Investor Overview

Q2 2008 Blackboard, Inc. Earnings Conference Call
Wednesday, August 6, 2008 4:30 p.m. ET

Event Details

Title	Q2 2008 Blackboard, Inc. Earnings Conference Call
Date and Time	Wednesday, August 6, 2008 4:30 p.m. ET
Duration	1 Hour

Blackboard Inc. Q2 2008 Earnings Call Transcript

Page 1 out of [21]| posted on: August 06, 2008 | about stocks: BBBB

Blackboard Inc. (BBBB)

Q2 2008 Earnings Call

August 6, 2008 4:30 pm ET

Executives

Michael Stanton - VP - IR

Michael Chason - President and CEO

Mike Beach - CFO

Analysts

Michael Nemeroff - Wedbush

Amy Junker - Robert Baird

Tom Roderick - Thomas Weisel Partners

Kirk Materne - Banc of America

Kash Rangan - Merrill Lynch

Robert Riggs - William Blair & Company

Presentation

Operator

Good day, ladies and gentlemen. Welcome to the second quarter 2008 Blackboard Incorporated Earnings Call. At this time, all participants are in a listen-only mode. (Operator Instructions) As a reminder, this conference call is being recorded for replay purposes.

I will now turn the call over to Mr. Michael Stanton, Senior Vice President Investor Relations. Please proceed.

Michael Stanton

Thanks, Jenny. Hello and thank you for joining us today for Blackboard's second quarter conference call. I would like to remind everyone that except for historical information presented the matters discussed today may contain forward-looking statements under the safe harbor provision of the Private Securities Litigation Reform Act of 1995. Such statements are based upon management's current expectations and are subject to a number of risks and uncertainties that could cause actual performance and results to differ materially from those discussed in the forward-looking statements.

Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are delays in product development, undetected software errors, competitive pressures, technical difficulties, market acceptance, availability of technical personnel, changes in client requirements, risks of international operations, general economic conditions, and such other risks as described in the Risk Factors section of Blackboard's most recent Form 10-Q on file with the SEC. Blackboard undertakes no obligation to update nor revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or future changes in future operating results.

A few administrative notes is always related to some of the metrics we will provide today. First we will provide non-GAAP adjusted net income and non-GAAP adjusted net income per share on this call, as additional information regarding our operating results. The measures are neither in accordance with nor an alternative for GAAP and may be different from other non-GAAP measures used by other companies. Blackboard believes that the presentation of these non-GAAP financial measures provide useful information regarding additional financial and business trends relating to the company's financial condition and results of operation. A reconciliation of GAAP and non-GAAP metrics has been provided in today's earnings press release.

The second note relates to our contract value which we will also discuss today. Our contract value represents the annualized recurring ratable revenue under existing contracts with clients in effect at the end of the quarter without regard to the remaining duration or renewal of such agreements. This is not intended by management for the estimation of or as a proxy for future revenue to be recognized but management believes it is a useful tool for investors to evaluate current operating performance.

Finally, we have once again provided supplemental information related to licenses and contract value on the Investor Center section of the website at investor.blackboard.com. The document is titled Blackboard second quarter 2008 metrics.

On today's call are Michael Chasen, President and CEO and Mike Beach, our Chief Financial Officer. At this time, I would like to turn the call over to Michael Chasen.

Michael Chasen

Thanks, Michael. Hello everyone, and thank you for joining us today. I am very pleased with our performance in the second quarter. Our sales team did a great job of selling our product, which investors can see through our record contract value and deferred revenue. In particular I want to recognize our U.S. higher education team which had one of the strongest quarters in recent years.

I also want to recognize the tremendous job our entire team is doing with our new Blackboard Connect product where we once again had strong sales. I also want to highlight the first few statewide deals we have won because these are a key component of the strategic growth opportunity we see in front of us, as well as the unique and differentiated capabilities of our offering.

First, we closed our very first K-20 e-learning deal in the State of New Mexico. This landmark initiative which we were awarded in June will lead to the deployment of a single statewide e-learning platform that will connect teaching, learning, and training for the state's K-12 higher education, adult education and government communities. In short, this was a remarkable deal and we expect that as this program launches and becomes successful that we will win more statewide deals in the years to come.

The State of Florida selected Blackboard for a pilot program in allowing the Florida Division of Emergency Management and four Florida counties to use the Blackboard Connect product for time sensitive alerts and notifications. Collectively, over 1 million households will now be included in the pilot. We believe that this pilot program could expand greatly to potentially include every household in the state.

The State of Mississippi has implemented the Blackboard Connect product to provide the Executive Director of Mississippi Emergency Management Agency and the Governor of Mississippi the ability to communicate with residents and staff regarding time-sensitive incidents.

As I said, our U.S. higher education sales team did an outstanding job in the second quarter. A few examples of the deals that the team won include the University of Great Falls in Montana and the College of Desert in California are two new U.S. higher education clients who licensed the Enterprise Blackboard Learning System in our managed hosting offering.

A few competitive reevaluations in the quarter were Palm Beach Community College in Florida and Christopher Newport University in Virginia. Throughout the reevaluation process, we were able to turn them into significantly higher recurring revenue relationships. Both of these institutions elected to upgrade to the Enterprise Blackboard Learning System and add our managed hosting offering to support their e-learning programs.

The Oregon University System selected Blackboard's Connect-ED product to provide the university leaders at its nine campuses with the ability to quickly reach students, faculty and staff with time-sensitive information. Finally, we had a number of large deals for the Blackboard Transaction System including Fort Lewis College, New York School of Law, North Georgia College and State University and the University of Arizona.

On the international sales front, Imperial College of London in the United Kingdom added the Blackboard Community System and the Blackboard Learning System. Also in the United Kingdom, the University of Manchester signed a significant long-term deal for the Blackboard Learning System and our managed hosting offering.

Lastly, we had another significant expansion sale in Colombia with SENA which provides workforce development for more than one million learners. SENA has licensed the Blackboard Learning System, Blackboard Community System and the Blackboard Content System as well as our managed hosting offering and has significant plans to grow their program over the next several years. SENA has rapidly become the largest deployment of a course management system in the world.

In K-12 sales, I would like to highlight a couple of deals, including St. Paul Public Schools in Minnesota, which licensed the Blackboard Connect product to provide mass notification service for its 40,000 students. Volusia County Schools in Florida moved from the Basic to the Enterprise Blackboard Learning System. This was a great up sell, where we increased the client value fivefold despite some significant budget cuts in the State of Florida.

In terms of Blackboard Connect progress, there were nearly 200 new Blackboard Connect deals closed in the second quarter. Importantly, 35 of these deals were cross sells to existing Blackboard U.S. higher education clients. Outside of the US higher education market the Blackboard Connect team continues to do a great job, particularly in the K-12 in government markets.

Moving on to licenses. We ended the quarter with the total of 6,327 enterprise category licenses. Breaking out these licenses, we had 2,335 licenses of the Enterprise Blackboard Learning System, 811 licenses of the Blackboard Community System, 466 licenses of the Blackboard Content System, 29 licenses of the Blackboard Outcomes System, 444 licenses of the Blackboard Transaction System, and 2,242 licenses of the new Blackboard Connect offering.

In terms of the Blackboard Learning System-Basic product, we had 886 licenses. The total number of licenses, including Basic licenses at the end of the quarter was 7,213. In terms of our managed hosting business, we finished the quarter with 571 hosted clients which is a 16% increase over last year. Our renewal rate for the quarter was in line with where we ended 2007 at 92% and we expect that our renewal rate will remain strong throughout the remainder of 2008.

From a seasonal perspective, I remind investors the third quarter is typically the weakest quarter from a net license perspective due to the concentration of renewals. We expect that this trend will continue. We finished the quarter with an annualized contract value of $262 million which represents an annual increase of 29% measured on a pro forma basis including the Blackboard Connect formerly known as the NTI Group in both periods.

This is significant growth and was due to a continued trend by clients to engage in larger, multi-licensed deals and by the closing of a few statewide wins that I previously mentioned. Overall, the continued and increasing commitments from our clients demonstrate the strength of our value proposition.

Our total headcount at the end of the second quarter was 1,080 people and was comprised of the following. We had 251 people in sales, 88 in marketing and business development, 234 in product development, 202 in support, managed hosting and production, 137 in professional services and 168 in operations.

Before I hand the call over to our CFO Mike Beach, I want to close with some specific comments on three items in particular. One, our large statewide wins. Two, professional services. And three, my general perspective on the current state of our business.

First, in terms of the statewide wins, I do want to reinforce that these initial sales are just the beginning, particularly in the case of our Blackboard Connect product in Florida and Mississippi and in K-20 deals like New Mexico. With our initial foothold in these states we anticipate that we will be able to realize significant seven-figure annual-recurring-revenue relationships.

As we have success with larger more complex deals, it is important to note that they will generally result in higher upfront commission, service and support costs. Based on our model, revenue recognitions maybe delayed several months or even quarters until the system is launched. Therefore we incur expense before we get the benefit of revenue. While these large wins are long-term positives for the business, investors should note that we expect that these higher costs will impact the second half of the year.

Second, in terms of professional services, we experienced some challenges in the second quarter which resulted in reduced revenues of approximately $1 million. This was primarily due to a delay in the release of the latest version of the Blackboard Transaction System. We have subsequently released the latest version of the product and are beginning implementation.

Additionally, we will also be performing services with a value of approximately $1 million under the New Mexico deal, but not recognized any material revenue until 2009. As a consequence of these two factors, service revenue for the remainder of the year will be flat over the same period in 2007. We have reflected both, the increased expenses associated with the large deals as well as the variability around professional service revenues and margins and our updated guidance with Mike Beach, our CFO will take you through in a few minutes.

Third, let me talk with you about what we are seeing in the industry. We recently hosted over 2,200 people at our Annual Users Conference Blackboard World 2008. This event is an opportunity to gain an even deeper insight into our client community and the industry overall. Our clients relayed to us that they were very pleased with the investments and improvements that we've made in support over the last year. They were also impressed by the continued enhancements of our managed hosted offering, and a client base was especially excited by the vision we outlined of our next generation e-Learning technology.

I believe that all of these are very positive signs for the year to come. Our business is clearly benefiting from a number of important factors which we saw firsthand at Blackboard World, but are also evident in our metrics such as contract value and deferred revenue. Our experiences in the first half of the year coupled with many of the conversations I've had at Blackboard World reinforce in my mind the following.

First, we operate in the education industry, which has historically proven to be resistant to economic pressures. Second, we provide the industry's leading enterprise solutions that are well aligned to an institution’s overall mission and address their most pressing needs. And third, we have a foundation of more than 5,200 very loyal client relationships with institutions around the world. These are relationships that we continue to grow every year and are also responsible for generating a significant number of reference sales to new clients.

With that, I'm pleased to hand it over to our Chief Financial Officer, Mike Beach to detail our financial results and provide you with our financial guidance for the remainder of the year. Mike?

Mike Beach

Thanks, Michael. I will organize today's financial review around the income statement, the balance sheet is and cash flow and close with the outlook and guidance for the third quarter and full year 2008.

Revenues for the second quarter of 2008 were 75.5 million, up 27% from the same quarter last year. Product revenues for the quarter were $68.4 million representing an increase of 31% over the same quarter last year. Professional service revenues for the quarter were $7.2 million, which represents an increase of 1% over the prior year.

As Michael mentioned, we were pleased with the overall revenue coming in line with our previous guidance. We're able to achieve this even with the absence of approximately $1 million in revenue that was pushed due to the delayed release of the latest version of the Blackboard Transaction System.

In terms of revenue characterization, we also break out our revenue by the nature of the revenue streams, which include ratable recurring, ratable non-recurring and other revenues. For the quarter, we continue to show strength in our ratable recurring revenues which increased 34% to $59.6 million as compared to $44.6 million in the same quarter last year. Ratable non-recurring revenues increased 16% to $6.6 million as compared to $5.7 million in the same quarter last year. Other revenues increased 2% to $9.3 million as compared to $9.1 million in the same quarter last year.

Moving on to gross profit, our gross profit for the second quarter, excluding stock-based compensation and the amortization of acquired intangibles, was $52.7 million as compared to $43.6 million in the same quarter a year ago, representing an increase of 21%. For the quarter, our gross margin was 70%, which was slightly lower than our expectation, due to the lower than expected service revenues in the quarter.

Total operating expenses, excluding the cost of revenue, stock-based compensation and the amortization of acquired intangibles, were $38.4 million, representing an increase of 30% as compared to $29.5 million in the same quarter last year. Sales and marketing expenses were slightly higher due to the commissions and sales expenses related to the large deals, which closed at the end of the quarter. Additionally, we did benefit from $3.3 million of operating income resulting from the payment of the Desire2Learn patent infringement award.

For the quarter, we incurred stock based compensation expenses $3.8 million and amortization of acquired intangibles of $9.7 million. Other income was $3.8 million in the second quarter, benefiting from a gain on an investment in a small private company which we marked to market based on the valuation of their initial round of financing. Net income was $1 million in the quarter, resulting in net income per diluted share of $0.03. Adding back the amortization required intangibles and the associated tax impact results in non-GAAP adjusted net income of $6.9 million or non-GAAP adjusted net income of $0.22 per diluted share.

In terms of the balance sheet we closed the quarter with $55.3 million in cash and cash equivalents. Accounts receivable increased to $94.1 million at the end of the quarter up from $64.7 million for the same quarter last year. Total deferred revenues increased to $142.7 million at the end of the second quarter up 31% from the $108.7 million at the end of the second quarter last year. Current deferred revenues related to our recurring products totaled $124.9 million compared to $89.3 million for the same quarter last year, representing an increase of approximately 40%.

Moving on to cash flow. Cash flow provided by operations totaled $1.2 million for the second quarter, and capital expenditures were $9.4 million in the second quarter 2008.

Moving to guidance. For the third quarter of 2008, we expect revenue of $82 million to $84 million, amortization of acquired intangibles of approximately $9.9 million, net loss of $600,000 to net income of $700,000 resulting in net loss per share of $0.02, to net income per diluted share of $0.02, which is based on an estimated 31.3 million basic shares and 32.3 million diluted shares respectively and an estimated effective tax rate of 0%.

Non-GAAP adjusted net income excluding the amortization of acquired intangibles and associated tax impact of $5.8 to $6.6 million resulting in non-GAAP adjusted net income per diluted share of $0.18 to $0.20 based on an estimated 32.3 million diluted shares and an estimated effective tax rate of 37%.

For the full year 2008, we expect revenue of $312 million to $316 million, amortization of acquired intangibles of approximately $38.3 million, stock-based compensation expense of approximately $15.5 million, net loss of $300,000 to net income of $2.3 million resulting in net loss per basic share of $0.01 to net income per diluted share of $0.07 which is based on an estimated 31.8 million basic shares and 32 million diluted shares respectively, and an estimated effective tax rate of 0%.

And non-GAAP adjusted net income excluding the amortization of acquired intangibles and the associated tax impact of $23.5 million to $25.1 million resulting in non-GAAP adjusted net income per diluted share of $0.73 to $0.78 based on estimated 32 million diluted shares, and an estimated effective tax rate of 37%. The effective tax rate is based on our expected annual earnings and you should note too this implies an estimated effective tax rate of 28% in the fourth quarter.

Finally, we are raising our guidance for cash flow from operations to be $75 million to $80 million for the full year. Cash flow year-to-date has been slightly better than our expectations, and we expect this will continue in the second half of 2008. One last comment on taxes related to the guidance I've just provided.

During the quarter our GAAP effective tax rate was approximately 65%. As we discussed on our last call, depending on the amount of GAAP earnings and the mix of domestic and international income, we may experience material variations in our GAAP effective rate. We point this out to highlight the possible variability in our effective rate for the remainder of the year, and due to this complexity we encourage investors to focus on the estimated effective rates provided with our guidance.

That concludes the discussion of Blackboard's financials. Now let me hand it back to Michael Stanton for closing. Michael.

Michael Stanton

Thanks, Mike. Just a quick update. We will be at the Canaccord Adams Software Conference in Boston on August 12, as well as Citi's Annual Global Technology Conference on September 2 in New York City. We will also be at the Banc of America conference, September 15 in San Francisco.

That does it for now. This concludes our prepared remarks, and happy to take everybody's questions. Jenny, go ahead and start Q and A.

Question-and-Answer Session

Operator

Yes, sir. (Operator Instructions) The first question from the line of Michael Nemeroff from Wedbush. Please proceed.

Michael Nemeroff - Wedbush

Hi. I just had a couple questions, first for Mike Beach. I'm just trying to work through the guidance, especially on the bottom line. So the way I have calculated, tell me if I am wrong. So, there was the $0.04 increase on the higher end of the guidance range from Desire2Learn, $0.04 from tax. So essentially you are raising the high end of the guidance on the EPS by about a $0.01 or $0.02. Did I calculate that correctly?

Mike Beach

I think the impact of the Desire2Learn is going to be more than $0.04 on the full year. So I think it is probably closer to six.

Michael Nemeroff - Wedbush

Okay.

Mike Beach

However, I think, yes, the tax on Desire2Learn numbers are generally in line with what we would calculate.

Michael Nemeroff - Wedbush

Okay. Then on the revenue that you did not get, the million in revenue from the delay in shipping the transaction, the new version of transaction. Is that revenue that is going to be able to be made up in future quarters? Or is that just roll off because it is ratable?

Mike Beach

We would expect to make that up in future periods. Unfortunately we have got a window of installations that occurs in the summer months. So a big portion of that will push in to next year. So we will get that revenue. It is just that some of it will occur in the third and fourth quarter, large amount of that we will actually push into 2009.

Michael Nemeroff - Wedbush

Great and then Mike Chasen, you mentioned in your prepared remarks that the spending environment for academic institutions, you do not feel it as much as the normal enterprise software company. Can you just compare what the pipeline looks like or looked like coming out of the User Conference this year than it did coming out of last year's conference? Was it sharply up or could you give us some qualitative comments around that? Then also, if you comment on our customers, in your conversation with customers, are any of them delaying purchases of any new modules in anticipation of Version 9?

Mike Chasen

Sure, thanks, Mike. We were extremely pleased with Blackboard World Conference this year. I think it was our strongest conference to date and really I think we have the strongest pipeline coming from that conference. Generally and as I said, the client comments to us on the improvements that we made in support, the enhancements to our managed hosting as well as the vision that we laid out there really was exciting.

I can tell you that personally I was involved in a number of pretty large sales meetings and deals that were taking place in the conference that we expect to have good, strong results for the rest of this year. I do think that what is reflective of the industry as is our high contract value number, and our larger revenue where we are continuing to see strong demand particularly for our products, and whether that is our e-Learning product or our new Blackboard Connect and Blackboard Transaction product, as well and we are continuing to increase our sales focus to make sure that we are getting this product out in the hands of the clients; and we are seeing a lot of success there with the cross selling.

Just a technical note to your comment about the next release of our software. All of our clients are on annual subscriptions, so they continue to upgrade and get all future releases of our software just as they are released to the public, so there is not any delayed reaction to purchase because of that, if anything I think it really gets people excited about the future direction that we are headed in as a company and certainly we think that just as the vision we are outlined can also help enhance our new sales opportunities.

Michael Nemeroff - Wedbush

Then just one follow-up for Mike Beach if I may. At the User Conference and analyst sessions, you talked about the dilemma of how you account for some of these statewide contracts and the number of absolute enterprise licenses that you will book. Can you tell us how you accounted for the State of New Mexico this quarter and how you plan on accounting for those statewide deals in the absolute enterprise count going forward? Thank you.

Mike Beach

It is a great question, Michael. As it relates to the enterprise counts, currently New Mexico is included in the counts, just that the amount of clients that were previously using the product in New Mexico. When the system goes live which will be the end of this year, early next year, then we would be able to better determine the number of actual users of the system and I think that relates as well to the revenue recognition impact that we also will not be able to recognize revenue on this deal until the end of the year.

We talked about the fact that, about a $1 million of services revenue that would have been recognized had it been another type of transaction will be pushed from this year into next year just related to services, but also the run rate of this contract which is about $2 million in product revenue, that will not begin until the system goes live .So we will get virtually no revenue recognition off the New Mexico deal, obviously have both selling and other upfront cost that we will incur this year and all the revenue benefit will begin next year.

Michael Nemeroff - Wedbush

Thank you.

Operator

Your next question will be from the line of Amy Junker of Robert Baird. Please proceed.

Amy Junker - Robert Baird

Hi. If I can just ask a clarification question to you, Mike Beach about the two gains, just for purposes of modeling, if we wanted to strip those out what the after-tax amount of the $4 million gain that you got as well as the $3.3 million from D2L. Do you have that information?

Mike Beach

Yes, so Amy, basically pretax income back out those gains and then apply the 35% effective rate that we applied that we had guided to, the impact of those items are going about $0.12 in the quarter.

Amy Junker - Robert Baird

Okay. Perfect. That is helpful. Just to clarify, when you provided guidance for the second quarter in your last conference call, did that assume either the $4 million gain or the proceeds from the patent judgment?

Mike Beach

No.

Amy Junker - Robert Baird

Okay and do you expect any more gains from the patent judgment or is that a one-time thing that should not continue going forward?

Mike Beach

Yes we would not expect anything and it is not in guidance.

Amy Junker - Robert Baird

Okay, great. Michael Chasen, I was hoping you spend a minute to talk about the announcement that you made with the plan to develop the Sakai Integration, what exactly do you hope to achieve with that announcement and can you talk a little bit on the timing? I know you are waiting for the NextGen product to come out with that, but can you just share a little bit of the timing?

Mike Chasen

Sure at the Blackboard World, we talked about how in the future of our product and this is an issue we are actually working closely with a couple of universities on, that our learning system will be able to load other course management system courses through our interface. One of the issues they were having is a lot of campuses have standardized on the Blackboard system and we are the standard product for almost the entire campus, but there maybe an individual teacher or a very small department that is using either a home-grown system or maybe an open-source solution and then why really should the students or faculty members have to go to a separate url or a separate log-in to be able to access those courses.

So recognizing that Blackboard is that campus industry standard we have actually gone ahead and opened up our course management APIs to allow for home-grown systems or home-developed systems or other third-party systems to be served if you will and load through our interfaces so that you can log in once and access all of their courses whether they are Sakai courses as you mentioned or other open source or home-grown solutions all from the Blackboard Interface and I think this will help improve teaching and learning on the campus because you are able to aggregate all of your courses in one area.

As well as to show that if you are looking at installing Blackboard on your campus, you are installing a very open system that you can customize to meet your institution's needs. We have had nothing, but tremendous positive feedback from the industry and in particular our clients on that announcement.

Amy Junker - Robert Baird

Great and then last question, just can you talk a little bit about the trends you are seeing internationally, what the growth was like in the quarter and how that has been faring? Thanks.

Mike Chasen

We continue to see a lot of opportunity internationally. We are doing certainly very well throughout Europe and as you know I like to focus some of my time on some of the emerging markets such as China and the Middle East which I will be heading back to in just a month or two for our very second Blackboard Dubai Day.

As I mentioned in my comments, the SENA is now one of the largest international e-learning installation and that continues to grow at a very large rate and we are very proud that it is our technology that is powering that initiative. So, I think throughout, and really, globally around the world we are really starting to see some strong demand in different countries.

Amy Junker - Robert W. Baird

Great, thank you.

Operator

Your next question is from the line of Tom Roderick of Thomas Weisel Partners. Please proceed.

Tom Roderick - Thomas Weisel Partners

Hi. Good afternoon and thanks. I just wanted to see if you could go into a little bit more detail on some of these big deals, New Mexico, in particular, with respect to the impact on the financials of some of the metrics. So you talked a bit about the impact of the cost side and the revenues will be taken later. Can you give us a sense as to how much some of these deals impacted the contract value? Then also, as we look at the balance sheet, there is big jump in accounts receivable this quarter. So help us get our hands around the DSOs as well, were those impacted by the big deals? Thanks.

Mike Beach

So as it relates to contract value, New Mexico is not in contract value. Will not be until this system goes live, the other two deals, I believe, are. We look at them from an order of magnitude. The New Mexico deal, as I said, has about $2 million run rate of product revenue. The other deals are more in the $0.5 million range with some potential to become much larger over time.

About the revenue recognition on the other deals we talked about, we will have revenue recognition on those starting in the third quarter. However, New Mexico is the one that is going to have the largest delay right now. As it relates to receivables, really what is driving that is a lot of these large deals closed at the end of the quarter, so we had had some very large receivables that were created and sent out at the end of the quarter, and that is driving that dynamic.

Overall, the aging looks really good; much better than it has looked in the last couple quarters. So feel real good about where receivables are today.

Tom Roderick - Thomas Weisel Partners

Okay, good. Maybe looking at the renewal rate, so the 92%ish is still very good. Can you just remind us with Q3 coming up, and that is your biggest renewal period, what should we have for an expectation about the total license count, in particular the Enterprise license count, knowing that is your biggest renewal period? Should churn rates stay even where they are? Should we think about that number being flattish, down, up? How would you encourage us to think about for next quarter?

Mike Beach

I would look back at the dynamics over the last two years, particularly last year, and I would expect that we would have similar dynamics in Q3 of this year. Obviously it is a big renewal quarter. Due to that fact, we experienced by far the largest amount of drops just due to the nature of the timing during the year. So those drops are offsetting the new sales we are having in the quarter. It is a dynamic that, looking to last year, would give you the best way to model.

Tom Roderick - Thomas Weisel Partners

That is great. That is it for me. Thank you.

Operator

Your next question is from the line of Kirk Materne of Bank of America. Please proceed.

Kirk Materne - Bank of America

Maybe just for Michael Beach, just so it is clear, at least I have it clear, the only really change, perhaps, from an operating cost standpoint, has been the fact that some of bigger deals are bringing on more cost upfront. For the next couple quarters, but maybe looking out over the next year or so, I think you have talked publicly about trying to save out 200 basis points of margin expansion. Is that still the goal? Or is this new focus or these new opportunities going to make that harder to achieve?

Mike Beach

No, we still are targeting 200 basis point expansion next year. Looking at these big deals, I think they are going to help us as we enter into 2009 from a margin expansion perspective.

Kirk Materne - Bank of America

Okay. So as you start getting, as they start rolling in that, as we get into '09, that should counteract any negative effects you are going to have in the back half of the year. Is that fair?

Mike Beach

Yes. That is correct.

Kirk Materne - Bank of America

Okay, great. Then just for Michael Chasen. Can you just talk a little bit about, you have rolled our some new starter products in the K-12 area, I gather it is still very new around those. However, could you just give some color in terms of how those are doing thus far and some of your thoughts around that area?

Mike Beach

Sure. It is still very early to say we have really just started to work to make sure that our e-learning product is specifically fitted to tackle the unique challenges of the K-12 market base. One thing I can say is, we have some very good early positive momentum and we are started to build up a lot of excitement in the K-12 space around it. So they are early to tell but we are feeling very good about it.

Kirk Materne - Bank of America

Okay. Then just one last question. Clearly you have done a lot of work around the code-base and WebCT. Talk about some of the customer perceptions that you came away from at Blackboard world? Is that customer base now able to be up sold into at this point in the back half of the year? Is that more of an opportunity for 2009, in your view?

Michael Chason

Well, I think already this year, we have started to cross-sell successfully into the WebCT installed base, also as many of the WebCT clients have moved up to the most recent version of the software, they have noticed auto considerable amount of their problems that have now gone away as we manage to fix the offending bugs and issues in the code. However, most importantly, at Blackboard world, the sense we got from when we laid out our vision of where we were driving the products and the company, and combined with the improvements they have seen in support in our product, it really excited them to continue to stay and expand with Blackboard in the long run.

So I think we are going to continue to see tremendous amount of opportunity from across our whole installed base, whether they were previous Blackboard clients and at this point, I might be so bold to say that really all of our clients see themselves as now just Blackboard clients moving forward and are looking for additional opportunities to be able to expand the relationship with us.

Kirk Materne - Bank of America

Great, that is all I have. Thanks very much.

Operator

Your next question will be from the line of Kash Rangan of Merrill Lynch. Please proceed.

Kash Rangan - Merrill Lynch

Hi. Thank you very much. I am just trying to reconcile the new guidance, especially in the earnings side with the one-time gains and how much of it is attributable to the core business absent the one time gain. So maybe, Michael Beach, if you bridge that for us, and look at your previous guidance, $0.61 to $0.69, if I just look at the high end of that range, and look at the new guidance, it is $0.73 to $0.78. It is about $0.09 bump-up and you had a $0.12 benefit from these one time items. So if you can just bridge us with what the Delta is? How much of that is coming from lower than expected tax rate? How much of it is coming from higher than expected, perhaps, sales and marketing expenses in the second half of the year? That will be great. I have a follow-up question.

Mike Beach

Okay. So obviously, the Desire2Learn work as $3.3 million and the gain from other income, $3.8 million. They have the $0.12 impact in third quarter, from a tax perspective, full-year, it is contributing the benefits about $0.04 cash. Then the remaining difference is really are the items that we talked about, the increased expenses related to these larger deals, and the impact on services, particularly the lack of revenue recognition on the New Mexico deal.

Kash Rangan - Merrill Lynch

Okay, got it. So if I take the low end of the range, the $0.12 bump-up is entirely attributable to the one-time, and what you are saying is a tax benefit of $0.04 is offset by the sales and marketing expenses, and the loss of $1 million in professional services revenue that offset the tax benefit by $0.04. That is one way to look at it.

Mike Beach

Yes, I think that is generally in line.

Kash Rangan - Merrill Lynch

Okay, great. Thanks for the clarification and also, looks like Connect had had a really strong quarter, a lot of the excitement was palpable at the User Group. I am just curious, with what seems to be more than one quarter of execution, good execution along the way,

I would have expected you to be able to take up guidance even more than what, you obviously raised the low end of the revenue guidance, but the contract fairly coming in as strong as it did, I'm just curious what are your thoughts on this are; are you being conservative with what you expect out of the Connect business for the second half of the year as can be implied by your revenue guidance not really going up a whole lot? That is it for me. Thanks, good quarter.

Mike Chasen

Sure, thank you very much. The one thing that I do want to point out, certainly we are very excited about the early success we have seen with Blackboard Connect, the amount of deals we have been closing, focused not only in the higher education market, but in K-12 and the government opportunity as well.

We are also really excited how we have started to take advantage of the installed base we already have in the number of cross sells we have had. That being said, our organic contract value growth was very strong as well, as I mentioned in my prepared remarks. Our higher Ed team had really what I consider to be one of the most successful quarters in years.

So, we had a very successful growth just in contract value based on the e-Learning and Blackboard Transact business as well. Certainly, as we look at the numbers for the rest of the year as we have now closed out Q2, we have very strong recurring product revenue and a big deferred revenue balance and we do factor that into the guidance. So I think we are really accurate in our projections for the rest of the year, but are certainly very excited about the opportunities.

Mike Beach

I think, Kash, as you look at the revenue guidance, the thing to keep in mind is, obviously the New Mexico delayed revenue recognition related to services and the transaction system delay related to the rollout of the product is going to have some impact in the rest of the year. So really services are countering the increases that we are seeing in product revenue for the remainder of the year.

Kash Rangan - Merrill Lynch

Okay, that helps to understand the ops. So obviously the Connect business is tracking ahead but it has a negative impact from the BTS delay and the New Mexico not being recognized in 2008.

Mike Beach

Yes, and the important thing to remember is our service recognition is generally upfront, whereas obviously all the product recognition is ratable.

Kash Rangan - Merrill Lynch

Got it.

Mike Beach

So service is pushing, has a material impact, much more material impact in the quarter, or in near term, but it is getting offset and for the second half of the year we slightly took up the revenue number for the second half of the year. It is getting offset by stronger product revenues, which are being recognized ratably. So we feel really good about the top line.

Kash Rangan - Merrill Lynch

Great. That is it for me. Thanks a lot.

Operator

Your next question will be from the line of John Lee of Signal Hill. Please proceed.

Unidentified Analyst

Hi. Good afternoon. Can you discuss margins and if you see an ongoing trade-off between margins and growth? Then more specifically, if you regard the R&D is in elevated level right now as a percentage of revenue or if you think it is going to come down.

Mike Chasen

I think if you look at the operating margins for the remainder of the year we would expect to get some leverage in the next two quarters, more leverage in Q4 than Q3. I think, as you look at it by line item, I would expect for the full year, as a percent of revenues the operating expense items to be generally in line with what we experienced in Q2 which is generally in line with the guidance we gave at the start of the year which was that we would exit this year similar to how we exited last year. The only difference is sales and marketing as a percent of revenue is going to be slightly higher for the reasons we discussed on the call.

Unidentified Analyst

What about R&D in the longer term over the next couple years as you chase the international opportunity or K-12 or anywhere else?

Mike Chasen

One of the great things about the education market is specifically the area that we are focused in is that when you look globally, education is then very similarly across all the markets. We are able to leverage the significant investment we have made which was originally focused in higher Ed into the K-12 and the international markets with very little additional development.

Certainly a small amount for the languages of international and one or two specific items in K-12, but otherwise throughout all of our R&D, we are able to really leverage well across the market. So I think we will continue to see the expansion of the margins as R&D becomes a smaller piece of overall expenses for the long run.

Unidentified Analyst

Okay, great. Then just one more question. Can you discuss the drivers of growth in contract value per license? How important is the migration from basic to enterprise licenses versus the other factors?

Mike Chasen

So, I think if you look in the quarter, the drivers of growth are going to be just the strong general sales during the quarter, particularly in U.S. higher-ed on the historic Blackboard side of the business, and up sells contribute to that, but, it is just one factor. I would not say it is a predominant factor. You also had the NTI sales. NTI grew nicely during the quarter. Overall, within both NTI and Blackboard, a driver of contract value was really larger deals than in the past. So those are really driving it.

Unidentified Analyst

Okay, great, thank you.

Operator

(Operator Instructions). Your next question will be from the line of Robert Riggs of William Blair & Company. Please proceed.

Robert Riggs - William Blair & Company

Hi. I have just a couple of quick questions. Can you comment on the average new deal size that you are seeing versus what you saw in Q1?

Mike Beach

If you look at the average deal for the quarter, it is going to be lower because of the volume of Connect sales.

Robert Riggs - William Blair & Company

Okay.

Mike Beach

You can see that in contract value per license. It is down quarter-over-quarter basically because of the volume of deals on the connect side and their average selling price.

Having said that, we talked about some very large deals during the quarter, so we are seeing some very nice large deals, but we do have the new dynamic of the Connect business, which on average a lower price point per customer. However, again, their price point per customer can range pretty radically, but on average it is going to be lower than the Blackboard average license price.

Robert Riggs of William Blair & Company

Great. Then you keep adding clients to do hosting. Can you comment on any trends in hosting, maybe differences between what you are seeing in the U.S. than in the international markets?

Michael Chason

One of the things, we talked about this earlier in the year, is that sometimes well either from a legal or marketing perspective, our international clients require that the hosting is done within the continent, either because of their own country regulations, or just from a marketing aspect they want to know that the data is hosted in continent. So, certainly as we have established our hosting centers overseas we have started to see some of it conflict with international hosting.

Overall, a general trend that I can talk to, is certainly, as our clients continue to achieve the scale and success they have, they recognize that they need professional commercial organization to be able to run and monitor their e-learning installations, and they are continuing to turn to Blackboard to run the systems for them, whether they are new clients just now coming on board, recognizing the importance of their system, or existing clients that have not deployed locally but have reached a certain level of either required uptime or complexity that they want to hand it off to Blackboard to continue to run. So we see a very strong continued pipeline for managed hosting.

Robert Riggs of William Blair & Company

Great. Thanks.

Operator

Your next question will be from the line of Amy Junker from Robert W. Baird.

Amy Junker - Robert W. Baird

Hi. I just had one last question. Can you speak to what the contribution was in the quarter from NTI and the revenue line and how much you wrote off? I was interested in how much actually contributed to revenue and what the actual total revenue would have been if you did not have to write it off.

Mike Beach

The actual revenue contribution for the quarter is $6.8 million, and the adjustment would have been $4.3 million in the quarter.

Amy Junker - Robert W. Baird

So $4.3 is what you booked?

Mike Beach

No, 4.3 is the adjustment. That would have been the purchase accounting adjustment.

Amy Junker - Robert W. Baird

So then the difference is what actually hit the revenue line.

Mike Beach

6.8 hit the revenue line.

Amy Junker - Robert W. Baird

Okay, sorry. Thanks.

Mike Beach

That is no problem.

Amy Junker - Robert W. Baird

Thank you.

Operator

I show there are no more questions at this time. I will turn the call back over to management for closing remarks.

Michael Chason

Thanks, Jenny. Thanks, everyone, for participating. Hopefully we will see you out on the road over next couple of months. Otherwise we will plan on talking to you in all likelihood the last week of October, first week of November. Thanks very much. Bye-bye.

Operator

Thank you for your participation in today's conference. This concludes our presentation, and you may now disconnect. Have a great day.