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XRX - Q2 2018 Xerox Corp Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the Xerox Corporation Second Quarter 2018 Earnings Release Conference Call, hosted by John Visentin, Vice Chairman of the Board and Chief Executive Officer. He is joined by Bill Osbourn, Chief Financial Officer.

During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor. At the request of Xerox Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox. After the presentation, there will be a question-and-answer session. (Operator Instructions)

During this conference call, Xerox executives will make comments that contain forward-looking statements, which, by their nature, address matters that are in the future and are uncertain. Actual future financial results may be materially different than those expressed herein.

At this time, I would like to turn the meeting over to Mr. Visentin. Mr. Visentin, you may begin.

Giovanni G. Visentin - *Xerox Corporation - Vice Chairman & CEO*

Good morning, and welcome to Xerox' Second Quarter 2018 Earnings Conference Call.

Before we go through our second quarter results, I'd like to take a few moments to share with you my initial thoughts about Xerox since becoming CEO and the priorities we have set to drive value for all our stakeholders.

I joined the company because I saw an opportunity to rebuild Xerox into a leading tech company. I've spent considerable time talking with customers, partners and employees. There is one common theme: they want us to succeed. We are an important and often critical component of our customers' and partners' work processes and their success. They recognize the quality and ease of use of our products and many have strong, personal relationships with our company. Channel partners work with us because of the breadth of our portfolio and because of the support we provide, such as the marketing and training tools and resources that help them grow their business. Our customers and partners expect Xerox to bring breakthrough solutions to the market more quickly to help them keep pace with continuously changing technology landscape, and we need to be easier to do business with. Xerox employees care deeply about our company. One of the first things I did as CEO was reach out to employees and ask them to share with me what they think of Xerox. What do we do well? And where do we need to improve? Their responses reaffirmed my assumption that the team has the knowledge and enthusiasm to transform this company, and they want change. They want to be part of a company that is growing, a company with a new way of working, a company they can be proud of.



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We have a portfolio of leading-edge, feature-rich products and solutions that support the needs of our customers. In the office, we have ConnectKey technology that is powered by an embedded, secure, cloud-enabled workflow management software platform with artificial intelligence and real-time analytics that enables the same app-based flexibility on our products that app stores do on mobile phones. Software-based flexibility is the new paradigm for hardware, and we are leading our industry with ConnectKey. With the Xerox App Gallery, users can download apps to a ConnectKey device and make their work easier. There are apps with broad appeal, like those that scan to a cloud-based repository and apps that are industry-specific, like the health care MFP app, which enables the HIPPA-compliant paper-to-digital content workflow.

At the high end of the business, our focus is on helping our graphic communication customers be more profitable. In May, we launched the Iridesse Production Press. What is special about Iridesse is its ability to use clear and metallic silver and gold dry inks for print embellishments, a lucrative market for commercial printers. By layering the inks, it can create images that are iridescent in one pass through the machine, eliminating multiple presses and processes, saving our customers both time and money. Demand for Iridesse has exceeded our plan.

Beyond products are our software and services. We are a leader in managed print services. Industry analyst firms, IDC, noted in their most recent report that we have been at the forefront of the industry when it comes to enabling workflow optimization. We are growing this business, expanding offerings for the channel, but growth remains in the low single digits. This tells me that we have more work to be done.

Our software business are some of our best-kept secrets. They are small, but they have tremendous growth potential. For example, our DocuShare offering, think Dropbox, think Box, is a cloud-enabled and helps companies manage their digital content, one of the biggest challenges we all face. We will soon launch a series of solutions for our DocuShare Flex cloud repository that will connect and allow the integration with applications, such as Salesforce, Intuit and DigiSign. Such integrations will simplify business processes and enable automated workflow apps. XMPie is a second software business, and it provides customers with technology to transform their print business into omnichannel print and digital communication businesses. Just last week, we won an InterTec award for XMPie's Circle PersonalEffect Edition. This automation software connects every stage of marketing campaign production. We need to take our software and services businesses to the next level.

One of the first areas I recognize that we must take better advantage of is our innovation in high-tech portfolio. I conducted reviews in PARC in our operations in Webster, New York and was impressed by what I saw. We have valuable and differentiated offerings that are underutilized as well as some new technologies, work that's underway in our labs that has the potential to disrupt industries. And as we develop and deploy these technologies, we must think differently about business models. Is our role to be the system integrator and provider of the entire offering? Or for some of these technologies, are we better off following the model of Intel in the PC industry and focus on high-value technology elements and sell them broadly across an industry? What I saw in our labs tells me that Xerox has the potential to go beyond our current core markets and achieve scale by providing a critical technology element for several high-growth emerging areas where we do not participate today. While we may choose not to develop the product, we have technology that will go into others' products: it could be inks and imaging systems for digital packaging, it could be printheads and materials for 3D printing, it could be low-cost pollution or hazardous gas sensors to keep us and the environment safe. The exact path of these opportunities is hard to predict, but the opportunities are real.

Another opportunity is in optimizing our business. To do that, we need to look at things differently. Xerox has been running cost takeout programs for years, but they have not been effective. The benefits are not flowing to the bottom line. And as we saw this quarter, margin was down 130 basis points. The processes and the systems we use are complex, as is our operating model. For example, there's a lack of clarity on decision authority and who is accountable for outcomes in our current matrix organizational construct. Often, the result is management by committee and a painful decision-making process. We have over 1,000 IT systems. It takes resources to manage all these systems and disparate data from various systems hampers the decision-making process. From order entry to product install, to repair and billing, we need to redefine our supply chain not only to meet customer requirements, but also increase our competitiveness. We will anchor the transformation of our business on improving how we serve our customers and partners, better differentiating our products, services, systems and resources based on the way they want to be served.

The majority of our revenues are recurring, which drives the dynamic of a relatively stable cash flow over time. This cash flow gives us the room to invest in the business and more directly return cash to shareholders. We have not effectively deployed our capital. M&A has been minimal, and we've not done share repurchases in the recent past. It's important that we have a maniacal focus on maximizing cash flow, ensuring its strength well into the future.

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From this assessment of the business, we can pivot to our priorities. First, we have an opportunity to drive improvement in our top line by addressing how we go to market. We need to take a strategic approach to customer engagement, to meet their evolving needs, both in how they choose to buy and the level of service necessary for their business. We're going to make sure that we have the right mix of direct, indirect and online or e-commerce channels to support our various clients. And we're going to work with our channel partners, whether they are agents, concessionaires, document technology partners, solution providers or velocity partners to create frictionless processes and quick response times. To make this happen, we need to optimize our operations, which is our second priority. This is more than just process optimization. We need to optimize the way we are organized, our product portfolio, our supply chain, our financial model.

Xerox carries the legacy of a much larger business with processes, systems and resources beyond what are required or affordable today. We need to change the way we operate. In our supply chain, we need to think differently and holistically to eliminate costs while ensuring we get the right offering to the right customer at the right time. We will drive for greater efficiencies, reduced complexity and faster time-to-market to enable an integrated customer experience.

As we improve our operations, we know that to be a tech company, we must reenergize our innovation engine and to revamp our innovation business model, to invest in our own capabilities as well as M&A to enable commercialization of technologies we create. We also need to pursue more partnerships to accelerate our competencies while still maintaining our core differentiation in IP for value capture. And finally, we will have a priority of always focusing on our cash flow and capital returns to generate shareholder value.

I spoke earlier how cash flow is a critical measure. We are looking at everything, all the pillars of working capital to drive cash flow growth. And in terms of capital deployment, we are revitalizing our M&A engine, and we'll deliver our commitment to return at least 50% of our free cash flow to the shareholders. And today, we announced that Xerox Board of Directors authorized a \$1 billion share repurchase program and that the company will opportunistically repurchase up to \$500 million in 2018. This positive step forward is a strong endorsement of the company and represents an immediate action to deliver value to our investors.

I want to directly address some of the most frequent questions I hear. First, we are not conducting an auction process for the company. An auction is time-consuming and costly. If a potential buyer comes forward, it is the responsibility of the board to consider any proposal that could generate additional shareholder value. The team and I are committed to doing what's best for Xerox, and we are focused on strengthening the company. We've been asked if all the recent news, headlines and changes have negatively impacted our business. That's not something that is easily measurable, but I can tell you we're not here to give excuses. What we've realized is that our customers and partners want us to succeed. We have work to do to further simplify our operation, but we have a solid base to start from. And that is going to be our focus. We're not looking back. That's also why I'm not going to talk about Strategic Transformation program. We are taking a new comprehensive end-to-end approach to optimize our operations, drive sustainable cost saving more directly to the bottom line and improve how we serve our clients and partners.

The final 2 questions are related to Fuji Xerox. As you know, in June, I sent a letter to Fujifilm Chairman, Komori, in response to their lawsuit seeking to save the proposed merger of Fuji Xerox and Xerox. We are confident in our right to terminate the transaction and we'll defend ourselves through the legal process. The lawsuit was the first communication I received from Fujifilm or Fuji Xerox, and it was a surprising tactic from a company that is also our supplier.

The letter to Fujifilm stated that we currently do not intend to renew our TA agreement with Fuji Xerox when it expires in 2021. I want to clarify what that means. First, Fuji Xerox is a joint venture between Xerox and Fujifilm, and the TA establishes the technology and brand licensing relationships between the 2 companies. Not renewing the TA does not dissolve the joint venture. We have a 25% ownership position in Fuji Xerox that is governed by a separate joint enterprise contract.

As I have said, we will do what is best for Xerox. This is true of the work that we are doing to improve our supply chain to be more competitive. This means we need to source products, parts and supplies from the best and most competitive suppliers. Fuji Xerox is one of our suppliers today providing 59% of our cost production, and we will continue to work with them in areas where they are competitive. We manufacture a portion of the remaining 41% ourselves and have high-quality suppliers for the rest. But we are rethinking the way we choose our suppliers. The company in the past has not seriously pursued other suppliers. But recently, we were successful in partnering with a supplier for a new product. Just because a supplier has had business with Xerox in the past does not guarantee future business. They will have to earn our business. With all of our suppliers,



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we execute comprehensive contracts for each product. And these contracts assure continuity of parts and supplies over the product's life. As for Fuji specifically, we have not seen any disruption in our supply chain. I am confident in the continuity of supply of Xerox equipment parts and supplies, and we have time to work changes in our supply chain to be more competitive and to better serve our customers and partners.

At this point, we turn to the financial results. Our second quarter results were mixed. Equipment revenue and cash flow were good while margin was pressured. Total revenue declined 4% at constant currency. Within that, equipment revenue was better, up 0.9% or down 0.6% at constant currency. Post sale revenue was a disappointment, down 5%. There were a couple of one-off factors that Bill will cover, but we need to deliver multiple quarters of better equipment performance to drive post sales revenue improvement.

Profitability in the quarter was lower than expectations. Adjusted operating margin of 11.9% improved 150 basis points from the first quarter, but declined 130 basis points year-over-year as cost savings were not enough to offset the impacts of revenue declines and other factors. As a result, adjusted EPS of \$0.80 was down \$0.06, reflecting the impact of the overall lower operating profit.

Through the first half of the year, we generated \$451 million of operating cash flow, which was above our expectation, and we ended the quarter with \$1.3 billion of cash on the balance sheet. As I mentioned previously, with the restart of our share repurchase program, we plan to opportunistically repurchase up to \$500 million in shares in 2018. We are committed to returning at least 50% of our free cash flow to shareholders in the form of dividends and share repurchase. Return of cash flow to investors is an important and appropriate element of our capital allocation policy given our strong cash flow profile. And we are pleased to restart the program, especially at a time when we believe our shares are not trading at their underlying value.

I'd like to hand the presentation over to our CFO, Bill Osbourn, to review our financial performance in more detail.

William F. Osbourn - Xerox Corporation - Executive VP & CFO

Thanks, John. I'll start with the review of the income statement.

Revenue in the quarter was down 4% in constant currency while at actual currency was down 2.2%, reflecting almost 2 points of translation currency tailwinds, a diminishing benefit from the approximate 4% top line currency impact in Q1.

As John highlighted, we are not seeing the degree of turnaround in revenue that we believe should follow our recent significant product launches. And while equipment revenue market share improved 1 point year-over-year in Q1, the latest available share data, we need our market share to recover over multiple quarters to drive increases in machines in field and improve trends in post sale. I'll cover in more detail what we're seeing in revenue by geography and product area on the next slide.

Turning to profitability. Adjusted operating margin of 11.9% declined 130 basis points year-over-year. The decline came from the combination of insufficient productivity to offset revenue declines as well as a few quarter-specific headwinds. Gross margin of 39.9% was down 70 basis points in the quarter, driven in part by a less profitable mix of revenues. From a stream perspective, we had a higher percentage of equipment versus post sale. And within equipment, we weighted toward lower-end product sales. Additionally, last year's results included positive impacts in post sale from a contract buyout and higher licensing revenue.

Within SG&A, as forecasted last quarter, we were impacted by \$13 million of accelerated depreciation related to a decision to consolidate facilities in Rochester. The combined Q1 and Q2 impact was \$22 million. Going forward, it will save us about \$13 million annually. We also had a \$7 million impact from the write-off of an IT project, within delivery, that would seem to no longer have a sufficient return on invested capital due to changes we are making in the business. Absent these 2 factors, SG&A would have shown a reduction year-over-year of \$22 million. Lastly, both R&D and equity income were essentially flat year-over-year, so did not impact margin.

Turning to the below-the-line items. Adjusted other expenses net of \$14 million were \$20 million better year-over-year, driven by a gain of \$16 million associated with the sale of a noncore business asset. Adjusted tax rate of 26.7% was within our full year range of 24% to 27% and roughly flat year-over-year. Overall, adjusted EPS of \$0.80 was down \$0.06 from the second quarter of 2017, driven by the lower operating profit.

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On a GAAP basis, we had \$0.42 of earnings per share, which was down \$0.21 in the quarter, driven by \$0.17 of transaction costs. The difference between GAAP and adjusted EPS also includes our normal adjustments around restructuring and related costs, including those for Fuji Xerox; non-service retirement-related costs; and amortization of intangible assets; as well as the \$58 million in transaction costs.

Revenue continues to be a mixed picture. Overall, total revenue was down 4% in constant currency, which is modestly better than Q1 and full year 2017, driven by equipment revenue. One factor impacting revenue is higher declines in our OEM business, reflected under other revenue, which was down \$31 million in the quarter and represented nearly half of actual currency revenue decline. As noted previously, the OEM business has a very concentrated set of customers, and we recently have been impacted by the change in strategy by our largest customer. We expect this headwind to be with us for the remainder of the year with an approximate negative 1 point impact on total revenue.

Turning to the geographic sales channels. North America revenues were down 1.8% versus down 2.8% in quarter 1 with continued growth in Global Imaging Systems reflecting SMB business as well as an improvement in U.S. enterprise and channels driven by equipment. International declined 3.9% versus 5.5% in quarter 1 at constant currency with the continued pattern of declines in Europe being partially offset by growth in developing markets. Our highest area of decline was in other, driven by the OEM business, as just highlighted.

Looking at the revenue streams. Equipment sales revenue, or ESR, in the quarter was relatively flat at constant currency, reflecting improvement of the prior year weak equipment sales. From a product area perspective, we saw the following: entry equipment revenue grew 10.6% in constant currency with double-digit growth in both entry color and black and white products. This was a good recovery off the 11% decline last quarter and reflected good demand for new products. Mid-range equipment revenue comprised 69% of equipment revenue and grew 7.4% in constant currency and had a third quarter in a row of double-digit color install growth. We have started to see share gains after having lost share in mid-range prior to last year's product launch. It is important we maintain this positive momentum so we can rebuild our machines in field. Lastly, high end continues to be weaker, down 9.9% in constant currency, which was consistent with quarter 1. Although we saw a good reception for our recently launched Iridesse platform, we only had a partial quarter of benefit, and it was not enough to offset declines in other product segments, including iGen.

Post sale declined 5% in constant currency, which was about 1 point worse than trend driven by the continuing dynamics of lower page volumes, reflecting equipment sales declines in prior quarters as well as an approximate negative 0.5 point impact from the lower licensing and prior year contract buyout I referenced earlier. Within post sale, we did see some improvement in supplies revenue, which comprised 13% of total revenue and grew outside of the OEM business. I'll wrap up revenue by highlighting that Managed Document Services grew this quarter, up 2.3%, driven specifically by growth in the SMB-focused Partner Print Services as well as from higher equipment sales.

Turning now for a closer look at Xerox' profitability performance. As stated, operating margin in the second quarter was 11.9%, an increase of 150 basis points from Q1, however, down 130 basis points year-over-year. And adjusted EPS in the quarter was \$0.80, a decline of \$0.06 year-over-year. As highlighted earlier, there were a few unique onetime items we're calling out as we think it is helpful to talk separately to the more operational performance and then to the truly unique items. We believe our operational performance drove an adjusted operating margin of 12.7% and adjusted EPS of \$0.81. This reflects a decline year-over-year of 50 basis points to margin and \$0.049 to EPS, driven by the impact of revenue declines, which includes ongoing price declines of an approximate 5% on equipment and low single digits on post sale as well as a less favorable margin mix of revenues described earlier. These factors were only partially offset by the positive impact of cost savings and currency.

In terms of unique onetime items in the quarter, there were 3 that we believe should be highlighted, 2 negative and 1 positive. They include \$13 million of accelerated depreciation associated with the consolidation of real estate in Rochester. This had a 52 basis point impact to margin and a negative \$0.036 impact to EPS. As of June 30, this accelerated depreciation has been fully recognized. In addition, there was a \$7 million IT project write-off, which had a 28 basis point impact to margin and a negative \$0.019 impact to EPS.

Partially offsetting these impacts was a noncore asset sale of \$16 million. This came through other expenses net so had no impact on margin, but was a boost to EPS of \$0.044.

For the second half of the year, we're not giving specific guidance on margin as we continue to build out the plan to support the priorities John highlighted. That said, it is correct to take away from our discussion that the focus on improving profitability is very high, and we expect higher

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margins from this business over time. Operating cash flow was a source of \$235 million in the quarter, and we are at \$451 million through the first half while free cash flow was a source of \$203 million in Q2 and \$401 million for the half.

Cash flow is priority 1 to the business, and I'd like to take a minute to cover our results through 6 months. Working capital has been a use of \$93 million through 6 months driven by timing of payments and includes \$38 million of transaction and related payments. A great emphasis is being placed on improving all the cash conversion cycle pillars to drive even greater cash efficiency.

Finance receivables have been a source of \$149 million through 6 months, which compares to \$167 million for the same period last year. Typically, finance receivables are higher source in the first half given the seasonality of revenues, but this is an area where we would trade in being less of a source for higher equipment sales. Pension contributions are \$75 million through 6 months while restructuring payments are \$91 million. Our guidance was for \$200 million for the full year for each of these areas. Pension contributions are running under that amount so there could be an opportunity to do better there while restructuring payments will likely not be an opportunity given the greater focus on productivity.

Lastly, CapEx in the quarter was \$32 million and is at \$50 million through 6 months. This is an area where we are placing greater scrutiny and could be an opportunity as we move into the back half of the year.

In summary, the first half cash flow performance puts us well on track to maintain our full year expectations for both operating cash flow and free cash flow.

If we turn to the next slide, I'll finish by speaking to our capital structure. The second quarter ended with \$5.2 billion of debt and \$1.3 billion of cash on the balance sheet. In the quarter, we reduced debt by approximately \$265 million through the repayment of the May 2018 senior notes. We break down debt between financing and core by first calculating the finance debt by applying a 7:1 leverage ratio to our financing assets, finance receivables and other equipment on operating leases with the remaining debt assumed to be in support of our core business. In Q2, this calculation resulted in an assumed financing debt of \$3.5 billion and core debt of \$1.7 billion. As the debt letters shows, we have no remaining maturities in 2018, with our next maturity of approximately \$400 million coming in March of 2019.

Another important element of our capital structure is our pension assets and liabilities. As of December 31, 2017, our net unfunded position was \$1.4 billion, which compared to \$2.2 billion as of December 31, 2016, and includes approximately \$850 million unfunded pension liabilities, which, by design, do not get funded. From a net unfunded perspective, we believe we are well positioned following the higher pension contributions last year.

Before turning it back to John, I'd like to spend a minute to talk about guidance. As you just heard from John, we are confident in our business as demonstrated by a reiteration of our cash flow guidance and the resumption of our share repurchase program. We will be driving for improvement in all financial measures. And with 75% of our business recurring in nature, we expect results will follow recent trends. However, we want to be sure we are making decisions for longer-term sustainability and hence, won't be giving specific near-term guidance, think balance of the year, outside of cash flow. We will be providing additional details on financial expectations for the business during an Analyst Day in late 2018 or early 2019.

I'll now turn it back to John for some concluding comments.

Giovanni G. Visentin - Xerox Corporation - Vice Chairman & CEO

Thank you, Bill.

Let me wrap up the presentation with a few closing remarks. We have an opportunity to transform Xerox to return to a technology powerhouse. We are starting from an enviable position. We have tremendous assets. We have great product portfolio and robust innovation capabilities. We have a recognized and respected brand. We have a great customer base, supportive partners and committed employees who are ready for change. We are ready.



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We will now open the line for questions. Jennifer?

Jennifer Horsley - Xerox Corporation - VP of IR

Thanks, John.

Before we get to Q&A with John and Bill, I will point out that we have posted on our Xerox Investor Relations website a full set of earnings materials to provide you with a review of our second quarter earnings. (Operator Instructions) Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ananda Baruah of Loop Capital.

Ananda Prosad Baruah - Loop Capital Markets LLC, Research Division - MD

I appreciate all the -- John and Bill, thanks for all the incremental context. That's helpful to start. Just, I guess, a couple if I could, and I'll try to be brief. Just, John, going to some of your remarks about initial impression when kind of peeling back what -- how you see Xerox to start. You made comments about opportunities to get more quickly to market, comments about opportunities to be easier to do business with. Could you maybe talk a little bit more about that? Are those significant opportunities? And how quickly can those things be addressed? Those seemed to be things you might speak to being able to impact the last year revenue growth. Then I have a quick follow-up also.

Giovanni G. Visentin - Xerox Corporation - Vice Chairman & CEO

Okay. Hi, Ananda. If you think of -- if I look at the initial perspective on the business, I see tremendous opportunity and with focus on the priorities we've discussed. But the complexity of the business is greater than I thought. So part of what we're doing in cost opportunities is we're looking at it in an operational way. Let me give you just an example. If you're looking at manufacturing a box for a client, you need to look at it end-to-end, from the manufacturing, what the costs are, to the development of it, to what's the value to the client, to how do you maintain it and how you ship it. And something as simple as if you can manufacture and ship a box under 45 pounds, you only need one person to deliver that box versus having 2 people delivering it. So when we're looking at optimizing the business, we need to look at things differently. Today, as an example, we have 1,400 IP applications to support our business. How do we simplify that? How do we take resources that manage all these systems and put it into an end-to-end solution? And our job is to identify all these issues in our processes so we can drive a clear accountability for decision-making and financial performance.

Ananda Prosad Baruah - Loop Capital Markets LLC, Research Division - MD

Got it. Got it. And then just quickly, your comments about new market opportunities, you highlighted software in a couple of different context. How prominent do you think software can become at the company? And then to the extent you can share that, what might be sort of, I believe philosophically, some other market segments that you guys think could be attractive to look at?

Giovanni G. Visentin - Xerox Corporation - Vice Chairman & CEO

Yes. Capitalizing on our innovation is a key priority, Ananda. Look, so we have assets like XMPie and DocuShare that we have not fully looked at the potential of these, both of these offerings. We also have new technologies that have potential to be disruptive. 3D printing, to make printheads that could change the industry in 3D printing. Packaging, we're creating inks that could revolutionize the way the packaging industry is out there



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today. We're working on artificial intelligence. We're looking at augmented reality innovations that will bring more content and be more useful, more valuable to our client. So our researchers are putting a lot of efforts in how do we take all of this and how do we capitalize on it. So I see a lot of opportunity in our innovation in our software business, which albeit today is small but growing, but how do we continue to focus on that.

Operator

Our next question comes from the line of Shannon Cross of Cross Research.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

I guess, John, you commented that auctions are off the table and that if a buyer presents itself, you would consider it. So should we read from that, that there are no active engagements right now for a deal? And are you -- or like -- are you committed to the fact that there's no relationship or no potential for an actual deal with Fuji Xerox to come together?

Giovanni G. Visentin - *Xerox Corporation - Vice Chairman & CEO*

No. So an auction -- to run an auction -- oh, first of all, hi, Shannon. To run an auction is time-consuming, and it's costly, and it's taking our people away from what's important, which is what we said our priority is to fix the business. So we are, first and foremost, focused on doing what's right for Xerox in strengthening the company. The board will evaluate a strategic alternative as indicated. But at the end of the day, someone -- if someone is -- if someone wants to offer -- wants to come in with a strategic offer, we would need to evaluate it and bring it to the board.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

Okay. And then...

Giovanni G. Visentin - *Xerox Corporation - Vice Chairman & CEO*

But I would not -- I -- yes. So I'm not commenting on any potential discussion. So...

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

Okay. And then what are your thoughts -- one of the things that didn't come up during the call were thoughts on investment grade. That's been something that Xerox has maintained for many, many years since the challenges back in like 2000. So -- or actually, I guess it took a while to get back. But what do you think about investment grade? Is it something that you need to keep? And then obviously, there was commentary in the press about the leasing business. What are your thoughts on the leasing business at this point?

Giovanni G. Visentin - *Xerox Corporation - Vice Chairman & CEO*

Yes. I would say, we're currently committed to our investment-grade rating. Nothing we announced today should signal otherwise. We have a strong balance sheet. We've met our commitments on paying down debt earlier this year. So we've got priorities in place to strengthen even further our business. So the board, in keeping with its responsibilities, will consider, when appropriate, strategic alternatives for the company. But there are no changes to communicate at this time.



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Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal & Analyst*

Okay. And then just my final question. I appreciate you're not providing earnings guidance because you're still going through the strategic review. But I don't know if you or Bill could possibly just talk about some of the trends or thoughts that you think will happen over the next couple of quarters just so people's numbers don't get sort of massively out of whack in terms of where you guys think things will flow through because obviously with cash flow, there are a lot of different levers you can pull to generate the cash flow. But in light of where we are at in earnings, it would be great to have some color.

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes. Thanks, Shannon. So yes, just a few things. To reiterate a few of my comments on the prepared remarks. We are very confident in the business. Yes, we think that the share repurchase is a clear indication of that confidence in the business and we believe that our current stock price does not reflect the true value of the company. We're driving for improvement on all measures, not just the cash flow measure. And as you know, 75% of our revenues are recurring in nature. And thus, you wouldn't expect our results to differ significantly from recent trends overall. And specifically, I know you understand that we're early in the new leadership here at Xerox, and we're specifically looking at all things. And we're making decisions for the longer term on sustainability. But our overall commitment is to do what's best for Xerox and that won't be measured by the next 3 to 6 months of an adjusted EPS number. With that said, we do believe that the cash flow guidance does provide some guide rails as far as overall expectations on where we'd be for the rest of the year. A few things to think about when you look back at last year's results, obviously, Q4 will be a tougher compare versus Q3. There were some one-time items you can go back to, specifically looking at what we reported last year in Q3 and Q4, like a headwind in Q3 this year from the Grenoble technology sale last year which will create about a \$0.03 headwind, there was also a lower tax rate during Q3 of last year given some tax reserve adjustments that took place which would create an additional \$0.06 headwind. But overall, when you look at just seasonality of the business is still true no matter what that Q3 tends to have lower operating margins than Q4. And then, I guess I'm trying to think through these things. Finally, on share repurchase, people can model through the impact, but we don't expect much of an impact in Q3 from the buybacks. However, there could be a modest benefit in Q4, up to \$0.05 or so potentially of an impact, depending if you go to the higher end of the range, which is up to \$500 million. And those are sort of things at a higher level to give some context on year-over-year thinking.

Operator

Our next question comes from the line of Paul Coster of JPMorgan.

Paul Coster - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Thank you, John, for the clarity and candor of your assessment of the company. I think it really helps [prioritize] the risks and for us to understand the opportunities better. That said, obviously, there's a ton of action points falling out of your assessment already and it -- I'm sure you're going to bring it all together into some kind of program that you'll disclose at the Analyst Day then. Can you now give us your hunch as to how long you think it will take to sort of bring about the sort of change in direction that you seek? And to save time, just a quick question for Bill. On total contract value, it looked like there's a little bit of weakness in that enterprise segment. If you could just provide some color there.

Giovanni G. Visentin - *Xerox Corporation - Vice Chairman & CEO*

Yes. Thank you, Paul. And look, as I said in my statement, there's significant opportunities to optimize our business. And we're looking at how we do things differently, and it's always focused on how we better serve our clients. In terms of timing, by fourth quarter, end of fourth quarter, early first quarter, we'll have an Analyst Day and we'll take you through the whole plan and everything. But we're focused starting today on doing everything that we've said in our business priorities, which is how do we help drive revenue, how do we optimize our operations, how do we reenergize the innovation engine and our continuous focus on capital returns and on cash flows. So that starts today. In fact, it started 8 weeks ago, but -- and we're continuing to focus on that.



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William F. Osbourn - Xerox Corporation - Executive VP & CFO

Yes. Hey, Paul, it's Bill. Yes. Regarding if you're looking at signings in the quarter being down. And yes, signings down 20.6%, just breaking that down in a little bit more detail. New business signings, which are really the -- not all signings are important, but it's critical to say that new business signings were actually up 2% during the quarter. Renewals are somewhat can be lumpy in nature, depending on what is the opportunity and what's available. And actually, the amount that came up for renewals during the quarter had a fair amount of impact. There was just less coming up in Q2 of this year versus Q2 of last year. But renewals were down. And part of that was also due to the win rate. Percentage was clearly lower than our targeted 90% plus win rate and lower than our prior year win rate. We were at about 75%. But really that was driven by 2 larger enterprise deals. And so like I said, there's lumpiness and there's also large deals that can drive that percentage from quarter-to-quarter. And clearly, you look at it, yes, we're striving to do well in all parts of the market. But clearly, we're also very pleased with what's happening in the SMB side of the signings area where we don't get as quite as much detailed information because we're dealing with partners a lot. But the end results when you look at what's happening in the MDS, we feel good about that.

Operator

Our next question comes from the line of Jim Suva of Citi.

Jim Suva - Citigroup Inc, Research Division - Director

John and Bill, and I'll ask my questions and you guys can decide how to divide it up. And thank you for the details so much. So first of all, John, in your prepared comments, you mentioned several times about Xerox needing to come to market faster and be more efficient. For myself as well as many of us on the call, we've heard this many, many, many times in the past. So can you help us understand about really what's new or what you found that has prevented this from happening because it feels like a little bit of a broken record? And then my follow-up question is on the renewal rate of 75%. That seems to actually counter to your prepared comments of the great relationships you have and the need and the value that Xerox is providing because a renewal rate of 75% is not overly encouraging. So can you help us bridge the gap of those prepared comments and kind of what we're seeing in maybe just a matter of time or timing, but something just I'm not grasping there.

Giovanni G. Visentin - Xerox Corporation - Vice Chairman & CEO

Okay. So look, Jim, let me start with answering it. We've talked to a lot of clients, talked to a lot of partners. And what came out was a common theme: one, they want us to win; two, they like the products we have. As we look inside of our own technologies and our own innovations, the questions that they were asking us is how do you take this to market faster and how do we help you take it to market faster. So we have existing products today that go through our channels, go through our different channels. But how do you take other products, whether it's a new technology that you are -- that you have in your innovation, those are some of the best-kept secrets out there in the industry. So as recently as a few days ago, I spoke to a very high-level executive in a financial organization and just took them through some of the offerings we have over and above what we offer today, the MDS, the services. And we're going to do an Innovation Day with their team. And this is in a competitive environment. So it's a non-Xerox account. And they want to see. Because most of our clients are asking us, tell us what we don't know. You have these great products. But what else do you have? And that's where I got excited when asked, "Hey, John. What's different than I got here?" That's one of the areas that's different, that our innovation assets are much better than I even assumed when I was looking at it. But how do we get it to market faster? And that's part of getting it to market faster. It's not just what we have today, but a lot more. How do we capitalize on that? We have tremendous assets like DocuShare, whether it's XMPie. These are game changers for clients. How do we assure ourselves that we use our go-to-market like channels to help us get that to clients faster.

William F. Osbourn - Xerox Corporation - Executive VP & CFO

Yes. And I would just add on, Jim, that as I said in my response to the previous comment, the 75% was driven by primarily 2 larger enterprise contracts that came up for renewal. We don't want to lose any contracts, obviously, and we would prefer not lose that. But I would not extrapolate



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from just 2 renewals that we didn't win to how our overall customer base, how satisfied they are with us. And as John said, based upon our discussions and our overall feedback, our customers are clearly with us and want us to do well and serve them well.

Jim Suva - Citigroup Inc, Research Division - Director

Great. And then my quick follow-up is in the past, the management team kind of gave, I believe, some EPS ranges of -- I think it was, if I remember right, \$3.50 to \$3.70 and revenues down 2% to 4%. You reiterated cash flow for this year. Is it fair to say that the revenue and EPS is something that you guys are no longer affirming to?

William F. Osbourn - Xerox Corporation - Executive VP & CFO

Yes. Effectively, that's -- in my response to Shannon's earlier question, really just giving a rationale that we have guide rails, we believe, by pointing to the cash, people know. As you know, the industry that there are the trends, 75% recurring revenues, et cetera. But -- and you wouldn't expect significant changes from recent trends. With that said, over the next 6 months, we have a new leadership team in here. John has been here for roughly 10 weeks. And we're making decisions that are going to benefit Xerox' shareholders for the longer term. And we don't want to be bound just by the next 3 to 6 months of results. With that said, we are very confident overall in our business. And there's stability in the organization. We're back to work. Not that we were away from work or anything, but there was a lot of noise out there in the media or in here, but that didn't impact us while we were going through that. And certainly now, we're all back to work.

Operator

Our last question comes from the line of Katy Huberty of Morgan Stanley.

Kathryn Lynn Huberty - Morgan Stanley, Research Division - MD and Research Analyst

Just following on some of the last few questions. Obviously, there is some concern around the weaker MDS signings. High-end equipment sales were also weaker and so it just speaks to confidence around the strategy and stability in your large enterprise customer base. So I wonder if you can comment now that the leadership team has been put in place for a couple of months. As you said, everybody is back, engaged at work. Have you seen stabilization in those 2 metrics, MDS signing and high-end equipment sales, in the month of July? And I'll just ask my follow-up. Bill, on cash flow, you talked about needing to improve working capital. When should we expect to see that impact? What are you specifically doing? And do you need improved working capital in order to hit the free cash flow targets for the remainder of the year?

William F. Osbourn - Xerox Corporation - Executive VP & CFO

Great. Let me -- I think most of those questions all you -- fall towards me. Let me answer the last one first regarding working capital. There has always been a focus on working capital within the company. I would tell you with John coming on board that there has been even more. It's -- John said in his comments, maniacal focus on cash. I would view it in terms of that. We're comfortable with the cash flow guidance that we provided originally that we're reiterating, that we provided recently in January. As far as the working capital pillars, days sales outstanding, day sales in inventory, days payable outstanding, we're working to improve all of those significantly. Even though we had originally planned that -- it's just that the need to actually -- those will make it even better, I guess, I would view it from a cash flows perspective that if you look at where we're at year-to-date on cash flows, we're already at \$400 million of free cash flow year-to-date. And seasonally, Q4 is the strongest, that improvements in working capital, additional improvements will only help us and give us upside. It's really my perspective on that. From an MDS perspective, don't like -- they start going to the months. As we get to the lumpiness, it can be even lumpier within months within a quarter. With that said, overall, MDS was up 2.3%. MDS revenues, up 2.3% in constant currency, driven by a significant improvement in ESR, equipment sales revenue, in Q2 within MDS. The channels or the SMB part of the business continues to be strong. It's growing double digit again and up 14.4% in MDS revenues. And enterprise, still continue to be -- it's more competitive, more mature market was down about 1% in revenues for the quarter. So overall, we view

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ourselves as the market leader in MDS. And we expect to continue to be that. The 2 larger deals we lost during the quarter, we're not happy about. But overall, to the longer term, we're still expecting to be strong in MDS.

Jennifer Horsley - Xerox Corporation - VP of IR

Great. Thanks, Katy. Let me hand it back to John to wrap up with a few closing comments.

Giovanni G. Visentin - Xerox Corporation - Vice Chairman & CEO

Look, I'll start -- I'll end as I started, like this is a new beginning for Xerox. And I look to updating you on our progress. We have work to do. But I want to be clear of our objectives and they include: we're going to drive revenue; optimize our operations for simplicity, which is key for what our clients are looking for; reenergize the innovation engine; and we're going to focus on cash and increase capital returns. At the end of the day, our success will be measured based on our ability to satisfy our clients and deliver value to our shareholders. So I'd like to thank everyone for joining our call.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day.

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