and infrastructure investments to support our move to the cloud, amounting to $3 million in CapEx, primarily associated with our new headquarters and investment in infrastructure, and $10 million for capitalized software development.

During the quarter, we paid out $6 million in cash dividends to shareholders and ended with $400 million in net debt. Our capital strategy calls for a debt to EBITDA ratio of less than 3.5 times; and at the end of Q3, we stood at 2.0 times.

Turning to the full year, we updated our full-year financial guidance on October 8. The change in our outlook can be summarized into three major categories. The first category is one-time services. One-time services was roughly half of the variance to plan since we last updated you on our Q2 earnings call.

We are shrinking our one-time services revenue by design, which has been part of our strategy for several years now and a positive shift in our business model. For the second year in a row, the rate of decline in one-time services and other has exceeded our initial estimates. Our latest projections now have us declining at roughly $16 million for the year, which is a similar decline what we experienced in 2017 and a faster rate of decline on a percentage basis.

Category two is transactional revenue. This category is nearly as large a variance to plan as category one. We have seen some recent shifts in consumer behavior that are impacting our transactional business. The transactional nature of this business makes it the least predictable in our recurring portfolio to forecast.

And although our sales teams have improved our ability to attach transaction-based solutions onto new deals and have successfully closed larger deals, we are experiencing slower-than-expected growth due to consumer behavior and fewer major one-time events.

The third category is subscription revenue, which is the least material variance. We are now underway with a major project to more aggressively ramp sales headcount and continue to drive sales productivity and hire more than 100 sales and sales support roles. We anticipate this headcount ramp to fuel growth in late 2019 and more fully in 2020.

As we expected and shared with you previously, our retention rate has declined a point this quarter. Overall, our unit retention is now 92%, which is positive on the whole, given we are in the midst of customer migrations and sunsetting multiple legacy products. We are more than three-quarters the way through our sunset program, which has gone well. And we are actively migrating customers onto Blackbaud SKY-powered solutions.

The revenue shortfall driven by these three categories is primarily resulting in our revision to non-GAAP operating margin, diluted earnings per share, and free cash flow. We received some questions on free cash flow, given we had a larger revision in operating income, so I want to provide clarity on that change.

First, the mix of business we lost associated with the revenue shortfall isn't our lowest margin profile. This is the biggest driver of the change. The second-largest driver is roughly $9 million associated with the acquisition of Reeher, given acquisition costs, interest expense, and software capitalization. And third, to a lesser extent, the original free cash flow guidance didn't contemplate the investment we are making into sales.

Finally, as Mike mentioned, we're making incremental investments as part of our workplace strategy. We currently expect to incur before-tax restructuring costs associated with these activities of between $6 million to $8 million, with substantially all of those costs expected to be incurred by the end of 2019.

Year to date, we have recorded approximately $3.6 million in restructuring charges associated with this initiative. We are expecting to gain operating efficiencies beyond 2019 with an estimated payback of roughly two years and future annual before-tax savings of between $3 million and $4 million per year beginning in 2020.

The midpoint of our current guidance indicates a free cash flow margin of roughly 17%. Excluding the $9 million impact from the acquisition of Reeher, free cash flow margin would be roughly half a point higher than the 17.4% margin we posted in 2017.

In summary, we are continuing to execute against our strategic plan, which is strengthening the business. And we are maintaining our disciplined approach to balance investments that drive growth with improved profitability. We will continue to execute on our capital deployment strategy to maintain a strong balance sheet, return capital to shareholders, and create growth and scalability.

With that, I'd like to open up the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Tom Roderick, Stifel.

Tom Roderick *Stifel Nicolaus - Analyst*

Thanks for the question. So Tony, I know you're not in a position to offer any sort of formal guidance for next year just yet. But I was hoping that you might be able to offer us some qualitative commentary as to how we ought to marry your comments here on the call about aggressive investments for new initiatives and the reality, of course, that those benefits won't begin to accrue from those investments until the end of 2019 and into 2020.

So as we think about our own models for next year, is it sort of best to think about the current recurring organic growth rate as being sort of the new normal for right now until some of those investments start to pay off? And then as we think about the current margin rate, is that just temporarily depressed because of the hit to payments and services this quarter?

Or is that a level that we ought to again use as kind of a baseline when we think about adjusting our models for those investments that are going in for next year? Thanks.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Thanks, Tom. The investment in sales -- we talked about this a bit at Investor Day; I want to make sure we are clear. This is kind of a planned new norm for us as a Company. We have historically added about 10% a year.

We noted at Investor Day that we have 100-plus openings posted. So we would expect that you will see this kind of heightened and accelerated hiring for the foreseeable future, not just a one point in time.

We started seeing the ramp in those heads coming on board in Q3, as we spoke about. So we ended up at 472 direct sales heads. At end of Q3, I think we had 440, which is roughly in line with where we were at the end of 2017 and the end of Q2.

So we ramped up a bit there, but still quite a bit more to go through the rest of the year. And then through 2019, we will continue to ramp sales headcount because of the sheer size of the market opportunity and need for better coverage.

So that will continue to push and create downward pressure on margins through 2019 because we won't see the real impact of those additions until late 2019 or 2020, more so, from a revenue perspective. By the time they get hired, get onboarded, build pipeline, and close deals, and then we recognize that ratably. So that will put some pressure on margins.

We are doing other things hopefully to improve our growth rate in the nearer term. So we are very focused, as you know, and have been on improving our productivity of the existing sales force, which is now 470-plus heads. So I'm hopeful that we will see some improvements in organic growth in 2019, which will help a bit.

This quarter, to the other part of your question, this quarter, margins were certainly muted by the investments in the sales hiring and marketing hiring. That said, the falloff in some of the one-time transactional revenue, because we didn't see that kind of repeat of major one-time events and then some of the things we had related to just consumer behavior on the Smart business, did put some downward pressure on margins in the quarter that, assuming we see some improvement on those revenue trends in Q4, would be a bit more accretive.

Tom Roderick ***Stifel Nicolaus - Analyst***

Excellent. That's really helpful commentary. Thank you. Mike, when I think about sort of the new education initiative, and you talked about student information and management services, can you talk a little bit about some of the incumbents in the new areas where you are going after?

I know there has been a lot of questions about, hey, are you going to go after sort of the Blackboard or Instructure course management markets. Or who are the incumbents on the information management side? Can you just talk about some of the incumbents that you think are sort of ripe for an opportunity to go after as you look at these new initiatives in education? Thank you, guys.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Sure. Yes, we are really excited about that announcement. First of all, what we have done, and we started this a while ago, is we have essentially taken the Education Management platform that is in our K-12 market that we talked about a lot in the last couple of years and we have built on that and added a lot more sophisticated functionality for universities.

And so it is the same core platform. So although it is a new Cloud Platform for Universities in that market from us, it's not a whole new software platform. It's an enhanced platform.

The key message there is it's a commercially solid, scalable, with many, many customers in production in K-12 on the same platform extended for universities. So it is not starting from scratch, if you will.

The incumbents there are companies like -- Ellucian is in there and College Campus and a few others. We have several clients signed up using the system already. I highlighted one at our conference a couple weeks ago and there is a few that we are talking about now. So those are the incumbents.

What is exciting for us is before this, we were predominantly focused at the college and university level only in the development office and the fund-raising office. So now we cover a much broader platform set and wallet share with the IT departments in universities than we ever have.

We have gone from basically a departmental player to an enterprise player within colleges and universities. And we are starting with the smaller institutions, given where we are with the platform and who is using the system today.

But those are the incumbents. And we are not anticipating to see someone like a Workday. They are going after the much larger universities, but this is a pretty wide open market with many legacy players in there. So we think we have a really great opportunity like we've had with K-12 schools and still have with K-12 in this new market. So we're pretty excited about this whole opportunity.

Operator

Rob Oliver, Baird.

Matt Lemenager ***Robert W. Baird & Company, Inc. - Analyst***

Great. Thanks, guys. It's actually Matt Lemenager on for Rob this morning. Mike, a question on the faith-based solution. In terms of the functionality that customers are asking for, what types of things were already built into the Blackbaud portfolio from other products? And then what areas need to be built out before that product is released into general availability?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Sure. So in that faith-based market, several of our cloud solutions have already been available for a while. So in things like fund-raising or when some of those institutions have K-12 schools, that whole cloud platform has been available. And our financial platform, Financial Edge NXT.

What we announced was a whole church management set of capabilities that is brand-new for us. And so those are several modules that run a church from facilities to daycare and many other functions that we have never had before. And those are integrated with the other solutions that we provide, like financials and fund-raising.

So in that market at the church level, we are now able to replace 10 or 12 or more single-point solutions and replace all those vendors with one single cloud. So it's a pretty big move for us. It really simplifies the operating side of a church by having one integrated platform with a common user experience and a common reporting system.

If you think about a church that might run on 10 or 12 standalone individual pieces of software from multiple vendors, they all have separate logons and separate reporting systems. It's really complex and difficult and clunky compared to what we've just announced in the market.

So on the church management side, that is what is new. We have several customers already using it, and it will be in general availability in production sometime in Q2 of next year.

Matt Lemenager ***Robert W. Baird & Company, Inc. - Analyst***

Got it. Thanks. And if I could -- a quick one would be I know the transactional, we have seen less one-time events. And with the upcoming midterm elections here, how much does something like that help the transactional business? Is that expected to be a little bit of an impact in the fourth quarter or not really?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

You know, it's hard to tell, right? So presidential elections, especially the last one, we saw some uptick in different types of institutions because of advocacy and lots of other activities related to that. Midterm elections, I don't know; it's hard to tell really what our customer base might or might not do related to midterm elections.

We don't have a solution that is actually used for elections, but we have a lot of customers that generate activity about advocacy related to elections. And again, we've seen it with the last presidential election; there was a big effect there. So it's really hard to say what may or may not happen based on midterm elections.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

And Matt, I would just add on. The one probably thing we are still looking at now going into the end of the year or a good indicator for us is just how the tax reform might impact, giving as how we do on Giving Tuesday, which is coming up in the near term. So we will have a better sense there. That is probably the only other wildcard is to see how end-of-year giving goes.

Operator

Brian Peterson, Raymond James.

Brian Peterson ***Raymond James & Associates, Inc. - Analyst***

Thank you. So Tony, this is probably for you. But just on the sales investments, I know you are adding a lot of capacity over the next several quarters. Can you just remind us on the typical ramp to productivity for new sales hires, when should we expect those to drive new bookings?

And given that this is a big investment for you, does that maybe make you take a little bit more of a conservative approach towards your guidance as you think about 2019, 2020, just from a philosophy perspective going forward?

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Yes, Brian, one of the things is how quickly will we be able to hire the right folks. So we are being selective about who we hire. As we talk about the business model changes we made the last couple of years, we have also moved to the hunter-farmer model.

And so a lot of these hires, a much bigger percentage will be focused towards true prospecting because we still are way over weighted towards back to base. And so we will hope to correct that, this balance a bit through those hiring efforts over the next couple of years. And those PAEs, as we refer to them, prospect account execs, are largely going to be out in the field, which does make it a little tougher to hire at times and onboard.

The time to ramp on the reps is really disparate. If you are hiring kind of associate account reps or telesales kind of folks, they have a much quicker ramp time, in just a handful of months to productivity, where I think probably the longest is looking at those true new prospect AEs in a specific vertical with a very specific large product set that they are selling, a large cloud with a lot of different solutions.

And that can stretch out. I would say that if you get to the extreme with enterprise and strategic reps, could be out more than a year to kind of full productivity. And then folks in between there, depending on the types of reps and what they are selling and where. So we will be conservative.

I think one thing I forgot to mention with Tom's question as well, we do take a little bit more of a hit initially when the new reps are ramping. We pay out a draw in lieu of commission to those folks and that draw is not capitalizable as commissions would be in most cases. So we actually have a bit higher expense that we incur during that ramp period.

And again, because it's mostly -- I think we last quarter made it to 90% recurring revenue roughly, which is about two quarters sooner than we anticipated as a total Company. Because of that, the mix of one-time versus recurring has now shifted to like 70/30. We expect it will shift more to recurring over the next couple years as well, which means a little later revenue recognition also.

Brian Peterson ***Raymond James & Associates, Inc. - Analyst***

Got it. And just maybe on the transactional component, and I understand that there is not as much visibility into that part of your revenue. Is there any way you could parse out maybe what is happening domestically versus internationally?

I think you guys called out some of the UK dynamics before. Just curious what's happening domestically with regards to your transactional business and how that trended through the third quarter. Thanks, guys.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

So the domestic looked good. So the number of accounts we signed, the volumes we were seeing looked good. The one thing we did have was average transaction size was down a little bit from where we expected. So that was probably the biggest issue.

And then one-time events, and when you think about last year, it's unfortunate, but it also drives volumes. We had a couple of big hurricanes that hit very populated areas last year by the end of the third quarter and that drove a lot of giving. We also had international events.

And so there is the seasonality or inpredictability of when those one-time events will happen and how many and how big. So that's kind of some of the difficulty of forecasting that.

And probably the last piece for the US would have been the Smart Tuition piece. That one is an oddity in and of itself, and we don't have good visibility of that until the school year starts. And we talked about that at Investor Day a bit.

It was just a different pattern with the mix of parents and kids for that total Smart population. We had a bit of a change this year and we noted that after the school year started. We just had a higher mix of parents that were paying with ACH versus credit card and a higher mix that were paying on time instead of past due and therefore less follow-up fees. So that kind of shifted the mix on Smart.

And then the last thing we noted with Smart that impacted us a little bit. Because we are now selling Smart as part of this overall K-12 cloud, we've got to do a better job -- we've got an opportunity to do a better job with our sales team to get the schools to implement the Smart Tuition piece earlier in the process, not later.

So in many cases, they have to implement over a couple of school year period, just because there is fairly -- several modules to be implemented. And we have got to do a better job of making sure they get Smart in upfront, where what we have seen is that trended the other direction a little bit on us this year that was not anticipated. So they are implementing Smart later in the process and therefore missing a whole school season.

Operator

Justin Furby, William Blair & Company.

Justin Furby ***William Blair & Company - Analyst***

Thanks, guys. Mike, I was hoping you could give some color around RE NXT and where we are from a development standpoint. Are there still functionality gaps that exist when you compare to the old on-prem Raiser's Edge solution that you haven't brought over yet?

Or what you think at this point, if you are still an on-prem customer, what are the biggest gating factors of getting them to migrate? And just as we sit here today, how many more years do you think we have left on that migration?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Sure. So there is no gaps to the functionality of the on-prem, but there are some gaps to things like integration still. And there's some also, there's some plug-in modules that exist out there that aren't over in the NXT world yet. So those represent some gaps for us that we still need to close and we are doing that.

But there is no functionality differences really. In fact, the NXT Cloud solution is significantly more functionality and capabilities than the on-prem. And whole new categories, like online digital marketing, which is inherent in the Raiser's Edge NXT, never even existed in the on-prem.

So there is actually a huge amount of functionality in the new platform, but there is still some gaps to plug around integration and some unique plug-in modules. So we are knocking those down.

It takes a while to go through this process with any product. So when we announced this a couple years ago, we said it would take several years and there is still a couple years left to kind of knock this down. And the customers that are still on-prem either need to see some of these integration or plug-in module gaps get closed or just hasn't been the right time for them. And we are not forcing anyone to move. So it just takes some time.

But the performance of the product and the reception of that solution has been outstanding, actually. And it's really filled the gap that we didn't have before related to all the functionality in that solution.

The other thing, too, is because that product, Raiser's Edge NXT, was the first thing that we did in the SKY architecture. All the subsequent things that we are doing are inherently integrated. So like the faith-based Church Management Solution, day one it's a part of Raiser's Edge NXT. There's really no extra integration work; it is just core. It shares all the core tech stack.

And so the level of integration with RE NXT and new things like the Church Management is at a level where we haven't had before because there is no integration work to do. It is just one environment. So really, really great from a competitive advantage standpoint.

Justin Furby ***William Blair & Company - Analyst***

Got it. That's helpful. And then maybe, Tony, for you. You talked a little bit about your guidance philosophy with these new reps and the impact. I'm just curious on the other side, transactional business. Just given what happened this year, does it make you sort rethink your guidance approach to that business when you look out next year and going forward? Thanks.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Yes, Justin, that's actually a really good question. We have been doing a lot of work internally this year on building out some new tools to better forecast the transactional business.

You know, we have had several acquisitions and then just fairly sizable growth over the last couple years in our kind of standard BBMS platform for the business. And then when you add Smart and Just Giving and some of the other acquisitions and some of the planned expansion of products will drive even more on that front.

So we are actually building out some fairly robust tools that are using more sophisticated data modeling techniques and allowed us to forecast at a more granular level as well than what we would have done historically. So we can understand better impact of all the migrations, legacy product impacts, these one-time events and their impacts across the base.

As you can appreciate, when you have something like a hurricane, you've got to be able to sort across the entire population and understand what impact that had on a various set of customers that would participate in something like that. Or the earlier question of presidential election, there was what we call the Trump effect. And so there was quite a few different kinds of orgs on both sides of that equation that were impacted by those kind of unusual events.

And so we are building a much more robust set of tools to forecast that. And with that, also we are looking historically back at these one-time events to make sure we understand those more clearly and what kind of frequency they happen and when. So getting a lot more sophisticated on that front.

So I think going into 2019, I feel that we will be in a much better position to more accurately forecast our payments business at a much more granular level than we have historically. And we will also understand the kind of dynamics of these historical one-time events more fully so that then we can clearly articulate what we anticipated and included in our guide for those things going forward.

Operator

Rishi Jaluria, D.A. Davidson.

Rishi Jaluria ***D.A. Davidson & Co. - Analyst***

Thanks for taking my questions. Let me start by asking about the jointly developed solution with Microsoft, the nonprofit resource management. Just wondering if you could give some details.

Is this something that both you and Microsoft are going to sell jointly, separately? Is there kind of a revenue-sharing arrangement? And is there kind of a joint go to market? Maybe if you could give a little bit of details about how that selling motion from the relationship standpoint looks like. And then I've got a follow-up for Tony.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Sure. This is Mike. I will take that. We in general have had a building partnership with Microsoft; it started several years ago in engineering and a lot of the work we have done with the SKY platform. And it continued into operations with our commitment to move production to Azure.

And then about a year ago, we announced a go-to-market partnership, which was another layer of relationship with them. We announced that a year ago. And so we are in the market with them in all of the vertical markets that we are in and they are together, which are several nonprofits and education institutions and healthcare are a couple I'll mention.

And so we do go to market together now. It is still early days on that, but we are partnering on sales deals and winning together in the market. It's still fairly new. We are still building the connective tissue with their go-to-market teams and ours.

What we announced here is another layer of collaboration between us and Microsoft, which is to jointly develop a new solution. And we are developing that together, and the first component of that on nonprofit resource management is a goods distribution.

You can think of it as a -- and I will just -- a category of something like a supply chain management solution specifically for nonprofits and we are developing in that together. And because we are, it naturally will be integrated with both of our environments, Dynamics and Office 365 and our solutions as well, which are complementary in the market.

So jointly developed, and then specifically to your question, also jointly sold. It will be sold; both of us will be selling it together, standalone and together, because we are partnering on new opportunities in the markets that we serve.

Rishi Jaluria ***D.A. Davidson & Co. - Analyst***

Got it. Thanks. That's really helpful, Mike. And then Tony, you gave us some color on the Reeher acquisition. Is that $9 million impact, is that indicative of how the business model looks? Or is that a reflection of some kind of one-time costs related to accounting and the acquisition itself? And is this an asset that you can turn to be accretive to margins? Thanks.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Yes, so the $9 million was referring to the cash flow impact. And as you know, when we typically do guidance, unless we have a deal that's very certain to close, would not be included in our original guide. So Reeher was not in our original free cash flow guide.

We were able to cover that because of the range we had on guide initially. And what became the problem is then later in the year, we also had not anticipated ramping sales headcount, so that was not in our original budget and guide either. So we had that ramp in sales, and then also some of this revenue performance issue is what really caused the update in guide.

The $9 million would be inclusive of all the one-time acquisition integration-related costs. All the legal and deal costs, etc., also would be inclusive of the incremental interest expense on the debt that we incurred as well as any incremental CapEx or cap software. So a lot of -- a big chunk of that would be one-time in nature, more associated with the actual acquisition and not kind of future run rate from a free cash flow perspective.

And we would expect and anticipate that we will get Reeher, which is what we said right up front, to be accretive from a profitability standpoint. I think what we said initially when we did the acquisition -- you guys correct me if I am wrong -- that it would be dilutive the first year, but we expected we would get to be accretive in the first full year following the acquisition. So next year.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, this is Mike. I will just add that we have already fully integrated that acquisition. So it's essentially no longer a company, but a product and it's fully integrated. The management team has stayed; it's a really great management team and a really great additive product for us. And it is performing as anticipated from a growth and sales standpoint.

But we went fast and integrated it quite quickly, a couple months. And that is behind us now, which helps from a go-forward operating standpoint.

Operator

Kirk Materne, Evercore ISI.

Peter Levine ***Evercore ISI - Analyst***

Thank you, guys. This is Peter Levine in for Kirk. On the Church Management, can you kind of walk us through the sales process? I know you talked about there's 8 to 10 disparate systems that these churches are using.

I mean, what products are they using? What's the sales process like? I'm not sure how in-depth church IT departments are, but, I mean, who are you really selling into to kind of get them in and deploy your new Church Management solution?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Sure. It depends on the size of the institution, because there are churches of all sizes. There are institutions that have tens and sometimes hundreds of churches within an institution. So it really depends on if the sales motion is a single church or a large group of churches, and we are selling to both of those types. And there are differences in sizes, too, as well.

The folks that we sell to are typically the CFO and IT folks. Typically, the structure in a faith-based institution is the individual that is the equivalent of the President or CEO is someone that is in the institution based on the fact that they were a priest or their function in the institution is one of faith. And they moved up in the organization to then head up the whole organization. And they typically have reporting to them a CFO and a head of IT. And so that is typically where we are as far as the sales motion.

The solutions come from lots of different software providers out there. There is, like all of our markets, there's lots of small providers. In faith-based there is a couple of larger ones; one of them is called Ministry Brands. It's a private equity-owned business with lots of legacy solutions.

And this new faith-based cloud that we have is now allows us to go into an institution where historically we would sell fundraising and financials. And now we cover pretty much almost the entire IT spend and we can start a journey of replacing older solutions module by module from an implementation standpoint.

So, for example, a faith-based institution might sign up for the whole cloud platform that we have. And based on their point in time, they might decide to implement a new financial system first or fundraising and then implement a church management solution.

If they have a school, we provide our K-12 platform. Some of them have universities as well, so this new higher ed announcement applies directly to them also. So it really depends on the institution, the selling motion.

But what is good for our folks that are in sales in that business unit is we cover all the topics now as opposed to just a departmental topic of fundraising. It's a very, very different place than we have been historically. And that holds true with our university higher ed announcement as well.

Peter Levine ***Evercore ISI - Analyst***

Great. The second question I had is your go-to-market strategy. I know -- I believe at your Analyst Day, you talked about hiring a more vertical-focused sales team. So the new reps that you are hiring, are they going more towards the church, higher ed? If you can kind of just provide a little more color on where we could see headcount pick up, just on the product side.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, we are adding them in across the whole Company and internationally as well. So we think -- I think in terms of the fact that we have such a large addressable market, we are adding sales headcount everywhere. Predominantly on, to Tony's earlier point, on the new logo side, but it's in all of our verticals.

Over the last several years, we talked a lot about K-12. Well, we are still adding sales headcount there as well. There is over 30,000 addressable private K-12 schools in North America. So we have a large addressable market opportunity in each of the verticals, including the newer ones, in these new cloud solutions like faith-based and higher ed. So it is across the board.

Operator

Monika Garg, KeyBanc.

Monika Garg ***KeyBanc Capital Markets - Analyst***

Thanks for taking my question. Generally you have talked about lower double-digit recurring revenue growth. But given that in the back half of the year, of course, it is less than that. Maybe could you just talk about how to think about that recurring growth rate going forward?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, sure. So the challenge that we have, we've described on the last Investor Day and the call we had a couple weeks ago, is that predominantly one-time revenue on an annual basis of 2018 and some transaction revenue -- Tony answered some of those questions a couple of minutes ago -- put some pressure on organic growth at the total Company level.

The transition that we have been going through related to the fact that we have a much smaller one-time revenue is obviously quite healthy for the Company, but puts some short-term pressure on total organic growth.

And so we don't see that as a long-term issue at all. In fact, the announcements we've made in the last couple of months, faith-based and higher ed clouds obviously aren't producing revenue today, but they are producing lots of opportunity. And those announcements have expanded our TAM by $2 billion. So lots of future opportunity to drive reoccurring revenue, which in turn drives organic growth as well in those -- in our existing and in those new markets.

Also, from a sales standpoint, I talked a little bit about the growing partnership with Microsoft. It's a growing partnership on the go-to-market side as well with their entire ecosystem. They obviously have a very large global footprint and we are partnering with them.

It is still fairly new, but we are partnering with them in North America and internationally as well. So actively involved in new pursuits today around the world with Microsoft, but it's still a new relationship and new relationships are being formed. But we have really fantastic support from the executive team globally at Microsoft to drive a focus in this particular market.

They have a high interest in helping education institutions and nonprofits around the world. They have a new business unit, a nonprofit business unit, that's a little over a year old. And we are very partnered with that business unit, including the verticals that are the common footprints to our verticals. So lots of opportunity there to drive organic growth with new solutions and a partnership with them.

Monika Garg ***KeyBanc Capital Markets - Analyst***

All right. Thank you. And then how to think about expansion of free cash flow margin going forward? Thanks a lot.

Tony Boor ***Blackbaud, Inc. - EVP, Finance and Administration and CFO***

Hey, Monica. This is Tony. We had a really good quarter from a free cash flow perspective. I think on the year, taking into consideration some of the difficulties we've seen on the one-time services side of the business and just some of the transactions with these one-time events not repeating, I feel like we are doing really well on that front.

As we said earlier on one of the questions, we had a $9 million impact estimated for the Reeher acquisition, which put downward pressure. And then we also, if you recall, moved into our new headquarters facility this year, which was a fairly sizable increase in cost.

And we have also taken quite a few charges as part of our facility and workforce optimization strategy. And those things are going to give us really nice paybacks, but it's going to take a couple of years.

I think this year, the rough math, if I had -- if we didn't do the acquisitions with that $9 million impact, plus backing out the impact of our new headquarters, we would have been at about a 19% free cash flow margin. So I feel really good on where we are there. And I think that as we ramp sales investments, that's going to put some downward pressure because it's going to put pressure on our overall profitability.

But as we start growing, to your point, our recurring revenue more quickly over time, that will give us a lot more room to expand margins more fully and continue kind of what we have done over the last few years. So I do think that over time, get past some of these initial investments, start seeing some of the paybacks, we will be able to see some expansion in free cash flow margins.

When I look at the balance sheet, one of the things that really hit me: the team has been really focused on cleaning up our accounts receivable. If you look comparably, our deferred revenue balances are up substantially from year end, yet our accounts receivable is relatively flat. That tells you we are doing a really good job on collecting those new billings, and overall DSO continues to improve.

So from a working capital perspective, I think the team has been doing a really stellar job there as well, which will help free cash flow margins going forward also.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, and I will just add on the facilities front, we have talked about this before. We have a long-term global plan related to facilities and it includes better facilities, closer to our customers, and a lot more flexibility for our associates.

And that long-term plan puts a little pressure on increased costs in the short run, but actually will be adding to margin in the longer run. So the plan is economically feasible for the Company from a margin standpoint and creates a better footprint for us globally as well.

Operator

Ryan MacDonald, Needham and Company.

Ryan MacDonald ***Needham & Company - Analyst***

Yes. Good morning, Mike and Tony. I guess first off, now that we have anniversaried the Just Giving acquisition, I guess which was in early October, can you sort of refresh us on sort of how that business is progressing from an integration perspective? As well as any updates to the timeline for when you expect Just Giving to be launched in the US?

And then as you look at Just Giving and Everyday Hero strategically moving forward, whether those solutions you are expecting to integrate them or leading with one versus the other?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, sure. The Just Giving acquisition has been a really great expansion for us because it gets us into a direct-to-consumer platform that we really didn't have at that scale.

The challenge we had this year, which we've talked about in the last couple weeks, is giving is down in the back half of the year in the UK in general, which puts a little bit of pressure on Just Giving. But the platform and the business is performing quite well.

We have hired some really great folks to globally expand that platform, including in the US, from cloud software companies. These folks came from some cloud software companies that are consumer-facing, so some really good skill adds.

We are integrating the platform with our middle and back-office solution, so it will make it unique in that regard. It will be the only platform like that which is integrated with core Blackbaud solutions. And that is well underway.

And so by doing that, it makes it operationally friendly, if you will, for our customers. Where today, from other platforms, if they are used to make a donation, for example, it creates a lot of back-office work for our customers and then a lot of cost. We will eliminate that with the integration work that we are doing.

So we are happy with the acquisition. It is performing well; a little less than anticipated this year, but mostly due to a year-over-year compare of less one-time events as well on that platform. But overall, it's been a really great add for us and a really great expansion into a direct-to-consumer facing model. And we are working on launching that platform in the US fairly soon.

Ryan MacDonald ***Needham & Company - Analyst***

Great, thanks. And then just a quick follow-up. In terms of sort of the strategic focus of the business, I guess, as we look out into 2019, obviously a lot of work is being done now in ramping that sales headcount and really building out some of these newer solutions that you have announced for early adopters right now and then general release in mid to late 2019.

Can you talk about sort of the balance and focus of continuing along that organic growth focus versus typically some focus on expansion via M&A? And whether or not you are shifting the balance there as we look out into 2019, 2020?

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Yes, I would say that we continue to look at candidate acquisitions that make sense for us for near-adjacency TAM expansions for the vertical markets that we are focused in. We are not changing that. And so that strategy continues from an M&A standpoint.

What has changed significantly is our ability to add significant TAM through organic development. So the faith-based announcement, the faith-based cloud and the higher ed cloud, as I mentioned, added about $2 billion in TAM for us and those are organic developments.

And so we have two plays we can run now from a TAM expansion, which is continue to look at well-run cloud tuck-in TAM expansion acquisitions and organic builds. And so we will continue down the path of both of those as they make sense.

And so the ramp-up with the organic builds has begun, if you will. And that is with early adopters and going to general availability in the back half of next year. And as we continue to add go-to-market folks in those verticals and the others.

So I wouldn't say that it's -- it's not binary, meaning there is no flip to organic-only TAM expansion. What we have had -- what we have done is we have just added a second play, which is organic build of TAM expansion, to the M&A playbook that we have. So we will continue to do both.

Operator

That does conclude today's question-and-answer session. I'd like to turn it back over to Mike Gianoni for any additional or closing remarks.

Mike Gianoni ***Blackbaud, Inc. - President and CEO***

Thanks, operator. Thanks, everyone. I will just close by saying that we remain committed to driving innovation, as we have shown with our recent announcements, around our cloud solutions for faith and higher ed markets and the joint development with Microsoft for nonprofits. All of these have added $2 billion to our TAM.

So we are really excited about the future related to those investments. We look forward to updating you on our progress on the next call. Thanks, everyone.

Operator

That does conclude today's conference. Thank you for your participation. You may now disconnect.
