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OTEX.TO - Q3 2019 Open Text Corp Earnings Call

EVENT DATE/TIME: MAY 01, 2019 / 9:00PM GMT

OVERVIEW:

Co. reported 3Q19 total revenue of $719m, GAAP net income of $73m or $0.27 per diluted share.

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PRESENTATION

Operator

This is the conference operator. Welcome to the Open Text Corporation Third Quarter Fiscal 2019 Earnings Conference Call. (Operator Instructions) I would now like to turn the conference over to Greg Secord, Vice President of Investor Relations. Please go ahead.

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

Thank you, Operator, and good afternoon, everyone. On the call today is OpenText 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, direct investors to the Investor Relations section of our website, investors.opentext.com, where we have posted two presentations that will supplement our prepared remarks today. The first is our strategic overview, which is titled, "Open Text Investor Presentation." The second, titled "Q3 Financial and Business Results"; includes information and financials specific to our quarterly results, notably our updated quarterly factors, which are on Page 8.

In May and June, OpenText management is looking forward to meeting with investors in Canada and United States. Please feel free to reach to me or the IR team directly for more information.

And now, I'd like to tell you about some exciting investor events coming up in the next few months. OpenText will be participating in the CIBC Technology Conference in Toronto on Tuesday, May 14th, with Mark presenting as the lunch keynote that day. OpenText is also pleased to invite institutional investors and financial analysts to attend our User's Conference, OpenText Enterprise World, on Tuesday, July 9th, taking place at the Metro Toronto Convention Center in Toronto. Note, this event takes place during quiet period, so we will not offer an investor presentation or update on the company's performance or strategy. The conference will offer an incredible opportunity for investors and financial analysts to learn more about OpenText and the company's latest innovations in enterprise information management. It's a one-stop opportunity to research the company, full conference access, providing a great environment for open dialogue with our customers and partners onsite. Please contact investors@opentext.com or the IR team directly, and we'll give you more information and an RSVP for the event.

In addition, we'll be holding a Capital Markets Day for investors in the morning of Friday, September 6th in New York. This event will be our annual investor update, featuring strategic presentations from key members of our executive leadership team. Please save the date in your calendars, and we'll provide more details during our next earnings call.

And with that, I'll proceed to 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, of course, 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 Mark.

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

Thank you, Greg. And hello, everyone, and I appreciate you joining for our fiscal '19 Q3 call. Q3 is a continuation of our total growth strategy. Total revenues are up 7.7% to $738 million; annual recurring revenue, or ARR, is up 7.8% to $562 million; cloud is up 16% to $243 million, all in constant-currency. Also, adjusted EBITDA is up 320 basis points to 36.4%, and operating cash flow is up 6% to $286 million. By all accounts, this is a solid quarter, and customers are responding well to our enterprise information management products, or EIM; to our enterprise-ready cloud; and to our vision of the intelligent and connected enterprise.

Our Enterprise World Europe and Asia events this quarter underscore all of this, with over 2,000 attendees, 500 partners, 100 sessions, and 60 exhibitors. Our revenue growth was driven by demand within our core offerings of content services and business networks and the emerging importance of our security and AI products. The demand was both cloud and off-cloud. Our margin expansion was driven by additional scale and efficiencies in our cloud and support businesses, as well as product mix. Our cloud margin expanded 160 basis points year-over-year.

As we look longer-term, there continues to be ample opportunities to expand our margin. We take the approach that the best-run companies keep getting better year-over-year, and we plan to keep improving and expanding. Year-to-date, our adjusted EBITDA is 38.5%, already entering our fiscal 2021 aspirational range of 38% to 40%. We ended the quarter with $765 million in cash and a net debt to adjusted EBITDA ratio of 1.7 times. This is the strongest level in 8 quarters, and we have ample M&A capacity.

Given this incredible execution, progress and outlook, we are raising our quarterly dividend by 15% today, from $0.1518 to $0.1746 per share. Six years ago, we started our dividend program. Our first-year dividend was $71 million. Our last 4 quarter dividends totaled $163 million. And we have returned to shareholders a total of $667 million to date. Our capital allocation strategy continues to target returning 20% of our trailing 12-month operating cash flows to shareholders via our dividend program. Please note that, going forward, we plan to more naturally align our annual dividend review with our annual results earning call. So that means our next annual dividend review will be during our Q4 fiscal '20 call, not during our Q3 fiscal '20 earnings call. We'll remind everyone as we get closer to the date. We think that alignment to our annual calendar is a better way to do a dividend review.

The OpenText leadership team is world-class. They executed very well within the quarter while also on-boarding Liaison and Catalyst. And to note, both acquisitions are on target to be on the OpenText operating model and be fully integrated within the first 12 months.

It has also been 8 quarters since we acquired the ECD Documentum division from Dell EMC. Let's reflect on our incredible progress. We're now number 1 in content services, our core market, with a $15 billion total addressable market, or TAM; delivered double-digit cloud growth; stellar margins, 38.5% adjusted EBITDA year-to-date; $647 million OCF year-to-date; ample M&A capacity. We've rapidly de-levered and have returned to our pre-acquisition net debt to adjusted EBITDA levels. As I noted earlier, we're currently at 1.7 times. And through time, we have now returned $667 million in cash dividends and growing, far more than our $600 million equity offering in December 2016. We delivered these results by putting in action the OpenText Business System.

There are 5 key wins I'd like to highlight from the quarter as they reflect our strategy and our continued focus as an EIM software company. Tata Steel is a global provider of iron and steel, generating approximately $20 billion in revenues. Tata will be leveraging the Open Text Business Network to digitize their supply chains. It is a large and complex supply chain of sourcing, subcontractors, engineers, manufacturers, buyers, and sellers.

Norton Rose Fulbright is a global law firm of over 4,000 professionals and approximately $2 billion of revenues. Norton Rose will be leveraging our LegalTech software to provide advanced analytics and machine learning for legal review and discovery of critical evidence.

NTT DATA is a multinational system integration company with 118,000 employees and approximately $19 billion in revenues. NTT DATA will be leveraging our content services platform for its clients worldwide.

The European Parliament is extremely important in today's world as the binding party for EU policy, governance and law, reflecting 40 languages, hundreds of parliamentary members, and over 11,000 employees. The European Parliament is standardizing on OpenText Content Services and our information platform.

Canada is among the top 10 economies of the world, $1.8 trillion in annual commerce, 400,000 government employees, a G7 country, and the home, both physically and culturally, to OpenText. We are proud to announce that we have won the next-generation digital platform for the government of Canada. These

Q3 wins highlight our strategy execution around the Global 10,000, or G10K for short. The G10K are the world's largest companies, typically those greater than $2 billion in revenues, as well as the world's largest governments and organizations. This is the marquee market for EIM in organic growth. To date, we're only one-third penetrated in the G10K, and we can more than double OpenText in the coming years by focusing on and connecting the G10K to our information platform.

Let me also comment on our professional services. We run and operate one of the industry's most effective and profitable PS businesses. Over the last year, we've partnered more with global system integrators. We have discontinued low-margin contracts we inherited from acquisitions. And more work is becoming standardized and moving into the OpenText cloud. Within Q3, we delivered $71 million of revenues at 21% margins. You should expect the same levels of revenue here in Q4.

Finally, let me provide a brief update on our IRS matter. The IRS matter is following a standard IRS process, and we are now entering the appeals phase. As the matter has progressed and we begin to enter the next phase, time has strengthened our resolve. We remain steadfast in our position that the IRS is wrong, and we are vigorously defending our position.

Let me transition my remarks to fiscal '19 and the annual nature of our business. We plan on an annual basis. We measure ourselves annually. Our recurring revenue is just that - annual, or ARR. We typically deliver large product releases annually, and our customers budget annually while thinking over multi-year periods. We're an annual business. And running our business on an annual cycle allows us to make better long-term strategic and operational decisions centered on value creation. Quarters will vary. Any low single-digit quarterly variance is not meaningful in the context of our annual business. I'm excited about the growing basis of our annual recurring revenues.

In fiscal '09, 10 years ago, fiscal '09, our annual recurring revenues was $405 million. We have grown ARR every year over the last 10 years, including this year. Our ARR this fiscal year is on track to be greater than $2 billion, representing 400% growth over the last 10 years. We're also on target for our fiscal '19 business plan, and we're on target for our fiscal '19 target ranges and our fiscal '21 aspirations. On our next earnings call, we'll recap fiscal '19 and highlight fiscal '20 targets, as well as provide updated 3-year aspirations that will then include fiscal 2022. On our current annual trend, fiscal '19 will be a strong year for ARR, cloud revenues, adjusted EBITDA, and adjusted EBITDA dollars and cash flow.

Next, let us go through our Q4 quarterly factors. As a reminder, our quarterly factors are those key items for you to factor into your short-term financial modeling. The items are important but tactical, and these items do not affect the long-term nature of our business. Our Q4 factors include the following: global recession concerns continue. We all read the same newspapers. We see the same concern around trade wars, tariffs, goods and wage inflation, prolonged Brexit uncertainty, GDPR, and data regulation concerns. Secondly, the U.S. dollar continues to be strong against the euro, pound, Canadian dollar, and yen. Expect a Q4 negative revenue impact of approximately $20 million USD due to FX when compared to the prior year.

Third, our business is annual, as I said earlier, and quarters will vary. Given strong execution in Q3, do not expect the historical sequential revenue uplift in Q4 compared to Q3. Expect PS revenues to be consistent sequentially, and Q3 revenues were $71 million. Also, Q4 is the last quarter of the fiscal year. Expect operating expenses to be up quarter-over-quarter 4% to 6%, given end-of-year expenses. And though Q4 is a seasonally higher quarter for adjusted EBITDA, it is historically lower than Q2. And consistent with last quarter, we expect Liaison to negatively impact adjusted EBITDA by approximately 100 bps in Q4.

Looking beyond the short-term now, my fourth topic is to talk about the longer-term, the next 12 to 24 months and how we plan on competing, growing, and creating value. Let me step back and look at the big picture. Our business is incredibly strong. We have market-leading retention rates in our support business, powerful product releases, and incredible customer loyalty. Our core business is tremendous, and it is about 75% recurring and coming from highly predictable revenue sources. This will grow stronger, as more workloads and customers move to the Open Text cloud as more digital transformation happens, as security requirements grow, and the market transitions to Industry 4.0 and customers rely not just on automation, but AI and machine learning, as well.

Our flagship offering of Release 16 will have Enhancement Pack 6, or EP6, delivered to customers this month. Release 16 EP6 has intelligent capture, continuous endpoint monitoring, wider integrations to all major ERP and CRM providers. Our Cloud Suite 19.2 includes a new identity access management platform, application-to-application integration, and new track-and-trace capabilities. OT2 has a large update for industry applications and financial services, pharma, legal, and retail. We're already managing over 1.5 million trading partners, 30 million endpoints, and 60 million identities all in the OpenText cloud.

We built a comprehensive, horizontal market-leading information platform for digital transformation. Over the last 5 years via the OpenText Business System, we have deployed $4.5 billion in capital and $1.3 billion in R&D creating our intelligent information platform. We will continue to run our OpenText Business System playbook. We'll continue to acquire strategically, to then integrate and then to innovate, and deepen and strengthen our intelligent information platform for customers. We are now on the other side of an inflection point, an important milestone, where we can self-fund our core M&A. High margin and effective tax rate, low CapEx and strong cash flows has put us into this new and powerful zone of self-funding core M&A. The world's most trusted companies trust OpenText to transform into Industry 4.0.

Let me wrap up my prepared remarks. Q3 is a continuation of our total growth strategy, growth from acquisitions and growth from organic execution. It was a solid Q3, and we're on plan for fiscal '19. The Open Text cloud remains our greatest opportunity. Our enterprise cloud strategy is scaling into a $1 billion business. Our annual recurring businesses will be north of $2 billion this fiscal year, and our adjusted EBITDA year-to-date is already in our fiscal 2021 aspirational range of 38% to 40%. We are well on track to a record fiscal year for annual operating cash flow and a return of capital.

Since the inception of our dividend program, we have returned to shareholders $667 million. And given our confident outlook, as we mentioned earlier, we are raising our annual dividend by 15%. We are the market leader in both of our core markets of content services and business networks. Our roadmap has never been stronger, with additions like OT2, intelligent capture, new IAM and Liaison application-to-application integration. Our total addressable market is $100 billion. We have a strong balance sheet and getting stronger, with ample M&A capacity to deploy on the right target at the right ROIC. Our M&A pipeline is active. Our R&D pipeline is strong.

I'm sure I'll see many of you before our Global Enterprise World event. I hope you can make the Toronto event July 9th. Sir Tim Berners-Lee, the inventor of the World Wide Web, will be joining me at Enterprise World, and Sir Tim will be outlining a compelling vision of what's next over the World Wide Web. We look forward to our very bright future, and thank you for the support of OpenText. It's my pleasure to hand the call over to our CFO, Madhu. Madhu?

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

Thank you, Mark, and hello, and thank you all for joining us today. Q3's results strongly reflect our collective efforts to maintain upper quartile operational performance, including integration work on two acquisitions. The results show consistent and significant improvement over last year across all key metrics.

Now, turning to details of our quarterly and year-to-date results, and similar to prior quarters, my references will be in millions of USD and compared to the same period in a prior fiscal year. As you will see from our results, the impact of foreign exchange was significant and broad across all lines of revenue at $19 million during the quarter and $31 million year-to-date, given the strength of the USD since the start of our fiscal 2019.

Total revenues for the quarter were $719 million, up 4.9% or up 7.7% on a constant-currency basis. As we continue to look at our business on an annual basis, year-to-date total revenues were $2.1 billion, up 2.9% or up 4.5% on a constant-currency basis. The geographical split of revenues in the quarter was Americas 61%, EMEA 30%, and APJ 9%. Annual recurring revenues were $549 million for the quarter, up 5.4% or up 7.8% on a constant-currency basis. Year-to-date, annual recurring revenues were $1.6 billion, up 4.7% from last year or up 6% on a constant-currency basis. Annual recurring revenues as a percentage of total revenues remain solid at 76.4% and 75.4% respectively for the quarter and year-to-date.

Our cloud revenues were particularly strong in the quarter at $239 million, up 14.1% or up 16.1% on a constant-currency basis. We also generated $63.8 million in new MCV, up compared to $52.7 million in Q3 last year. Year-to-date, cloud revenues were $666 million, up 9% from last year or up 10% on a constant-currency basis. Cloud renewals remain in the mid-90s range. Our customer support revenues were $311 million, down 0.5% or up 2.3% on a constant-currency basis. Year-to-date, customer support revenues were $933 million, up 1.8% from last year or up 3.3% on a constant-currency basis. Our customer support renewal rate was consistent with prior quarters and prior years at approximately 91%.

Our license revenues were $99 million, up 17.4% or up 22.2% on a constant-currency basis. Year-to-date, license revenues were $308 million, up 3.6% from last year or up 5.9% on a constant-currency basis. Our professional service revenues were $71 million, down 11.6% or down 8.4% on a constant-currency basis. Year-to-date, professional service revenues were $215 million, down 9.3% from last year or down 7.1% on a constant-currency basis.

Turning to the details of our margin performance in Q3, GAAP gross margin for the quarter was 67%, up 210 basis points over the same period last year. Our adjusted gross margin for the quarter was 73%, up 140 basis points over the same quarter last year and primarily driven by scale and product mix. Cloud was 57%, up from 55% last year. Customer support was 90%, up from 89% last year. Our license margin was 97%, up from 96% last year. And professional services margin was 21%, up from 20% last year. FX had a negative impact on adjusted gross margin in the quarter by approximately $14 million.

Our adjusted EBITDA was $262 million this quarter, up 15% year-over-year. Adjusted EBITDA margin was 36.4%, an increase of 320 basis points compared to 33.2% in the prior fiscal year and driven by our deep operating lens into the business as well as the restructuring activities we first announced in our Q1 call. Year-to-date, adjusted EBITDA was $816 million, up 10.5% compared to the same period last year. Adjusted EBITDA margin year-to-date was 38.5%, an increase of 270 basis points compared to 35.8% in the same period last year.

GAAP net income for the quarter was $73 million, up $0.27 per share on a diluted basis, up from $59 million, or $0.22 per share for the same period last year. Year-to-date, GAAP net income was $214 million, or $0.79 per share on a diluted basis, up from $181 million, or $0.68 per share for the same period last year. Our adjusted net income in the quarter was $173 million, up 18.6% year-over-year or up 21.2% on a constant-currency basis. Year-to-date, adjusted net income was $550 million, up 12% compared to the same period last year, or up 12.5% on a constant-currency basis.

Our adjusted earnings per share for the quarter were $0.64 on a diluted basis, up 18.5% from $0.54 per share for the same period last year. Year-to-date, our adjusted earnings per share was $2.04, up 10.9% from $1.84 for the same period last year. Our operating cash flows for the quarter were $286 million, up 5.7% year-over-year. Year-to-date, operating cash flows were $647 million, up 28.3% from the same period last year.

And turning to the balance sheet, we had $765 million in cash net of the $70 million payment for Catalyst. Our consolidated net leverage ratio at 1.7 times is well within our external debt covenant ratio of 4 times and provides us with meaningful flexibility to execute on our total growth strategy. In the third quarter, DSO was 60 days and compared to 67 days in the same quarter last year. We achieved record quarterly collections in the quarter. And overall, a huge applause to the OpenText teams for achieving such outstanding cash flow results while integrating two acquisitions in the quarter. We continue to learn from and optimize our cash management framework.

On dividend, as Mark indicated in his remarks, we are very pleased to be raising our quarterly dividend by 15% today, up from $0.1518 to $0.1746 per share. Our dividend program continues to be a very important component of our capital allocation strategy.

And now for perspectives on our operating model. As Mark outlined, we remain on track to our fiscal 2019 target model which, as a reminder, is included in our investor presentation on our IR website. So let me summarize and reiterate the quarterly factors that we anticipate for our fiscal Q4. Q3 was negatively impacted by FX of $19 million. As we look at where the rates are today, as well as geographical level components of our business, we expect FX headwind in Q4 of approximately $20 million. Given strong execution in Q3, do not expect historical sequential uplift in Q4 compared to Q3, PS revenues in Q4 to remain constant sequentially, and Q3 PS revenues of $71 million.

As the last quarter of our fiscal year in Q4, we expect operating expenses to be up quarter-over-quarter in the range of 4% to 6%, and given end-of-year expenses. With respect to adjusted EBITDA, Q4 is a seasonally higher quarter, although historically lower than Q2. And Liaison is expected to negatively impact adjusted EBITDA by approximately 100 basis points in Q4. It is important to incorporate these quarterly factors as you model us for Q4. Note that Liaison and Catalyst remain on target to be on our operating model and to be fully integrated in the first 12 months.

On the interest expenses, they remain as noted in our fiscal '19 target model of $144 million to $149 million, and our adjusted tax rate remains at 14%. So turning to our long-term targets, as Mark mentioned, with year-to-date adjusted EBITDA margin at 38.5% and year-to-date operating cash flows at $647, we are strongly on our way to adjusted EBITDA margin in fiscal 2021 of 38% to 40% and operating cash flows target of $1 billion annually as we exit fiscal 2021. On our next earnings call, we look forward to recapping fiscal 2019, sharing highlights of our expectations for fiscal 2020, and provide updated 3-year aspirations to include 2022.

At the start of the year, we introduced our communication framework and quarterly factors to help you model OpenText in a way that is closely aligned to how we see our business. And within that framework, there are two metrics at the end of each fiscal year that we will provide to you on a historical basis - annual organic growth and return on invested capital, or ROIC. We will update you on both of these annual metrics during our next call.

So before I conclude, I am really excited, on behalf of Mark and the management team, to welcome Harry Blount to OpenText. Harry has joined our team this week as Senior Vice President and head of Investor Relations. Harry brings decades of broad experiences and will oversee all aspects of our global Investor Relations strategy with the continued support and leadership of Greg Secord. Greg has served OpenText extremely well, and with the addition of Harry's leadership, we're excited and confident that the enhanced Investor Relations team will help drive several important initiatives for us. So Harry, would be great if you can share a few words.

Harry Blount - *Open Text Corporation - Senior Vice-President of IR*

Thank you, and thank you to Mark, Madhu, and Greg. I'm very excited to join the team and be part of the next phase of the company's growth. OpenText has built a strong leadership position in enterprise information management, driven by strong execution, financial discipline, and our total growth strategy. I look forward to meeting many of you in the coming weeks and the very bright future ahead. Thank you, Madhu.

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

Thank you, Harry, and welcome again. So, in summary, our Q3 results are a great reflection of the high performance of the OpenText team as we continue to drive operational excellence. A big thank-you to everyone. We look forward to sharing our continued progress over the long-term with you, our shareholders, whose trust and confidence we greatly value. During May and June, we plan to engage with our investors and analysts through conferences and one-on-one meetings in Canada and the United States. Please do connect with Greg Secord for more information.

So at this time, I would like to open the call for your questions. Operator?

QUESTIONS AND ANSWERS

Operator

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

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

A couple of quick ones from me. First, I think maybe a question for Madhu on the strong license revenue. Was wondering if you could elaborate a little bit on that, just given that it's a seasonally light quarter. Just based on your comments around the quarterly factors, wanted to make sure I understood it correctly, so that it was mainly driven by timing or pull-forward of deals? I was just wondering if it was at all driven by perhaps larger deal sizes or any other factors that you'd point out.

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

It's Mark here. I'll probably take the first one, and on quarterly factors, Madhu can certainly speak a little more deeply to the quarterly factors.

We had a strong quarter in both cloud and off-cloud, and it was driven by competing very effectively against IBM. There's a new enterprise software landscape forming. So we've always been -- as we've transitioned to the cloud and transitioned to our recurring revenue focused, we are agnostic to how customers purchase, whether it be a license, a subscription, a managed service, other options in our cloud. So we're not calling out any larger deals. Q3 was a continuation of our total growth strategy, both organically and acquisition. I will note, we are competing very effectively on what I call the new enterprise software landscape that has a shrinking IBM presence in it.

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

Thank you, Mark. And do you want to expand on your question on the quarterly factors so that I--?

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

--No, just based on the comments around the sequential fiscal Q3 to Q4, not (inaudible) because of the strong execution. I was just trying to, I guess, piece together the puzzle, whether it was driven by just a pull-forward of deals into fiscal Q3, and that's why we're not seeing the historical bump into Q4. Or was the strength driven by other factors that you would also point out? I think Mark answered part of the question on not calling out larger deal sizes, but was wondering if there were any other factors that drove the strong license revenue this quarter.

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

Right. So, Mark I think addressed the license revenue. I would just -- I mean, I would just reiterate, just when you look at Q4 revenue, right, there are 3 factors. One is the FX, and we are looking at where we sit today at about $20 million impact to Q4. And back to the overall strong execution in Q3 license and the cloud, it's important to not expect the same historical sequential uplift in Q4. And of course, professional services, for all the reasons outlined. We do expect a constant PS revenues between Q3 and Q4.

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

I think the only thing I would add to Madhu's statement, if I can, is back to the other remarks -- to the prepared remarks. We're an annual business, right, and any given quarter might vary a little here or there, but we're very focused on the annual nature of the business. And again, Phillip, to the question, we're not calling out any big deals. We compete [it] second. We're competing very effectively on what I call the new enterprise software landscape. We're competing effectively against those incumbents like IBM and others, and we've got a strong outlook.

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

That's very helpful. And then just quickly on the global recessions concerns, I know it's a very similar wording that you put in in the last quarterly factors, as well. Was just wondering if you could give us an update on any visibility on potential impact to your pipeline. I know you mentioned that there wasn't any that you've noted in the last quarter, so was wondering what your thoughts are for an update on that comment.

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

Yes. We're keeping it in our quarterly factors. We don't see a change yet to the trajectory of our business, but I'll just continue to note, you don't know where Brexit still is going to land. There are headline news around growth in Europe plateauing or shrinking slightly. Typically what you would see is either the close dates moving out, deal size shrinking, more approvals coming into place. We're not seeing any of those statistical factors in our pipeline. But I think it's healthy to kind of continue to call out a headline kind of bullet in this category.

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 I'm attending a conference this week, and the theme of this event has largely been this explosion of data. It seems to be still a fairly big pain point for a lot of enterprises. I'm kind of just wondering, in your role I think on the technology side as well, what you see today as sort of your biggest challenges from your customers when it comes to data.

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

Richard, thanks for the question. I think I'll put my CTO hat on for a moment, little more of a CTO question. I think back 10 years ago. I remember the headline, "Mobile Eats the World"; I think back a few years ago, and we're all software companies, right? And maybe the headline this year or next year is, "We're All Data Companies." And how can each company unlock their data and monetize -- excuse me, leverage the data to make them smarter, a more effective competitor in the market, or to use their data or data exhaust to go out into the market and go sell. And I think back over the last 10 years, ERP has really provided a processed advantage. I think over the next 10 years a look at EIM, we're here to provide the information advantage.

So I think the biggest challenge right now, when I look into the enterprise landscape, is taking an inventory of the data. Is it in the right format? And do I have the right tools to kind of unlock that data exhaust? So I think the greatest challenge right now is I think everyone gets it. They understand it. The landscape is shifting from process automation to leveraging the data. So we see trends like platform consolidation, master data management, getting data into a usable format, picking the right algorithms, right, to make yourself better, or can you then get to a next step to sell your data in the right way for that information advantage.

And then, of course, is it secure, is it governed, does it meet the right privacy? So I think, Richard, it's a great actual question, and those are some of the immediate things that I see. And I think we sit in a great place to help take advantage of it.

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

Yes, it sounds like you are. And I guess the context of my question is that, when you look at products that you have, like Magellan, for instance, do you think that we're in a position that your enterprise customers are currently evaluating it, and we could see this potential that you kind of get a real material increase in those products? And also, what has the traction been like for Magellan lately?

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

Yes. Well, I think there are 2 things. The first is Microsoft is a wide, horizontal company. You don't have the pharma version of Word, right, or the paper and pulp version of Excel, right? They're a wide, horizontal platform. OpenText is a wide, horizontal platform. And we want to get into the Global 10,000 and be the standard for the horizontal information platform. We want their supply chain, cash management, content services, we want to be the standard for that intelligent and information core for that wide, horizontal platform. And that is the largest opportunity in front of us to keep driving that type of penetration.

On top of that, we're going to continue to deliver vertical applications. OT2 is coming to market with healthcare, financial services, legal tech applications. And then another pillar on top of that for a long-term strategy is the AI and analytics with Magellan. And of course, securing that platform, as well.

So it's still early days with Magellan. It is contributing to the P&L, and it's a very strategic piece for us in the future.

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

And just one last one from me with respect to the acquisitions. Have you changed the comfort level in terms of what your leverage ratio is? I forgot what it was last quarter, but if you'd just remind us, that'd be great. Thank you.

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

Thanks, Richard. No, we still believe in the same ratios, that we think up to 3 times leverage is a comfortable zone. I think we all can take some confidence in looking back over the last 2 years. There's one thing for a management team to say what they believe in and then deliver data points performance. We said we would be comfortable going over that slightly in the short-term, and then rapidly de-levering if we needed to. So we went up to about 3.3 times when we completed the Documentum/EMC acquisition, and here we are 8 quarters later sitting at 1.7X of net debt to adjusted EBITDA ratio.

So our philosophy is consistent, hasn't changed, of going up to 3 times, and I think we can take confidence that, if we do need to go above it, we would rapidly de-lever just as we have shown.

Operator

Our next question comes from Walter Pritchard of Citi Research.

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

Couple question here, Mark. Just on the IBM side, I wonder if you could call out which areas of the business are you seeing that. I mean, obviously not a new trend, but they took [business that did the best] (inaudible) this quarter. I'm curious which areas of the business are you seeing in particular that resonate positively in your sale pipeline and activity.

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

Yes, thanks, Walter. I'd say 3 areas. The first is FileNet. We've called out a few times where they have not been innovating as rapidly. And the enterprise landscape is just changing -- excuse me, let me correct myself -- has changed, and that there really is a new set of enterprise software companies, from Slack, ServiceNow. I'm putting ourselves in this category as well. As companies look to get that information advantage versus a process advantage, we've turned our platform into a cloud-ready platform, containerized. We have a SAAS version, with OT2. We have deep application integration, deep SAAS integration, integration to SAP, to Oracle, to Salesforce. And we're just competing very effectively against a FileNet.

The second area is IBM Sterling Commerce, which is their commerce platform. And the commerce platform has evolved. It's evolved into an identity and access management platform. We acquired Covisint Technologies and been able to bring in and bring version 2 and version 3 their identity and access platform. And I think we're up to almost -- we're well over 10 million IOT devices connected into our network.

Our acquisition of Liaison has put us into the market of any-to-any integration. I hate to throw out examples like this, but I'll use an example of Mulesoft, right, where we now have a library of 10,000 canonical connectors where we can tie ERP to ERP, cloud to cloud, process to process within our business network. So we're competing very effectively against IBM and Sterling Commerce.

And lastly, the IBM cloud is sort of a -- clouds are not a place to go to just get a cost advantage. It needs to be a platform of innovation. And so I look at our cloud today and us being able to provide this full EIM stack. And yes, we can provide a cost advantage and security, but we can also now provide it as a platform for innovation for the next generation of workloads.

So, these are the 3 areas we're competing effectively - content services, commerce platform, and the cloud.

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

And then, maybe, Mark, for you, as you brought this up on the call, around sort of a new era and other side of an inflection where you can self-fund M&A, but then still mentioning the 3X leverage. Is the takeaway here just, as you get larger, you can do bigger deals, or should we expect -- I'd almost think if you're talking about self-funding, you may be looking to take on less leverage, going forward. Help us interpret what you were saying there.

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

Yes, I don't know if it -- all of the above. Look, it's always the right deal at the right price with the right ROIC. And it's really a very simple mantra for us. And our pipeline is active, as I like to say, in small, medium, and large categories. Got to be the right company at the right price in the right ROIC. Our model is different than other companies. We look to acquire, integrate and innovate. We've delivered a -- we're delivering a horizontal platform. So pipeline active. We have ample capacity. In general, we think as a management philosophy up to 3X leverage is a good ratio. Say it very simply, if the world will go sideways, I like to pay my debt off in 3 years, right? I mean, that's the philosophy of a ratio. And if we take our cash flows and just very simply take out interest, take out dividend, take out CapEx, that puts us in a place to be able to self-fund, self-perpetuate our core M&A.

Operator

Our next question comes from Howard Leung of Veritas Investment Research.

Howard Leung - *Veritas Investment Research Corporation - Investment Analyst*

Thanks for taking my question. I had a few of them. The first one I'll start with is for the gross cloud margin. They're kind of at the 56%, 57% level now for a few years. Can you maybe give some comments or some color around what could potentially drive it higher and what you see is the result -- is why it's kind of stayed at that level?

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

Howard, welcome, and thanks for the question. Mark here. So we delivered 56.5% cloud margin in the quarter, up 150 basis points year-over-year. And last quarter, we were just under 60% in cloud margin.

Look, we're targeting medium-term to be in the low 60s for our cloud margin. And as we've on-boarded new acquisitions like Liaison and Catalyst, and making investments to grow in the cloud, cloud was $243 million in constant-currency this quarter, up 16%, margins have dipped a little bit below 60%, but all for the right reasons, right, to grow the cloud, to on-board a couple great acquisitions. And note the margin is up year-over-year 150 basis points. And our target range for the year is between 57% and 59%, and we're smack in that range. So it's right where we want it to be.

Howard Leung - *Veritas Investment Research Corporation - Investment Analyst*

That's very helpful. And then, the other one I wanted to touch on was on license revenues. It looks like for the quarter, based on the MD&A, there was a $17 million impact from the 605/606 conversion, and I think that was just kind of acceleration of some of the licenses upfront. Just want to find out, for that $17 million, how many term licenses were sold that contributed to the $17 million?

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

Howard, a very detailed question. Let me start sort of at the conceptual piece. So, first and foremost for us, it's all about how a customer wants to buy. And we don't go into the Global 10,000 and say, "You must buy this one way." It's all around how a customer wants to procure and deploy. So if they want to do that in our cloud, off-cloud, license, or in somebody else's cloud, we're all in, right? For us, it's all about the annual recurring revenue, adjusted EBITDA, and cash flow. So I've just started at the principled level. It's all about how a customer wants to procure.

Second, the 606 business, it's all new business for us, right? These are brand-new wins. These are new contracts. It's all new business for us. And third, there is no alternative. It is GAAP, and it is the standard. There is no alternative for us. So I don't know if that answers your question or if there's another level to the question that you have.

Howard Leung - *Veritas Investment Research Corporation - Investment Analyst*

I mean, I completely understand. It's not an accounting choice at all. It's just a change in the policy. I was just wondering, for these new licenses which you have signed for the quarter, it's not in any way I guess pulling forward from future quarters. It's just kind of new business that you guys won?

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

No, new business, new wins, very good wins.

Howard Leung - *Veritas Investment Research Corporation - Investment Analyst*

It looks very strong this quarter, so that's good. Thanks, guys, that was really helpful.

Operator

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

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

I just wanted to touch on services revenue for a minute. Mark, I was hoping you can give us a bit of an update on your thoughts on that services business, and maybe go into a bit more detail of the puts and takes that you mentioned in your prepared remarks.

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

Thanks for the question. We run a very -- I think of our PS business sort of in 3 pillars. Pillar 1 is always accelerated time to value for the customer. And we run one of the best PS organizations inside a software company. Our PS organization does an amazing job deploying our software, getting accelerated time to value. I'd put our organization up against anyone's any day.

Second is, can you do that profitably? And I look back to companies like BMC, CA, other large enterprise companies who had run their PS businesses at no to negative margin. And that's just not in our philosophy. It's not a loss leader. It's a profit center, because there's value that we're delivering for customers. So regardless of our revenue levels, we've been able to deliver margins around 20%, which is in the zone of the world's best-run PS businesses.

The third sort of pillar, if you will, is the quantum of the revenue. And we've taken out the strategy that we're going to bring on more global system implementers, like an NTT, like TCS, Accenture, Deloitte, others, and they're going to go out and put us into their framework, and we think we can grow the more strategic revenues of cloud by having that partnership. We're going to give up some PS revenues to do that, and that's perfectly okay.

Second is, as more work becomes standard in the cloud, and it's configured, it's self-serviced, you need less of the PS organization. And that's fine, as well.

And then, thirdly, we acquire businesses that don't quite have our philosophy of how to run a PS business, and we need to wean ourselves off that and complete deployments, and then move on. So, I mean, those are the 3 reasons why PS is down slightly. Other revenues are up, and it's all for the right strategic reasons.

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

And then, in terms of your slide deck, the slide on selected customer and product expansion seems to be growing here. I'm hoping you can talk about cross-sell opportunities in the install base and whether they were a factor in the outperformance in the quarter.

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

Thanks for pulling it out. We have it in our investor deck, and I'm just reaching for it here, Slide 13, 14, and 15, where we have selected customer and product expansions, where we're kind of showing businesses like Coca-Cola, Fujitsu, GM, Nestle, who are running multiple pillars for us. Look, it is a key strategy for us, is to have a strong portfolio of solutions to provide. I'd go back to some of my earlier comments around how we've expanded our offering, and companies like IBM have not in content services and/or the business network.

I'd say the strength in the quarter was, again, I'd go back to our two core markets, content services and business network, and just keep widening the capabilities we're deploying.

Operator

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

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

With respect to your Q4 outlook, I'm just a little unclear on your commentary. So just to be very clear, are you suggesting there will be no quarter-on-quarter revenue uptick, or are you suggesting that there may be a quarterly revenue uptick, but that it will be a more modest uptick than we've seen historically for Q4?

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

There will be -- we expect an uptick, just not as seasonally strong.

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

That's what I thought, but I just wanted to confirm that point. In terms of cash flows, your cash flow was obviously up year-over-year, as you highlighted, although your cash conversion of EBITDA was lower than for Q3 last year. Was that just because of a working capital drag from the two recent tuck-in acquisitions?

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

Yes, Thanos, this is Madhu. I would say yes, and some of the billings and the deferred revenue this quarter were also much higher, right? So that also contributed to the conversion. But the conversion is still very high, keep in mind.

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

And just one last one from me. Was all the Liaison/Catalyst revenue in the cloud services line, or was it sprinkled in some other lines, as well?

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

It's predominantly in the cloud services line.

Operator

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

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

In regards to the (inaudible), I don't want to beat a dead horse, but you mentioned FileNet. I remember before when they were public, they had some very significant deals in the 8-figure range. Just hoping you can put some bounds around the potential size of deals, if you can confirm that there weren't any deals as large as in the 8-figures.

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

Yes. FileNet, they've been private a long time, haven't -- they've been private a long time. Thanos, we're not calling out any larger deals in the quarter. So I appreciate the commentary. Again, we're competing very effectively in our 2 core markets, and we're not here to call out any larger transaction.

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

Just turning to Documentum or EMC/ECD when you mentioned that earlier, how does the -- are you seeing Documentum customers migrate to the latest versions of your products at a similar rate to the core OpenText customers and also consider your cloud as a similar rate as your core business?

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

Paul, thanks for the question. I can just say, off the top of my head, I'm not seeing any real difference in a rate of upgrade or migration. I'll have to go back and kind of check the data, but I'm pretty data-sensitive, but nothing's sort of jumping out at me as a different rate.

In terms of embracing the cloud, this is a strong upsell opportunity for us. And customers are looking -- I used this phrase a little earlier -- a platform for innovation. And our cloud allows our customers to get the latest and greatest software, to get a fuller stack of software, to remove the burdens of security and compliance and management, up time, and really free their brains up to innovate.

So yes, the ability to upsell managed services, to upsell SAAS workloads, is a strong opportunity for us in the Documentum base.

Operator

Our next question comes from Steven Li of Raymond James.

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

I have a question for Madhu. So, Madhu, given 606 has a positive impact on revenue recognition, when you do your organic growth calculation next quarter, would you be adjusting out the positive 606 impact, given you're base in 2018 would be on 605?

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

Thank you for the question. I'd go back to what Mark said earlier. Growth is growth, and new business is new business, and all of this is new business, right? So when we look at the Q4, we are looking at new businesses. And what I'd probably point out is look at the $739 million of revenue in constant-currency. And even if you took the $21 million that we shared as sort of adjustment 605 to 606, it's $718 million. And if you do apples-to-apples, it was $686 million in Q3 of last year but $698 for 605 adjusted. We still grew, from $698 million to $718 million, and I would encourage that's how you think about growth.

Operator

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

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

All right. Thank you, Madhu. Thank you, Greg. Thank you, Harry. And thank you, everyone, for joining our call today. I'm excited about the quarter, the direction of the business, our leadership in content services in the business network, the OpenText cloud. And you can obviously hear in my voice, I'm excited about the future. Hope to see you at the CIBC Conference in May and Enterprise World in July. And have a great rest of the week. Thanks for joining the call.

Operator

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