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Xerox Holdings Corp. (XRX)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation's Fourth Quarter 2023 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions]

At this time, I would like to turn the meeting over to Mr. David Beckel, Vice President of Investor Relations. Please go ahead, sir.

David Beckel
Vice President & Head-Investor Relations, Xerox Holdings Corp.

Good morning, everyone. I'm David Beckel, Vice President and Head of Investor Relations at Xerox Holdings Corporation. Welcome to the Xerox Holdings Corporation fourth quarter 2023 earnings release conference call hosted by Steve Bandrowczak, Chief Executive Officer. He's joined by John Bruno, President and Chief Operating Officer; and Xavier Heiss, Executive Vice President and Chief Financial Officer.

At the request of Xerox Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the expressed permission of Xerox.

During this call, Xerox executives will refer to slides that are available on the Web at www.xerox.com/investor and 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'd like to turn the meeting over to Mr. Bandrowczak.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

Good morning and thank you for joining our Q4 2023 earnings call. I'd like to start by commending the Xerox team for delivering strong growth in full year adjusted operating income, EPS and free cash flow amid a challenging and uneven macroeconomic environment. We achieved 2023 adjusted operating income margin and free cash flow guidance, despite slightly weaker-than-expected macro conditions in the second half of the year. Our ability to overcome top line headwinds and meet full year profit and cash flow targets is a testament to this company's culture of operating discipline, which has been forged and strengthened in recent years through operational and macroeconomic challenges.

Summarizing results for the year. Revenue of $6.89 billion declined 3.1% in actual currency and 3.3% in constant currency. Our core Print, Digital and IT Services businesses performed much better than this top line result would suggest however. As Xavier will describe later in the call, revenue declined less than 1% in 2023 after adjusting for the effects of backlog reductions in the current and prior year structural simplification efforts and the intentional de-emphasis of certain nonstrategic businesses. Adjusted EPS was $1.82, $0.70 higher year-over-year. Free cash flow was $649 million, an increase of $547 million over 2022. And adjusted operating margin of 5.6% was higher year-over-year by 170 basis points within our guidance range.

2023 was a pivotal year for Xerox and marked the first full year of a multi-year strategy to reposition our businesses for long-term sustainable growth in revenue and profits, which we call our Reinvention. We took structural and foundational actions to improve our core business and simplify operations, resulting in greater operational focus and a clear path for more transformative Reinvention actions this year and beyond. All the while, we delivered key accomplishment towards the strategic priorities set out at the beginning of 2023, which provided momentum for our Reinvention in 2024.

Starting with client success. Client success is and always will be a point of competitive differentiation for Xerox and is foundational to maintaining a strong and stable Print business. Since accepting the CEO position in August of 2022, I directed my team to put more emphasis on client outcomes and solutions-based products and services that address the productivity challenges of a hybrid workplace. Our rigorous focus on positive client outcomes solidifies our position as a trusted advisor as clients build workplace technology solutions for the future and improves the predictability and repeatability of our business and expands total addressable market by ensuring we remain responsive to and take advantage of evolving market trends.

Last year, we took actions to enable complete operational focus on the delivery of positive client outcomes in our core Print, Digital and IT Services businesses. We divested PARC, Xerox Research Center of Canada, and Elem, our 3D printing business. We signed partnerships with PEAC Solutions, an affiliate of HPS Investment Partners, allowing FITTLE to focus exclusively on financial solutions that support the sales of Xerox equipment and services. We also reduced our presence in certain nonstrategic markets with lower levels of profitability, such as paper and certain types of IT hardware.

In 2023, an enhanced focus on client success delivered the intended results, proving client centricity can drive revenue stability, even in secularly challenged industries like print. Xerox Net Promoter Score improved. We grew our share of equipment sales in the markets in which we compete, and we achieved revenue renewal rates above 100% across large account contract renewals, evidencing our ability to sell new print and digital services that more than offset reduction in traditional print spend.

Moving to profitability. Transformation of the scope and scale contemplated by our Reinvention requires a strong base of profits and margin profile from which to build. In 2023, we improved adjusted operating profit by more than $100 million and adjusted profit margin by 170 basis points year-over-year. Improvements stem from structural cost reduction efforts, pricing discipline and ongoing operational efficiencies, and deliberate reduction in nonstrategic revenue with low levels of profitability. These actions and the restructuring announced earlier this month put us firmly on the path to returning Xerox to double-digit profitability by 2026, while improving our capacity for tactical reinvestment in growth areas.

Finally, shareholder returns. It is important to our board and management team that investors are rewarded, while accompanying Xerox on its Reinvention. In 2023, we achieved our shareholder return policy, while reducing total debt. More than $600 million of free cash flow, when combined with excess cash on our balance sheet, was used to pay our $1 per share dividend, lower our debt balance by approximately $450 million, and reduce our share count by more than 20%. We will build on these achievements as our priorities evolve in 2024, year two of our Reinvention.

Our first priority of 2024 is the continued strengthening of our core Print, Digital and IT Services businesses. These businesses form the bedrock of our strategic repositioning from which new capabilities and our client-centric mindset will be leveraged to drive incremental service opportunities and revenue diversification. Earlier this month, we announced a significant reorganization of our businesses, including the adoption of a business unit rather than a geographic-led operating model, along with the greater focus on a partner-led distribution. These changes are expected to both strengthen our core business and position us to capture new ancillary revenue opportunities over time.

John Bruno, our President and COO, will provide more details on the operating changes. In short, a business unit led operating model sharpens our client-centric mentality by more closely aligning Xerox products and services with the economic buyers of today's hybrid workplace. And with the establishment of a global partner ecosystem, we will pursue new partner relationships to expand the reach of our core businesses. Stronger end market alignment and partner reach is expected to further improve equipment market share and Print, Digital and IT Services penetration rates with existing and prospective clients, resulting in new client wins and higher rates of revenue as contracts renew.

Our second priority is the successful implementation of structural cost improvements associated with our reorganization, which build on efficiencies and improvements put in place in 2023 and are expected to drive profits meaningfully higher again in 2024. We announced last quarter that Reinvention is expected to deliver $300 million of net adjusted operating income improvements above the 2023 levels through 2026. We expect to achieve more than one-third of that improvement in 2024, due in large part to organizational cost savings associated with the reorganization announcement earlier this month.

Our newly formed Global Business Services organization, or GBS, which John will further describe, will catalyze these expected organizational savings in 2024. Beyond 2024, we expect GBS to be an engine for continuous cost improvement and improved client satisfaction as this group works to embed advanced technologies like machine learning and AI into key internal processes, making it easier to do business with and within Xerox.

This year, we also began a more comprehensive optimization of our geographic footprint and product offerings, the savings of which are expected to further augment those associated with the recently announced restructuring program.

Finally, capital allocations. As I mentioned, management and the Xerox board of directors believe it is important to directly reward shareholders as we execute our Reinvention. In 2024, free cash flow is expected to be used to pay our $1 per share dividend and reduce leverage. Excess free cash flow is expected to be used to tactically invest in projects or acquisitions with higher rates of expected returns on invested capital.

Each of these three priorities puts us on the path towards achieving our long-term Reinvention goals.

I'll now hand the call over to John Bruno to provide more details on our recent organization announcements and our Reinvention road map.

John G. Bruno

President & Chief Operating Officer, Xerox Holdings Corp.

Thank you, Steve, and good morning, everyone. I appreciate the opportunity to speak to you today and provide more context around our multiyear Reinvention journey. At its core, Reinvention is about operationalizing a balanced strategy to improve our legacy business and build a foundation to address adjacent opportunities with existing and new clients. These adjacent market opportunities are available to Xerox today, but they require enhancements to our client coverage model and our service offerings. By the market, I'm predominantly referring to the mid-market, where Digital/IT Services remain underutilized by our clients.

There is opportunity for Xerox to improve client penetration of Digital and IT Services within this market, an assertion to be validated through primary and secondary research as part of our Reinvention planning. Critical to more fully addressing these market opportunities is a core business that is stable, fit for purpose in today's market environment and capable of meeting the evolving needs of our clients. We understand the dynamics of the markets we're in, and to win in effectively challenged market like print, we must be more competitive, easier to do business with, and relevant to our clients as their needs evolve.

As such, our Reinvention is aimed at addressing the complexity of our business that was built over time and for a different time. In its place, we are designing a simpler, more operationally efficient organization to address our clients' most important hybrid workplace challenges now and into the future.

I have been part of similar transformation efforts with other large companies, which, like Xerox, have strong heritage. Pattern recognition tells me Xerox has what we need to successfully modernize and transform this business. In my first year, I've experienced very little resistance or lack of desire to change. Our people are eager to embrace and direct change, and they are asking for it. And that's a great place to be as the work to reinvent any company is complex and requires tenacity and discipline.

As Steve noted, 2023 was a foundational year for Xerox. We narrowed our focus and removed competing priorities to reduce our operating costs and organizational complexity. We set up a strategic Program Management Office, comprised of 16 workstreams with more than 200 initiatives. This team designed, defined and are currently executing organizational and business operating system simplification spanning from reductions of legal entities, ERPs, payroll and invoice systems to just name a few examples.

2024 marks the second year of our journey. The focus this year is building on the structural and foundational changes made in 2023 with an improved operating model. Earlier this month, we announced a new organizational structure that merges sales regions, flattens layers of management, streamlines our global offering teams, and collapses our go-to-market offering and delivery teams all to one business unit. We moved from a geography to business unit-led operating model to align our groups responsible for our Print, Digital and IT Services businesses, from product development to sales and services, as one team to empower fewer leaders with the information they require to improve decision rates and be more agile.

We formed a new organization, Global Business Services, or GBS, that will drive enterprise-wide efficiencies and productivity gains by centrally coordinating internal processes, leveraging shared capabilities and platforms. The formation of GBS goes well beyond previous cost efficiency efforts at Xerox. It involves an end-to-end redesign of our operations to enable touchless internal and external customer experience. GBS will leverage the success we achieved from Project Own It and embed leading technologies to drive continuous innovation. We see GBS as a key enabler of long-term sustainable profit improvement.

In 2024, we will selectively optimize our geographic distribution to improve regional profitability and reach, as well as narrow offerings where we lack sufficient competitive differentiation to generate required rates of return on invested capital. These strategic actions will have a negative effect on revenue initially, but are expected to generate improvements in total operating profit. The overhead costs currently in place to support these geographies and offerings more than outweigh potential reductions in revenue and associated gross profits.

In summary, the reorganization announced earlier this month is a key enabler of expected profit improvement in 2024. Progress toward our three-year operating income target of $300 million above 2023 levels will be driven by three concurrent efforts. The first, operating model simplification throughout the Reinvention journey with continuous savings initiatives led by GBS. The second is geographic and offering simplification efforts and they're going to continue into 2026 with net savings being generated from the replacement of direct operations in certain geographies with more efficient partner-led solutions and lower cost associated with a more simplified product portfolio. Finally, tactical investments in partnerships to grow our Digital and IT Services business will provide a more favorable revenue mix and profit profile through 2026 and beyond. I look forward to keeping you updated along our journey as our Reinvention delivers improved financial results and shareholder returns.

I'll now hand the call over to Xavier.

Xavier Heiss

Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

Thank you, John, and good morning, everyone. As Steve mentioned, important steps were taken in 2023 to simplify our business and improve Xerox's balance sheet and profit profile. For the year, we delivered strong growth in earnings per share and free cash flow, despite a modest decline in revenue, reflecting the successful implementation of a more flexible cost structure and rigorous operating discipline. Additional structural efficiencies enabled by our reorganization are expected to drive further profit improvement in 2024, our second full year of Reinvention.

In Q4, revenue, margin and profit declined year-over-year due mainly to a significant reduction of equipment backlog in the prior year quarter. Revenue growth was further affected by the intentional reduction of certain non-strategic revenue. Excluding this factor, revenue would have increased low-single digit year-over-year.

Turning to profitability. Gross margin declined 130 basis point over the prior year quarter, due mainly to lower activity, higher product cost and the termination of Fuji royalties, partially offset by strategic pricing action, lower freight cost and the benefit of structural cost reductions. Adjusted operating margin of 5.4% declined 380 basis points year-over-year due to lower revenue and gross profit and higher compensation expense, partially offset by the benefit of pricing and structural simplification effort.

Adjusted other expenses, net, were $45 million higher year-over-year due to lower sales of non-core business asset and an increase in non-financing interest expense. Adjusted tax rate was 15.2% compared to 21.9% last year. The decrease was largely due to the benefit associated with change to deferred tax asset valuation allowances and redetermination of certain unrecognized tax position.

Adjusted EPS of $0.43 in the fourth quarter was $0.46 lower than the prior year, driven by lower operating income and higher other expenses, net, partially offset by the benefit of lower sales. GAAP loss per share of $0.50 was

$1.24 lower than the prior year. This included a $78 million after-tax restructuring charge associated with a recently announced workforce reduction, or $0.62 per share. Let me now review revenue and cash flow in more detail.

Starting with revenue. Equipment sales of $458 million in Q4 declined 17.3% year-over-year in actual currency, or 18.3% in constant currency. The prior year effect of backlog reduction drove more than 25-percent-point of the year-over-year decline. Underlying demand for our equipment remained stable and order activity is gaining momentum as backlog and macroeconomic conditions stabilize.

Total equipment revenue outpaced installation activity due to favorable product mix. Installations of high-end color equipment, which were less affected by prior year backlog reductions, increased year-over-year, while entry and mid offerings declined. Declines in entry reflect prior year reduction to backlog and current year constraint, while declines in mid primarily reflect prior year reduction to backlog.

Post-sales revenue of $1.3 billion declined 5.8% in actual currency year-over-year and 7.5% in constant currency. Excluding the effect of non-strategic and lower margin paper and IT endpoint device placement, which we plan to continue to reduce over time, as well as the exit of Russia, the termination of the Fuji royalty and the absence of PARC revenue, post-sales revenue declined only modestly. Geographically, both region declined in actual and constant currency.

Given the significance of certain non-strategic item on our revenue trajectory in recent quarters and for the full year, I will provide additional commentary to help clarify the underlying revenue trends associated with our core businesses.

For Q4, the prior year reduction in equipment backlog contributed around 690 basis point to the year-over-year decline in total revenue. Lower sales of nonstrategic paper and IT endpoint devices contributed around 160 basis point to the decline and the effect of lower Fuji royalty revenue and strategic action taken to simplify our business contributed around 190 basis point of the decline. When these combined effect are removed, revenue from our core businesses grew low-single digit this quarter, reflecting stable demand and growth in Digital and IT Services, partially offset by decline in printed page volumes.

For the year, this same item in the aggregate contributed around 230 basis point to the year-over-year decline in revenue. Therefore, core business revenue for the year would have declined a little less than 1%.

Let's now review cash flow. Free cash flow was $379 million in Q4, higher by $211 million year-over-year. Operating cash flow was $389 million in Q4 compared to $186 million in Q4 2022. The improvements were mainly driven by a net source of cash associated with a reduction in financing receivable and improvement in working capital. Finance asset were a source of cash this quarter of $92 million compared to a use of cash of $169 million in the prior year, reflecting the benefit of our Forward Flow program with HPS and lower origination as expected.

Working capital was a source of cash of $115 million, resulting in a $42 million year-over-year increase in cash, driven mainly by a reduction in inventory. Investing activities were a use of cash of $8 million compared to a source of cash of $17 million in the prior year due to lower proceed from the sales of non-core business assets, partially offset by lower CapEx. Financing activity consumed $383 million of cash this quarter, which includes a payment of around $300 million of secured debt and dividend totaling $34 million. During the quarter, we repaid a bridge loan with proceed from the issuance of a term loan credit facility.

Turning to segments. FITTLE origination volume declined 25% year-over-year, reflecting FITTLE change in strategy to return its focus toward captive only financing solutions. Captive product origination were up 2%. FITTLE finance receivable balance declined around 3% sequentially in actual currency, reflecting the runoff of existing finance receivable on HPS funding of FITTLE's origination. As previously highlighted, we expect our finance receivable balance to decline and normalize closer to $1 billion by 2027.

FITTLE revenue was down slightly year-over-year in Q4 due to lower finance income and other fees associated with the decline in FITTLE finance receivable balance, partially offset by higher commission from the sales of finance receivable assets. Segment profit for FITTLE was $7 million, up $6 million year-over-year, mainly due to lower bad debt expenses and lower intercompany commissions.

Print and Other revenue fell 9.5% year-over-year in Q4 due to lower equipment and post-sales revenue, reflecting the effect of prior-year backlog reduction and declines in non-strategic items, mentioned in my prior comments. Print and Other segment profit declined 50% versus the prior-year quarter, resulting in a 430-basis-point reduction in segment profit margin year-over-year, driven by lower revenue, partially offset by structural cost efficiencies and pricing actions.

Turning to capital structure. We ended Q4 with $617 million of cash, cash equivalent and restricted cash. Around $2.4 billion of the remaining $3.3 billion of our outstanding debt support our finance assets, with the remaining debt of around $900 million attributable to the non-leasing business. Total debt consists of senior unsecured bonds, finance asset secured borrowing and the new term loan. We maintain a balanced bond maturity ladder over the next few years.

Finally, I will address guidance. For revenue, we expect a decline of 3% to 5% in constant currency in 2024. Included in this guidance are the effect of prior-year backlog reduction and headwind associated with the de-emphasis of certain non-strategic businesses, all of which are unrelated to the performance of our core Print and Services businesses.

More specifically, the reduction of backlog in 2023 is expected to contribute around 200 basis point to the year-over-year decline in revenue, with another 200 basis point attributable to the decline of certain non-strategic revenue, including lower sales of paper. Excluding the cumulative effect of this item, core business revenue is expected to be roughly flat year-over-year, reflecting stable Print demand, growth in Digital and IT Services, and neutral macroeconomic condition.

As future strategic action involving product or geographic simplification are decided, we will update guidance on the respective effect of these actions accordingly. In terms of quarterly cadence, the headwinds previously noted, particularly the year-over-year effect of backlog reduction, are expected to affect revenue growth most significantly in the first and second quarter of the year. Q1 revenue is expected to decline at a rate between that of Q3 and Q4 2023, with sequential improvement in year-over-year revenue trajectory expected throughout the year.

We expect 2024 adjusted operating income margin to be at least 7.5%, an improvement of at least 190 basis points year-over-year, resulting in the realization of more than a third of the expected $300 million improvement in operating profit, above 2023 level, expected from Reinvention through 2026. The increase in profit and profit margin in 2024 will mainly be driven by structural simplification action enabled by our reorganization, including the effect of the workforce reduction decision announced on January 3.

Operating margin will be lowest in Q1 due to seasonal factor and the timing of structural cost reductions throughout 2024. We are expecting slight improvement in Q1 operating margin from Q4 2023 level, with more significant improvement throughout the year. To be clear, our ability to achieve profit guidance is not predicated on revenue growth, as the expected savings associated with our reorganization far outweigh the reduction in profit associated with lower non-strategic revenue.

Free cash flow is expected to be at least $600 million in 2024. Free cash flow will once again benefit from a reduction in our finance receivable balance. Improvement in cash flow from underlying operations are expected to be offset by onetime restructuring payment, higher cash taxes and an increase in pension contribution.

We plan to pay our $1 a share dividend and outstanding debt obligation as they come due. Excess free cash flow is expected to be deployed opportunistically according to expected rate of return on investment, including opportunity to strategically reinvest in the business and acquisition.

In summary, we enter 2024 on solid footing, with stable demand for our product and services, momentum in orders and signing, a simplified operating structure and clear line of sight to savings that will enable another year of meaningful improvement in operating profit.

We will now open the line for Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. One moment for our first question. And our first question comes from the line of Ananda Baruah from Loop Capital. Your question, please.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Thanks, guys, for taking the question. I guess, a couple, if I could. The headwinds to revenue that you guys pointed out on the call and you sort of quantified in the deck as well and I think they impacted last quarter as well. What's a good way to think about how those roll off as we move through the year? And I guess, at what point in time do you expect them to be fully rolled off and for the reported revenue to kind of be sort of apples-to-apples? And then I have a quick follow-up.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Okay. Hi, Ananda. Xavier speaking here. So, yeah. So, phasing of the headwinds that we have, they are difunctional by nature here. But the main one, as you mentioned it, so if you look at the – next year, our forecast here is minus 3% to minus 5%, and we said we have around 400 basis point that are, I would say, are normal by nature as they do not impact the core business here. So, first one is the backlog. So backlog is 200 basis point out of the 400 basis point impact. So, backlog, we expect the end of the compare of backlog to end at the end of quarter two 2024. So, quarter three and quarter four should be normal compare, because last year in 2023, we still had the impact of flushing the backlog.

The other item, the [ph] 200-basis-point (00:32:36) item that we have there, which phase out during the year, there are some items related to – we mentioned paper sales, IT endpoint, they will stay within the year here. But the Fuji royalty, for example, is an item that will end at the end of Q1. So – but they are less important in nature. The largest one is a backlog, and the backlog is end of quarter two.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's super helpful. And then just sort of like a sanity check here, it looks like – this is easy math to do, but it looks like you're forecasting OP profit to be up year-over-year and maybe nicely up. I'm getting like $90 million, $80 million to $100 million or something like that depending on what revenue you use. Is that accurate? Is that an accurate assessment?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Yeah. Annualized, it is even higher. So the operating margin this year is 5.6%. After last year, it was 3.9%. So quite a nice progression that we have done in operating profit. And for next year, we are forecasting – guiding at least 7.5%. So this is a 190 basis point progress here that we are doing in operating margin. In absolute value, we are speaking about more than $100 million after this year, which has also been in operating income, adjusted operating income of more than $100 million as well. So, a nice momentum that we are building.

And the other point I want to flag that is, the dependency of delivering this operating profit or operating margin improvement is not entirely driven by revenue. We have, as you know, given our revenue guidance. You understand the once-off impacts here. But a lot of the action that are supporting the operating profit, operating margin improvement are already action that we have in play. One of these being the action that we have announced at the beginning of January, which is a large restructuring action that we have started now.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

And that's super helpful. Just let me dovetail that into one last one. Can you remind us of the $300 million that you have for the 2026 goal, incremental OP income, how much of that is revenue driven versus things that are completely under the company's control? And that's it for me. Thanks.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

One of the things – it's Steve, one of the things we did, as you remember, we announced the very, very strategic structural changes and the launch of the Reinvention and the combination of which drives an end-to-end simplification, drives cost out and has a very strategic strengthening of our core business, and make sure that we have flexibility to adjust when the revenue goes up, our revenue goes down. So two pieces of it. One, Reinvention will drive simplification. We talked about GBS and what we're doing there to drive our overall margins and drive improvements to our business. Second, we're going to take strategic actions in our geographies and our products. So the whole $300 million of operating profit, independent of what happen with the revenue, so that we can adjust up and adjust down based on whatever decisions we make on nonstrategic revenue.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

I got it. So, Steve, so any incremental revenue driven would be in addition to the $300 million....

[indiscernible] (00:36:01)

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

It should. We are very strategically targeting higher revenue that has higher profitability. And by default, you're absolutely right, we increase our revenue, we should increase our profitability.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay, great. Thanks, guys. Appreciate it.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Samik Chatterjee from JPMorgan. Your question, please.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Yeah. Hi. Thanks for taking my questions. I guess, if I can start with a clarification on your revenue guide for 2024. You're guiding to flat when we ex-out the backlog and the exit from certain non-strategic businesses. How do I keep that in context of what you're referring to here for 4Q, which is a mild softening in demand in the European markets? How are you sort of thinking about or baking in the macro impact you've seen in 4Q into your 2024 outlook? And I've a follow-up. Thank you.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah. Let me take a stab at that and then turn over to Xavier for numbers. We took a look at Q4 and we saw strong signings in our Services business and grow that and that backlog looked extremely strong. We also see strengthening in our core business in the areas that we play today. So, a combination of increase in orders, backlog and our service. And the other piece that Xavier mentioned was in-house signings. We're signing now at over 100% on revenue renewal in our core contracts in our Services business. Those gives us good foundation for growth and stability as we go forward. Xavier?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Steve, I will add as well. So, the macro conditions that we were observing, specifically in Europe quarter three, a little bit smoother in quarter four. We see a little bit of easing specifically around interest rate on both side of [indiscernible] (00:37:59). So this give us a little bit of confidence on this revenue side.

But the important thing, Samik, is when you look at the revenue, normalized revenue, as you mentioned it here, this is flat to minus 1%, this is what the industry is seeing here. When we look also at the trend of return to office [indiscernible] (00:38:20), we have also indicator that is telling us that the number that we put on paper here can be sustained.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. Okay. And so my second one on cash flow, you did $649 million in 2023. There's an operating income improvement of $100 million or so. And then you have the HPS transaction continue to sort of accrued some cash. So maybe help us with the walk there and particularly what's the restructuring piece in there as well and why isn't the cash flow guidance a bit higher? Thank you. For 2024, I mean.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Samik, that's a good question. So free cash flow, we said at least $600 million at this stage of the year. The improvement in the operating cash flow, which is directly related to the improvement of the operating income, we are still expecting our conversion rate from the operating income or adjusted operating income to free cash flow be in the 70%, 80% range, which is what we are used to produce there. But for this year, as you mentioned it, we have a restructuring provision. Restructuring provision, from a cash point of view, has an impact of around $140 million. Then we have also an additional contribution in pension that we have to do in the US and due to the profitability as well, additional cash tax there.

So when you net all of these, it give us this number of around $600 million. Over time, we will provide more visibility quarter-by-quarter on how this trend is going.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you. Thanks for taking my questions.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Thank you, Samik.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Erik Woodring from Morgan Stanley. Your question, please.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Hey, guys. Thank you for taking my questions. I have a few as well. Steve, maybe if we just start, helpful color on the renewal rates for large customers. Can you maybe just help us understand what percentage of, I don't know how you'd frame it, services contracts, those large customers represent? And then, how to think about the rest of those cohorts, the same metric for smaller customers? I believe you have a fairly long tail of SMB customers. So how do renewal rates look for that cohort and how do I think about the importance of the large enterprise versus kind of SMB customer set? And then I have a follow-up, please. Thank you.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah. Thanks, Erik. Appreciate it. So it's roughly about one-third of our overall revenue. And so, what we're seeing there is the opportunity to really embed IT and Digital Services on top of our core services contracts. As we start to see and we're seeing renewals come up year-over-year, we put a big focus on client centricity. And what that means is how do we help our clients drive productivity, how do we help them solve some of the biggest challenges they have. So if you think about headwinds, whether it's around use of capital, whether it's around labor pressure, whether it's around pressure on profitability, we continue to bring products and solutions that helps them to offset that. And that's why we've been successful and our renewal rate is up.

Same thing applies in our SMB businesses, right? When we look at our SMB, it's probably even more of an opportunity. We see significant SMB has the same enterprise challenges with profitability due to increase of whether it's labor cost, whether it's pressure on capital, whether it's pressure on overall increase in cost, they're looking to us to help to offset. So we continually bring solutions. We talked about some of these last quarter on some of the vertical solutions that we're really focusing on. How do we help inside of healthcare? How do we help inside of universities, law firms, et cetera? And so, as we look at those renewal rates, we continue to bring solutions on top of it. And we've been very successful.

And I've made the statement a couple of times now that we have a great opportunity to expand in existing accounts with products and services that we already have. Better stated, the TAM for us is beyond just the core that everybody sees as our core business, we need to execute and grow inside of our client accounts with products and services that we already have. And we're seeing evidence of that with new signings.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Super. Thank you. Very helpful, Steve. Xavier, if I maybe turn to you. Can you maybe help us all better understand maybe the trajectory of gross margins relative to OpEx in 2024 to kind of land at that 7.5% operating margin target. And I just ask because, depending on how we think about gross margins, we're looking at a, as a percentage of revenue, fairly significant reduction in OpEx. I understand you announced the RIF on January 2 (sic) [January 3] (00:43:07), but it would imply revenue as a percentage of OpEx that is quite low. And so, really just want to better understand how to think through some of those dynamics and how much you might be reinvesting on the other end. So just all of that collectively, if you could help us understand that for next year – or this year, 2024, please.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Erik, you got the big picture here. So what we are expecting is a slight expansion of gross margin. And this is just to, I would say, [ph] via (00:43:40) all the actions that we have put in place, you know that we have supported or enabled a lot of pricing action that have driven some margin expansion this year. But next year as well, we will have some expansion of gross margin. And also, as we mentioned it, we are exiting or reducing some low-profitability revenue, we mentioned paper, I mentioned also IT endpoint solution with lower margin. And we are offsetting this margin – or this revenue reduction by other type of revenue stream with a higher profitability.

OpEx is clearly the area with improvement, and you have already been able to measure it this year. If you look at RD&E specifically, with the PARC donation that we have done, it's a significant improvement year-over-year and it reduced the RD&E amount that we had related to PARC by more than 100 basis point here. When you look at the trajectory we will have on SAG, with the restructuring here, again, this is – this will be the main driver of the operating margin – adjusted operating margin improvement year-over-year.

So 190 basis point based on action that we have already either announced and actioning or action that were taken last year, on the back end of last year, where we will see the benefit of the flow-through. So the key point behind my message here is that the dependency on the revenue trajectory, it is less than on us executing the cost actions.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Erik, the other thing I'd like to add, because we always get the question, you did the big actions with Own It, now you're doing Reinvention. And so, in the beginning of the year, we really looked at all of our end-to-end cost structures, whether it was IT, finance, whether it's SG&A, what we did with sales coverage, et cetera. And when you look at that against industry benchmarking and look at that against opportunity to where we can drive this company, that's where we're confident. We still got a lot of work to do to simplify this business, whether it's around the number of systems we have, number of processes we have, the variations and different ways in which we do business.

So when we look at it, just from a pure benchmark standpoint, against other companies and industries, we've got a lot of opportunity ahead of us. And obviously, we got to execute. We'll execute that through the next 24 to 36 months. But there's still a lot of room for us and that's really where we put GBS in place. GBS is really focused – our Global Business Services is really focused on looking at each and every one of those end-to-end processes, looking at the cost that we're using and that we're expanding in each one of those processes, how do we simplify it and then think about how do we automate and how do we drive technology.

We see AI, we see ChatGPT, RPA, robotic process automation, and the simplification of our business adds a significant opportunity to grow those margins in the future, independent of the revenue line staying flat or slight decline. So, we're very, very optimistic that we can execute and we can drive. And we've got a lot of room in our cost basis to make this company a lot more efficient.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Super. Thank you. Thank you for that incremental color and Xavier, at the beginning for that. Maybe one last quick question and that was on capital allocation. Obviously, we didn't really hear about buybacks. And so, just want to make sure I kind of understood those priorities right, and that we should not be thinking about any buybacks being done in 2024. And then that's it for me. Thank you.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

You are correct.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you so much.

Operator: Thank you. This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Steve Bandrowczak for any further remarks.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

Thank you for listening to our earnings conference call this morning. We are firmly on our path of Reinvention. Our focus in this second year of our Reinvention is to strengthen our core businesses, further reduce structural costs through reorganizations, and allocate the more than $600 million of free cash flow we expect to generate in 2024 in a way that optimizes total shareholder returns. We have clear line of sight to targeted profit improvements in 2024 and are laser focused on ensuring we exceed our three-year goal of at least $300 million of adjusted operating income profit improvement above the 2023, 2024 levels by 2026. Thank you for listening and have a great day.

Operator: Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.