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OTEX - Q3 2018 Open Text Corp Earnings Call

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OVERVIEW:

Co. reported YTD total revenue of $2,061m, GAAP net income of $181m and GAAP EPS of $0.68. 3Q18 total revenue was $686m, GAAP net income was $59m and GAAP diluted EPS was $0.22.

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PRESENTATION

Operator

Thank you for standing by. This is the conference operator. Welcome to the OpenText Corporation Third Quarter Fiscal 2018 Conference Call. (Operator Instructions) And the conference is being recorded. (Operator Instructions)

I would like to now turn the conference over to Greg Secord, Vice President of Investor Relations. Please go ahead.

Greg Secord - *Open Text Corporation - Vice-President of IR*

Thank you, operator, and good afternoon, everyone. On the call today is OpenText Vice Chair, Chief Executive Officer and Chief Technology Officer, Mark J. Barrenechea; and our Executive Vice President and Chief Financial Officer, Madhu Ranganathan. We have some prepared remarks, which will be followed by a question-and-answer session. The call will last approximately 60 minutes with a replay available shortly thereafter. I'd like to take a moment and direct investors to the Investor Relations section of our website, investors.opentext.com, where material relating to today's call is posted.

I'd also like to highlight that Enfuse 2018, OpenText's Annual Security, Digital Investigations and e-Discovery Conference will be taking place in Las Vegas from May 21 to 24. During the conference, IR will host a product teach-in lunch session for investors on Wednesday, May 23, with Mark Barrenechea and Muhi Majzoub, our Head of Engineering. For those unable to attend on site, presentation materials and audio webcast from the discussion will be made available on the Investor Relations section of our website.

I'd also like to remind everyone that Enterprise World, OpenText's Annual Users Conference, will be taking place in Toronto again this year during the 2nd week of July. As part of that conference, we'll be holding OpenText Investor Day on Tuesday, July 10. For further details or to register to attend, please contact Investor Relations. We look forward to seeing you there.

And now, I'll proceed with the reading of our safe harbor statement. Please note that during the course of this conference call, we may make statements relating to the future performance of OpenText that contain forward-looking information. While these forward-looking statements represent our current judgment, actual results could differ materially from a conclusion, forecast or projection in the forward-looking statements made today. Certain material factors and assumptions were applied in drawing any such conclusion. Additional information about the material factors that could cause actual results to differ materially from a conclusion, forecast or projection in the forward-looking information, as well as risk factors that may project future performance results of OpenText are contained in OpenText's Form 10-K and recent 10-Q, as well as in our press release that was distributed earlier this afternoon, each of which may be found on our website. We undertake no obligation to update these forward-looking statements unless required to do so by law.

In addition, our conference call may include discussions on certain non-GAAP financial measures. Reconciliations of all non-GAAP financial measures to their most directly comparable GAAP measures may be found within our public filings and in other materials, which are available on our website.

And with that, I'll hand the call over to Mark.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Thank you, Greg, and let me begin by welcoming Madhu Ranganathan to OpenText. I'm excited to have Madhu join the company to shape and scale the future of our operations and organization. Welcome, Madhu.

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

Thank you, Mark.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

As you'll hear, OpenText could not be in a better position to deliver on its total growth strategy. We delivered growth through acquisitions. We delivered growth through our innovations and organic efforts. We delivered growth through expanding our sales distribution, both direct and indirect, all with an emphasis on expanding recurring revenues and operating cash flows. This is total growth.

In Q3, we delivered $686 million in total revenues, up 16% year-over-year. Our annual recurring revenues were a record high of $521 million, up 18% year-over-year. Our cloud revenues were $209 million, up 18% year-over-year. And we had positive organic growth within the quarter.

We generated a record $271 million of operating cash flow, up 73% year-over-year. Let me also note, on operating cash flow, it is up 62% quarter-over-quarter, up 43% from our previous high in fiscal '16 Q3 and up 50% year-to-date.

As some of you have written about, Q3 is a softer quarter for the company due to our seasonality, coupled with a tougher year-over-year compare. Some of you have also written about the great potential of OpenText being a cash flow-centered business. As you see in our results today, OpenText delivered record recurring revenues and record operating cash flow.

We also ended the quarter with $605 million of cash on hand and a net debt to adjusted EBITDA ratio of 2.1x, down from 3x 12 months ago, positioning us right where we expected to be after the completed integration of our ECD acquisition.

OpenText is a global business and geographically diversified. You see this reflected in our customers, revenues, workforce and our global cloud platform. We're approaching 2,000 customers running their business in the OpenText cloud located in the U.S., Western Europe, U.K., Canada, Japan, Asia, Brazil and more. We own and operate our own cloud platform, and this is a sign of more promising things to come.

The modern CEO agenda includes digital transformation, outsourced infrastructure into the cloud, customer experience-centric organization, new supply chains, security, information insight and more. OpenText is leaning into all of these agenda items.

Our customers view our business over a 10-year period, at least, as they make decade-long technology decisions to support that CEO agenda. The nature of work and workforces are changing. CEO's are employing new digital core technologies that are foundational pillars for the future. Our market strategy is centered on the information company that incorporates these forward-looking technologies. We estimate that market size to be $100 billion USD. This momentum translates into all aspects of OpenText as we view our business financially on an annual basis and beyond, rather than on a quarterly basis.

When viewing OpenText year-to-date, our total revenues are up 27% from $1.63 billion to $2.06 billion, and our annual recurring revenue is up 26% from $1.22 billion to $1.53 billion. Our license business is up 21% from $246 million to $298 million, and these results show our balance of total growth.

OpenText has created incredible scale in our cloud business, and year-to-date, our cloud business has delivered $611 million of revenues and is up 17%. And this is a right result.

We are a hybrid business, delivering both on-premise and cloud solutions. Our customers and partners are accelerating cloud adoption, as you can see in our results today, and we too are moving faster into the cloud. Licenses, of course, remain important for our customers, and we expect licenses to grow, for the long-term and faster growth will be within our cloud and recurring revenues.

We're also making key investments in our cloud for GDPR, security and more automation. And again, over time, we expect our cloud margin to expand as well and this is factored into our targets in our fiscal '21 aspirations.

More recurring revenues will generate longer-term cash flows and even more predictability in our business model. Madhu will take you through the complete results, but let me spend a few moments and look beyond the quarterly or our year-to-date numbers. We have delivered significant, sustained, profitable growth, implementing our unique business system that we have formalized into the OpenText business system. This is important to highlight as it centers on our culture and how we work. Please look at the investor presentation posted earlier on our website. You will see that our business system starts with total growth. We apply operational excellence methods and tools. We focus our execution on key metrics, such as annual recurring revenues and operating cash flows. This feeds into our disciplined capital allocation approach, where ROIC is always the one metric in doing a deal. Also, this fuels strategic acquisitions where integration and value separate OpenText from others. We then complete the circle in a well-formed strategy that brings us back to total growth. This is OpenText. This is what we're centered on. This is how we work.

Based on our current strong and expected cash flow, we are raising our quarterly dividend by 15% to $0.1518 per share. We have also modeled our dividend distribution through the lens of 20% of trailing 12-month cash flows approximately. As we grow our cash flow, we grow our dividend. We have returned close of $500 million to shareholders via our dividend policy, and we have increased our dividend 15% every year since we started a dividend program, all based on the strength of our cash flow and our capital allocation model.

Let me also highlight the importance of our fiscal 2021 aspirations of landing adjusted operating margin between 36% and 40%. When you look at our current robust performance, trajectories and our aspirations, we expect the OpenText business model to produce USD 1 billion in operating cash flow per year as we exit fiscal 2021, subject, of course, to the mix and timing of total growth and margin.

We are ready for all competitors, we are ready for the modern CEO agenda, we are actively working our M&A pipeline for a solid balance sheet. And we are preparing for 2 major customer events: Enfuse in May and Enterprise World in July. We'll be showcasing our digital platform and new application, cloud and managed services, information and endpoint security, AI and the Internet of Things. We expect to attract thousands of customers and partners, and I hope you will join us so you can experience OpenText directly.

As it relates to our Q4, let me again highlight, we are a hybrid business and we intend to grow faster in the cloud and we are making key investments in our cloud, and recurring revenues generate more predictability and long-term cash flow growth.

I want to comment on one further item before I close and turn the call over to Madhu. We are enthusiastic about the opportunities ahead for OpenText. We're confident in our ability to deliver shareholder value through expanding annual recurring revenues and operating cash flow. We have developed and maintained a long-term strategic vision, have always been transparent and approachable quarter-over-quarter, year-over-year and that will not change.

As you can see from our investor deck and my comments today, we have a proven growth strategy, strong liquidity and a balance sheet, a perspective annual target model and a defined path to fiscal 2021.

Let's highlight our performance by comparing the period of calendar year '12 to the last trailing 12 months. Total revenue is up 114% from $1.3 billion to $2.7 billion; annual recurring revenue up 167% from $748 million to $2 billion; cloud revenue up 764% from $92 million to $795 million; adjusted operating margin up 400 basis points from 29% to 33%; operating cash flow up 94% from $313 million to $607 million; and adjusted EPS up 92% from $1.27 to $2.44. And that's our performance by comparing the period of calendar '12 to the last trailing 12 months.

Further, over the last 20 years, OpenText has delivered 1,551% return against the NASDAQ's 343% return. Or said differently, we've outperformed the exchange by 4.5x. As such, we believe that OpenText is in a position of strength, and that our experienced leadership team plus our strategy for total growth, gives us a market advantage as the information company. We are confident in our ability to deliver long-term annual recurring revenues and operating cash flow expansion, and that significant shareholder value over both the near and long-term, as is evident from our value-enhancing acquisitions, such as GXS, Actuate, Documentum and Guidance.

In closing, let me state to our shareholders, on behalf of over 12,000 colleagues at OpenText, we're just getting warmed up. OpenText is an organization focused on making an impact and helping our customers be widely successful. OpenText is the information company that enables intelligent, connected enterprises and aspiring a new way to work. This is why companies like ADP, Corsair, MBTA, Progressive Insurance, Swiss Life, the U.S. Census Bureau, the National Grid and the City of Philadelphia selected OpenText last quarter.

Just a few weeks ago, I was on stage with the refugee agency of the United Nations. They talked about how information is changing lives for the good. For example, when you're a refugee, you have very little. But the UN is using retinal scans at ATM machines to distribute needed funds at the right place, to the right people, at the right time. It is humbling. This is why we are so deeply motivated about being the information company.

Madhu, over to you.

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

Okay. Yes. Thank you, Mark, and hello, everyone. Before I get into financial details for the quarter ended March 31, I wanted to share how excited I am to be part of OpenText. To Mark and the team at OpenText, thank you for the great opportunity. It is a highly talented and sufficient team at OpenText who have built a very differentiated model over the years, and I'm ready to be part of the next phase of success here. I know Mark and I will be meeting with many of you during the coming days and weeks and really looking forward to it.

So now let's go to the numbers. And similar to prior quarters, my references will all be rounded in millions of USD and compared to the same period of the prior fiscal year, unless I indicate otherwise.

Total revenue for the quarter was $686 million, up 16% from last year, or $657 million on a constant currency basis, up 11%. And revenue was positively impacted by $29 million due to foreign exchange and negatively impacted by $6 million due to acquisition accounting rules. Year-to-date, total revenue was $2,061 million, up 27% from last year, or $2,013 million on a constant currency basis, up 24%.

Annual recurring revenue was $521 million, up 18% from last year, or $502 million on a constant currency basis, up 14%. Year-to-date, annual recurring revenue was $1,527 million, up 26% from last year or $1,497 million on a constant currency basis, up 23%.

License revenue for the quarter was $84 million, down 4% from last year or $80 million on a constant currency basis, down 8%. Year-to-date, license revenue was $298 million, up 21% from last year or $288 million on a constant currency basis, up 17%.

Cloud revenue for the quarter was $209 million, up 18% from last year or $204 million on a constant currency basis, up 15%. New MCV bookings during the quarter were $53 million, up slightly compared to $52 million in the same period last year. Year-to-date, cloud revenue was $611 million, up 17% from last year or $606 million on a constant currency basis, up 16%.

The customer support revenue for the quarter was $312 million, up 19% from last year or $298 million on a constant currency basis, up 13%. Year-to-date, customer support revenue was $916 million, up 32% from last year or $891 million on a constant currency basis, up 29%. Our customer renewal rate this quarter was in the low '90s and similar to last year.

Professional services revenue for the quarter was $80 million, up 23% from last year or $75 million on a constant currency basis, up 15%. Year-to-date, PS revenue was $237 million, up 42% from last year or $228 million on a constant currency basis, up 37%.

Next, the impact of foreign exchange. For the quarter, the foreign exchange positively impacted revenue by $29 million and had a positive $0.03 impact in adjusted EPS. The effect of this by revenue type is broken down as: license, $4 million; cloud services and subscription, $5 million; customer support, $15 million; and PS, $5 million. On a year-to-date basis, foreign exchange positively impacted revenue by $48 million and had a positive $0.06 impact on adjusted EPS. The effect of this by revenue type is broken down as: license, $10 million; cloud services and subscription, $5 million; customer support, $24 million; and PS, $9 million.

And now to gross margins. For the quarter, the gross margins were as follows: license margin was 96%, up slightly from 95% last year; cloud margin was 55%, down slightly from 56% last year; customer support margin was 89%, up compared to 87% last year; PS margin was 20%, up compared to 15% last year and reflecting efficiency from postacquisition integration activities.

For the next section, as I discuss our income and operating margin details, I did want to reiterate that we are tracking to our fiscal 2018 adjusted operating margin target model of 32% to 35%.

For the quarter, adjusted operating income was $204 million, up 18%, and adjusted operating margin was 30% compared to 29% last year. We are seeing the positive impact of margin improvement as a result of bringing our recent acquisitions into the OpenText-adjusted operating margin model. Year-to-date, adjusted operating income was $673 million, up 32%, and adjusted operating margin was 33% compared to 31% last fiscal year.

Adjusted EBITDA was $227 million this quarter, up 20%. Adjusted EBITDA margin was 33% compared to 32% in the prior fiscal year. Year-to-date, adjusted EBITDA was $737 million, up 33%. Year-to-date adjusted EBITDA margin was 36% compared to 34% in the prior fiscal year.

Adjusted net income was $146 million this quarter, up by 22%. On a constant currency basis, adjusted net income was $137 million, up by 14%. Year-to-date, adjusted net income was $491 million, up 37% from last year and was $475 million, up 33% on a constant currency basis.

Interest expense was $35 million in the quarter, which was $1 million higher than our previously disclosed run rate of $34 million. Adjusted earnings per share for the quarter was $0.54 on a diluted basis compared to $0.45 per share for the same period last year, up 20% and up 13% on a constant currency basis at $0.51 per share. Year-to-date, adjusted earnings per share on a diluted basis was $1.84 compared to $1.42 last year, up 30%. On a constant currency basis, adjusted earnings per share was $1.78, up 25%.

GAAP net income for the quarter was $59 million or $0.22 per share on a diluted basis, up compared to $22 million or $0.08 per share for the same period last year. Year-to-date, GAAP net income was $181 million or $0.68 per share compared to $980 million or $3.91 per share for last year. However, as previously mentioned, prior year-to-date GAAP net income included a onetime tax benefit of $876 million that was recorded on account of the company's internal reorganization to further consolidate our intellectual property back within Canada.

And now, turning to operating cash flows. As Mark mentioned, we had the highest operating cash flows in our history, at $271 million, up 73% year-over-year. This achievement was attributable to an increase in net income of $96 million after adjusting for noncash operating activities and an increase in working capital items of $18 million. We had significant collections during the quarter from customers renewing annual maintenance contracts at the end of December 2017. Year-to-date operating cash flows were $504 million, up 50% year-over-year. On the balance sheet, we ended the quarter with $605 million of cash and $761 million of deferred revenue. We reduced our debt by $100 million, with a repayment on our revolver. As previously mentioned last quarter, we focused on building a very solid balance sheet and improving leverage ratios.

And moving to tax update. So let me now discuss the impact of the U.S. tax reforms for this quarter. The corporate tax rate reduction was effective for OpenText as of January 1, 2018, and accordingly, will reduce our U.S. federal statutory rate to approximately 28% in fiscal 2018 and 21% in fiscal 2019. As previously mentioned, we have accordingly revised our adjusted tax rate from 15% to 14% for fiscal 2018. As we normally do, we will provide an update to our adjusted tax rate in Q4. In Q2, we recorded a provisional expense of $15 million that was necessitated by the new legislation. Approximately $8 million of this expense is a noncash charge that's related to the re-measurement of U.S. deferred tax assets and liabilities, and $7 million relates to the taxation of unremitted earnings of non-U.S. subs, owned directly or indirectly by U.S. subs of OpenText. The taxation of unremitted earnings will be paid over 8 years as provided by the legislation.

In the current quarter, we recorded an additional $5 million noncash charge that's related to the remeasurement of U.S. deferred tax assets and liabilities, based on adjustments and underlying tax balances. Note that these adjustments are provisional and will be finalized on or before December 22, 2018.

We'll continue to assess implications of the U.S. tax reform, and we'll update you for any material impact to our tax analysis or plans.

And regarding the IRS matter, there is nothing new to report. We will continue to keep you updated on any material new development.

I will now update you briefly on ASC 606. I want to reiterate from the last quarter that the new revenue recognition rules on the U.S. GAAP, ASC 606, is applicable to OpenText effective July 1, 2018, and we will be reporting revenues under these rules for the first time for the quarter ending September 30, 2018. Although the new rules provide guidance and recognition and measurement of revenues across all revenue streams, the impact seems limited to our accounting for implementation services within a cloud arrangement and accounting for on-premise subscription offerings. We continue to assess the impact with the new accounting rules will have on our FY '19 results, and if material, we will provide you with updates with regard to the expected impact.

With that, I will turn my comments to our 2021 aspirations. As mentioned last quarter, we raised our 2021 aspirations for adjusted operating margin by 200 basis points for a range between 36% and 40%. Please see our 2021 aspirations in our IR presentation on our website.

The team at OpenText has fully embraced the approach of total growth, combined with operational excellence and disciplined capital allocation. Our collective efforts and high focus will support us in achieving our fiscal 2021 aspirational adjusted operating margin and produce $1 billion in operating cash flows per year as we exit fiscal 2021, subject, of course, to the mix and timing of total growth and margin.

As far as outlook for the remainder of fiscal 2018, we are a hybrid business and we continue to grow faster in the cloud. With respect to expenses, as you saw in the third quarter, we continue to invest throughout the year in cost of revenue and operating expenses, particularly relating to OpenText cloud.

In addition, our fourth quarter generally includes expenses that relate to year-end target attainments based on specific annual sales compensation plans. On May 8, 2018, our Board of Directors approved a 15% increase in cash dividends from $0.1320 to $0.1518 per share for shareholders of record on June 8, 2018, and payable on June 29, 2018.

And thank you once again to Mark and the OpenText team.

I will turn the call back over to Greg.

Greg Secord - *Open Text Corporation - Vice-President of IR*

Operator, can we poll for questions, please?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Phillip Huang of Barclays.

Phillip Huang - *Barclays Bank PLC, Research Division - Senior Equity Research Analyst*

I wanted to ask you first on the $1 billion operating cash flow target for 2021. Was wondering if you could maybe give us some directional color as to how much of it will come from just growing and optimizing your existing assets versus an acceleration or further acquisitions that you see.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Phillip, thanks for the question, Mark here. There are multiple paths, as you just highlighted. We have our path of acquisitions, we have our path of organic growth, we have our path of increasing efficiency, as reflected in our margin through continuing to balance our global workforce and getting more automated in our business. So we have many paths to get there, within what we call total growth, either through acquisition, optimizing what we have and organic growth. That gives us the confidence to put that aspiration forward today of $1 billion in OCF exiting fiscal '21.

Phillip Huang - *Barclays Bank PLC, Research Division - Senior Equity Research Analyst*

That's helpful. And the range of possible outcomes in terms of getting there, obviously, I guess, the timing of acquisitions, those are perhaps a little bit harder to fully be within your control. Are there anything specific that you need to -- like are there specific assumptions that we should be making? I'm just even thinking in terms of the way we model to get to $1 billion cash flow. I'm just wondering sort of even directionally, what we should be assuming when it comes to what's achievable through margin expansion and through -- obviously, you've been a target for the margin expansion. Just trying to figure out exactly where the different -- what's the easiest path to get there, if you will? I know there's, obviously, multiple paths to get there, but what would be the sort of default scenario, I guess, to get to the $1 billion operating cash flow?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, for sure. And multiple paths will be multiple models. The way I think of it is relatively simple. I think of our base business and you look at our margin, our efficiency optimization through the years and just optimizing the base business, getting between the 36% and 40% adjusted operating margin by fiscal '21, so it's obviously a key variable in the model. The next is organic growth rate, and we had organic growth again within Q4. And I think that will produce a baseline where then you can factor in some historical M&A, and you can play with those sort of 3 to 4 variables and that will land you in your model.

Phillip Huang - *Barclays Bank PLC, Research Division - Senior Equity Research Analyst*

Right. No, that's helpful. And I guess, with the expected rapid growth in cash flows over the coming years, how should we think about your capital allocation? Does anything change at all? Your leverage is set to come down pretty quickly, I would imagine. Just wondering if -- would your ideal scenario be to accelerate acquisitions to the extent that you could make that happen and the opportunities present themselves or would you also consider perhaps returning some additional capital?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes. So a lot in there. I -- certainly, part of what I'd like you and others to take away from today is us targeting the $1 billion in annual OCF as we exit fiscal '21. We -- as Madhu and I talked, we raised our dividend by 15% today, it's based on the strength and trajectory of the business. We've modeled our dividend on 20% to trailing 12-month cash flows. We've raised our dividend 15% every year since the inception of the dividend. And as we grow our cash flows under that model, we continue to grow our dividend distribution. I'm real proud of our deleveraging, if you will, on a net debt to adjusted EBITDA ratio to -- from 3x down to 2.1x. And we'll evaluate all the forms of buyback. But right now, I still think applying it to acquisitions in our dividend policy and continuing to delever is the right use of capital.

Phillip Huang - *Barclays Bank PLC, Research Division - Senior Equity Research Analyst*

Right. A final question for me. Looking to Q4, typically a very seasonally strong quarter for license and cloud. Was wondering if we should expect a very similar seasonality this year, and if there's any sort of one-time side benefit or impact that we should keep in mind?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes. Thanks, Phil. I think a couple of things. I would then -- I know Madhu probably has a couple of comments as well here, and I look at the economy and demand, and demand and interest remain positive in the marketplace. We all read the same newspapers, see the same headlines and there are things to keep watching for. Customers and consumers are watching tariffs, sanctions, data privacy, ethical supply chains and we just need to continue to watch those topics. We don't provide guidance, and I'd go back to my comments that we're leaning more into the cloud, annual recurring revenues and stronger cash flows. And Madhu, do you want to give any comments on the expense side?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

Yes, sure, Mark. And as I shared in my prepared remarks, from an expense investment perspective, we clearly invest throughout the year, right? And I think that's something to keep in mind. And I did allude to the fourth quarter, there are several sales compensation plans that are annual in nature, and you can see -- I mean, a pickup in sales expenses in the end of the fourth quarter. But I do agree with Mark on the overall comments there.

Operator

Our next question comes from Richard Tse of National Bank Financial.

Richard Tse - *National Bank Financial, Inc., Research Division - MD and Technology Analyst*

Welcome aboard, Madhu. I'm not sure if this question is for you or Mark, but kind of at a high level. Obviously, you've made a number of acquisitions in recent years, and I've asked this question in the past, but I'll ask it again. It's that, obviously, you brought on a lot of complementary products, can you help us understand or get a gauge of how well those products are being upsold into your existing base? And just trying to get a feel for that upselling, cross-selling strategy and how it works and whether you have any metrics on that, that you can share?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Richard, thanks for the question. I'll certainly take that one and maybe Madhu will take it next quarter. But let me take that. Going into our installed base is a great opportunity for us to go win and sell security, such as Guidance. If we're the enterprise platform for information management, let's go secure those end points. As we build from world's largest archives, we have the opportunity to go in and sell Magellan and AI. If we've deployed customer experience management, we have an opportunity to go in and sell content services, and if we're in there on a business network, or we have opportunity to sell archive and other things. So I think over time, we've gotten more focused on kind of the key workloads and use cases, enterprise and more targeted. And in fact, I think you've seen that in -- reflected now in a variety of quarters of organic growth that we've talked about. I think the largest opportunity in front of us is actually is to go faster in the cloud, and to go in and -- we've taken a different approach where we're not looking to do revenue substitution, we're not looking to take $1 of maintenance and substitute it for $1 of cloud, what we've gone in to do is to say if you own a license today, let's have you keep you owning that license through maintenance, strong renewal rates and let's go host that and try to manage service in our cloud. I think that's one of the larger opportunities we have and it's somewhat reflected in our statements. So we're going to go a little faster now in the cloud, given that we've built a lot of confidence and value over the last few years in scaling our cloud business from -- kind of like from 0 to near $800 million over 7 years. So it's an important question, and I say we've gotten more focused on key use cases. And the largest opportunity we see in front of us is having customers, existing customers move their license into our managed service and/or upfront selling new managed service.

Richard Tse - *National Bank Financial, Inc., Research Division - MD and Technology Analyst*

Okay. And I guess, a related question on the organic growth is that, are there sort of internal targets that you guys have set out in terms of the level of organic growth that you want here over the next 3 years?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

We've talked about low single-digit organic growth.

Richard Tse - *National Bank Financial, Inc., Research Division - MD and Technology Analyst*

Okay. What was organic growth this quarter, by the way?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

As you know, we don't describe the actual quantum. We're just discussing positive, neutral and negative. It was another quarter of positive organic growth.

Richard Tse - *National Bank Financial, Inc., Research Division - MD and Technology Analyst*

Okay. And last question for me. Obviously, I think it's important to get some feel from you guys as to the state of the acquisition environment, whether it's evaluations of the obstacle today or what the opportunity set is like. If you can give a bit of color on that, that would be great.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, thank you, Richard. Well, I make 3 points. First point is when we view the business through the information company, we see a wider market, we see a $100 billion total addressable market. And through time, we've started at the search company to the content experts, enterprise information management, and now the information company and bringing in markets like security, IoT, artificial intelligence, cloud businesses. My first point is it's widened the market opportunity for us. There is no scarcity of assets in our business model for us to go look at. Second is that M&A remains the centerpiece for our total growth strategy. And as our balance sheet gets stronger, our net debt-to-EBITDA -- adjusted EBITDA ratio, and we continue to delever, and our cash flows get stronger, M&A is a centerpiece to that strategy. And third, we are actively in the market. We're actively in due diligence, working our pipeline, and we'll continue to close acquisitions.

Operator

Our next question comes from Stephanie Price of CIBC World Markets.

Stephanie Price - *CIBC Capital Markets, Research Division - Director of Institutional Equity Research & Software and Business Services Research Analyst*

Mark, I was wondering if you could talk a bit about the investments. You've mentioned several times you're making some investments in the cloud right now.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, fair enough, thanks. Thanks, Stephanie. Yes, I mean, I -- if you'll allow me, I'll just talk a little bit about the cloud business with the investments in that context. We're close to 2,000 managed service customers now, 50,000-plus network customers on our value-added network from messaging through cash -- ACH cash management, SWIFT traffic, EDI. We've learned scale and delivered quite a bit over the last 6 years. And as I've noted, over the last 6 years, $92 million to $795 million, that's 764% growth in the business. And we're winning platforms like ABB, U.S. Steel, John Deere, National Grid, Nestle and others. And we've learned a lot. And part of the investments that we're making right now includes security, new standards coming out, data zones, GDPR. We can run a European managed service and all the people, data, systems remain in Europe or remains in Asia Pacific. So those are types of investments around more automation, faster time to value, security, GDPR. And note that we own and operate our own platform globally, right? We don't run our large cloud business in a third-party cloud, we own and operate it. So those are some of the investments that we're making.

Stephanie Price - *CIBC Capital Markets, Research Division - Director of Institutional Equity Research & Software and Business Services Research Analyst*

Great. And then just briefly on EP3 -- or sorry, EP4. I know you just released it. Wonder if you have any customer feedback so far and if you could talk about the parts of the suite that you're most excited about?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes. Thank you for that. So Release 16 Enhancement Pack 4 or EP4 is in the market, and we're working on EP5. But on EP4, I provide just one thing, and it's security is job 1. There's a lot of competing priorities, but I'd say the one thing that I'm most excited about in Release 16 EP4 is all the security features that we've brought into the product. They're deploying information management as a secure digital platform, owning the end point through Guidance -- if you're designing nuclear power, engineering construction, financial services, power distribution, your end points need to be secure as well. So if there's one thing, it's security. If there's two things, it's security and AI. And we work through a lot of proofs of concepts and early deployments. It hasn't translated yet into the P&L, but all our learning is way up on how to extract the value from our content platform and our business network. So if it's one thing, it's security. If you allow me two things, it's security and insight with Magellan.

Operator

Our next question comes from Paul Treiber of RBC.

Paul Treiber - *RBC Capital Markets, LLC, Research Division - Associate*

In regards to your comment on the expanded addressable market, the $100 billion market, what do you see as the company's greatest competitive advantage against incumbents in those markets? And then also related to that, I assume you've entered those additional markets through acquisitions. Now how would the returns or other metrics or the integration of acquisitions in those new markets differ from the previous ones that you've done?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Paul, thanks for the question. I would say that just unequivocally, we're not looking to change our value methodology or approach to value that we've deployed through the years as that -- TAM has expanded. So we're going to apply the same discipline, the same OpenText business system into that expanded TAM. And I'll translate maybe the first part of your question a little bit into how we are going to compete. And we're going to compete first in 6 areas that we want to win in. The first place is our digital platform, our digital core. We're becoming more of an applications company through our digital apps, our engineering and construction, case management, contract management, electronic invoicing. Third area is, of course, our digital B2B network. And it's not just a volume business, it's more capabilities from self-service, centralized trading grids. An interesting aspect from last week in the news was an ethical supply chain, where was Cobalt coming from in new electric cars? We have a large auto company running on our business network, and what used to take 2 years, they want to deploy instantly a new supplier screen for ethical supply chain of those supplying Cobalt into that business network. Three other areas, AI, security and the developer. So first, there are 6 areas that we want to go win in. Second is going faster in the cloud through our managed services. And third, I think we're going to differentiate and compete on our expertise as the information company, a clear path and rapid time to value in the global 10,000. So 6 product areas, go faster in the cloud and our expertise.

Paul Treiber - *RBC Capital Markets, LLC, Research Division - Associate*

Okay. And then just one more for me. Earlier in the presentation, you mentioned that ROIC is a key metric that you use to evaluate acquisitions. How -- in regards to the new cloud investments, how would the expected return on ROIC in those new investments in the cloud compare against the ROIC threshold that you use for acquisitions?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

So it's an interesting question of an internal ROIC versus and external ROIC. And maybe we want to get back to you on that. But maybe I would say this, on an external side, you got to count what adjustments you want. And when you kind of take out kind of all your adjustments, we're operating in the mid- to high teens for an external ROIC. I guess, internally, I'd look towards our adjusted operating margin and how that -- and how we've expanded over time and where we're looking to land that in fiscal '21. So I guess the short form is externally, you've taken out certain adjustments, it's mid to high teens. Internally, I guess, I'd look at it as a blended rate of adjusted operating margin. Madhu -- anything you'd add to that?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

No. I agree completely.

Operator

Our next question comes from Paul Steep of Scotiabank.

Paul Steep - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Mark, can you -- we've talked a little bit so far in the call about cloud, but you certainly sound more aggressive. You're looking to maybe accelerate the move there. What's changed, either in your -- in the external environment or in your maybe go-to-market approach here today that we should be taking away from this call?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, I would -- I'd say two things. I think we've hit a -- there's like -- there's going from 0 to 1, right? And then there's 0 to $500 million, maybe 0 to $0.5 million, 0 to $0.5 billion, and then approaching $1 billion business. We're in a very maturing stage, and we've built confidence, a lot of experience and we've delivered a lot of value in our managed services. So I think one thing that's changed is just the experience, our customer feedback and a greater confidence in what we've delivered over the last 4, 5, 6 years. Second, I would say, in certain markets, customers are shedding IT expertise and just getting rid of it, and now they're looking to us to provide all the expertise. But there -- maybe the second thing is just customer perspective. Through the years, they've shedded IT expertise, now they're looking to us to provide it. So I would highlight to those two things, Paul.

Paul Steep - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay. Welcome, Madhu, I'm not sure if this one's either for you or Mark, but if we look at this -- I don't think anyone would ever accuse OpenText of being light on cost discipline or making sure the margins work, but your commentary tonight in the deck about increased automation and the opportunity to reduce cost and further drive OpEx margins, how should we think about that as we move to sort of your 2021? Is this a year of investment and plans under way that maybe accelerate us into '19 or where -- how should we think about that?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

Sure. Big question, and thank you for the welcome. When you look at the base of our business, right, and you look at the size of the operating expenses or the size of the cost of revenue and to your point, and also what Mark said, we've been very disciplined, even in acquisitions, to bring them over to the OpenText model of the adjusted operating margin within a very defined period of time and we've hit those targets every single time. So that remains our overarching target. But as we grow, when you look at the scale of expenses we currently have in our infrastructure, in addition to making the right investments towards the cloud, as Mark said, there are always opportunities for being more efficient, where there is a people-based spend or sort of translating the people-based spend with more automation. That's really what we're going to be focused on. I would think about it as 2 parallel streams, the internal efficiencies as well as the incremental investment Mark talked about.

Paul Steep - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay. Just to clarify that then I'll leave the line here, but I guess, is there a larger program underway? We've gone through it numerous times over the years of larger cost, takeout programs. Is there a specific program or is this just part of the ongoing cadence we've had for the last few years?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

I would say the ongoing cadence that Mark and the team have had, and we're going to continue that. And you would expect, in any business, we will keep doing a programmatic view of all the P&L items on a continuous basis. And there are rooms for automation. And Mark, do you want to add anything?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

I was just going to say, welcome, Madhu. So -- and that's emphasis on your shoulders. But you know the -- you know, Paul, the dialogue as we scale from here forward and Madhu's perspective of how we can more efficiently grow revenues at a nonlinear expense trajectory. So I would just amplify the ongoing efforts and new insight with Madhu's leadership.

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

And thank you, Mark. So perhaps I would add to that, coming from not just a software technology background but also having services experience, I think it's going to be very helpful and, again, with a fresh insight. But really, I would say continuing the work Mark and the team have kicked off.

Operator

Our next question comes from Thanos Moschopoulos of BMO Capital Markets.

Thanos Moschopoulos - *BMO Capital Markets Equity Research - VP & Analyst*

G&A went up a fair bit sequentially even though G&A head count was flat. Can you explain the dynamic there?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

Sure. We did have some, I would say, infrastructure type of expenses. If you're looking at sequentially quarter-over-quarter, that's really where the increase came from.

Thanos Moschopoulos - *BMO Capital Markets Equity Research - VP & Analyst*

And were those kind of one-time in nature or will those continue into Q4 and beyond?

Madhu Ranganathan - *Open Text Corporation - Executive VP & CFO*

I would look at it as -- again, we invest on an annual basis during each quarter, right? So this is more a part of normal investment.

Thanos Moschopoulos - *BMO Capital Markets Equity Research - VP & Analyst*

Okay. And maybe some early -- the cloud margins dipped sequentially. Does that reflect a higher level of investment particular to your comments or is it some other dynamic there?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Thanos, I'll take that one. Yes, it does reflect our investments. And over the coming quarters, we're going to continue those investments as we lean more into our cloud and recurring revenues. And we expect that to then expand margins from there. So yes, we're down slightly quarter-over-quarter or this year's still in our blended margin range, which is the range of record, if you will. And then we'll, from those investments, begin to expand again. So we're just -- if you will, just tapping the accelerator a bit on our investment. And as we go faster and slightly faster into the cloud, and then we'll begin to grow the margin again.

Thanos Moschopoulos - *BMO Capital Markets Equity Research - VP & Analyst*

Okay. And then finally, the percentage of license revenue coming from new clients, which is one of the metrics in your report, that's been lower than typical over the last couple of quarters. Does that reflect the fact perhaps that you've been more focused on upselling to the existing base rather than hunting new accounts, or should we not read too much into that metric?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

No, it's an important metric. I think in the quarter, it was low 20s. In other quarters, it's been in the high 20s. It's still a very healthy number. And yes, it's a little reflected that we're going in to try to do more of the cross-selling that we talked about earlier and also kind of bringing our install base forward into a modern cloud platform.

Operator

Our next question comes from Walter Pritchard of Citi, Research.

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

I'm wondering 2 questions, kind of follow-ups here. On the cloud side, have you or are you anticipating making any sales compensation changes that would encourage your sales people in that direction? It sounds like you're not really encouraging substitution but I'm curious on the new business side. And then just had a follow-up on the longer-term model question after that.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, Walter. Thank you. So we already factor in annual contract value into our account executives variable comp. So I think one of the advantages of being a consolidator is when we do due diligence, we get to look at a lot of comp plans, a lot of business plans. And I think we have it right in how we give a blended target towards sales force or account executives, that they have a number to go make, whether it's through total -- annual contract value or license and maintenance, first year maintenance combined. So I think we have the plan, right. No anticipated changes when we finish the fiscal year. We'll certainly look into F '19, if there's any little tweaks, but I think we have it right.

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

Great. And then just on the longer-term model side, I'm wondering your leverage ratios you talked about the past like 3x, is that -- as we think about cash flow number you're targeting yourselves on for '21, is it safe to assume that 3x still applies?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Thank you. I think our bank covenants are higher than that, but the management threshold that we've always looked at is around 3x. And as we look at the fiscal '21 goal, yes, the 3x still remains. I'll note that if we need to go above it slightly in the short term to do a strategic acquisition, we won't hesitate like we did in Documentum. And I think our track record over the last 12 months is a good indication of that where we need to go slightly above it and then within 12 months, we're dramatically below it.

Greg Secord - *Open Text Corporation - Vice-President of IR*

Operator, we have time for one more.

Operator

Our next question comes from Blair Abernethy of Industrial Alliance.

Blair Abernethy - *Industrial Alliance Securities Inc., Research Division - MD of Equity Research & Equity Research Analyst of Technology*

Mark, I'm just wondering if you could provide us with a little more color on the license side of things. I guess, 2 questions here. One is around the cadence of distribution of deals from the December quarter to the March quarter. You fairly well outperformed, I would say, in the December quarter and it seems to maybe have -- has that drawn down part of what we experienced this quarter?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Blair, thank you for the question. And you said it correctly and maybe I'll just use my words to it, that's Q2 and Q3 balance each other out. And we look at our business on an annual basis.

Blair Abernethy - *Industrial Alliance Securities Inc., Research Division - MD of Equity Research & Equity Research Analyst of Technology*

Okay. And the second question is, again, around the license side. What impact are you seeing at this stage from GDPR? It's been in the works for a couple of years now but the deadline is a couple of weeks away. Is that helping you, hurting you? Where are you seeing -- how are you seeing your customers react to this?

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

Yes, thank you for that. I'm seeing customers react. I know there's -- I think it's May 24, which is the deadline to replace -- it's the removal of the U.S. safe harbor, progress the EU director, May 24 is a date with GDPR. I see customers really looking at it in the long term. I've seen customers use it as an opportunity to drive just general process change around HR and other types of systems. But I actually see customers taking a long-term view of information security, information governance. And with Cambridge Analytica and others in the news, I'm starting to see North American customers going, "Maybe we should adopt something similar even if there's not legislation yet." So I think things like Brexit will actually drive some enterprise demand. You might need 2 licenses instead of 1, ultimately, or 2 subscriptions versus 1. And I think GDPR is actually a longer-term demand driver, and I'm starting to see some North American customers look at similar solutions.

Operator

I will now hand the call back over to Mr. Barrenechea for closing remarks.

Mark J. Barrenechea - *Open Text Corporation - Vice Chair, CEO & CTO*

All right. Well, I'd like to thank everyone for joining us today as we walk through our total growth strategy, as we're targeting $1 billion in annual operating cash flow for the year as we exit fiscal '21 and on our great cash flow performance in the quarter. And I hope you'll join us at Enfuse and Enterprise World and we look forward to speaking to everyone soon. Thank you so much.

Operator

This concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.
