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OTEX - Q2 2018 Open Text Corp Earnings Call

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OVERVIEW:

Co. reported YTD total revenues of $1,375m, GAAP net income of $122m and GAAP EPS of $0.46. 2Q18 total revenues were $734m, GAAP net income was $85m and GAAP diluted EPS was $0.32.

CORPORATE PARTICIPANTS

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

John Doolittle *Open Text Corporation - Executive VP & CFO*

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

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

Steven Li *Raymond James Ltd., Research Division - SVP*

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

PRESENTATION

Operator

Thank you for standing by. This is the conference operator. Welcome to the Open Text Corporation's Second Quarter Fiscal 2018 Conference Call. (Operator Instructions)

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

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

Thank you, Ben, and good afternoon, everyone. On the call today is OpenText Vice Chairman, Chief Executive Officer and Chief Technology Officer, Mark J. Barrenechea; and our Chief Financial Officer, John Doolittle.

We have some prepared remarks, which will be followed by a question-and-answer session. This call will last approximately 60 minutes with a replay available shortly thereafter. I'd like to take a moment and direct investors to the front page of the Investor Relations section of our website, where we posted presentations that will be referred to during the call.

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 or 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 of certain non-GAAP financial measures. Reconciliations of any non-GAAP financial measures to their most directly comparable GAAP measures may be found within our public filings and other materials, which are available on our website.

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

John Doolittle - *Open Text Corporation - Executive VP & CFO*

Okay, Greg. Thank you very much. Welcome to the call, everybody. Before I get to the numbers, I just want to acknowledge that I'll be leaving the company in September after 4 great years. I'm extremely proud of our accomplishments. The OpenText team is amazing, and I'm pleased to be able to announce this news on a high note with such a strong quarter. Until September, I'm fully committed and dedicated to driving performance and ensuring there is a seamless transition.

Okay. So let's go through the numbers. My references will all be rounded in millions of U.S. dollars and compared to the same period of the prior fiscal year, unless I indicate otherwise. Total revenue for the quarter was $734 million, up 35% from last year, $720 million on a constant currency basis, up 33%. Revenue was negatively impacted by $13 million due to acquisition accounting rules, positively impacted by $14 million due to foreign exchange. Year-to-date total revenues $1,375 million, up 33% from last year, or $1,356 million on a constant currency basis, up 31%. Total annual recurring revenue is $516 million, up 31% from last year, or $508 million on a constant currency basis, up 29%. Year-to-date annual recurring revenue was $1,005 million, up 30% from last year, $995 million on a constant currency basis, up 29%. License revenue in the quarter was $135 million, up 38% from last year, or $131 million on a constant currency basis, up 34%. Year-to-date, license revenue, $213 million, up 35% from last year, or $208 million on a constant currency basis, up 31%. Cloud revenue for the quarter was $208 million, up 19% from last year, and new MCV bookings this quarter were approximately $65 million, up compared to $54 million in the same period last year. Year-to-date cloud revenue was approximately $402 million, up 17% from last year, and foreign exchange on cloud revenue is de minimis on the quarter and year-to-date. Customer support revenue for the quarter was $308 million, up 40% from last year, or $301 on a constant currency basis, up 37%. Our customer renewal rate was in the low 90s, similar to last year. Year-to-date, CS revenue, approximately $603 million, up 40% from last year, or $593 million on a constant currency basis, up 38%. Professional services revenue for the quarter was $83 million, up 65% from last year, $81 million on a constant currency basis, up 61%. Year-to-date, PS revenue is approximately $156 million, up 54% from last year, $152 million on a constant currency basis, up 50%.

Next, to foreign exchange. For the quarter, FX positively impacted revenue by $14 million and had a positive $0.02 impact on adjusted EPS. The effect of the positive $14 million by revenue type: customer support, $7 million; license, $5 million; and PS, $2 million. Year-to-date, FX positively impacted revenue by approximately $19 million and had a positive $0.03 impact on adjusted EPS. The effect of the positive $19 million by revenue type: customer support, $10 million; license, $6 million; PS, $3 million. Gross margins for the quarter were as follows: license margin, 97%, down slightly from 98% last year mainly due to mix of products; cloud margin, 57%, down slightly from 58% last year mainly due to the impact of recent acquisitions; customer support margin was 89%, up from 88% last year; and PS margin was 22%, up compared to 20% last year, reflecting positive integration activities. Adjusted operating income, $268 million this quarter, up 45%, and adjusted operating margin was approximately 36% compared to 34% last year. Year-to-date adjusted operating income, $469 million, up 40%, and adjusted operating margin is 34% compared to 32% last fiscal year. We are tracking to our fiscal 2018 adjusted operating margin target model of 32% to 35%. Adjusted EBITDA was $290 million for the quarter, up 45%. Adjusted EBITDA margin, 39.5% compared to 36.8% last year. Year-to-date adjusted EBITDA was $510 million, up 39%, and year-to-date adjusted EBITDA margin was 37.1% compared to 35.4% last year. Adjusted net income was $203 million this quarter, up by 52%. On a constant currency basis, adjusted net income was $197 million, up by 48%. We are seeing the positive impact of margin improvement as a result of bringing our recent acquisitions under the OpenText adjusted operating margin model. Year-to-date adjusted net income was $346 million, up 45% from last year, and $338 million, up 42%, on a constant currency basis. Interest expense, $34 million in the quarter, which is in line with the estimated run rate we've previously disclosed. And adjusted earnings per share for the quarter was $0.76 per share on a diluted basis compared to $0.54 per share for the same period last year, up 41%, and 37% on a constant currency basis. That's $0.74 per share on a diluted basis. Year-to-date adjusted earnings per share was $1.30 compared to $0.97 last year, up 34%, and on a constant currency basis, $1.27, up 31%. GAAP net income for the quarter was $85 million, $0.32 a share on a diluted basis, up compared to $45 million or $0.18 a share on a diluted basis last year. Year-to-date GAAP net income of $122 million or $0.46 per share, and last year, year-to-date GAAP net income of $958 million, but this included a onetime tax benefit of $876 million that was recorded on account of the company's internal reorganization, which further consolidated our intellectual property within Canada.

Operating cash flow. We had the highest Q2 operating cash flows in our history at $167 million, up 56% year-over-year. This achievement was primarily due to an increase in net income of $111 million after adjusting for noncash operating activities, partially offset by a decrease in working capital items of $52 million. I'm really pleased with our cash flow performance this quarter, and I would like to point out that historically, the third quarter of our fiscal year has been our strongest quarter for operating cash flow. And the balance sheet, we ended the quarter with $476 million of cash, $627 million of deferred revenue. We have a very solid balance sheet with improving leverage ratios that are now below our indicated threshold less than 3x.

Now turning to tax update and starting with the U.S. tax reform. I'd now like to discuss the impact to our Q2 results as a result of the recent changes to U.S. corporate income tax law, which were enacted on December 22, 2017. First of all, we do not see any material impact in fiscal 2018 or 2019 from the U.S. tax reforms. The corporate tax rate reduction is effective for OpenText as of January 1, 2018, and accordingly will reduce our U.S. federal statutory rate to approximately 28% in fiscal '18 and 21% in fiscal '19. As such, we have reduced our adjusted tax rate from 15% to 14% for fiscal 2018, and we will update this as we normally do in the fourth quarter. This quarter, we reported a onetime tax expense of $15 million necessitated by the new legislation. Approximately $8 million of this expense is a non-cash charge related to the remeasurement 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 the unremitted earnings will be paid over 8 years as provided by the legislation. These are provisional amounts and will be finalized on or before December 22, 2018. And like all corporate taxpayers, we continue to assess the long-term implications of the tax reforms, and we'll update you for any material impact to our tax analysis or plan. Regarding the IRS matter, there's nothing new to report. We will continue to keep you updated on any material new developments. We have revised the disclosure of estimated aggregate liability in our 10-Q to $600 million, up slightly from previous disclosures, solely related to estimated interest that has accrued.

ECD update. The margin performance for ECD improved by approximately 800 basis points from last quarter to 33%. We are pleased that ECD is now integrated and on OpenText's adjusted operating margin model as planned. Give you an update on ASC 606, the new revenue recognition accounting rules. We'll just take a minute to update you on these new rules under U.S. GAAP. ASC 606 is applicable to us effective July 1, 2018, and we will be reporting revenues under these rules for the first time for the quarter ended September 30, 2018. We'll adopt the new accounting standard using the cumulative effect approach as allowed under the rules. We've established a project team with the primary objective of evaluating the effect the new standard will have on our business processes, systems, controls and results. Although the new rules provide guidance on 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 these new accounting rules will have on our fiscal '19 results. And if material, we'll provide you with updates with regard to the expected impact.

Now on to our 2021 aspirations, see the organization is stronger than ever, and utilizing the principles of the OpenText Business System, we integrated the largest acquisition in our history. This foundation gives us confidence to raise our aspirational target model for 2021. We raised our aspiration by 200 basis points and anticipated adjusted operating margin for fiscal 2021 to be 36% to 40%. And please see the aspirational model in our IR presentation, which has been updated accordingly. Board of Directors declared a cash dividend of $0.132 per share for shareholders of record on March 2, 2018, payable March 23, 2018.

And with that, I will turn it over to Mark.

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

Thank you, John, and welcome, everyone. I have 5 topics to cover on today's call. First, I want to start with an overview of our business model, in first principles. And even if some of this is repetitive, I want to bring it all together in one place for today's call and future reference. Second, I'd like to discuss select highlights from our terrific Q2 results where we delivered strong positive organic growth, record annual recurring revenues and solid operating cash flows. Third, provide an update on our recent acquisitions and M&A in general. Next, discuss the Madhu and John CFO transition. And lastly, provide a few comments on Q3 and the second half of fiscal 2018, then I'll open the call to your questions.

I want to start today's call speaking to our business model, our first principles, and our approach to where we play and how we win. In many ways, I am reemphasizing what is well chronicled for OpenText. The OpenText market strategy is centered on Enterprise Information Management. The EIM market is large, growing and strategic to enterprise customers, and therefore, it's high profit. EIM is enabling key trends, such as new content platforms, new customer experiences, business network, digitalization, security, governance, Internet of Things and artificial intelligence. Enterprise customers are the world's largest 10,000 businesses, and I use a shorthand to describe them, and that is the G10K. G for global. EIM is creating intelligent and connected enterprises, intelligent EIM automation, intelligent clouds, more intelligent endpoints, unlocking the value of enterprise information through AI and insight. Businesses are becoming more connected. In fact, there's soon to be 4 billion humans connected to the Internet and potentially, over the next decade, 1 trillion machines on the same network. Mobile is consuming the world, and businesses are integrating their transactions with other businesses and networks over the Internet. EIM is a long-term market opportunity. OpenText has evolved over a series of strategic eras. Given the expanding demand of our customers through time, we have grown our EIM portfolio from where we started in search to enterprise content management, to business process management, customer experience management and discovery to the business networks and, more recently, to security, the Internet of Things and artificial intelligence. We have been very successful in expanding our market thesis, our vision and addressable market because we bring our customers with us. And this is reflected in our annual recurring revenue numbers. Organizations count differently, and depending on what you include or exclude, EIM is approximately a $40 billion addressable market. We've also evolved our business model from a license-centric model to an ARR-centric model, from on-premise deployments to managed services. We capture this opportunity by examining strategic EIM areas and acquiring value-based businesses that further advance our EIM vision and our financial profile. We lead with M&A growth, all connected through integration and innovation that yields organic growth. This implies that in any given year, the number of companies we acquire can vary. But over the long term, and with 58 acquisitions completed, we have a clear history of performance and trends. A first principle is operational excellence. This is firmly rooted in our corporate DNA. Look no further than ECD, which is now operating at 33% adjusted margin after OpenText just owning the business for 12 months. Covisint and Guidance Software were losing money, and after our first quarter of ownership, they are now profitable. Operational excellence drives intelligent growth. This is an OpenText term, where we create new product introductions, positive organic growth and customer coverage expansion. Intelligent growth drives ARR, adjusted operating margin and operating cash flows. We deploy our capital measured by simple metrics, cash-based analysis, ROIC and clear payback periods over 5 to 7 years. This is the engine that powers our acquisitions. Again, acquisitions continue to be our leading growth driver. Look to the strength within this quarter, ARR of $516 million, adjusted operating margin of 36.5% and an adjusted EBITDA margin of 39.5%. Our acquisition activity continues, and there's no scarcity of EIM companies for us to consider. We have ample target assets, leadership bandwidth and available capital. Another first principle of the OpenText Business System is learning and continuous improvement. We have our OpenText point of view, and we learn from ourselves. We also learn from other high-performing software companies with strong operation, high margins and strong cash flows as well as from large conglomerates like a Danaher or Roper Technologies on their business systems and capital deployment.

Let me start with a few of our learning moments and how we take the long view. Over 6 years, we've transitioned again from a license-centric business to an ARR-centric business. We've transitioned from PS deployments to a powerhouse in managed services. We advanced from zero cloud revenue to our first $200 million plus cloud services quarter, and we have advanced from the mid-20% of adjusted operating margin to 36.5% here in Q2. And today, we increased our aspiration to land between 36% to 40% adjusted operating margins by the end of 2021. We integrate our acquisitions while delivering continuous innovation to our product lines. Release 16 has been very successful for us, and our approach to rapid releases via our Enhancement Packs series, the EP series, is evidence of this. EP3 is showing strong customer demand, and we're on track to deliver EP4 next quarter. Our tax rate is efficient. For every $100 million of acquired revenues, this implies deploying $200 million of capital at 2x revenue multiples. Over the long term, by consistently adding revenues acquired at these multiples, expanding margins and cash flows, maintaining that effective cash tax rate, we created a trifecta that demonstrates how we generate enough free cash to self-fund our acquisitions. This all feeds back into operational excellence. The cycle repeats, learns and improves. We call this the OpenText Business System.

We look at our business on annual cycles, not quarterly cycles. And we look at our business system over the last 10 years, not just 6 years, but 10 years. Revenues have grown from $596 million to a trailing 12-month of $2.6 billion. Cloud has grown from zero to trailing 12 months of $763 million. ARR has grown from $288 million to a trailing 12 months of $1.9 billion. Adjusted operating margin has grown from 22% to 33%. Operating cash flow has grown from $111 million to trailing 12 months of $493 million. We introduced the dividend program from zero to trailing 12 months of $134 million returned to shareholders. And over the last 10 years, we've completed 30 acquisitions, with a simple average of 3 per fiscal year. I wanted to bring this all together today to talk about the OpenText Business System, our first principle, and our point of view. In short, this is where we play and how we want to win, and we'll continue to refer back to this in the future.

Let me move on to Q2 highlights and year-over-year comparison. I'm extremely proud that OpenText has been added to the TSX 60, the 60 most valued companies in Canada. This is a recognition of our achievements, our future potential and the esprit de corps of the company. I'm very humbled by this, and with sincerity, I want to thank everyone who contributed to this success. This is a shared success for OpenText. We had a tremendous Q2, and then to calendar year 2017, all revenue lines and all geographies grew. Total revenue was $734 million, up 35%. Americas delivered $419 million in revenue and grew 32%. EMEA delivered $243 million of revenue and grew 38%. In Asia Pacific and Japan, APJ, delivered $73 million of revenue and grew 47%. We had strong positive organic growth in Q2. Annual recurring revenue is $516 million, up 31%. This is another record high for the company. ARR is the key revenue metric for OpenText. ARR was $1.7 billion last fiscal year, and we have grown ARR every year for the last 5 years, and combined cloud and license renewal rates are among the best in technology. Customer satisfaction, product adoption, business value, strong product road maps, these all drive ARR. Within ARR, cloud revenue was $208 million, up 19% year-over-year, and customer support was $308 million, with 40% year-over-year growth, as John noted earlier. We have 30 deals over $1 million in value, 14 in the cloud, 16 on-premise. Key customer wins included L.A. County, Air France-KLM, Pandora Media, Canon Electronics, Peabody and Zodiac Aerospace. We delivered a record $135 million of licenses, or 38% year-over-year growth, and $65 million of new MCV or 20% growth. As I've highlighted for the past couple of years, hybrid is the destination. Hybrid is not a way station along the journey. Hybrid is the destination. It's important to view license and MCV together again. The main difference between a license and MCV is simply a customer deployment choice. Customer interest remains high in our digital platform, security, AI as well as our managed service offering. PS revenue was $83 million and up 65%, and we delivered a gross margin of 21.7%. We are focused on higher-value services, such as managed services and upgrades, that will optimize for long-term value over short-term contracts. We run a world-class PS organization where customers place their trust in OpenText every day. On our book of business, 18% originated from new customers and 44% was influenced by a partner. We had strong support from our indirect channels, ECO-System partners, GSI partners, our VAR network, new OEMs and our inside sales teams. Industries that contributed 10% or more included technology, financial, consumer goods, services in general, and the public sector. Adjusted operating income was $268 million or 36.5% and again, adjusted EBITDA was $290 million or 39.5%. Operating cash flow of $167 million, up $100 million quarter-over-quarter and up $60 million year-over-year. Cash on hand, $476 million. And we have ample cash flows, ample capacity for M&A, and we are well within all our operating covenants. As John noted, our ending debt-to-EBITDA ratio was under 3x. These are terrific Q2 results, and our field and operation teams performed very well.

Let me move on to the third topic, which is M&A. Over the last 12 months, we completed 3 acquisitions: the ECD business from Dell EMC, Covisint Corporation and Guidance Software. And we're on our internal business plans for each of them. Further, we remain active in the market and continue to build our pipeline. There is no doubt that last year was an extraordinary year with the onboarding of ECD, not unlike 4 years ago when we onboarded GXS. As a reminder, our 10-year total revenue CAGR is 14%. On a peak year, we had 26% year-over-year revenue growth, and on a low year, we were flattish on revenues but optimized extremely for margin performance. That total CAGR of course includes FX, acquired and organic growth contributions.

A few comments on ECD. The integration is now complete, and we're on our internal business plan. ECD is now on our operating model, with adjusted operating margins of 33%. We transformed the low-margin business onto the OpenText operating model in just 12 months. Customers are very happy with our progress, support and product road maps. In Q2, we had strategic ECD wins at US WorldMeds, Tata Consultancy Services, CBA, ConvaTec and Syngene. There are numerous ECD leaders, senior leaders that have taken leadership roles within OpenText. Our APAC leader and various country managers reporting into Ted, our Customer Elite Program reporting into James and senior engineering leadership reporting directly into Muhi. We're delighted with the leadership and talent and expertise that we've assembled from ECD. We continue to cross-pollinate our install bases with extended ECM for SAP, CEM and archiving solution. Customers are making application and platform decisions that can span a decade or more, and we are competing rather in more opportunities today than we were a year ago. With integration now complete, our focus turns to further efficiencies, innovation, more customer adoption and, of course, revenue growth.

Let me turn to Covisint and Guidance for a moment, both Covisint and Guidance are profitable. And we remain on track to have them fully integrated within the first 12 months of operations. We purchased Covisint for their core auto business, which performed well, and we continue to explore their early releases of Identity and Access Management and the Internet of Things and the long-term potential of these 2 markets. Guidance is a more mature business in electronic discovery and information security. Recommind plus Guidance are simply better together. Guidance with information security, the leading product, of course, being EnCase. We had customer wins within law enforcement, defense and intelligence. EnCase is running a 40 million end points today and represents a strategic long-term opportunity as well as artificial intelligence in Magellan. Guidance Software's annual conference, Enfuse, will continue. It will be in Las Vegas this May 21 through May 24, and the conference will center on government, security and AI. I plan on being there and delivering the keynote, and perhaps we'll see many of you there.

Next, let me provide some comments on our CFO transition. I announced today that Madhu Ranganathan, CFO at [24]7.ai, a leading company for AI and customer experience software, will join OpenText as EVP and CFO effective April 2. John will continue as CFO through April 2 as well and will remain with the company until September 28, ensuring a successful transition. I'm very pleased to welcome Madhu to OpenText, a Silicon Valley veteran and a highly experienced global finance executive. Madhu brings over 25 years of strategic and financial leadership experience, with a deep operational focus on software, hardware and tech-enabled service businesses. Madhu is formerly with PriceWaterhouse LLP, holds an

MBA in Finance in the University of Massachusetts and is a certified public accountant and chartered accountant of India. I want to deeply thank John for his 4 years of great service to OpenText, and let me recognize his contributions, his professionalism, his integrity and his commitment to the transition period. I wish him all the best in his continued journey. He has set out to accomplish a set of goals, and he did. Thank you deeply, John.

John Doolittle - *Open Text Corporation - Executive VP & CFO*

Thanks.

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

And lastly, let me conclude with some Q3 and summary comments. As noted above, it was a tremendous Q2: $734 million of revenue and 35% year-over-year growth; record annual recurring revenues of $516 million and 31% year-over-year growth; strong, positive organic growth; adjusted operating margins of 36.5% and adjusted EBITDA margins of 39.5%; OCF of $167 million and ending cash on hand of $476 million; and a debt-to-EBITDA ratio under 3x. We had strong execution in Q2. We also had some help with $14 million of revenue from FX, a handful of larger wins, and we benefited from some end of year customer spending. The quarter truly shows the power, the potential power, of our business engine and robust business model. As we look into Q3, it is traditionally our strongest quarter for OCF, and our lowest for revenues in any given fiscal year. We expect this usual historical seasonality in this Q3. Q4 is typically a seasonally strong quarter, and we expect that same historical seasonality as well. Also, as I noted in the press release today, we are introducing our fiscal 2021 adjusted operating margin range of 36% to 40%, reflecting the continuous strength and strengthening of our operations and the scaling of our business. We'll update you on our progress over the coming quarters. And needless to say, the placement within this range could vary based on the timing of any given acquisition. We're also confirming our fiscal 2018 target model, including adjusted operating margin. And as for a final recap comment, I'd like to add this and a little bit from John's script. The new U.S. Tax Cuts and Jobs Act should have no material effects in fiscal '18 and fiscal '19. And in fact, we lowered our adjusted tax rate for fiscal '18 to 14% as John noted. ASC 606 impact seems limited. We'll update you more as we get into fiscal '19, but again, the impact seems limited. GDPR and Brexit actually should increase demand for our software and our services as clients look to become more compliant and may need a second copy of software. And current NAFTA discussions are not expected to have any effect on us. Our IP is mainly in Canada, and we have a separate U.S. entity for selling into the U.S. government that has been in place for many years, and these are some of the cornerstones of the current NAFTA discussions.

With these remarks, let me open the call to your questions.

QUESTIONS AND ANSWERS

Operator

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

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

A couple of questions from me. First, on the -- I was wondering if you can provide an update on cross-selling into your recent acquisitions. Obviously, this isn't your first rodeo. And I guess I'm curious what you might have learned in terms of selling to these new relationships, specifically for Documentum. What are some of the solutions that are relatively easy in terms of cross-sells to make? And what are some of the things that are a little bit more complex, that are taking a little bit longer to realize based on what you've learned so far?

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

Yes. Great question, Phillip, and I appreciate it. Look, I think some of the -- what we've learned through time is that we need to be laser-focused, and with focus comes results. And bringing extended SAP, a big strength of ours, into the Documentum install base, Customer Experience Management as well as our managed service offering has really created opportunities for us. I think the next wave is going to include products like Guidance security for information forensics as well as AI in Magellan. So it's always about fulfilling a customer need, sort of laser-focusing your sales force. And quite candidly, I think we saw some of the results of that in Q2, with very strong positive organic growth. But I'd say it's about understanding the customer need, laser-focusing your sales force, getting them engaged and picking the best of your portfolio to get into the install base.

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

Any surprises so far in terms of what you've learned versus what you were expecting? Obviously, you were planning the integration well even before, so I was wondering if you can sort of compare it to your expectations heading in. And were there any sort of differences?

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

Well, of course, I'll note that we're done with the integration and just delivered fantastic operating margin in Q2 of 33%. And winding back, large asset integrations take time. You're reissuing comp plans, HR letters, employment letters. You're not buying a company, so you have to integrate all the systems and people. And that takes a little time. If I rewind the clock, maybe we could have done a little better job communicating kind of some of that complexity in the early days. On the flip side of that, we felt we could get ECD to be within our model from kind of low margin into the 30s in 12 months, and the team accomplished that. It's just an incredible journey. Right now we're on to more efficiencies and more growth.

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

Great. I wanted to touch on that margin as my second question. Your 2021 aspiration is certainly impressive, 36% to 40%. I was wondering if you can elaborate a bit on the visibility you have behind that aspiration? I'd imagine that the scale benefit from Documentum was a significant driver behind that. So any color will be helpful.

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

Yes. Very good. Thanks for that question as well. Well, we've come out with that new range with confidence and visibility. It's going to be around continuing to scale our cloud managed service and renewals business, continue to scale through our indirect business. And it's about scaling revenues faster than our cost, of course, and more automation, more automation in the business. So I'm looking to kind of scale revenues through the sales force, our indirect channels, continue to scale our support organization and doing this on lower cost as well as more automation in the business. John, anything you want to add?

John Doolittle - *Open Text Corporation - Executive VP & CFO*

Yes, I agree with that, Mark. Phil, as we talked about when we laid out the 2020 model, it's a programmatic look at every line on the P&L and increasing license margins and CS margins and reducing OpEx and scale. So I agree with Mark, that will continue, and the progress, we've seen tremendous progress, and that will continue, and that's what give us confidence into the future.

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

Yes, very well, and I look at Q2, that just gives the organization confidence, right? 36.5% adjusted operating margin and 39.5% adjusted EBITDA.

Operator

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

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

So in your press release, you referred specifically to cross-sell, upsell opportunities as kind of the focus this year. Does that mean you're kind of a lot more focused this year relative to previous years on organic growth?

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

Richard, thanks for the question. I think the short answer is yes, but I think we can walk and chew gum quite candidly, and with the scale of the business, continue to prosecute M&A opportunity and deliver organic growth. Q2, again, we had strong, positive organic growth. We have great stability in the sales force. We have greater scale. We have a cycle of new product introductions with EP3, EP4, Magellan, which is very topical, and a great interest in our new security offerings from Guidance. So look, I think we have to do multiple things simultaneously. M&A will continue to be the lead growth driver and complemented with organic growth.

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

On Magellan, can you give us an impression of the initial uptake you're getting on that?

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

Yes. Sure thing. So we won numerous customers last quarter both in analytics and in AI. And I'm not sure the precise count here, but we're running near 100 proofs of concepts in our install base, and we're learning a lot. We're learning a lot around deep integration into EIM, new workflows and use cases from -- everything from field service to customer journey optimization. Where we want to compete, and I think this is a very -- where we want to play and where we want to win, is AI integrated into EIM. We're not looking to win kind of a standalone AI platform, but we'll win some of those. We want to go out and capture the entire content install base from Documentum and Content Suite. We want to go out and win the entire business network. We want to go out and win our million trading partners and the x trillion of commerce over our network for AI. So this is going to be a very steady set of progressions. EP4 has a whole new wave of features in it for Magellan from our first wave of learning. So we had wins in Q2. We have a lot of proofs of concepts going on. Our learning is way up on what we need to continue to deliver in the product. And I think a key -- very key philosophical point is it's AI integrated into our automation is where we're going to have very long-term benefits for our customers and eventually flow through to revenue.

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

That's helpful. And just on Covisint and Guidance, now that you're through ECD. Would the synergies from those subsequent transaction scale fairly evenly over the sort of 12 months from which you acquired them? Or are they sort of front-end loaded or back-end loaded?

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

I'd say sort of an even linearity there.

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

Okay. And then last question, I can't help but ask, John, what are you going to be doing by end September there?

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John Doolittle - *Open Text Corporation - Executive VP & CFO*

Richard, a lot of things on my list, but I'm going to be totally focused for the next few months on the job through April, and then making sure there's a seamless transition. So we'll give you an update later on in terms of what the plans are for September.

Operator

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

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

Mark, revenues obviously came in well above the guidance you provided for the quarter. And so if we look at the sources of strength, can you provide some color on what drove that? Is there anything specific you can call out? Was it maybe just a great macro environment? Was it maybe seeing the fruits of your cross-selling initiatives? Any color you can provide on that front?

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

Yes. Thanks, Thanos. I think it's a handful of things. Our acquisitions performed very well, and that was one big contributor. Second is customer interest in our EP series, so just that kind of core organic demand. And the field was very focused in its execution, so acquisition performance, our product cycle. Again, we had some help from FX, we had a handful of larger deals. And those things are certainly helpful in any given quarter. But I would highlight 2 things: acquisition performance and focus and execution of the sales force on organic growth.

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

Okay. Now you've mentioned that Q3 will be seasonally weaker as is typically the case every year, but given how strong this quarter was, should we look for a larger-than-typical seasonal drop for the upcoming quarter? Or is there no reason to think that?

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

I'll state in my prepared remarks that Q3 is typically our strongest cash flow quarter, and our lowest in revenue, and we expect to see that usual historic seasonality.

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

And maybe one last one, just given the margin performance this quarter, it would seem that you're well positioned to maybe break to the top end of your full year margin target. Any mitigating factors that we should be aware of that might prevent that?

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

I've got to go back to my prepared remarks and confirming our 2018 range.

John Doolittle - *Open Text Corporation - Executive VP & CFO*

Yes, I mean, Thanos, we're only in the second quarter, so we're going to stick with the range we put out.

Operator

Our next question comes from Stephanie Price, who's with CIBC.

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

Could you talk a bit about the current competitive landscape and what you're seeing in terms of the competitors out there for the ECM Suite specifically?

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

Yes, sure thing. Thanks for the question. I didn't have anything in my prepared remarks today, so I'm delighted to have the question. On the kind of EIM suite from our content platform, digitalization, business network through AI and managed services, it's IBM that remains the macro competitor. And as you've seen from sort of a series of campaigns we run and #1 campaigns and customer testimonials, IBM remains kind of the centerpiece of our study, how to beat them and how to kind of show our value over their platform. We also have a -- we look very closely at vertical competitors, like Veeva, Oconics and others. I think the next wave of our evolution is more and more vertical capabilities. We have a strong new engineering and construction module out. We have a new QMS, clinical trials and pharmaceutical and biotech module out from -- inspired through ECD, and we put a press release out a couple of days ago on Pac Life, which is a kind of a file sync-and-share collaborative workflow that's competitive against Box, if you will, and a win against Box. Now we still see Box in the mid-market, but there are some collaborative workflows that we're going to go compete in now with our latest release of Core, and Pac Life is an example of a win against Box. And let me kind of give a new expression out there, I look at Box really as a feature, not a company. And with our latest release of Core, our wins like Pac Life, I think, it's going to open up a new set of use cases and workflows for us to go after.

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

Great. And then in terms of the reseller agreement you announced with Dell EMC, can you talk about the incremental size of that opportunity? Like how should we think about that?

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

Yes. It's -- we're excited about sort of turning the corner from a buyer, if you will, to a build demand relationship. And what we're going to focus on initially are the larger, more complex information Lifecycle Management environments. So InfoArchive, big content platform deployment. And these typically will go into large insurance companies, financial services, government installations that really take tight hardware integration to further that information Lifecycle Management platform. So it's really, I'd say, a very strategic view of larger, more kind of integrated platform opportunities in the largest businesses. And that's where we're going to start and build from there.

Operator

Our next question comes from Paul Treiber of RBC Capital Markets.

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

I just wanted to turn our attention to capital allocation for a moment. Previously, you gave an outlook to deploy $3 billion on acquisitions over several years. Do you have an update for that? And then, if you can't give a specific number, how should we think, generally speaking, about the financial capacity to make acquisitions, particularly in light of leverage and free cash flow generation?

John Doolittle - *Open Text Corporation - Executive VP & CFO*

Yes. Paul, obviously, a great quarter in terms of operating cash flow and EBITDA and our leverage ratios coming down accordingly to below 3 and really no constraints from a covenant point of view in our bank deal or revolver. We're well below any kind of threshold there, so we have a lot of capacity. And then, as Mark and I have said, obviously, we want to maintain a conservative balance sheet. You've seen the leverage ratio has come down, which is freeing up capacity each and every month. And so as Mark said in his script, we got lots of capacity to do acquisitions and still maintain a conservative balance sheet.

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

And then in terms of like the broader M&A strategy for EIM, are there -- within the pillars that you've outlined, are you still -- is it starting still to go deeper within those pillars? Or do you see an opportunity to expand among the pillars over time?

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

I am very pleased, Paul, with sort of the breadth of our market visibility, if you will, across the definition of EIM. We've been very successful not just being ECM or CEM, more business process management, we have our business network, Internet of Things, AI and security now. So it's a much wider playing field. The TAM is about $40 billion. So it's given us kind of a wider berth, if you will, in the market for M&A. We continue to look at white spaces, and we want to fill white spaces as aggressively as we can. We like vertical opportunities as well and, occasionally, a geographic opportunity. But I'd say whitespace and verticals within our definition of EIM is a very long-lasting strategy for us.

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

And then somewhat related to that is the -- with EMC, ECD now being owned for about a year or so, you're controlling a lot more than messaging around, I guess, EIM in the market, are you seeing customers beginning to think more strategically from a buying decision point of view in regards to EIM versus point solutions?

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

Absolutely. It's a fantastic point. And this is why we're coming in behind more global SIs, global system implementors, such as Accenture, Deloitte, TCS, Dell EMC, which may not be technically a GSI, but they have obviously a huge ecosystem around them. But yes, customers are looking more broadly at an information strategy, a digitalization strategy that can touch everything from managed services to a content platform, supply chains, business network, analytics, information and security. So yes, there's a lot of good news happening in our ability to sell higher in an organization, wider solutions. But we also need a little more help in doing that, and thus, our GSI partnerships.

Operator

(Operator Instructions) The next question comes from Paul Steep with Scotia Capital.

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

Mark, can you just talk a little bit about the field force? I think it seems like we've seen a period here of much stronger field execution than I can remember in an exceptionally long time at OpenText. What's changed? And do you think the stability there is now sort of ingrained in the organization?

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

Yes. Thanks, Paul, for the question. I think there's -- I am very pleased with how we're organized. We have Prentiss Donohue leading professional services and managed services, and that's a very -- it's a unique buyer. I mean, it's got -- it's buyer in its characteristics, and you just see the stellar results in Q2 from professional services. We have James McGourlay leading 1 renewals organization. And we -- with almost 2 decades of experience here, the cloud looks a lot like on-premise for us in how to run a renewables organization. And we brought all those teams together, and we have 1 renewals organization under James McGourlay, and that's completely separate from our hunters in the field. All right, so we got a point of view where we organize around PS and managed services in Prentiss. We have our renewals organization with James and his great leadership, and that hunter organization is led by an OpenText veteran, Simon Ted Harrison. So I think the org structure has helped. I think the focus of 3 key executives driving their revenue lines, our product cycle and strong acquisition contribution, yes, all came together in Q2. But most importantly, I'm going to look at the structure and the leadership we have across Ted, James and Prentiss.

Operator

Our next question comes from Steven Li of Raymond James.

Steven Li - *Raymond James Ltd., Research Division - SVP*

Mark, just wanted to dig a little deeper on the go-to market with the global SIs. You've talked about some initiatives in the past. Are you pleased with the progress? And any SIs doing particularly well with you?

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

Yes. Fair enough, Steven. Well, this is a -- you got to get a partner approach into your culture. You can't kind of balance in and out, right, you have to have some real staying power here over the long term and build this partner mentality. And we're doing that. We put a great leader in place. You probably saw Patty Nagle at Enterprise World, who now leads all worldwide partners and alliances for us; our ecosystem partners, like SAP, AT&T or Dell EMC; our global SIs, Accenture, Deloitte, TCS, Cap, our value-added resellers, OEM and inside sales. Specifically, on the GSI side, I would point to probably TCS and Accenture, where we have a lot of momentum right now in various verticals and geographies. But it's a holistic view from our ecosystem partners to GSIs to raise us up in our organization, go wider in our breadth and get us into more strategic opportunity.

Operator

This concludes time allocated for questions on today's call. I will now hand the call back over to Mr. Barrenechea for any closing remarks.

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

All right, very good. John, once again, thanks for your incredible service to OpenText and look forward to working together over the coming months and through September, so thank you for everything. Thanks for joining today and for your questions. This quarter, I'll be attending the Goldman Sachs conference on February 14 in San Francisco, and we hope to see you there. So thank you, everyone. Thanks for your time today. This ends today's call.

Operator

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