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OTEX.TO - Q2 2019 Open Text Corp Earnings Call

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OVERVIEW:

Co. reported 2Q19 total revenue of $735m and GAAP net income $104m or $0.39 per diluted share.

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PRESENTATION

Operator

Thank you for standing by. This is the conference operator. Welcome to the OpenText Corporation Second Quarter Fiscal 2019 Earnings Conference Call. (Operator Instructions) And the conference is being recorded. (Operator Instructions) I would now like to turn the conference over to Greg Secord, Vice President, 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 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 to direct investors to the Investor Relations section of our website, investors.opentext.com, where we posted 3 presentations that will be referred to during today's call. First is titled OpenText Investor Presentation. The second is titled Q2 Financial and Business Results, which includes information and financials specific to our quarterly results. And the third presentation, with additional information, about our announced acquisition of Catalyst Repository Systems.

In February and March, OpenText management is looking forward to visiting with investors in Canada, the United States and Europe. We will also be participating in the Morgan Stanley Technology, Media & Telecom Conference in San Francisco on Monday, February 25, with Mark presenting in a fireside chat that day. I'm happy to highlight that Enterprise World Europe is taking place in Vienna, Austria this year. European investors are welcome to join us at this customer event for an opportunity to learn about OpenText, watch Mark's keynote presentation on Wednesday, March 13 and meet our customers and partners on site. In addition, we'll be visiting London for investor meetings in March. Please feel free to reach the IR team directly if you're interested in arranging a meeting in London or attending Enterprise World Vienna.

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 recent forms 10-K and 10-Q as well as in our press release that was distributed earlier this afternoon, which may also 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 Mark.

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

All right. Thank you, Greg. And hello, everyone, and thank you for joining us today as we provide our fiscal 2019 Q2 update. It's my first earnings call from a polar vortex, so I'd like to welcome everyone. Let me encourage you to have our press release and IR presentations in front of you as we go through our call today. Further, let me continue to emphasize we view our business on an annual basis. We are now at the midpoint of fiscal 2019, and our key financial metrics remain centered on annual recurring revenues, or ARR; adjusted EBITDA, and the dollars are always more important than the percentages; operating cash flow, or OCF; and return on invested capital, or as we like to say, ROIC.

I'm pleased with our results from the quarter and our progress at the midpoint of the year. Q2 is a solid data point, along the path to our fiscal 2021 aspirations. Let me go through a few quarterly highlights. Total revenue of $735 million, up 10% quarter-over-quarter, with 1.5% year-over-year growth in constant currency. Record annual recurring revenue, ARR, of $530 million, up 2.6% year-over-year and 72% of total revenue. Adjusted EBITDA of $308 million or 42%. PS margin at 24%; CS margin at 90%; and cloud margin at 60%. OCF of $189 million, up 14% year-over-year, ending cash of $595 million. Net debt to adjusted EBITDA of 1.9x, well under 2, 35 deals over $1 million, 16 in the cloud, 19 off-cloud. 50 private -- 50 new private cloud customers. We completed the acquisition of Liaison. Customer support renewal rate in the low 90s, cloud renewal rate in the mid-90s, positive organic growth.

And let me highlight a few key customer wins from the quarter. The International Committee of the Red Cross, an organization formed in 1949 as part of the Geneva Convention to protect those affected by conflict and armed violence, we're honored to work with the Red Cross with their 16,000-person workforce as they digitize to provide the right need to the right places at the right time. A key win in the quarter includes the Philips Radiation and Oncology group that selected our EIM platform to connect their oncology systems real-time to accelerate cancer treatment plans. On a business network, we're pleased to welcome Coca-Cola and FedEx, enabling global digital supply chains. And within OT2, we had nice wins at Bose and the U.K. NHS, both for external review and collaboration.

PS was up in margin, down in revenue. The general trend is that we expect PS revenue to remain consistent on an absolute basis, though we are gradually transitioning out of lower-value work. We'll always optimize for high-value implementation services that garner higher margin. This strategy is proving effective as noted, with PS margins at 24% during the quarter. Lastly, well, we completed the acquisition of Catalyst Systems today.

It was a solid Q2. These results reflect quintessential aspects of our long-term strategy and thinking. OpenText has a unique point of view. We see a $100 billion addressable market for Enterprise Information Management software, or EIM. We intend to capture that opportunity through M&A, organic growth, distribution expansion, strategic and disciplined capital allocation and upper-quartile productivity as reflected in our margins and cash flows. I can't emphasize enough how strong 42% adjusted EBITDA in the quarter is.

When we purchase companies, we unlock their value. We do that through integration. We do that by providing a global distribution platform. We do that by instilling operating discipline via the OpenText way. We do it by innovating. We take businesses from the challenger quadrant to the leadership quadrant, and in fact, we emerge as the powerhouse in our recurring revenues in the cloud. Other consolidators have proven that they can deploy capital for sure, but that alone is not a successful formula. You must also integrate and innovate, deliver high ROIC, and high ROIC and integration and innovation to us is that perfect trifecta as a consolidator. We've also, through time, believe that EIM is as important as ERP. EIM is the digital platform, enabling global businesses to compete and win in the fourth industrial revolution. The EIM market is large, strategic and is still a young market. We were ranked #1 in business network by IDC and #1 in content services by Gartner, both of whom published at the end of calendar 2018. We are leading in EIM. Customers want to purchase from leaders, from OpenText, and they want to purchase a suite of products, not a series of point solutions. Our intelligent and connected enterprise messaging is relevant and transformative in resonating with customers. Over the next 5 years, we expect to invest near $2 billion in organic R&D for EIM and much more than that in acquisitions. We're all in to win EIM, and most important, the greatest opportunity for OpenText today in our unique business model and our unique approach to intelligent total growth is the OpenText Cloud.

Let me expand on this. Cloud is less than 20% penetrated within our install base today. The super majority of all enterprise workloads still run off-cloud. Our business is scaling to $1 billion-year run-rate in the cloud, and scale matters. We own and operate the OpenText Cloud from 37 data centers in 9 countries, and thus, we control our own service, our own features, our own capabilities, our own certifications on a global basis. We can demonstrate massive and proven value to our customers for migrating into the OpenText Cloud, whether a customer is trying to grow revenues, get into a new market or cut costs. OpenText will always be the best possible -- will always be in the best possible position to run, operate and secure OpenText software in the OpenText Cloud so customers don't have to.

We are just beginning to partner with Google Cloud platform, Amazon AWS and Microsoft Azure. These are untapped go-to-market opportunities for us. The OpenText Cloud strategy is unique and diversified, and we see it in 3 core offerings. The first is our business network, connecting business-to-business, application-to-application. Liaison strengthens the business network. We see it in the second part, the private cloud, via managed services. We now have 2,000 global customers running in our private cloud, and I believe we can double this business over the next 5 years. Catalyst strengthens our private cloud. And we have the third part, the public cloud as part of OT2. OT2 is deeply integrated into our off-cloud solutions. It will compete standalone as a public SaaS offering and will compete against pure-play SaaS providers. That's our 3-part strategy to our cloud.

Continuing on why this is our greatest opportunity. Over 1/3 of our pipeline today is now cloud. We have over 6,000 professionals educated, trained and certified on the OpenText Cloud. We now have 63,000 customers running in the OpenText Cloud, as I mentioned, 2,000 global businesses running in the private cloud, got 50 new private cloud customers in the quarter, marquee names like FedEx, Coca-Cola, and we are very profitable in the OpenText Cloud.

The greatest opportunity we have is the OpenText Cloud. Both Liaison and Catalyst significantly enhance that opportunity as they are recurring cloud revenue businesses and leading in their respective markets.

Moving on a little bit to M&A. We closed Liaison on December 17, and we're very pleased with the reaction from customers, employees and trading partners. We have the opportunity to expand our B2B integration capabilities and to a new and expanding market of application-to-application integration as newly deployed cloud applications require significant integration to both cloud and off-cloud applications and workloads. We purchased Liaison for approximately USD 311 million. Trailing 12-month revenues were approximately $100 million. In our first year of operations, we expect revenue down 15% to 20% or $15 million to $20 million due to PPA and normal integration disruption. For the second half of fiscal 2019, we expect approximately $41 million in revenue contribution and expect a negative 100 bps of adjusted EBITDA impact in Q3 and Q4. Liaison will be in our operating model within the first year of operations. This is a strategic cloud acquisition, and we have a strong growth thesis in the years to come as we work through the first year of integration. That thesis includes bringing the technology to Europe, integrating to GXS and bringing self-service application-to-application capabilities to the OpenText install base.

We announced closing Catalyst Repository Systems today. Catalyst is a leading provider of eDiscovery solutions in the U.S. legal industry, addressing both in-house legal organizations as well as leading law firms. They are based in Denver, Colorado, with 150 employees. Catalyst plus Recommind plus eDOCS puts OpenText in a leading position to address this key multibillion-dollar legal tech vertical. The legal industry is ready for digital and cloud transformation, and we're in a fantastic position to capture that opportunity. We purchased Catalyst for approximately USD 75 million. Trailing 12-month cloud revenues were approximately $45 million. In our first year of operations, we expect revenue down 15% to 20% or $7 million to $9 million due to PPA and normal integration disruption. For the second half of fiscal 2019, we expect approximately $14 million in revenue contribution. Catalyst will be on our operating model within the first 12 -- within the first year of operations, and we expect then to expand in the market from there. We have an opportunity to expand our operations into Europe, grow our customer base in the top 200 law firms and large enterprise corporations.

Combined, this is $385 million of capital deployed, $145 million of trailing 12-month revenues before first year PPA and normal integration disruption or 2.3x revenue multiple, with expected ROIC in the high teens.

Let me transition and turn our attention to quarterly factors. These are the short-term factors to help you model the business. They have little bearing on the long-term strategic nature of the business, but could affect short-term 90-day cycles. As I stated earlier, our business is annual and quarters will vary. So we are focused on our annual results. Calendar Q1 or our fiscal Q3 is our seasonally low quarter for revenue and adjusted EBITDA. To put that into more context, calendar Q1 fiscal Q3 is a start of a new fiscal year for the vast majority of the market, and budgets are typically just being planned and finalized and then the spend ramps through the calendar year. Included in our quarterly factors, there are concerns for global recession as those concerns continue. The after-effects of the U.S. government shutdown and perhaps another shutdown in weeks. Trade wars and tariffs, goods and wage inflation, and front and center remains Brexit, GDPR and data regulation concerns.

Continuing our quarterly factors, the U.S. dollar continues to strengthen against the euro, pound, Canadian dollar and yen. We continue to expect a negative revenue impact due to foreign exchange in fiscal 2019 when compared to currency rates a year ago. And lastly, in our quarterly factors, is the OpenText Cloud investments. Liaison to negatively impact adjusted EBITDA margin by approximately 100 bps in Q3 and Q4 and our continued cloud investments focused on operations and integration.

I'd like to leave you with 3 key points in my prepared remarks today. First is the cloud is our greatest opportunity. We're on a $1 billion run-rate for the cloud on an annual basis, 60,000 customers, 2,000 private cloud customers, only 20% penetrated in our install base, and we have scale, 9 countries, 37 data centers. Second key point I'd like to leave you with today is that we completed 2 acquisitions -- 2 key acquisitions over the last 60 days. We put $385 million of capital to work smartly, all from cash on hand. We've acquired $145 million of trailing 12-month revenues, all in the cloud. High teens ROIC expected, 2.3x revenue multiples. Third key point I'd like to leave you with today is here in the shorter term, it was a solid quarter. Total revenues of $735 million; ARR of $530 million, up 3%; adjusted EBITDA of 42% or USD 308 million; operating cash flow of $190 million, up 14%, resulting in positive organic growth.

So lastly, M&A continues to be our leading growth driver, supported by organic growth. We continue to track to our fiscal 2019 model, organic growth and F '21 aspirations of adjusted EBITDA and OCF goals. And a shifting landscape, we plan to take share from our competitors. We're ready for all economic scenarios and position to ensure all our stakeholders win. And please be mindful of our quarterly factors as you model the company in the shorter term.

It is my pleasure to hand the call over to our CFO, Madhu. Madhu?

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

Mark, thank you. And hello, and thank you all for joining us today. During Q2, we maintained a laser focus on operations and productivity in every line of business and it shows in our results. And turning to the details of our quarterly results and similar to prior quarters, my references will be compared to the same period in the prior fiscal year. Total revenue for the quarter was $735 million, up 0.1% or up 1.5% on a constant currency basis. As we look -- as we continue to look at our business on an annual basis, and let me note that year-to-date, total revenue was $1.4 billion, up 2% or 2.9% on a constant currency basis.

The geographical split of revenues for the quarter was Americas, 57%; EMEA, 33%; and APJ, 10%, consistent with the prior year. Annual recurring revenue was $530 million for the quarter, up 2.6% or 3.9% on a constant currency basis. Our cloud revenue was particularly strong in the quarter at $219 million, up 5.3% or 6.3% on a constant currency basis. We also generated $67.9 million in new MCV, up slightly compared to $65.1 million in Q2 last year. Our customer support revenue was $310 million, up 0.7% or up 2.2% on a constant currency basis. We delivered $133 million in license revenues, down 1.8% and essentially flat on a constant currency basis. Our professional services revenues were $73 million, down from $83 million, 12.2% or 10.1% on a constant currency basis.

Turning to the details of our margin performance in Q2. As you can see by our improved adjusted gross margins and adjusted EBITDA margin, we continue to maintain a clear and deep operating view into all aspects of our business. GAAP gross margin for the quarter was 69%, up 170 basis points. Adjusted gross margin for the quarter was at a record of 76%, up 180 basis points, with consistent improvement and most evident in our annual recurring revenue lines. Cloud was 60%, up from 57% last year. Our customer support was 90%, up 89% from last year. And license margin was 97%, stable compared to last year. And professional services margin was 24%, up from 23% last year. Our adjusted EBITDA was $308 million in the quarter, up 6% year-over-year. Adjusted EBITDA margin was 42%, another record for OpenText, and an increase of approximately 200 basis points compared to 40% in the prior fiscal year.

Year-to-date, adjusted EBITDA was $555 million, up 9% compared to the same period last year. Adjusted earnings per share for the quarter was $0.80 on a diluted basis, up 5% from $0.76 per share for the same period last year. GAAP net income for the quarter was $104 million or $0.39 per share on a diluted basis, up from $85 million or $0.32 per share for the same period last year. Operating cash flows for the quarter were $189 million, up 14% year-over-year. Year-to-date, operating cash flows were $361 million, up 54% from the same period last year.

During the second quarter, DSO was 59 days compared to 63 days in the same quarter last year. While DSOs can vary quarter-to-quarter, we had a very good Q2.

Turning to the balance sheet. We ended the quarter with $595 million of cash, net of the $311 million payment for Liaison acquisition. Our balance sheet and liquidity position remain very strong, and as of December 31, our consolidated net leverage ratio was 1.9x. This is well within our external debt covenant ratio of 4x and provides us with meaningful capacity to continue executing our total growth strategy.

An update on restructuring. During our Q4 call, we outlined a restructuring initiative which was successfully initiated during Q1 and largely completed as of Q2. Timing of the framework and execution could not be better. Our current estimate of savings is consistent with our updates during last quarter and impact of restructuring already factored in our fiscal 2019 target model. Full benefits of approximately $50 million are expected to be realized in fiscal 2020 and beyond.

And with respect to the IRS matter, we received final NOPAs from the IRS on substantially the same terms with what we've been expecting and what we have been communicating to you. As we have said in the past, resolving these matters take time, but we continue to strongly disagree with the IRS positions and we are vigorously contesting them.

Turning to foreign exchange. At the start of the fiscal year, we noted that foreign exchange would have a negative impact to revenue in fiscal 2019 of approximately $60 million compared to the prior year. As we look at the rates today and the geo level of components of our business, we see no change to that annual impact. This has been primarily driven by the U.S. dollar strength against the euro, the pound, the Canadian dollar and the yen. As you can see from our press release, we have realized about $12 million of that $60 million annual number to-date. Meaning, we anticipate the biggest currency impact to be in the second half of fiscal 2019. That is consistent with what we saw during the second half of fiscal 2018, where the rates are most advantageous to our results.

Now for prospectives on our operating model. As Mark mentioned in his commentary, calendar Q1, our fiscal Q3, is our seasonally low quarter for revenue and adjusted EBITDA margin. This is an important section, in that we share with you additional specifics for you to consider as you model us.

Our fiscal Q3, also being the first quarter of a new calendar year, we will be recording typical annual increases to payroll and related cost, which will impact all expense categories, cost of sales and operating expenses, by approximately 3% when you compare to Q2 levels. With respect to gross margins, on license, customer support, cloud services and professional services on an annual basis, we expect to remain within the range of our FY '19 target model. On R&D expenses, as we integrate Liaison and Catalyst acquisitions, we expect a 15% increase sequentially to R&D expenses on a full quarter basis in Q3, while we expect to remain within the range of our FY '19 target model.

Sales and marketing. As a reminder, certain expenses as commissions and incentives, they follow revenue goals and increase as the year progresses based on quota attainments as is typical of a technology company. Onboarding Liaison and Catalyst reduces our adjusted EBITDA margin by about 100 basis points during the third and the fourth quarter of fiscal 2019. And consistent with the past practice, our objective is to bring both acquisitions into our target operating model within a period of 12 months. Our interest expenses remain as noted in our FY '19 target model of $144 million to $149 million. Our adjusted tax rate remains at 14%.

In summary, Q2 is a peak margin for the year, while Q3 is a low point, and Q4 is a seasonally strong margin quarter, albeit below Q2 levels. We suggest you continue to build out your models for the remainder of the year accordingly. To summarize, no changes to our annual ranges in our fiscal 2019 target model, which, as a reminder, is in the investor presentation posted on our IR website. Turning to our long-term targets, as Mark mentioned, we remain focused on fiscal 2021 targets. Adjusted EBITDA margin in fiscal 2021 of 38% to 40% and operating cash flows target of $1 billion annually as we exit fiscal 2021.

As I wrap up my prepared remarks, then let me revisit our communication framework shared with you first in July of last year and reiterated in October. We provide information to help you model OpenText in a way that's closely aligned to how we see the business and reduce unnecessary short-term trading volatility for our long-term shareholders. And within the framework, we provide 2 metrics at the end of each fiscal year on a historical basis, annual organic growth and return on invested capital, ROIC. Q2 results are a great reflection of the excellent work with the OpenText team, continuing to achieve best-in-class levels of productivity. A big thank you to the entire team. We look forward to sharing our continued progress with you, our long-term shareholders, whose trust and confidence we value. During February and March, we plan to engage with our investors and analysts through conferences and one-on-one meetings in Canada, the United States and Europe. We're especially looking forward to sharing the OpenText story in Europe, which is an excellent geographical footprint for us in terms of customers, partners and employees. Please do connect with Greg Secord for more information.

I would now like to open the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Stephanie Price of CIBC.

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

Obviously, acquisition spending has been very slow in the last couple of months. Can you talk a bit about the acquisition environment and what you're seeing in terms of the pipeline of large and small deals?

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

Yes, Stephanie, thanks for the question. As we come here into calendar '19, the top of the pipeline activity is stronger, I think, with market volatility, --we're at the tail end of the effects of the U.S. tax rate increases from last year. And I think as markets kind of lean a little more towards volatility, it advantages buyers, consolidators, like ourselves. So we have high capacity. Top of the pipeline activity is stronger. And we're going to remain very strategic and disciplined in how we do due diligence and effectuate acquisitions. But as we talked about last time, I think last call, I do think calendar '19 is going to see more activity in the market.

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 revenues, you obviously came in at the top end of the guidance you provided for the quarter. Can you give us some color on some of the sources of strength with the cross-selling, geographic regions that were strong?

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

I'll point to one of the key highlights in the call, which is the cloud. License performed well, for sure. What we've talked about over the last few calls is that we're going to tap the accelerator on the OpenText Cloud. So more focused on training and education and certification of our 12,000 employees, bringing more capability to market, some upgrade of services in our managed services, new OT2 platform. So I'd really point to the cloud and how we're looking to tap on the accelerator. We're also executing very well in our off-cloud business, just the very -- the EP series is showing extreme strength and stickiness, if you will. And that's translating into our -- an off-cloud renewal rate in the low 90s and a great margin performance. That's really reflective of the strength of our off-cloud business as well. So I'd point to those 2 things and looking at the ARR, up near 3% year-over-year.

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

Great. And maybe I'll sneak one more in. Now that you've had Covisint and Guidance for a little over a year, can you talk about any positive or negative surprises that came into the integration and what you've seen in terms of cross-selling?

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

Yes, fair enough. I'll take them maybe one at a time. Covisint, when we purchased Covisint, they were shrinking and losing money. And we felt we could arrest that decline and turn them profitable, and we've done that. And it's -- and that's reflected on our 42% blended adjusted EBITDA. We have a great opportunity in Internet of Things. And I have got one reflection on Covisint, is I'm still very hopeful that the base business is exactly what we expected, and we always had to serve an upside thesis around the Internet of Things and we're still very hopeful around it. We're beginning to win new Identity and Access Management business, IAM business. I think we call it "yam" actually as an acronym, I-A-M. And we've learned a lot about Okta, O-K-T-A, probably the primary competitor in the Identity and Access Management space. So I know I don't talk a lot about them. That's sort of the space we're going to target in Identity and Access Management. On Guidance Software, it's -- we're very pleased with the security aspects of it. We didn't enter Guidance for their eDiscovery capabilities. Part of the thesis was they had outsourced all their renewals, and we had insourced that and bring that into our mechanism. We've now completed that. That might have taken 1 or 2 quarters a little longer than we wanted to do. So those will be my reflections, right? Covisint is what we thought it would be on the base business and still has its upside in Identity and Access Management as well as IoT. We love the security aspects of Guidance, and we're sort of completing the -- and we've completed the insourcing of the renewals business. There's still great promise on the security side.

Operator

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

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

I'm actually surprised to see you have so much opportunity in your longer-standing titles, like Catalyst and the Discovery market. My question is, are you thinking more about fortifying those silos, or would you ever kind of consider expanding into new market segments here?

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

Richard, thanks for the question. Okay. Look, we have really kind of -- think of this in 2 vectors. We continue -- Microsoft speaks broadly around a horizontal platform. And I think that's a good narrative and a good place to learn, where we have great opportunity to be this horizontal platform for content services, business network, application-to-application integration and Identity and Access Management. It doesn't need a lot of verticalization. The other vector is vertical apps. And there are a variety of really key industries for us, financial services, which is our largest industry; retail and CPG, which a lot of strength came from GXS; we're strong in engineering and construction. And there's a whole set of verticals, health care, government, but the legal tech sector is a great vertical. It's sort of where the content-rich, process-oriented, high-security needs around information, AI analytics, deep machine learning. The legal vertical is estimated to be about $3.5 billion in size, so we're going to go out and prosecute all these key verticals for us as -- through the years. We're strong in financial services today, manufacturing. Auto has always been a strong industry. We're building strength in legal tech. And I think you'll continue to see us both build on our own and acquire on a vertical basis.

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

Okay. And I think in your conference call in March, you talked about Coca-Cola and FedEx. And I think just from a supply chain perspective, I'm just wondering if you can sort of elaborate on that a little bit, just a bit more color.

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

Sure. So if we look at Coca-Cola, it's certainly on supply chain and distribution. FedEx is more logistics and transportation.

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

And that's -- what was that -- so it's like sort of loading all of the data related to that into your cloud? Or if you could put just a bit more color if you have that.

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

Yes, fair enough. Let me -- let's think what we can publish out there, Richard, on both the customers and see how we can get into more depth. So why don't you leave us with that, then maybe we'll get a case study out on both of them.

Operator

The next question comes from Phillip Huang of Barclays.

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

Mark, you pointed to continued global recession concerns in your remarks similar to the last quarterly call. I just wanted to sort of get an update on your visibility on any impact to your pipeline or what your visibility is to -- for the business.

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

Yes, fair enough. Yes, I called it out last quarter in our quarterly factors. I'll call it out again. And what I'm calling out is just sort of a general sentiment. If we look at the World Economic Forum and many of the headlines that came out of Davos over the last 2 weeks, the sentiment is quite different than a year ago. Now we haven't seen it impact our pipeline. We haven't seen it affect our business at this point. But I think it's worthy of calling out that it remains a concern, and it's more in the headlines of all the papers that we read. But we're not yet affected or calling out a change in our pipeline.

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

Got it. That's helpful. And then maybe one for Liaison. Obviously, you're paying a pricing, I guess, multiple that is above your historical average. I just wanted to maybe get your sense on what are some of the things that we should be aware of, that supported the valuations of the deal. The strategic rationale obviously makes a lot of sense. Just wondering, on the financial side, whether you also expect to see above-average growth and/or margins once the business is fully integrated.

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

Yes, fair enough, and it's a good question. I think it's always important to look at deals both on their own and in a basket, right? And in a basket, with Catalyst, $385 million of capital deployed, $145 million of trailing 12-month revenues or 2.3x multiple. So I think that's, well, one, that basket of 2 deals is important, around 2.3x. Standalone, it's just under 3, 3x. So it's a little closer to the range -- higher end of the range of the HP acquisitions that we did. Ultimately, it's about ROIC, right, return on invested capital. And we believe this will return a high-teens ROIC to us, and Catalyst will be even slightly better than that when we get it integrated into our model. But to support kind of the very high 2s, if you will, on Liaison, we're going to grow it. And part of that thesis is they're not yet in Europe and we got a strong basis in Europe with GXS. So we can bring the technology to Europe. I think one of the best comparisons in the market is a MuleSoft, of how Mule is doing application-to-application level integration. We don't have those capabilities today. We're -- we didn't have them before Liaison. We were more kind of deeper of this EDI transaction talking to this EDI transaction versus a repository of all these rules of how does SAP talk to DocuSign? Right? How does Oracle speak to Adobe? And you can think of a database of 4,000, 5,000 application integration rules, that we can now sit in the business network and allow our million-plus trading partners to say how does app talk to app versus EDI protocol talk to EDI protocol. We think that's a big opportunity, that app-to-app level integration. So our case here is once we get through the first year and we get through our PPA and integration disruption, which is typical of all the deals we do, we have a strong plan to grow the revenue.

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

Got it. No, that's very helpful. And then maybe one for Madhu. Just looking at the seasonality for the 2 acquisitions, it looks like Liaison, you're expecting $41 million in the back half of '19, which seemed like pretty evenly split between the quarters. But Catalyst seemed like it's seasonally a little bit lighter in the back half of the fiscal year. Am I reading that correctly, just even after adjusting for the PPA?

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

Thanks for the question. Yes and a little bit no. Catalyst is 2 months out of this quarter and 3 months in the last quarter, right? Like Liaison, we closed in the middle of December, so you see kind of the month effect and plus some seasonality. But I would definitely take the 1 month timing into consideration.

Operator

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

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

Mark, can you update us on the traction you're getting with the OT2 since, I think, it's been a couple of quarters since you launched it? Was that a contributor to the cloud strength this quarter? Or is it still relatively early days for that offering?

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

Yes. It's still relatively early. We had a couple of nice -- we had a few nice wins, for sure, that we're calling out. But it's still, Thanos, still early days. The stronger contribution was certainly on the value-added network and on-demand messaging and the business network. Very strong contribution from the private cloud, but a beginning contribution from OT2. Hightail actually did well within the quarter, our own new and native SaaS OT2 apps, Bose and U.K. NHS. So it's still early days, but they contributed. But OT2 contributed.

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

Okay. Good to hear. And you mentioned that you would expect PS revenue to be stable going forward. It sounds like that's a decision to offload more of that lower-margin work to your partners. Is that having an impact with respect to partner engagement and the level of new license and cloud bookings coming through that channel? Or would you expect to change on that front going forward as a result of them doing more of the work?

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

Yes, it's a good question. It's exactly as you highlighted it. We still may have a little pressure on the revenue line as we continue to transition out maybe lower-value services. Now value's in the eye of the beholder, right? What we view as lower-value is high-value to a partner because it's more in their implementation thesis. What we want to do is to be the experts in OpenText and getting the big value out of OpenText software versus maybe some run-rate implementation services. So value is in the eye of the beholder, but what we view as low value, we are transitioning to partners. They like it, helps them build more demand, so it's a nice virtuous cycle that flows. So maybe a little -- still a little more pressure on the revenue line, but in general, the absolute dollar performance should remain consistent. And again, right, it -- that strategy produced 24% margin in Q2, so we're -- it's the right strategy for us.

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

Okay. Just a question for Madhu. Madhu, when you're talking about the Q3 factors, you said licenses would be within the range of the 2019 operating model. Did you mean for Q3 specifically? Or did you mean on a full year basis?

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

I meant on a full year basis.

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

And operator, as we go into our next question, I'd just like to touch base on what Richard asked for, Richard, on Coca-Cola. It's really kind of core Coca-Cola talking to bottlers now on our business network. And in FedEx, it's really fleet management. So I just wanted that out. Thank you, operator.

Operator

The next question comes from Paul Steep who's from Scotia Capital.

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

Mark, can you talk a little bit about cloud? You talked about the pipeline being 1/3 cloud-driven. Can you talk about what the momentum looks like across the broader set? Are you getting -- seeing that start to pull through? I know you've always been agnostic, but how that's developing and what changes you're maybe making in the sales force around that.

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

Paul, thanks for the question. We're -- we still see the world as hybrid, and hybrid is the destination, it's not a waypoint. So I -- again, in the 60-40, 40-60, I'm not ready to say 70-30. But there's no doubt that when I look at, for OpenText today, the greatest opportunity is cloud. We're only 20% penetrated into the install base today, whether it be for business network, managed services. OT2 is so young and new. We haven't even begun to tap the opportunity with the hyperscalers. So it doesn't change our thesis of hybrid, but unequivocally, the greatest opportunity for the company today is driving the adoption of the network, of the private cloud in new and native SaaS workloads.

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

Great. 2 quick follow-ups for Madhu largely here. Cloud margins at 60%, we saw a rebound there. Is that exceptional in terms of anything unusual in the quarter? Should we think of that as achievable going forward? And then the other one for you, with regards to IRS, can you just remind us of what we're at dollar wise for the contested value and then maybe a broad brush of what the next step actually is?

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

Sure thing. I'll take the second one first. We are at, I think, through the $770 million in terms of our estimated exposure, right? Again, it's a disclosure item. And as a follow-up to that, as we -- as I've stated in my prepared remarks, we continue to stand very strongly by our positions, our technical positions, and we continue to be, as you have said, contesting the amounts and the IRS thesis on it. Back to cloud margin. What I would say is that we did really well. As Mark mentioned, we are going to invest in the cloud, so it's going to be -- it's going to depend on the business need and what happens in 1 quarter versus the other. And as you know, we are onboarding Liaison and Catalyst into the business and they are both cloud services. And hence, our direction that -- think about the cloud margins still on an annual basis in the 57% and the 59% we have on our FY '19 target model.

Operator

The next question comes from Matthew Wells with Citi.

Matthew Wells

On the backdrop of M&A integration and the 100 bps headwind, it looks like you maintained the EBITDA margin expectations of 36% to 38%. And does this account for Catalyst integration headwinds? And what gives you confidence here?

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

Yes, Matthew. Thanks for the question. Yes, we -- to answer your question, it factors in Catalyst for sure. I said we'll get them on our operating model within the first 12 months. Might get there actually a little sooner, right? So we're not calling out Catalyst for any special effect, if you will, here. Liaison is a little larger, if you will. So in Q3 and Q4, it will have a slight impact to the growth, basically, of adjusted EBITDA. So we're confident in the range of 36% to 38%. We got great visibility into our expense run-rate. We're very disciplined in that visibility. We know the investments in hand. We only got 5 months to go, right, until the end of the year. So it's the visibility, it's our integration, history and expertise. We can have great visibility into Catalyst and Liaison, so we're confident in the 36% to 38% on the year.

Matthew Wells

Okay. That's really helpful. And then switching gears, I just have a question on as OpenText continues to partner with public cloud providers, how are you investing on the opportunity? And do you see any risk of clients churning from the OpenText Cloud to these providers?

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

Yes, it's an interesting question. We own and operate our own infrastructure. We've been -- we've built our OT -- we have acquired and built our cloud from 0 over the last 6 years. We worked from 0 to almost $1 billion run-rate annually. So we've got a lot of experience over the last year. The first workload that we think the hyperscalers can help us with, help our customers with, is the sort of secondary and tertiary workloads around disaster recovery backup. We're not in every market today, but Google's in various markets, so is AWS. So I think with those secondary, almost and sometimes tertiary workloads of Discovery -- sorry, DR backup, they're going to be helpful with. When we put our private cloud -- our public cloud is not going to run on a hyperscaler. So OT2 is not intended to run on a hyperscaler, so it's our private cloud. And when we have certain workloads, Google is the closest, customers will still get a better SLA from OpenText. And -- but a good enough SLA in a third-party cloud environment, and that's okay with us. We still want to win that -- the software platform -- the OpenText software piece, a third party can't win that. We're going to win -- we're going to provide the application performance management, and then the transformation services to leverage and use our software. So we're going after that value stack, not the hosted piece, if you will, with the hyperscalers. So there's really no risk to lose anything. It's sort of a trade-off of SLAs, is whether you run in the OpenText Cloud or run in a hyperscaler.

Operator

This concludes the question-and-answer session. I would now like to hand the call back over to Mr. Barrenechea for any closing remarks.

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

Very good. Well, I'd like to thank you for joining us today, and I'd like to conclude by leaving you with 3 things. Our top 3 messages that we wanted to convey today is that the OpenText Cloud is the greatest opportunity in front of us. Two, we've completed 2 acquisitions over the last 60 days and again, put $380 million of capital to work for a trailing 12-month revenues of $145 million, all cloud revenue, high-teens ROIC expected, 2.3x revenue multiple, and in the shorter term, it was a very solid quarter, with ARR of $530 million, up 3%, and adjusted EBITDA of 42% and operating cash flow of $190 million, up 14%, resulting in positive organic growth. Thanks for joining us today, and we look forward to seeing you in our investor conferences. Have a good day.

Operator

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