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OTC.TO - Q3 2016 Open Text Corp Earnings Call

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OVERVIEW:

Co. reported YTD total revenue of $1.34b and GAAP net income of $198m or $1.62 per diluted share. 3Q16 total revenue was $441m and GAAP net income was $69m or $0.57 per diluted share.

CORPORATE PARTICIPANTS

Greg Secord *Open Text Corporation - VP of IR*
John Doolittle *Open Text Corporation - CFO*
Steve Murphy *Open Text Corporation - President*
Mark Barrenechea *Open Text Corporation - CEO & CTO*

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PRESENTATION

Operator

Welcome to the Open Text Corporation third quarter 2016 financial results conference call. As a reminder all participants are in a listen-only mode and the conference is being recorded.

(Operator Instructions)

I would like to turn the conference over to Mr. Greg Secord, Vice President, Investor Relations.

Greg Secord ***- Open Text Corporation - VP of IR***

Thank you and good afternoon, everyone. I'd like to welcome you to today's call. With me is OpenText President, Steve Murphy; OpenText's CEO and CTO, Mark J. Barrenechea and our Chief Financial Officer, John Doolittle. As with our previous calls, we'll read prepared remarks followed by a question-and-answer session. The call will last approximately one hour with a replay available shortly thereafter.

I would like to take a moment and direct investors to the Investor Relations section of our website where we posted several PowerPoints that may be referred to during this call including our quarterly supplemental update on the financial results as well as our recently announced acquisitions. I encourage all investors to download the presentations.

As with previous quarters, we've updated a summary table highlighting OpenText's historical trends and financial metrics. These trended financial spreadsheet is downloadable from the front page of the IR section of our website as well. OpenText will be hosting an Investor Day in New York on Thursday, May 12. If you're interested in attending or want to find out more information, please contact myself or the Investor Relations team directly. And with that, I'll proceed to 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 while making a forecast or projection as reflected in the forward-looking information.

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 and the material factors or assumptions that were applied in drawing a conclusion while making a forecast or projection as reflected in the forward-looking information, as well as risk factors that may affect the future performance results of OpenText are contained OpenText's Forms 10-K and 10-Q, as well as in our press release that was distributed earlier this afternoon. Each of which may be found on our website.

We undertake no obligation to update these forward-looking statements unless required to do so by law. In addition, our conference call will include a discussion of certain non-GAAP financial measures. Reconciliations of non-GAAP financial measures to their most directly comparable GAAP measures have been included in today's press release, which of course, can be found on the website. With that, I'll turn the call over to John.

John Doolittle *- Open Text Corporation - CFO*

Very good. Thank you very much, Greg. Welcome everybody to the call. Let's go through the numbers and my references will all be in millions of US dollars unless I indicate otherwise. Total revenue for the quarter was $441 million, down 2% compared to $448 million for the same period last year, and up 2% on constant currency basis. This decrease is related to our professional services performance in the quarter, and Steve will comment.

For FY16 year-to-date, total revenue was $1.34 billion, down 2% compared to $1.369 billion for the same period last year, and up 4% on a constant currency basis. Recurring revenue for the quarter was $376 million, down 2% year-over-year compared to $384 million, for the same period last year, and up 1% on a constant currency basis. For FY16 year-to-date, recurring revenue was $1.143 billion, down 2.5% compared to $1.172 billion for the same period last year, and up 3% on constant currency basis.

Next, the impact of foreign exchange. In Q3, our revenues were negatively impacted by $15 million and the adjusted EPS was negatively impacted by $0.01 compared to the same period last year. The negative effect of $15 million by revenue type is broken down as follows; license, $3 million; cloud services, $4 million; customer support, $6 million; and professional services and other, $2 million.

For FY16 year-to-date, our revenues were negatively impacted by $80 million and adjusted EPS negatively impacted by $0.14. The negative effect of $80 million by revenue type is broken down as follows; license, $16 million; cloud services, $19 million; customer support, $33 million; and professional services and other, $12 million.

License revenue for the quarter remained stable at $64 million compared to the same period last year, and up 6% in constant currency. For FY16 year-to-date, license revenue was stable at approximately $198 million, and up 8% on a constant currency basis.

Cloud services revenue for the quarter remained stable at $148 million compared to the same period last year, and up 3% in constant currency. Year-to-date, cloud services revenue is $444 million, down 3% compared to $456 million during the same period last year, and up 2% in constant currency.

New MCV bookings this quarter were $46 million, compared to $38 million in the same period last year, up 21%. Year-to-date, new MCV bookings were $144 million, stable compared to last year, and up 4% in constant currency.

Customer support revenue for the quarter was stable at $184 million compared to the same period last year, and up 3% in constant currency. Year-to-date, customer support revenue is $553 million, up 1% compared to $548 million during the same period last year, and up 7% in constant currency.

Professional services and other revenue for the quarter was $45 million, down 14% compared to $52 million in the same period last year, and down 10% in constant currency. Year-to-date, professional services and other revenue is $145 million, down 14% compared to $168 million during the same period last year, and down 7% in constant currency.

Gross margins for the quarter were basically flat with the exception of professional services. License margins increased to 96% from approximately 95%, primarily due to lower third-party technology costs. Cloud services and subscriptions margin was 58%, compared to 59% in the same period last year. Customer support margin increased to 88%, compared to 87% in the same period last year, primarily due to a reduction in direct labor costs. And professional services margin was 16%, compared to 19% in the same period last year, due to the decline in revenue.

For similar reasons, gross margins year-to-date are as follows; License margin is 96%, compared to 95% in the same period last year; cloud services is 60%, compared to 61% in the same period last year; customer support 88%, compared to 87% in the same period last year; and professional services 21%, compared to 23% in the same period last year.

Adjusted operating income was $138 million this quarter, up 20% compared to $115 million in Q3 of last year. On a constant currency basis, adjusted operating income was $139 million, up 21%. Year-to-date, adjusted operating income is $459 million, up 8% compared to $424 million during the same period last year. And on a constant currency basis, it was $479 million, up 13%.

Adjusted operating income was up both the quarter and year-to-date basis as a result of a decrease in expenses of approximately $30 million and $63 million, respectively, resulting from restructuring efforts announced in May 2015, integration of actuate and ongoing expense management.

Adjusted net income increased by 21% to $98 million this quarter, up from $81 million in Q3 of last fiscal year. This is primarily due to a $23 million increase in adjusted operating income that was partially offset by higher taxes due to the change in the Company's adjusted tax rate from 18% to 20%.

Year-to-date, adjusted net income was $323 million, up 2% from $318 million during the same period last year, and up $22 million, or 7% on a constant currency basis. The increase on the year-to-date basis is primarily due to an increase in adjusted operating income of $35 million, partially offset by higher interest from the high yield notes that were issued in Q3 of last year and a higher tax rate, as I mentioned previously.

Interest expense was $16 million in the third quarter after recognizing approximately $2 million and income earned from our cost basis investments. Net interest expense this quarter is comparable to $16 million last year. On a year-to-date basis, interest expense is up $18 million due to interest on the high-yield notes and offset by the income that's been earned from cost basis investments, as I mentioned.

Adjusted earnings per share was $0.80 on a diluted basis, compared to $0.66 for the same period last year, up 21%. On a constant currency basis, adjusted earnings per share was $0.81, up 23%. Year-to-date, adjusted earnings per share $2.65 per share on a diluted basis, compared to $2.59 for same period last year, up 2% and up 8% on a constant currency basis of $2.79.

GAAP net income for the quarter was $69 million, or $0.57 a share on a diluted basis, compared to $27 million, or $0.22 per share on a diluted basis in Q3 of last year. Year-to-date, net income was $198 million, or $1.62 per share on a diluted basis, compared to $165 million, or $1.35 per share on a diluted basis last year. There were approximately 121.7 million shares outstanding on a fully diluted basis for the third quarter, and on a year-to-date basis, there were 122 million shares outstanding on a fully diluted basis.

Operating cash flow for the quarter was approximately $190 million, an increase of 33% compared to $143 million in the same period last year. The increase was primarily due to an increase in net income of $43 million. Seasonally driven increase in deferred customer support revenue and active management of our working capital. Driving cash flow improvements continues to be a top priority.

On the balance sheet at March 31, deferred revenues were $402 million, compared to $386 million at June 2015, and this increase is normal course. Accounts receivable, $266 million at March 31, 2016, compared to $284 million at June 30, 2015 and our trade accounts payable stood at $44 million, compared to $16 million on June 30, 2015. Year-to-date, the net positive change from these two working capital items is approximately $50 million.

Now, to the external target model. I reiterate the comments that I made last quarter, we are maintaining our FY16 non-GAAP operating margin target of 30% to 34% and we expect to land at the top end of the range. Tax update, there is no news from last quarter, nothing to update you on.

In terms of the dividends, on April 26, the Board declared a cash dividend of $0.23 per share for shareholders of record on May 27, 2016, payable on June 17, 2016. On April 18, we signed a definitive agreement to acquire certain customer experience software and service assets from HP Inc. for approximately $170 million. The transaction is expected to close in the fourth quarter of FY16, and is subject to customary regulatory approvals and closing conditions.

This quarter, we also signed a definitive agreement to acquire ANXeBusiness Corp. for approximately $100 million. The transaction is also expected to close in the fourth quarter of FY16 and is also subject to customary closing conditions. We do not expect any meaningful revenues within Q4 from the acquisitions, but we will have some acquisition-related expenses. Now, I'll turn the call over to Steve Murphy. Steve?

Steve Murphy - ***Open Text Corporation - President***

Thank you, John, and hello to everyone on the call. Let me touch on my first 100 days on the job. The first 100 days in my post as President of OpenText has been nothing short of spectacular. I've hit the ground running and I'm energized to be here. I made it a priority to take time to listen, learn and act where appropriate.

At OpenText, we have a culture of customer first and we live up to it. Since coming on board in January, I've met with 1,000 customers, partners and employees in North America, Asia, Europe, the United Kingdom and Australia. Speaking at the Innovation Tour was a great opportunity to engage customers in a dialogue about Release 16.

My philosophy is that customers don't buy from companies but rather they buy from people and I continue to be impressed with the high level of customer engagement that these in city events deliver. The feedback is clear. With Release 16 we have the best products positioned in the right market with deep customer loyalty, reflected both in the amount of follow-on sales and retention of CS and cloud revenues.

My other big observation is looking internally. OpenText has a strong operations-oriented culture, which fits my management style well. There is opportunity to balance cost discipline with driving sustainable organic growth initiatives.

Let's talk a little bit about the quarter in review. I'd like to take a quick look at the quarterly results. We had a strong quarter for licensed sales and I'm pleased with the performance of our customer support and cloud businesses. Professional services came in weaker than we had planned and I will touch on our plans to improve this a little later in my remarks.

So, some quick license stats. License revenue was up 6% year-over-year in constant currency. We had 10 on-premise license deals greater than $1 million, up from three in Q3 of last year. Average license deal size increased to $363,000, compared to $257,000 in Q3 of last year. The geographic split of total revenues was America's 58%, EMEA 33%, and Asia-Pacific Japan 9%.

On-premise customer successes in the quarter included PBS, the Public Broadcasting Service, Bosch, Diebold, Cancer Treatment Centers of America, Public Works and Government Services of Canada, Government of the Northwest Territories, National Bank of Canada, Zeiss, Mainova, SMC Corporation of America, and Cameron LNG. In terms of industry breakdown, financial, services and technology industries saw most of the demand.

Okay. Here are some quick cloud stats. Cloud revenue was up 2% year-over-year in constant currency. We had eight new MCV deals greater than $1 million, up from seven in both the same period last year and in last quarter. Cloud customer successes in the quarter included CIBC, Government of New Zealand, Tetra Pak, DC Comics, and Standard Insurance Company.

We also added 17 new managed services customers in Q3, which brings our total managed service customers up to 920. We had 21% MCV growth from $38 million to $46 million, compared to the same quarter last year. Average MCV deal size increased to $426,000 compared to $317,000 in the same quarter last year. Financials, services, consumer goods and technology industry saw most of the demand for cloud.

Overall, I've a lot of confidence in both our account planning and sales execution in the field. We delivered a strong quarter in license, CS and cloud. That being said, professional services did not meet our expectations. PS revenues were down $5 million year-over-year in constant currency and negatively impacted our adjusted EPS results by approximately $0.02. This is partly due to product and geography mix in transition to Release 16.

We'd make note that we hired a new leader of services, Prentiss Donohue, who joins us from Oracle, where he was the Group Vice President for North America Advanced Customer Services. Professional services is an important revenue stream for OpenText. We expect performance to return to normal levels in the next two quarters to three quarters.

Let me talk a little bit about Release 16. Something that is exciting for the whole sales force and the Company is Release 16. I'm focused on growing healthy and sustained organic license revenue for OpenText and I'm convinced that Release 16 will help us achieve this. We are making key Release 16 investments, both immediately and over the coming quarters, to focus on customers and market share gains through sales enablement and field readiness, customer upgrades and competitive replacement.

Our customers see the world as hybrid. We listened and provided them with flexibility and functionality as well as hosting expertise to support their deployment initiatives. OpenText has a healthy ecosystem with strategic partners and system integrators, including SAP, Accenture and Deloitte that are both industry and regionally focused. In many cases, it is better to have a partner service a region in which we don't have a presence. We support their initiatives with significant marketing and resources.

We will have a large presence at SAPPHIRE, SAP's user conference. And I personally look forward to being there and participating in that event promoting Release 16 and strengthening our relationship with SAP and our SAP customers.

Let me touch briefly on acquisitions. We announced a couple that we expect to close within the fiscal year. Namely, the assets of Hewlett-Packard Inc. and ANX. While it is early to talk about on-boarding the customer facing areas of these businesses, OpenText remains committed to customer care and satisfaction and these principles will carry over when we welcome new customers to the OpenText family.

So let me summarize before I hand over to Mark. Before I hand to Mark, a few key points. We delivered strong license performance, strong margins, strong income and strong cash flow. Professional services did not meet our expectations and I have taken actions, including putting a new leader in place.

Release 16 carries us into a new product cycle for FY17. It is early days, but I'm really encouraged by the level of enthusiasm and deal activity around it. As I said earlier, customers don't by from companies, but rather they buy from people. I've observed first hand that all around the world, customers like us and trust us. It is a huge competitive advantage. I look forward to meeting many of you at our Investor Day in New York on May 12. Over to you, Mark.

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

All right. Thank you, John and Steve. There are two topics I'd like to cover today, M&A and Release 16. Before I get into those details, let me start with a few comments on our Q3 performance. There are many metrics, but the one metric above all is cash flow as cash is king.

We are very pleased with our record operating cash flows of $190 million and the execution that supported it. The team delivered these results with a $15 million drag on revenue due to FX, a very busy quarter in deal flow and execution, while completing and launching Release 16, while strengthening my leadership team, on 12% less operating expenses, I know in constant currency OpEx was $179 million this quarter, compared to $203 million last year same period.

We delivered these results on a growing mix of revenue that is recurring and cloud-based. Recurring revenues were 85% to total revenues and cloud revenues were 2.3 times larger than our licensed revenues. And we delivered this while expanding adjusted operating margin 480 basis points, again in constant currency. Beyond the numbers and the 15% dividend raise, the Company got stronger in Q3, and it was a wonderful thing to see.

Onto my first topic, mergers and acquisitions. M&A is our leading growth driver and it is central to our business and financial model. We are generating expanding cash flows that will be reinvested into acquisitions at market leading rates of return. There are hundreds of assets available within the enterprise information management market and our pipeline of targets is increasing. OpenText is a consolidator and has a culture and proven history of integration.

Our M&A model is differentiated from others for many reasons, but let me just highlight two; an integrated go-to-market and an integrated engineering organization. We acquire businesses within our enterprise information management market strategy using our proven approach to M&A. We then operate those businesses leveraging our intelligent growth business system creating superior products, customer success and shareholder value.

Over the last 10 years, OpenText has delivered a cash flow CAGR of 25%. We are an industry consolidator, have completed over 50 acquisitions, and perhaps it is our Canadian roots, we have a culture of integration and we seek value. The enterprise information market is highly attractive. It has revenue scale, it is growing and provides transformative capabilities for customers. Its addressable market is well over $20 billion in customer spending with a greater than 7% growth rate and garnishes high profits, unlike other hardware, software or services markets.

Our market is reshaping itself today and OpenText is shaping its future. As I mentioned, there are hundreds of acquisition targets and the EIM customer base is marquis. By marquis, I mean there are larger deal sizes, the deals are more transformative and there's low credit risk given the marquis nature of the customers. EIM is at the core of long-term trends and purchasing decisions; digital, information governance, business networks, cloud, predictive analytics and security.

M&A models run in a continuum from what I like to call platform operators to asset acquirers. Companies such as Danaher, Roper, Amitech, Blackstone, KKR, Constellation and OpenText, have M&A models at their core and fall somewhere in this continuum. Platform operators pursue M&A led businesses with their strategic market thesis, purchase assets within that market strategy and then drive deep value through integration and innovation. Asset acquirers purchase individual assets and operate and optimize them as standalone businesses.

OpenText is a platform operator and we believe in the value of an integrated sales force, integrated engineering and integrated operations. And for our business, this should lead to the greatest cash flows, highest cash flow multiples, and thus, maximum shareholder return. Why? Because the model scales.

Our asset targeting methodology is all about unlocking value. We evaluate businesses within the context of our EIM strategy and look to fill functional white spaces, vertical capabilities or key geographic expansion opportunities. Ideal targets have special situations that would benefit from the OpenText intelligent growth business system and scale. We value recurring revenues paths to higher margin and strong cash flows. We are attracted to strong leadership teams, solid products and leading distribution models. And we are very capable of entering a challenging situation where one or more of these areas need immediate attention.

What we target is supported by our proven methodology. We have a seasoned and dedicated in-house corporate development team from all the way from sourcing to closing, which includes diligence, deal closing, asset integration and monitoring first-year performance. Cost synergies are more preferred to revenue synergies. Our business cases are mostly based on cost synergies and cash models.

We prefer cash flow over higher revenue growth and set minimal thresholds on AOM, AOI and cash flows. This is what we mean when we say on-boarding to the OpenText target model. Our internal financial models have simple and clear cash-based metrics on IRR, pay-back, terminal values and other key metrics.

Day one integration is a critical element of success. We have over $3 billion in accessible capital to deploy in the next few years. We arrive at the $3 billion number by adding together our current cash on hand plus future annual operating cash flows, new cash flows from acquired businesses, available debt within our conservative debt to EBITDA ratio of 3 times, less our potential dividend disbursements and CapEx investment.

Our two most recently announced acquisitions, certain CEM software assets from HP Inc. and ANX, are right down our M&A power alley. The HP assets will extend our leadership in CEM and ANX adds trading grid and cloud services capabilities in healthcare, transportation and auto. Valuation meets our traditional methodology. The HP assets will be on our operating model within 12 months. ANX will be in our operating model day one.

Higher recurring revenues and marquis install base. Under our leadership and distribution we can unlock more value and these two acquisitions will ultimately be cash flow oriented. With these two acquisitions we expect to on-board to between $115 million and $125 million of new revenues in FY17. The acquisitions are expected to close in Q4. We do not expect, as John said, any meaningful revenues from these acquisitions within Q4, though we will have some acquisition-related expenses.

Lastly, with our M&A capabilities expanding and our target pipeline growing, it is our intent to close and integrate more transactions at a more predictable pace. We will remain disciplined value buyers, cash flow oriented, patient capital allocaters but steady and measured wins the race. I expect to deliver more transactions at a more predictable pace in the coming quarters ahead.

Onto my second topic for today, Release 16. Release 16 is now available to our customers and partners and the early feedback is very favorable from our customers such as BNSF Railway, Oxford Properties, Phillips 66, and Bell Canada. It is the most complete and integrated platform for digital transformation in the industry as far as we can see. Release 16 is a platform to drive organic growth in the coming years and as a result of our approach, to innovation and integrated and sustained engineering.

The Company focus now turns to enablement and adoption. Release 16 is a singular platform for the management, analysis and exchange of enterprise information enabling digital transformations. One platform to manage all this information, digital experiences and processes. One platform for predictive analysis. One platform to exchange information through business networks, business to business, cloud to cloud and machine to machine. Hybrid both on-premises and in the cloud. It is the key platform to enable the digitalization of key enterprise processes, to able disruptive business models and to deliver the next generation of information and process-based applications.

Release 16 provides for many on-ramps for growth; new customers, competitive replacements, upgrades to new modules and full suites. New and expanded partnerships such as Accenture Digital and E&Y, to help bring Release 16 to their customers. New vertical opportunity like healthcare transportation and logistics. New adoption of the business network and analytics and predictive analytics everywhere within our suites.

Customers purchasing enterprise systems make decade long decisions. The market is changing real time and customers will look for stability, certainty, long-term commitment to innovation and a technology partner that they can count on, and that is OpenText. Just over the last 90 days, we have seen Lexmark and Sitecore being sold as well as the pieces of SDL. We have acquired core interwoven assets as well as ANX.

Given the early positive reaction to Release 16, the changing market landscape, we want to deliver more features and capabilities faster at a defined and predictable series of enhancement packs. We will follow Release 16 with a series of enhancement packs, or EPs. Release 16 EP1 is scheduled for Q2 FY17, EP2 for Q4 FY17 and EP3 for Q2 FY18. These enhancement packs will be available on premises and in the OpenText cloud and what will follow the EP series will be Project BANFF.

Let me highlight two very important aspects of these EP initiatives. EP1 will include extended ECM for Salesforce. What we have completed for SAP and Oracle, we plan on delivering for Salesforce. EP2 will include our next generation of analytics, our cognitive release. Actuate will be supporting Hadopp and Sparc-Apache, immediately enabling thousands of open algorithms and a developer platform for customers to create their own algorithms.

In many ways IBM Watson is a very closed and a very expensive platform. That sledgehammer is not needed for the majority of predictive work loads that we can see. In EP2, we intend to provide an alternative to IBM Watson. This is the time to invest and go faster. Where other companies are slowing their investments, deinvesting altogether, being sold or can't make a dollar or profit, customers should have full confidence in choosing OpenText for their digital platform and their next decade of infrastructure investment. I'm very excited about the opportunities of Release 16, extended ECM for Salesforce and our future cognitive capabilities. We'll talk more about Release 16, the EP series and Project BANFF at our May 12, Investor Day in New York City.

Let me spend a moment on the OpenText cloud. The OpenText cloud consists of three elements; managed services, number one; number two, our trading grid and value-added network; and number three, SaaS applications. We are approaching 1,000 managed service customers and we offer services across all our solution pillars with Release 16. Notable wins within the quarter include CIBC, DC Comics and Government of New Zealand. It is an important growth area for the Company. Cloud 16 added new key logistics and healthcare protocols. Our ANX acquisition will add key vertical capabilities to our value-added network and trading grid.

As it relates to our SASS applications, all customers renewing maintenance, all their cloud services agreement at par value will now receive equal usage rights for free on OpenText core. This new program will go live this quarter. We think there are approximately 10 million end users we can attract to core while providing even more value to our customer service and maintenance programs and revenue streams.

Once on core, customers can upgrade to more capability or capacity, and go from premium to paid. This program will enable customers to seamlessly and cost effectively integrate on-premises and in the cloud ECM solutions from one vendor. Only OpenText can enable this as a single provider and as the only vendor in the market today capable of integrating file sharing, sync and collaboration technologies, with core enterprise ECM records management and governance.

As for our overall financial model, as we on-board more cloud revenues, we have four years and yet another quarter of results and the results speak for themselves. As we on-board new cloud revenues, we continue to expand our adjusted operating margin, which was up 480 basis points this quarter. Looking towards our FY20 aspirations, we expect our mix of business to be 50% from the cloud, over 90% of our revenues recurring and our adjusted operating margins between 34% to 38%. And we expect to achieve this while a licensed business remains constant on an absolute basis. Sorry if I keep repeating myself over and over again on these collective points. I think it is very important to understand our financial model and four years of data points and yet another quarter.

In summary, it is an exciting time. The market is reshaping itself and OpenText is defining its future. Our M&A with our intelligent growth business system is a proven approach to delivering market leadership and shareholder value. M&A will be our leading growth driver for the years to come. As I said earlier, with our M&A capabilities expanding and our pipeline growing, it is our intent to close more transactions at a more predictable pace. We remain value buyers, cash flow oriented, patient capital allocaters and steady and measured wins the race.

We delivered record operating cash flows in Q3 on 12% less operating expenses. Release 16 is now available to customers providing a clear choice in the marketplace as to which vendor customers should choose. Release 16 has potential on-ramp to grow that Steve and the field are driving over the coming quarters. Some of those on-ramps include M&A, both announced and any potential future transaction, Release 16 for new customers upgrades and more adoption via suite, analytics and the business network, key vertical opportunities in financial services, healthcare, transportation, public sector, expanded partnerships such as Accenture and ENY, EP1 with Salesforce, managed services and capturing our install base with core.

And in general, we believe customers will look towards innovation, certainty and stability and OpenText will be a leading consideration for the digital transformation needs. The EIM segment is being recognized for its transformative capabilities. It is large growing and there are hundreds of potential targets for us. And we have a proven approach to M&A, the capital to deploy and the leadership team ready to execute and go capture that opportunity.

I am in my fifth year as CEO at OpenText and I'm honored and humbled every day to lead the business. I realign my leadership team and my responsibilities approximately 100 days ago and that realignment is already bearing fruit in our results and our strategy and in our announced plans. My energy, passion and optimism for OpenText has never been stronger.

I hope you will join us on May 12 in New York City for our annual Investor Day. We will go into more depth on the Company, strategy and plans. We have a solid day planned where myself, John Doolittle, Steven Murphy and Muhi Majzoub will be presenting and available for Q&A. With that, I'd like to turn the call over to the operator for your questions.

QUESTION AND ANSWER

Operator

(Operator Instructions)

Richard Tse, Cormark Securities.

Richard Tse - ***Cormark Securities - Analyst***

Thanks. I'm not sure if this is a question for Mark or Steve, I was wondering if you can elaborate a little bit more on the professional services? Did you say that the pull back was due to a pause in customers waiting for Release 16 to come out? Or can you give us a bit more color on that, please?

Steve Murphy - ***Open Text Corporation - President***

Yes, Steve here. I think that the pause itself is a little bit of a lack of managerial attention. I think that is part of it. I think that there are places like EMEA, quite frankly, where we have got backlog to burn through that could have been burned through and wasn't. So, I look to that.

Seasonally, Q3 has been a weak quarter for us and a lack of management attention associated with what I just described and the inability to burn through that backlog was part of what affected it. I do expect it's going to take two quarters to three quarters to get this business back on track. Those are the biggest things associated with the PS lag. Mark, anything to add to that?

Mark Barrenechea - ***Open Text Corporation - CEO & CTO***

No, not at all.

Richard Tse - ***Cormark Securities - Analyst***

Mark, you talked a lot about M&A and the predictable pace. Is that because you put in a place of process now or are things coming to you given the pricing has gotten better? Maybe give us a bit more color on that please.

Mark Barrenechea - ***Open Text Corporation - CEO & CTO***

Sure thing, Richard. It's sort of a combination of items. One is, we've expanded our in-house capabilities. We have more attention on it from the leadership including myself. And I also think the market conditions are more favorable to buyers today. So I think those things coming together and has created a unique opportunity in the near-term here for the Company. And M&A has always been at the heart of what we do, right? But I would say with the expanded capabilities of the team, more time for myself and others and market conditions, that we're putting more of an emphasis on it.

Richard Tse - ***Cormark Securities - Analyst***

And just one last one. On the cash flow, there was a big step-up in cash flow. So should we take that as being an increase in your former run rate here? Or was this -- it doesn't sound like it is a one-off, but maybe give us a sense of where that could be?

John Doolittle *- Open Text Corporation - CFO*

Yes, Richard. It is John. A couple things. One is, the bulk of the increase was related to the increase in net income. And secondly, we continue as I said on previous calls, to focus on working capital and driving improvements there. So there is more room to improve on working capital, but those are the two big contributors.

Richard Tse *- Cormark Securities - Analyst*

Great. Thanks, guys.

Operator

Steven Li, Raymond James.

Steven Li *- Raymond James & Associates, Inc. - Analyst*

Thank you. Maybe I will start with a question for John. So when I look at the sequentially Q2 and Q3. So your revenue base is lower in the March quarter, but your operating expenses is higher this quarter. John, are there any non-recurring costs on the expense side or is it the more increasing investments you're making?

John Doolittle *- Open Text Corporation - CFO*

Yes, Steven. Thanks for the question. We talked last quarter about increasing our investments and we have been doing that as we prepared for Release 16. So we have increased some of our headcount in sales and engineering and other areas. There is some degree of seasonality in there as well. So we had low vacation expense last quarter and that would've increased this quarter. So it is a combination of increased investment and a bit of seasonality on the expenses.

Steven Li *- Raymond James & Associates, Inc. - Analyst*

You expect it to be sustained, John, or does it taper off after some point?

John Doolittle *- Open Text Corporation - CFO*

Which part, Steven?

Steven Li *- Raymond James & Associates, Inc. - Analyst*

The investments for Release 16?

John Doolittle - ***Open Text Corporation - CFO***

I would expect us to continue to invest over the next couple of quarters, definitely.

Steven Li - ***Raymond James & Associates, Inc. - Analyst***

Okay. Mark, maybe a question for you. I know it's early days but the customers you highlighted for Release 16 like Bell Canada, any of those customers all have been competitive displacements?

Mark Barrenechea - ***Open Text Corporation - CEO & CTO***

I would say that the early wins are more of within our install base, Steve. As we get towards Enterprise World, it is sort of a natural progression. We're going to educate our sales force, we're going to educate our partners, we're going to educate our install base and we'll then fan out from there to more competitive replacements. So, as we march towards Enterprise World in July, we'll have quite a bit of news around competitive replacement programs. It is like a rolling thunder program, it is existing employees, install base and then new customers and competitive replacement.

Steven Li - ***Raymond James & Associates, Inc. - Analyst***

All right. Great. Thanks.

Operator

Paul Steep, Scotia Capital.

Paul Steep - ***Scotia Capital - Analyst***

Great. Mark, thanks very much for the description and the discussion around M&A. I think it articulates what lots of us have known over the years about OpenText. The one part I would be curious about though is, in the context of how you're thinking about deals, particularly large transformational transactions, would you -- do you differentiate the hurdle rates across your deal portfolio? And then I have got a quick follow-up.

Mark Barrenechea - ***Open Text Corporation - CEO & CTO***

Yes, it is a good question. Deals, opportunities really come in small, medium and large packages. And they also come with different structures, both HP, Inc. and ANX were carve-outs versus standalone companies and share purchases. As you move up in deal size, yes, I think some of the metrics do change a bit.

Our philosophy doesn't change around value and cash flows, but theoretically the larger the asset, typically a higher valuation is associated with it, which means that we have to look a bit more deeply on integration and cost synergies. But theoretically the larger -- this is just a theoretical M&A statement, that the larger the deal size, typically that scale comes with a slightly higher valuation. But our philosophical view of value and cash flow generation won't change.

Paul Steep - ***Scotia Capital - Analyst***

Great. I guess to follow on and maybe shift to Steve a little bit. We talked already about the PS change you've made. Are there any other changes or realignments in field operations that you've executed at this point? Or is it fair to think that you would wait until sales kick-off towards the end of the year?

Steve Murphy - ***Open Text Corporation - President***

Hey, good question. The answer is, that is the big one as far as bringing in someone from the outside to run CS. And stability is really my focus right now. So identifying some room to improve PS was clear and just maintaining stability with what is a quite frankly, a really solid team with some good products, I think has an opportunity to pay some really big dividends. Short answer is, that's about it for now and we're going to focus on continuing to do what we do well.

Paul Steep - ***Scotia Capital - Analyst***

Great. One last quick clarification, not to leave John out because I know he would be disappointed. On R&D --

Mark Barrenechea - ***Open Text Corporation - CEO & CTO***

John is eager to talk about the cash flow at $190 million.

Paul Steep - ***Scotia Capital - Analyst***

This would relate to the forward, which would be -- Mark talked lots about R&D investment into next year. Great developments that are going to happen for customers. Is it fair to think that those investments are all going to be within the existing envelope that we have been all thinking about? Thank you.

John Doolittle - ***Open Text Corporation - CFO***

Yes, Paul, it is. We've I think given a target model of 10% to 12% on R&D, and Muhi's done a great job managing within that envelope and he has been increasing his headcount but redistributing a lot of that in lower cost jurisdiction. So, we look at the overall expense holding pretty steady but he's actually been able to do that and increase headcount. And I would expect that to continue.

Paul Steep - ***Scotia Capital - Analyst***

Perfect. Thanks, guys.

John Doolittle - ***Open Text Corporation - CFO***

No change at this stage to the model.

Operator

Blair Abernethy, Industrial Alliance Securities.

Blair Abernethy *- Industrial Alliance Securities - Analyst*

Two things. Mark, I wonder if you can give us a sense, or Steve, of just what you're seeing with Suite 16 in the marketplace? How many weeks have you really been out there where you're actually selling it and what are the -- what areas of the suite are you seeing the most traction with?

Steve Murphy *- Open Text Corporation - President*

We've got -- we'll say a couple of months of exposure of putting the product out in the marketplace. And content management, whether it be a consumer package good company or a bank, those are two examples where we're seeing customers come in and say, yes, we would like to give it a try and understand how we would apply the technology, how quickly can we implement it and at what price point.

Definitely within financial services and banking and manufacturing, we have seen uptake, significant uptake. Government financial services and also the public sector or places where we're seeing content management, also some business process management solutions that customers are requesting. Anything to add to that, Mark?

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

Yes, Blair. Thanks for the question. Let me add to Steve's comments. I'll interject here on the competitive landscape a bit. We compete with IBM mainly in FileNet and in Sterling Commerce. And 16 quarters of revenue decline, boy, it must be getting tiring. I have to tell you that. On the EMC side, they sold off their cloud assets. They have not innovated and they are just core ECM. So they're not ECM with apps, CTM with SAP, they're not EIM and we're competing very effectively against them.

Adobe, we are winning in the digital asset management space, web experience management space and customer communications management. We just got stronger with the assets that we announced with Interwoven. You have FDL being sold in pieces, ByteCard went to private equity, Lexmark. Who knows where Kofax and ReSoft will end up? And, of course, we still see a fair amount of disruption on the archive side with Symantec.

It is early days, as Steve said with Release 16. Actually next quarter will be our first full quarter of GA. But I tell you, I've never felt on the competitive side where if you wind back 20 years in ERP, there were 100 ERP competitors and then it got down to 50 and 20, and 10, the J bops and then, two. Release 16 is a pivotal moment with these market conditions that I think we're getting down to three to five main competitors in this area.

Blair Abernethy *- Industrial Alliance Securities - Analyst*

Okay. That's great. Thanks for that, Mark. John, I just wonder if you could touch on maintenance renewals in the quarter? Customer support revenue was down a little bit sequentially. I suppose most of that is FX, but just can you talk a little bit about core license renewals, maintenance renewals and pricing?

John Doolittle ***- Open Text Corporation - CFO***

Yes, Blair, holding steady at around the 92% mark. No change in the quarter. We were up in constant currency in customer service. So the FX is the reason that you pointed out. That's accurate.

Blair Abernethy ***- Industrial Alliance Securities - Analyst***

Okay. Great. Thanks, guys.

Operator

Paul Treiber, RBC Capital Markets.

Paul Treiber ***- RBC Capital Markets - Analyst***

Thanks very much. I just wanted to focus on the go-to-market strategy for Release 16. A couple of years ago, you guys went through a large sales force expansion. How do you look at your sales force at this point and what are some of the investments that you're making from a go-to-market point of view?

Steve Murphy ***- Open Text Corporation - President***

Yes, Steve here. So a couple of things. We're not going to give any specifics on sales force expansion, but it is an area of investment. And I'm not go into and KPIs, but there is a robust opportunity to expand with quality where it makes sense. And with Release 16, there are plenty of places like I just said, financial industry, consumer package goods, government, where we will continue to grow and expand.

So we are a direct sales force and we will continue to be a direct sales force. We will partner closely with the big GSIs, the global system integrators, where it makes sense, and we'll continue to put a lot of effort and investment into SAP. That relationship has borne fruit for us and I see that it will continue to do so. And we'll do that with a focus on quality and on Release 16. From an industry vertical standpoint, I won't repeat myself, there are few with 16 where we already see it really having a great fit. There was a second part to your question, too. What was it?

Paul Treiber ***- RBC Capital Markets - Analyst***

Have they -- broader go-to-market strategy around Release 16?

Steve Murphy ***- Open Text Corporation - President***

I think that's it. I think I outlined it as far as the GSIs and SAP. That's about as broad as I think it gets for us. I think that as far as enabling the sales force and making sure that they have enough product knowledge to be capable, we have gotten very systematized around the different modules and tracking and training and making sure that our sales force can take that, the direct sales force.

I think that having a value-based sale -- the actual value proposition being well-defined by vertical is another area of focus for me. I've got a lot of experience based on the places I've been where we can take -- basically looks like an Excel spreadsheet that says this functionality which is unique within Release 16 is going to equal this much in value to you depending on what vertical industry you're in, and using that as part of the pricing process, the discount as low as possible. That is another method we've introduced with Release 16 by industry vertical.

Paul Treiber *- RBC Capital Markets - Analyst*

Secondly, could you speak to the opportunity around Salesforce and your partnership there?

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

Yes, I'll take that one, if that's all right. Thanks for your question, Paul. Just to amplify a couple points that Steve made. I think what's new with Release 16 are some of the large global SI partnerships that Steve and his team are building. What's new are key vertical opportunities. And probably a third one that's new that has come along would actuate our embedded opportunities that Steve and the team are working on. So those are sort of the new opportunities.

And on that vein of large software partnerships like SAP, we see an opportunity with Salesforce. The work we've done with extended ECM, we are going to extend into Salesforce with EP1 and provide full enterprise content management hosted in our cloud, cloud to cloud, with Salesforce, fully integrated into Salesforce.com and a modern HTML5 user interface and our full extended document management, archive, records management and governance capabilities that will be integrated to Salesforce with EP1.

Paul Treiber *- RBC Capital Markets - Analyst*

Okay. Thank you. I'll pass the line.

Operator

Eyal Ofir, Dundee Capital Markets.

Eyal Ofir *- Dundee Capital Markets - Analyst*

Thanks, I just wanted a quick question on Release 16 here in terms of the early days. Are you guys seeing more demand on the SaaS side or on the license? Maybe you could just talk to what the customer feedback is like and what type of take up you're seeing thus far?

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

Eyal, let me take that first, which is we're not really seeing a shift of SaaS or subscription versus on-prem kind of shift. We still see the world as hybrid. The best way to describe it is a ultimate 50/50 split.

In fact, we had two customers last quarter who went from our cloud services to back on-prem. And one went back on-prem because they've done the economic model. They have been in our cloud for a couple years and having a great service from us. They wanted -- they were looking at a multi-year model and just felt that for them and their usage, that economically, it was better to be on-prem.

We had another customer who had a security event, unrelated to us, who had decided that the system should be in-house versed in a cloud. We had two customers that I know of, there may be more, who went from cloud back to on-prem last quarter. We view the world as hybrid. I don't think Release 16 will change the dynamic that the world is 50/50.

Eyal Ofir *- Dundee Capital Markets - Analyst*

I appreciate that. Just on the acquisitions as well, you talked about integrations and getting them onboard your operating model. In terms of actually getting them onboard to your platform, how long does that take for each acquisition?

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

I'm sorry, Eyal. Could you repeat the question?

Eyal Ofir *- Dundee Capital Markets - Analyst*

Just to get them onboard -- I'm assuming that the plan is for both acquisitions is to get them on to your platform, technology as well, not just the financial model? So I was just wondering if it is the same timelines or if it is different and how long it would take?

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

On the financial model, we're looking for the HP assets within the first year. And on ANX, day one.

Eyal Ofir *- Dundee Capital Markets - Analyst*

I meant technology -- sorry, go ahead.

Mark Barrenechea *- Open Text Corporation - CEO & CTO*

Fair enough. On the technology platform, our view is really the next release cycle. So we want to be able to get the asset onboard, get them integrated day one, and then on the next release cycle, have them more in line with our technology standard. So I don't know if it probably in this road map around EP2 that they would be more on our technology platform. But conceptually within the next release cycle, which could be 12 months to 18 months, that would like them more aligned with our tech stack.

Eyal Ofir - *Dundee Capital Markets - Analyst*

Before I pass the line, last question for me on Documentum and rumors of EMC looking to sell it. Just wanted to get your thoughts on it and how are you guys looking at that asset as well? Thank you for that last question and we won't comment obviously on rumor or speculation. But we appreciate the question. With that, I think we will wrap up the call and we look forward to hosting everyone at our Investor Day in New York City on May 12, and hope to see you there. Thank you very much.

Operator

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