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PRESENTATION

Operator

Good day, and welcome to Blackbaud's Fourth Quarter 2019 Earnings Call. Today's conference is being recorded.

I'll now turn the conference over to Mark Furlong. Please go ahead, sir.

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

Good morning, everyone. Thanks for joining us on Blackbaud's Fourth Quarter and Full Year 2019 Earnings Call. Today, we will review our financial and operational results and provide commentary on our performance in the context of our 4-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 line 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 substitution 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.

Before I turn the call over to Mike, I will briefly cover our upcoming investor engagement activity, which is available on our Investor Relations website. During the first quarter, our team will be attending the Raymond James Institutional Investor Conference in Orlando. We will also be holding meetings with investors in Boston and New York.

With that, I'll turn the call over to Mike.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Thanks, Mark. Good morning, everyone, and thanks for joining our call today. Q4 was another solid quarter and a strong finish to the year. We furthered our strategic initiatives, positioning the company for long-term success. And thanks to the great execution by our teams across the business, we achieved our full year 2019 financial guidance, with total revenue and earnings per share exceeding the midpoint of our guidance ranges. Our team of over 3,600 employees drive our success. And we continue to strengthen our culture and modernize our approach to meet the needs of our expanding global talent and customer base.

A few weeks ago, we announced Maggie Driscoll has joined the company's executive leadership team as Chief People Officer, bringing with her more than 20 years of HR leadership experience and expertise in organizational effectiveness, mergers and acquisitions, talent management, diversity and inclusion and people development. Most recently, Maggie spent more than 15 years at BNY Mellon, leading global human resources with responsibility for HR strategic direction and change management. Maggie is succeeding John Mistretta who is retiring after 14 years at Blackbaud. And I'd like to thank John for his outstanding leadership and service to the company.

As usual, I'll provide a few updates in the context of our 4-point growth strategy before turning it over to Tony to cover our results in more detail. The first of our 4 growth strategies is delight customers with innovative cloud solutions. We're driving rapid innovation with a focus on creating lasting value for over 45,000 customers through the power of the market's leading purpose-built integrated solution set. A great example is the U.S. Naval Academy Alumni Association & Foundation, who through the power of Blackbaud CRM, Blackbaud Financial Edge NXT and Blackbaud Target Analytics, increased fundraising revenue by over $4 million, improved engagement with their more than 60,000 members and realized over $1 million in cost efficiencies. By partnering with Blackbaud, they were able to realize a 143% return on investment with a payback of 2.5 years. Our market is continuously seeking more cost-effective and efficient ways to manage their organizations and achieve their missions, and we meet that need with our purpose-built software solutions.

In 2019, we continued to demonstrate our ability to rapidly innovate and address the needs of our customers across our vertical markets. As you know, in October, we announced the general availability of our Cloud Solution for Faith Communities. And we now serve churches in more than half of the United States, representing congregations of all different sizes and spanning more than 13 denominations. We're seeing positive momentum as more functionality continues to be released. Market awareness is increasing and win rates are improving. We're also seeing momentum build in our higher education vertical where Blackbaud powers 24 of the top 25 private U.S. colleges as ranked by Forbes. A year after introducing the Cloud Solution for Higher Education, we continue to drive innovation and introduce solutions, taking full advantage of the rapid innovation, modern user experience and enhanced capabilities made possible by our Blackbaud SKY platform.

As you know, we extended our industry-proven education management portfolio upmarket to small scale, higher education institutions, and we continue to see strong sales momentum and look forward to seeing these customers begin to go live in 2020. We also recently introduced talent management capabilities as part of the Cloud Solution for Higher Education, providing institutions like University at Buffalo and University of Maryland College Park Foundation the first online performance tracking tool for fundraising leaders and managers, enabling transparency, proactive management and peer officer benchmarking. This is a significant opportunity for Blackbaud to deliver innovation with a connected cloud experience in the space that's comprised predominantly of disparate legacy point software. Blackbaud peer-to-peer fundraising powered by JustGiving continues to gain traction. Since the U.S. launch in early 2019, over 1,000 customers have signed up to use the solution. And I'll note that roughly half of these organizations are net new customers to Blackbaud. These are just a few examples of the relentless focus our team has on driving value and outcomes for our customers through our solutions. Blackbaud SKY, our platform for innovation, continues to power an unprecedented level of innovation by our engineers and enables a growing ecosystem of developers.

As I mentioned on the last call, there are now significantly more outside developers developing on our platform than Blackbaud engineers. And we're providing this community and our partner network with the tools to extend and enhance Blackbaud solutions. Also in October, we launched the Social Good Startup Challenge in partnership with global virtual accelerator, One Million by One Million. Last month, we announced 14 winners whose innovative solutions enable social good organizations to do everything from in-kind gift matching to donor bequest planning, mobile-first grassroots organizing, video storytelling, volunteer training, parent ambassador recruitment, credit card transaction-linked giving and more. This is a growing network effect. We are looking forward to working with these creative and diverse entrepreneurs to strengthen and expand the ecosystem of good.

I'll now turn to our second growth strategy, which is to drive sales effectiveness. As you know, we've been investing in sales and marketing to better address our market opportunity with a focus on adding additional sales headcount, improving productivity and putting a greater focus on adding net new logos. One way we're equipping our growing sales force to be more effective is by investing in the necessary technology and resources to efficiently drive an increased number of quality leads and better cover our large addressable market. We've been growing our lead generation teams, which we call business development representatives, to support our growing sales teams. And we've simultaneously increased the productivity of our business development representatives with the implementation of a leading sales engagement technology platform, enabling our teams to generate more prospects and convert those prospects into sales opportunities.

We're entering 2020 with an optimized ratio of business development representatives to account executives. And the lead generation from the team has increased substantially as a result of these changes. We've also implemented software tools to enhance our digital footprint and drive lead generation across the company. And for the first time ever, we're taking a multi-touch attribution approach to measuring the effectiveness of our marketing campaigns to drive efficiency in our go-to-market efforts and ensure we're getting the greatest return on our marketing dollars. This is just one of the many examples of how we're optimizing our structure, tools and processes to better address our large vertical market opportunities.

We've made big strides employing the foundation to develop a highly productive and scalable operating model, which included significant organizational structure changes as we centralized many back-office functions and aligned our go-to-market efforts by vertical. This transformation is now behind us, putting us in a position to drive improved productivity across our vertical sales teams. A good example is in our nonprofit vertical where Operation Smile chose to partner with Blackbaud because of our proven industry depth, customer knowledge, purpose-built solutions and partnership with Microsoft. The Chief Development Officer at Operation Smile said and I quote, "Blackbaud worked closely with our team to come up with creative, cost-effective solutions, some of the challenges we anticipated, which we found inspiring." These tenets, coupled with our trust in the people working directly with our teams, is why we chose Blackbaud."

I'll now turn to our third strategy, which is TAM expansion. The acquisition of YourCause a little over a year ago positions us as a global industry leader in enterprise corporate social responsibility and employee engagement technology. In fact, 1/3 of the Fortune 500 companies trust Blackbaud as their CSR technology partner. And in 2019 alone, YourCause solutions processed over $1 billion in donations and grants, which benefited over 170,000 social good organizations. In the first year since acquisition, we fully integrated the YourCause administrative functions into our global Centers of Excellence and expanded the sales team to fuel what is already a fast-growing business within the company. Our total addressable market currently stands at over $10 billion, and we remain active in the evaluation of opportunities to further expand our TAM through acquisitions and internal product development.

Our final strategic initiative is to focus on operational efficiency to strengthen the business and position us for long-term success. As you know, we've been executing a comprehensive workplace strategy to better align our organizational objectives with our geographic footprint. We designated Charleston, Austin, London and Sydney as our hub locations, and we're leveraging a more flexible office strategy to replace and upgrade some of our existing offices and expand our footprint into new locations for customer-facing roles. Most recently, we moved our London offices into a new flexible workspace, marking a significant milestone in the integration of our Blackbaud Europe and JustGiving teams. In 2019, we largely completed this optimization effort, and we will continue to evaluate our footprint in alignment with our global workplace strategy. The key for us is optimizing our office utilization, improving our geographic sales coverage, enhancing our employees' daily experience to improve productivity and effectiveness.

Overall, we had a strong finish to 2019 as we furthered our strategic initiatives and delivered on our full year financial guidance. Heading into 2020, we have a positive outlook as the market remains solid and we continue to be uniquely positioned to enable digital transformation within the markets we serve. We've made truly transformational changes across the company over the last several years as we built a scalable operating model, created a culture of innovation and better positioned ourselves to capture the large market opportunities in front of us. The significant structural changes in the business are now behind us, and we're well positioned to further differentiate ourselves as the leading cloud software company powering social good and deliver increased value to our customers, employees and shareholders.

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

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Thanks, Mike. Good morning, everyone. Over the course of 2019, we made strategic investments to further expand our go-to-market model, drive cloud innovation for our customers and ensure scalability in our business. Our fourth quarter results allowed us to deliver on our full year financial guidance, and we exceeded the midpoint of our guidance ranges on both revenue and earnings per share. Please refer to yesterday's press release and the investor materials posted to our website for the full detail of our Q4 and full year financial performance. Today, I'll focus on key highlights, so we can get to your questions.

Fourth quarter recurring revenue increased 9.8% over Q4 of 2018 and 6.7% on an organic basis. We posted solid recurring revenue growth through 2019, anticipate carrying that performance into 2020. We continue to see a healthy shift in mix of recurring revenue as onetime services and other revenue represented only 8% of our total revenue mix during the fourth quarter and declined $3 million in the quarter, which is a 15% decline versus Q4 of 2018. On a full year basis, we delivered $902 million in revenue, which exceeded the midpoint of our guidance and represents 6% growth over 2018 or 3.1% on an organic basis. Recurring revenue represented 92% of total revenue, which is 260 basis points higher than 2018 and grew 5.8% on an organic basis.

We continue to focus on opportunities to further shift our bookings mix towards ARR and optimize the mix of business within the ARR bucket. Onetime services and other revenue represented 8% of our total revenue mix and declined nearly $18 million, which is a 20% decline versus 2018. This decline is healthy for the long run. And as expected, this was an accelerated rate of decline when compared to the 17% decline in 2018. I'll also note that YourCause performed in line with our expectations, and we continue to be excited about that acquisition and the opportunity in the space. YourCause was excluded from our organic revenue calculations in 2019, but will be included in 2020.

Turning to profitability. Our fourth quarter gross margin was 56%. For the full year, our gross margin was 59.1%, which is a 170 basis point decline versus 2018. We generated full year operating income of $152 million, representing an operating margin of 16.8% and diluted earnings per share of $2.24. Strong execution on our internal initiatives enabled us to deliver on our full year guidance for operating margin and exceed the midpoint of our guidance for diluted earnings per share. 2019 was an investment year for us as we further expanded our go-to-market model, brought new solutions to market, continued our efforts to migrate our cloud infrastructure to public cloud service providers and grew our partner program, including third-party implementation partners.

We've been aggressively hiring in sales, and we ended the year with 560 direct quota-carrying sales headcount, representing 8% growth versus 2018. As I mentioned on our last call, in 2019, we made the last major structural change to the sales organization when we reallocated most overlay and associate account executives to first dollar quota-carrying account executives. As expected, this drove heightened levels of attrition within our sales force that we expect to normalize going forward. The key is that, in 2019, we significantly improved the mix of quota-carrying account execs carrying the full bag and with more than half being prospect account executives. And we expect improved productivity in 2020 as we increase the time spent in territory for our sales reps and continue to execute on our sales effectiveness initiatives.

Also, as Mike mentioned, we have substantially completed our facilities optimization restructuring plan as part of our global workplace strategy. And the cumulative restructuring costs incurred to-date were $11.2 million. This exceeded our estimated range of between $8.5 million and $9.5 million, largely due to operating lease right-of-use asset impairment costs recorded during the fourth quarter related to our inability to sublease certain office spaces we had previously ceased using. These restructuring activities are expected to result in improved operating efficiencies and future annual before tax savings of between $5.0 million and $6 million beginning in 2020.

Moving to the cash flow statement and balance sheet. In Q4, we generated $46 million in free cash flow. We continued making necessary innovation and infrastructure investments to support our cloud operations amounting to $2 million in CapEx and $12 million in capitalized software development. For the full year, we invested $11 million in CapEx for property and equipment and $47 million for capitalized software development, which, when combined, lands slightly above our expectation of $45 million to $55 million in total capitalized cost for the year, largely due to our heightened investments in innovation to bring new solutions to market and the integration of YourCause.

Our full year free cash flow was $124 million, a decrease of $25 million or 17% when compared to 2018. And our free cash flow margin was 14% for the full year. Free cash flow results were within our guidance range and included the heightened capitalized investments I just mentioned; as well as expected impacts from the investments we're making into the business; the 2018 cash tax refund of $7 million, which didn't repeat in 2019; accelerated restructuring associated with our workplace strategy; and impact from acquisitions of YourCause. During the quarter, we paid out $6 million in cash dividends to shareholders and ended with $435 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x, and at the end of Q4 we stood at 2.3x.

Now let's turn to 2020. We are guiding to non-GAAP revenue of $930 million to $955 million; non-GAAP operating margin of 16.0% to 16.5%; non-GAAP diluted earnings per share of $2.20 to $2.35; and free cash flow of $100 million to $115 million. From a revenue perspective, we expect another double-digit decline in onetime services and other revenue, and we are anticipating organic recurring revenue growth to be slightly above our 2019 organic recurring revenue growth of 5.8%. I'll also note that this could be the last year of material declines in onetime services and other revenue.

From a profitability and cash flow perspective, we will continue to invest to better position the business for accelerated growth and long-term success. We're underway in a multiyear effort to enhance our scalability by migrating our cloud infrastructure to leading public cloud service providers. We anticipate continued pressure on gross margins as we incur the necessary costs to make this shift. We also expect to continue a heightened pace of investment in our go-to-market model and cloud innovation to support the future growth of the business. Our estimate for 2020 combined capital expenditures is expected to be $55 million to $70 million, which is an increase over 2019.

While capitalized software development has largely leveled off, we're anticipating CapEx to increase year-over-year associated with onetime costs related to our continued shift to the cloud and necessary maintenance upgrades to our existing colo data centers. We're currently expecting to incur minimal before tax restructuring costs in 2020 as we've largely completed the optimization phase of our workplace strategy. We estimate our non-GAAP tax rate will remain consistent with 2019 rate of 20%. And after paying minimum cash taxes in 2019, we are expecting a modest increase of a few million dollars in cash taxes in 2020.

Our free cash flow will be impacted from the investments we're making into the business, the increases in CapEx and cash taxes I just mentioned and changes within working capital. Our deployment of capital strategy hasn't changed. We will continue to pay dividend, invest in our growth and operating initiatives and continue paying down debt to provide capacity for expansion opportunities.

In summary, we continued executing against our strategic plan. We're maintaining our disciplined approach to balance investments to drive growth with improved profitability. And 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) We'll now take our first question from the line of Tom Roderick with Stifel.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

So Mike, I wanted to hit you on the first question here, just taking a little bit more about the higher ed vertical, and congrats on some of the early successes there. I know you've been a company with a large presence in higher ed for a long time. I wanted to hear just a little bit more about this go-to-market function and what you've been able to do to build out sales capacity, drive more sales leads and, in particular, drive your existing installed base to some of the newer features within the product set? And can you talk a little bit more about what that's doing to deal sizes, what that's doing to adoption rates? Just some more details around that higher ed vertical would be fantastic since it's getting off the ground in a nice fashion.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Sure, Tom. Thanks. Yes. I'm really pleased with what's happening in higher ed. We've really moved in the last 18 months to a portfolio sale. And if you go back several years, we're exclusively focused on fundraising and the foundation part of the higher ed institutions. And now we're covering a much larger IT wallet spend, which is great. We're starting with smaller universities that we've announced and signing up a lot of universities for our education management platform. What I mentioned in my prepared remarks around focus on sales expansion and lead generation also applies to higher ed as well. We've done a really good job in recruiting in that part of the business. The marketing team has done a great job in that business and getting a much broader global footprint in higher ed, is showing up in a lot more places from a marketing standpoint. We've got continuing build of lots and lots of references. Most of the industry now is very aware of our move into the side of the business that runs the school, which is great. So I'm really excited about what's happening in that business, that vertical market for us and that expansion in the last couple of years. It's going quite well.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Outstanding. Tony, quick follow-up for you. Just in thinking about the construction of 16% to 16.5% operating margins this year. And you guys have been pretty forthright about the idea that you'd have some duplicative costs, some colo cost, services hitting you a little bit, that gross margins would still be on a little bit of a down trajectory. Take us through whether this 56% gross margin we saw in the fourth quarter, is this the low watermark, and then we start matching -- marching up from here? How would you encourage us to model on the gross margin side relative to the construction of that operating margin? And then should this year be the low watermark for gross margins?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. Tom, thanks. I can't speak specifically to gross margin since we didn't guide to that. But I'd say that we do expect, as we talked about in the prepared comments, to see continued pressure on the gross margin side. I think if you break that apart, we've not seen a downward pressure on gross margins from the payments business in more recent times than we saw historically. And I think that's because as we've talked about payments as not growing at a rate that's significantly faster than the rest of our subscriptions business. And so that's not -- no longer creating downward pressure. The real pressure is from the increase in cap software amortization. As you know, we've been spending a significant amount of investment dollars on innovation, not only with the existing products converting those to the next-generation products and building out the SKY platform, but also then as we were just talking about, Mike, the entrance into the higher ed cloud and then also in the faith community. So quite a bit of R&D investment on innovation that results in more cap software, which now is catching up from an amortization perspective up in the gross margin line.

And then, again, as we've spoken about quite a bit the last year or so, this conversion to third-party service provider clouds away from our colo data centers is putting quite a bit of duplicative cost pressure on gross margins, and that will continue for the foreseeable future. That's a fairly long migration time line to move out of all those colo data centers and into third-party cloud provider data centers. And so I would expect you'll see that through 2020 and a bit beyond that as we continue that migration. From an operating margin perspective, there'll still be some incremental investment as Mike spoke to in his prepared comments on the sales and marketing side of the business as we work to drive that. I think we've seen good leverage on the R&D side of the business considering all the investments we've made there. And then obviously, SG&A, we've been able to hold the ground pretty well on that side, which helps from the operating margin perspective. But the majority of the pressure will continue to come from gross margin.

Operator

Our next question comes from the line of Brian Peterson with Raymond James.

Brian Christopher Peterson - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

So I wanted to start off on the guidance. It looks like your guidance assumes that the organic recurring revenue base is going to accelerate. Just maybe double-clicking on that. What's given you the confidence in that acceleration? And maybe a couple of the products or segments that you think will ramp up in 2020.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Brian, it's Mike. Thanks for the question. Yes. This is really the first year that we haven't had a major organizational change in the company in a while as we restructured the business and most notably in sales. So we have increased sales headcount last year at the rate that we wanted to. But an even more important point is a year ago, January, we made some pretty big changes in sales. We moved a few hundred people around and gave them sort of first dollar assignments. We had a model where we had product specialists that had shared compensation with direct sellers and now they're essentially all direct sellers. And so although we increased the sales headcount last year in total heads, the actual increase is significantly more because of the reassignment. And as you know, in sales, when you reassign, you slow down productivity. So we wanted to correct the operating model to have all direct sellers last year. Even though we take a little bit of a hit in productivity last year, that's not reoccurring this year, right? Everybody is in territory. The entire team got their plans and all their information in the first week of January. We just had a great sales kickoff here in Charleston. So lack of organizational change typically leads to much better productivity in any kind of role, especially in sales.

Brian Christopher Peterson - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Understood. And maybe just on YourCause as a follow-up. So 170,000 social good organizations received donation this year. I believe you only have about 40,000 or 50,000 customers. So can you talk about how many of those 170,000 organizations would be addressable for Blackbaud solutions? And any synergies you've seen in selling the Blackbaud platform into that customer base?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes, sure. Yes. The YourCause platform has a wide reach, over 170,000 social good organizations, over $1 billion in donations and grants last year. Also, 1 in 4 folks that have access to that platform are located outside the U.S. So those 170,000 -- there's some duplicate, but not a lot. Those -- many are addressable by us. We're starting to work on that. Frankly, last year was really about getting the acquisitions sort of settled in, integrating some of the back-office, executing on plans to grow their sales teams. And so the cross-sell opportunity is there, was not a high focus in '19, but it's definitely an opportunity for us going forward.

Operator

Our next question comes from the line of Rob Oliver with Baird.

Robert Cooney Oliver - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Great. Mike, 1 for you and then I had a quick follow-up for Tony. We're a couple years now into the Microsoft partnership now, Mike. And I was wondering if you could provide some color around the ways in which Microsoft is contributing, whether it be at higher ed, where I know they have a big presence or as you guys expand your footprint within larger institutions? Just would love some more color on how that go-to-market partnership is working.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Sure. Yes. It's coming along nicely. We started years ago. The partnership was predominantly in engineering, and we collaborated with them on architecture and to some things that eventually came to be our Blackbaud SKY engineering platform. And then it sort of moved over more into using Azure, and we signed up as a big customer for the migration from our colos to Azure, which started a while ago and is underway. And then it moved over into go-to-market. Last year, we were awarded the 2019 Microsoft Partner of the Year award in education, which is pretty cool. And so we've sort of come out of the gate faster and earlier in the education business by basically connecting our education business units with theirs. And then we've now connected our nonprofit charity-focused businesses with theirs because they have aligning organization. And now we're starting to do that with health care. And so the way that we see success is we are sharing pipeline. We are introducing each other's teams into opportunities and relationships. We're winning deals together. We've announced a few in previous press releases, like Ducks Unlimited and others. And so we're in the market together now as well. So there's several points around architecture engineering, Azure partnership and go-to-market that's just been a building relationship in the last several years. And I think it's a great fit for us. We're also doing deeper integrations with things like Microsoft Office 365, and that platform is virtually everywhere in the world, including all of our verticals. So as we do a better job in deeper integration, then it's a natural synergy from a solution standpoint for our customers. So lots happening there, and it's going well.

Robert Cooney Oliver - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Great. Good color. I appreciate it. Tony, I know you mentioned on the free cash flow guide it would be CapEx and cash taxes that were weighing on that number a little bit. And just curious for any color you might be able to provide around the CapEx side in terms of maybe what the delta is relative to what you guys kind of had expected, or if it even was a delta, is that around platform spend and cloud spend? Where did you guys kind of see that delta in terms of free cash flow?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. Thanks, Rob. The -- what I'd say from a free cash flow perspective is that we're going to have a fairly strong cash earnings growth despite all the investments we're making in the business. And that growth in cash earnings or EBITDA will more than offset the impact of the increase in cash taxes. Those will still be kind of single-digit millions of dollar increase in cash taxes based upon current estimates and will also offset any increase in CapEx that we expect. So really, when you look at it, the real impact on the free cash flow is working capital changes. The CapEx side, Rob, is -- the biggest majority of that is investments we're having to make to keep our current colo data centers and related equipment up to speed, right? We've still got a lot of customers running on those rigs and equipment in our data centers. And so unfortunately, as part of this transition, that's some of the duplicative cost. We have to keep upgrading that equipment, hardware, software until we can get moved to a third-party cloud and get out of that hardware business. So that's just incremental investments. We've been trying to hold off on those investments as much as possible, but we've got to keep that equipment in good working order. So that's what's driving that kind of increase. And unfortunately, I think we'll see a little bit of that for the next couple of years until we get all of the data centers moved.

The working capital -- one of the biggest chunks there is just we performed better this year compared to plan. And so our bonus accrual would be quite substantially higher year-over-year versus what it was at the end of '18. And so you just have a higher bonus accrual that we got to pay out this year in the first quarter. And then change is really in cash conversion cycle days. We've made some really good improvement in DPO and DSO over the last couple of years. And those are just not something that you can repeat continually every year, year in, year out. Once you get DPO out there or a DSO down to kind of industry best practices, year-over-year comparison-wise that will be a bit of a hit on you from a cash flow that next period. So that's really what's driving it. And then just some minor individual timing-related issues with specific vendors of when we purchased and when those payments would be due would be the other piece of it. So I would put almost the entirety of the free cash flow on working capital being the big driver.

Operator

Our next question comes from the line of Kirk Materne with Evercore ISI.

Peter Marc Levine - *Evercore ISI Institutional Equities, Research Division - Analyst*

It's Peter Levine in for Kirk. 2 questions. First one for Mike. Could you give us kind of like an update on the -- the faith-based applications, the kind of the go-to-market strategy? And the reps that you have in place today, are they at full productivity? And then how are the partner conversations coming along with these solutions?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes, sure. The faith-based rollout has gone quite well. We've signed up a lot of customers of all sizes. We've built the sales team up quite a bit. The entire sales team is not at productivity because some are new. And as you know, it takes a while to ramp up. But the rollout's been great. We've got a new mobile app that we've built and rolled out with the platform. The market acceptance has been really great. One of our challenges there is we're in the -- with this broad portfolio, we're newer to the market. And so there's some marketing efforts underway around brand awareness and trade show attendance and conferences and things, which we started to work on a year ago, and that's going well. So in general, products in production, signing up a lot of customers, it's building. So the quota attainment looks pretty good. Revenue takes a while as you build these new businesses. I can also mention that our R&D team is just really doing a great job. If you look at the number of features coming out, it's built in our SKY engineering platform. So it's a high-velocity architecture and engineering environment that's really allowed us to bring a lot of features to production in Q3 and Q4 last year, tens and tens of features which is great. So the product gets more feature-rich every couple of weeks as we continue to drive that. And we're in a pretty good spot. We think we're going to be passing out the platforms in the marketplace related to capabilities now. So it's fairly early days when you start something like this, but we're really pleased with all the customers that have signed up, the customers are live and the references that we've built in the last 6 months.

Peter Marc Levine - *Evercore ISI Institutional Equities, Research Division - Analyst*

Great. Final question, Tony. On the infrastructure investments you're making, can you kind of give us a sense of where you are? I mean are you 50%, 80% completed with kind of migrating out of these colo centers? I mean just to get a sense of when we can kind of get a sense when this will come to an end and kind of see gross margins? I know you haven't guided, but is this kind of -- when can we kind of see that level off?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. It's really difficult to give a percentage. We have spun up a lot of environments in the new cloud. And so we're preparing and then we're doing quite a bit of work also in our colo data centers to prepare moves. We have over 38, 39 years. We have, as you can appreciate, a lot of data centers around the world that we have to migrate. And so it's going to be a fairly lengthy project. That said, as we begin -- from a margin pressure perspective, as we begin to migrate entire product sets for full data centers, we will begin to shut down networks and cost infrastructure. And so it will be kind of a stair-step approach that you'll see, the savings come in over time. But at least for the near term, I would expect that we will continue to see some margin pressure at the gross margin line, at least for the nearer term. And then longer term, we should start seeing some stair-step improvements as we shut down networks and individual pockets of equipment and data centers themselves.

Operator

Our next question comes from the line of Rishi Jaluria with D.A. Davidson.

Hannah Rudoff - *D.A. Davidson & Co., Research Division - Research Associate*

This is Hannah for Rishi. So it's nice to hear that your phase-based offering and higher ed offering are doing well. You guys mentioned successful engineering on this Blackbaud SKY platform. So my question is, how much could you add to your TAM in the near term by adding new features and functionality to existing offerings?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

I'll take that. This is Mike. Right now, for net new -- in the portfolio of our products, the net new is the higher ed and the faith-based. So we don't have short-term plans to create something organically from scratch. That's net new because there's a lot of work to do across the whole portfolio, including higher ed and faith-based. But the other thing I'd like to add is with this engineering platform, we now have a platform where we can add either a wholly net new, like we did in faith-based, or extensions that once in production are just naturally integrated to the core. So there's not much work to do from an integration standpoint. So the platform has really provided an environment for our entire engineering teams to be a lot more productive and bring solutions to market faster that run on just standard infrastructure with standard controls and integration. So the velocity of innovation has really picked up across all the teams that are using this platform.

Hannah Rudoff - *D.A. Davidson & Co., Research Division - Research Associate*

Great. That's helpful. And then maybe one for you, Tony. What does the path to achieving a Rule of 40 look like? Is this something you guys think about at all?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Thanks, Hannah. We continue to look at that as a benchmark. Obviously, in the software space, especially the SaaS space, that's a key benchmark folks look at. We're much older typically than the pure SaaS company that's out there and much more mature. We have a broader product set. I think when you look at our strategy that Mike and I have talked about for numerous years now, it's a balance between both growth and profitability or free cash flow. I think we've done a good job on that front and continuing to balance that kind of weigh between investments and profitability. We're in the midst of an investment phase to drive more TAM, as Mike and you were just speaking about, and more growth opportunities. So what we're really pushing on now, I think, from our strategic direction is how much faster can we grow as a company in the current space in which we play. And based upon what we're able to accomplish there, I think, will then determine how much focus we put in the future on profitability with a focus towards can we target getting to that kind of Rule of 40 as a company. And that's always in our forward-looking views as a business. Today, we're a bit in the investment phase of that and trying to drive more growth, but over the long term continuing to focus, as our strategy always has been on balance sheet growth and profitability.

Operator

Our next question comes from the line of Ryan MacDonald with Needham & Company.

Ryan Michael MacDonald - *Needham & Company, LLC, Research Division - Senior Analyst*

Great to hear that the -- a lot of the sales reorganization really is behind you, and you're now looking sort of into 2020 and focused on productivity. Can you walk us through a little bit of how we should start to think about that progression? I think, Tony, you mentioned at bbcon -- that about a little less than half of your direct sales reps were on a full quota in 2019. What should we think that starts to look like as we get through 2020 here?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes, I'll take it first. This is Mike. So with those changes, there's just -- with the lack of change, we have people just in territory more, which is always healthy. We grew headcount by about 8% last year, which we think is healthy. We've added to our key teams across the company, including international, by the way, as well. We think there's some interesting opportunities internationally. It's pretty simple, actually. With the lack of a need for an organization change and folks in territory more, we'll just get more productivity. The other thing that's important, and I mentioned this in my prepared remarks, is we continue to look at the whole ecosystem of sales, which includes marketing and lead gen. And we've got an increased investment in our digital footprint, and we're doing multi-touch attribution and tracking that all the way through the process. And so that's something we could dial up and dial down by geography or team, which we think will also drive productivity. We're doing that in a much bigger way than we have historically, which I think is going to get some good results for us.

Ryan Michael MacDonald - *Needham & Company, LLC, Research Division - Senior Analyst*

Excellent. And then just in terms of a follow-up. You mentioned that peer-to-peer with JustGiving is really tracking well. I think you mentioned over half the customers you've added are net new to Blackbaud. What does the cross-sell and expansion opportunity look like for those customers?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes. Well, basically, we have that platform that can start with a customer handling their peer-to-peer pretty easy for a customer to get going on that. And then we look to cross-sell opportunities for sort of the middle and back-office solutions that we have. And if they're a customer of a right set of attributes and size, it creates an opportunity for us for a full fundraising or financial platform. So they move into looking like a prospect that's a traditional Blackbaud prospect, if they fit the profile once they sign up as a JustGiving peer-to-peer customer.

Operator

Our next question comes from the line of Mark Schappel with Benchmark..

Mark William Schappel - *The Benchmark Company, LLC, Research Division - Director of Research & Equity Research Analyst*

Tony, starting with you. With respect to the sunsetting of your legacy products and migrating those customers to your cloud products, I was wondering if you just give us an update on where you are within your migration process here.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. Mark, the sunsetting, for all intents and purposes, is complete. I mean we still have a few stragglers here and there, but we completed our, by far, largest product, which was the Sphere product set last year -- early last year. So there's still some stragglers. And we'll always have some of those with acquisitions. YourCause, for instance, resulted in some migration needs and ultimately product sunsets where you had competing products in the market. So we'll have those as an ongoing, but not at the level that we had, obviously, when we announced the 26 products that were all going to be sunset kind of simultaneously. From a migration perspective, continue to see really good progress on the RE7, FE7 front. That's kind of marching right ahead and aligned with our plans. As we continue to build out those next-generation products, we continue to get capabilities, feature functionality in them that will allow us to move some of the more complex installed bases from RE and FE. And so that's a continued migration, and it's progressing very well. We're at the backside of that. So from a revenue perspective, even with the uplift, we've seen historically it's a tough growth compare now that we're on the backside of that kind of slope on the migrations, but continues to progress well on all fronts there from a true sunset and then the migration perspective.

Mark William Schappel - *The Benchmark Company, LLC, Research Division - Director of Research & Equity Research Analyst*

Great. And then as a follow-up, Tony, on your payments business, are you starting to see an uptick in that business yet?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

We had a good year. In '18, we had a few surprises. I think the U.K. market was off quite a bit. That is still not great, but it's stabilized, and we saw pretty good performance there. The end of the year in '18, if you recall, we had some performance issues in mid-December. It was kind of interesting because we ended the year pretty strong. But I think between tax reform potentially than the market correction in December of '18, we had some poor payments performance. And then, if you'll recall, we also had some related to Smart Tuition and just some change in demographics of some of the parents associated with Tuition Management. This year, we finished the year fairly well. Giving Tuesday was very positive, I think, across the board. And then end of the year we finished up strong as well, I think, as an industry and payments overall, there continuing to be a shift towards online donation in the market. And so all things fairly positive on the payments front. That said, that's now a fairly big base of business for us. It doesn't grow at the kind of accelerated rate that it did when we first launched that a few years ago, but it's quite a nice business for us and grew well and finished fairly strong.

Operator

Thank you, ladies and gentlemen. This concludes our question-and-answer session. I'll turn the floor back to Mr. Gianoni for any final comments.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Thanks, operator. I'll just close by saying I'm pleased with the progress we made against our objectives in 2019 and have a positive outlook on 2020. The structural changes in the business are now largely behind us, and we're well positioned to further differentiate ourselves as the leading cloud software company powering social good, ultimately delivering increased value for our customers, employees and shareholders. Tony and I look forward to updating you on our progress on the next earnings call. Thank you, everyone, for your participation.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.
