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Xerox Holdings Corp. (XRX)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and thank you for standing by. Welcome to the Xerox Holding Corporation's Second Quarter 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded.

I'd now like to hand the conference over to your speaker today, to Mr. David Becker, Vice President of Investor Relations at Xerox Holdings Corporation. Please go ahead.

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 second quarter 2022 earnings release conference call hosted by Steve Bandrowczak, Interim Chief Executive Officer. He is joined by 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 express permission of Xerox. During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investors, and we'll 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

Interim Chief Executive Officer, Xerox Holdings Corp.

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Good morning, and thank you for joining our Q2 2022 earnings call. I'd like to begin today's call by acknowledging the passing of our dear friend and colleague, John Visentin. As we mourn this loss, I am inspired and deeply humbled by how the Xerox family has come together and become stronger. We will honor John by continuing to execute across the four strategic initiatives he articulated for returning Xerox to long-term sustainable growth, and by operating as one cohesive team to help propel us forward. John instilled in all of us "one boat, one team" mentality, and these words will serve as inspiration as we work to fulfill his legacy.

I am honored to have received the confidence of the board to lead this great company.

Summarizing results for the quarter, revenue of $1.75 billion declined 2.6% in actual currency and grew 1.1% in constant currency. Adjusted EPS was $0.13, $0.34 lower year-over-year. Free cash flow was the use of $98 million, which includes the one-time contract termination charge of $41 million we disclosed in last quarter's earnings, compared to a source of $198 million in the prior year. And adjusted operating margin of 2% was lower year-over-year by 500 basis points.

Revenue was slightly ahead of our expectation and reflects momentum in demand for our products and services, notwithstanding a challenging operating environment. Equipment revenue declined 14.7% or 11.4% on constant currency basis. Supply chain constraints continued to limit our ability to fulfill demand, which remains strong, as evidenced by further growth in our equipment order backlog.

Post-sale revenue grew 1.2% or 5% in constant currency. This represents a sequential improvement mirroring a recovery in print related activities as employees gradually return to the office.

Page volumes once again grew modestly this quarter. And importantly, we are beginning to see the early benefits of pricing actions particularly for our transactional goods and service agreements. As a result, revenue for service agreements outpaced year-over-year growth in page volumes this quarter. Post-sale revenue also benefited from our faster growing adjacencies, IT services and digital services, which I will discuss in detail later.

Our margins declined year-over-year due in large part to a broad-based inflationary pressure and supply chain constraints, but we saw sequential improvement in both gross and operating margins this quarter, reflecting early benefits associated with price increases and Project Own It savings. We expect margins to continue to improve in the second half of the year as we realize benefits from additional price increases and cost reductions, as well as expected improvements in return to office trends and supply chain conditions.

Fears of an economic slowdown have emerged, but we do not yet see a slowdown in spending from our clients. Rather, we continue to experience a recovery in demand from post-pandemic lows particularly in equipment sales. Further, our IT services and digital services businesses are positioned to benefit from growing levels of investment in digital transformation projects and hybrid workplace solutions, which are far less susceptible to a pullback in IT spending. And we are now starting to see signs of supply chain improvements and resilience.

Given the strength in demand we see across our portfolio of products and services and a line of sight to margin improvements through price increases and cost reductions, we are maintaining our 2022 revenue and free cash flow guidance.

As I mentioned earlier, the same four strategic initiatives that have guided us since 2018: optimize operations, drive revenue, monetize innovation, and focus on cash flow are expected to lead to sustainable and long-term growth.

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Last quarter, we increased our targeted Project Own It savings for 2022 from $300 million to $450 million, primarily in response to inflationary pressures across our cost base. Such an undertaking is not done lightly and, in some cases, requires sacrifice within our organization.

As Chief Operating Officer of Xerox, I was responsible for designing and executing Project Own It, which has driven cumulative savings of $1.8 billion from 2018 to 2021. Project Own It is more than a cost-cutting program. It's a philosophy. And that philosophy, which includes the principles of continuous improvement and efficiency gains, is now firmly established in the culture of Xerox. We expect our team to achieve this year's savings target because we understand the importance of maintaining profitability and free cash flow regardless of the macroeconomic environment, not only for investors but as a means of preserving the health of our business and enabling our growth strategies.

A key source of future growth for Xerox is our print and services business. Growth will be driven by an expansion of our leading position in print and managed print services, as well as continued investments in our growth adjacencies, IT services and digital services.

In Q2, we continued to deliver the most advanced services and solutions portfolio for our customers. In Equipment, our ConnectKey offerings lead the industry, driving strong demand and growth in our backlog for end-to-end workplace solutions. A4 color installs grew significantly, which is a key driver of profit from supplies and production color had good performance in both the zero-graphic and inkjet categories due to better product availabilities led by Iridesse and Baltoro.

In managed print services, we were recently recognized by industry experts, Quocirca, as a clear Leader in Cloud Print Services. This cloud services supports our clients drive to digitalization, cost improvement and sustainability goals while ensuring maximum scalability and commercial flexibility. As a result, we have seen licenses sales for Workplace Cloud Print Services more than double year-over-year.

Advancements in our portfolio of offerings are resonating strongly with clients. In the second quarter, we announced the expansion of our relationship with the United States Department of Agriculture. The USDA has been a Xerox client since 2016. Over the years, our teams have worked closely to provide best-in-class print solutions for the USDA's over 100,000 employees.

This past quarter, we agreed to add services and solutions that further streamline the management of their print fleet and enhance the mobility, security and productivity of their print processes.

As a trusted technology solutions partner, we help the USDA optimize their print spend while expanding the overall value of our commercial relationships, culminating in a new 10-year contract worth $164 million. The deal is representative of the ways in which we approach our client relationships, with the goal being to create value through advanced solutions.

Digital services comprise a growing portion of our total service signings, a trend that is expected to continue well into the future as we invest in new capabilities to meet the evolving needs of our clients.

In the second quarter, signings for our Capture and Content businesses, which includes digital mailroom, data extraction, and processing services, once again grew double-digits. In July, we acquired Go Inspire, a UK-based digital marketing and communication service provider to bolster our customer engagement service offering in EMEA, and we recently launched a Global Intelligent Document Process offering to strengthen our capture and content capabilities. This new offering leverages artificial intelligence and machine learning to deliver best-in-

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class, inbound digital and physical data processing, enabling the interpretation of that information to make predictive outputs without human intervention and automate client business processes.

Our IT services business grew more than 30% organically this quarter, as we find new ways to partner with small and medium-sized businesses that are undergoing complex digital transformation and adapting to a hybrid work environment.

In our Robotic Process Automation offering, commercial transaction volumes in Q2 grew 40% sequentially due to growth in new and repeat SMB customer signings to help automate business processes such as invoicing, order entry, and document management.

Our new businesses are progressing along their commercial roadmaps. FITTLE grew non-captive originations 22% this quarter, a significant acceleration over Q1, growth of 7%. Growth in non-captive originations was more than offset by 25% decline in captive originations, reflecting constrained equipment availability.

FITTLE continues to expand its presence among independent dealers and third-party OEMs. During the second quarter, FITTLE added 41 new dealers globally, bringing the total dealer additions for the year to 65. FITTLE expansion beyond Xerox equipment and services has driven a stabilization of its asset balance on a constant currency basis, bringing FITTLE's total financing assets base to $3.2 billion. And strong underwriting has resulted in FITTLE's asset quality remaining consistently high over the past few quarters, with an LTM loan loss rate of only 0.5%.

CareAR added 72 new customer logos and expanded offerings to another 50 customers in the second quarter. CareAR continues to execute on its product development roadmap and expand its distribution network. In the quarter, CareAR added six system integrators and reseller partners. CareAR has also benefited from an improved overall time to revenue through these relationships.

At PARC, each of our innovation towers is pursuing opportunities in large and growing markets, and our recently launched businesses are defining new business opportunities through the commercialization of disruptive technologies. For example, Elem, our 3D printing business recently installed a 3D liquid metal printer on the USS Essex, the first of its kind to be deployed on a US Navy vessel.

We continue to assess the optimum means of maximizing the value of each of our new businesses. This requires balancing the funding requirements of each new business with the needs of our print and services business all while ensuring the adequate return of capital to shareholders and responsibly managing our capital structure.

Free cash flow was a use of cash during the quarter of $98 million or $57 million excluding a one-time contract termination payment. Excluding this one-time payment, we ended the first half with a slight use of free cash flow due in part to a buildup of inventories to support growth in the second half of the year. We remain committed to our guidance of at least $400 million of free cash flow or essentially $360 million excluding the one-time payment.

Free cash flow generations is of paramount importance and remain a key tenet to our strategic priorities. To ensure we hit our free cash flow target, we have taken appropriate measures to pass pricing increases along to our customers, offsetting some of the effects of inflation across our cost base. We've also taken actions to significantly lower our fixed cost base, which will not only help us to achieve our free cash flow target but provide incremental flow through of revenue to free cash flow as return to the office and supply chain conditions improve.

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To recap, we are pleased to see momentum in demand across our business. When combined with the line of sight to price increases and cost actions, we are confident in our ability to achieve full year guidance. We continue to be guided by our four strategic initiatives to position Xerox for sustainable long-term growth. The means of achieving that growth will necessarily evolve in response to a dynamic macroeconomic environment.

I will now hand it over to Xavier.

....

Xavier Heiss

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

Thank you, Steve, and good morning, everyone. As Steve mentioned, strong demand for our products and services this quarter, drove revenue growth in constant currency despite ongoing supply constraint. Equipment revenue declined as expected but orders continued to outpace supplies as evidenced by another quarter of backlog growth. Backlog in Q2 was $440 million, which is more than double last year level and exceeds a full quarter of revenue. Backlog remained elevated but is healthy and this rate of growth declined quarter-over-quarter. We expect to convert substantially all of our backlog into revenue and believe backlog is now at peak levels.

Post-sales revenue grew in actual currency and constant currency due to growth in IT services and print activity-driven revenue such as consumables and services. Consistent with prior quarters, we see a strong correlation between return to office trends and page volumes.

In the second quarter, we were encouraged to see service revenue growth outpaced page volume growth as contractual price increases began to materialize. We expect that trend to continue through the remainder of the year.

Turning to profitability, as with prior quarter result, profits were lower year-over-year due to lower equipment sales, lower margin on equipment, on post-sales revenue, broad-based inflationary pressure and incremental investment associated with our new businesses. However, early benefit of price increases and lower spending resulted in a sequential improvement in both profits and profit margin.

Gross margin declined 370 basis points in the second quarter. 340 basis point of this decline is attributable to supply chain costs and capacity restriction, including higher freight and shipping costs, constrained availability of higher margin A3 devices and higher product and service costs. Approximately 80 basis points of the decline relate to investment to support future growth, lower royalty from FUJIFILM Business Innovation and lower government subsidies. These declines were partially offset by currency and restructuring benefit.

We expect gross margin to improve in the second half of the year as supply constraints ease, product mix improves, particularly with A3 devices, and additional price and cost action are realized.

Adjusted operating margin of 2% decreased 500 basis points year-over-year, reflecting lower gross profit, investment associated with our new businesses, acquisition and prior-year benefit from temporary government subsidies and furlough measures. These headwinds were partially offset by the favorable impact from currency and Project Own It savings.

SAG expense of $459 million, increased $25 million year-over-year. Excluding $21 million of accelerated share-based compensation expense associated with the passing of our former CEO, SAG expense was up $4 million year-over-year. The year-over-year increase was mostly driven by investment in new businesses, benefit from temporary government subsidies and furlough measure in the prior year, higher bad debt expense and

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acquisition. These increases were partially offset by the favorable impact from currency, savings from Project Own It and lower sales and marketing expenses.

RD&E was $84 million in the quarter or 4.8% of revenue, which was an increase of 40 basis points as percentage of revenue year-over-year. The increase was driven largely by continued investments in our new businesses, specifically PARC and CareAR, partially offset by lower spending for print and modest productivity savings.

Other expenses, net, were $7 million higher year-over-year. The increase was mainly driven by an $18 million increase in non-service retirement related interest costs, mostly due to elevated interest cost associated with higher discount rate and higher settlement losses, as well as a $4 million loss on the early extinguishment of debt, which will be offset by lower interest expenses in the second half of the year.

This charge were partially offset by a $16 million benefit associated with a refund of excess employer contribution to a defined contribution pension plan in Latin America.

Second quarter adjusted tax rate was 18.5% compared to 9.7% last year. This increase was driven by prior year tax benefit associated with the change in tax law resulting in the remeasurement of deferred tax assets.

Adjusted EPS of $0.13 in the second quarter was $0.34 lower than in prior year. These declines were largely driven by a year-over-year reduction in adjusted operating income and a higher tax rate, offset by the pension refund in Latin America and the lower share account.

GAAP EPS of minus $0.05 was $0.51 lower year-over-year due to an increase in adjusted items, including higher non-service retirement related cost and a $21 million charge associated with accelerated share-based compensation.

Turning to revenue. Total revenue exceeded our expectations this quarter due to momentum in demand for our products and services. Equipment sales declined at the slowest rates since Q3 of last year and post-sales revenue grew at the fastest rates since Q2 of last year in constant currency.

Improvements in the fundamental of our business were broad-based. Equipment order once again outpaced supplies, resulting in a cumulative backlog this quarter of equipment and IT hardware of $440 million, a 4% increase over Q1.

We see little risk associated with the recognition of our backlog into revenue. Unlike some type of IT hardware, customer rarely place multiple order for office printer while they wait for equipment to arrive. A benefit of our equipment financing business model, customers typically extend their lease while waiting for new equipment, and product shortage at our competitor limit risk of defection.

Equipment sales of $366 million in Q2, declined 14.7% year-over-year, or 11.4% in constant currency. The decline was driven by supply constraints, which continued to limit our ability to fulfill demand. Installations were down year-over-year across all categories for black and white machine, which were more significantly affected by supply constraints on color machine. Entry color installation grew due to higher demand for new device and increased product availability. High-end color installations were also up versus last year due to increased product availability, particularly for our Iridesse and Baltoro products.

High margin mid-range products continue to be most impacted by supply chain constraint. We expect this constraint to ease in the second half of the year driven by the improved component availability and factory output

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that we observed at the end of June. Post-sales revenue of $1.38 billion grew 1.2% year-over-year or 5% in constant currency.

Page volume grew modestly year-over-year in Q2. Revenue growth tied to printing activity once again improved and correlations between page volume and usage based post-sales revenue remained high. Post-sales growth was driven by IT services, which increased more than 30% year-over-year on an organic basis and benefited from a full quarter of revenue from the recent acquisition of Powerland in Canada.

Sold supplies and paper revenue, which corresponded with printing activity, both grew this quarter and sold services revenue grew on a constant currency basis, outpacing improvement in service page volume due to recently enacted price increases. Post-sales revenue growth was partially offset by lower FUJIFILM Business Innovation royalty, lower financing commissions and lower financing revenue.

In our services business, total signings grew mid-single-digit year-over-year with increases in both new business and renewal and were led by double-digit growth in signings for our capture and content digital services.

Let's review cash flow now. Free cash flow was a use of $98 million in Q2 and was lower year-over-year by $296 million, driven by the receipt of $100 million FUJIFILM prepaid royalty in the prior year, and the $41 million one-time contract termination payment in the current quarter, as well as lower cash earnings, which included incremental investment in our new businesses, larger working capital outlay and the timing of management bonus payment.

Operating cash flow was a use of $85 million in Q2 compared to a source of $214 million in the prior year. Working capital was a use of cash of $65 million this quarter, $30 million higher than the prior year, mainly driven by an increase in inventory in anticipation of higher second half revenues, partially offset by growth in accounts payable.

Investing activity were a source of cash of $13 million compared to a use of $55 million in the prior year, due to proceed from the sales of property and lower cash used for acquisitions.

CapEx of $13 million was slightly lower year-over-year. CapEx overall support our strategic growth program on investment in IT infrastructure.

Financing activity consumed $438 million of cash this quarter, driven by the partial tender offer of our $1 billion, 2023 senior note and the net reduction in securitized debt. During the quarter, we paid dividend totaling $42 million and did not repurchase any shares.

We remain committed to returning at least 50% of our free cash flow back to shareholder. We expect to exceed this amount based on year-to-date share repurchase on our annualized dividend.

Turning back to profitability. Like last quarter, adjusted operating income was negatively affected by supply constraint, broad-based inflationary pressure across our cost structure and investment in our new businesses. We expect profitability to improve sequentially for the remaining two quarters of the year as supply chain costs normalize, particularly freight costs and through an easing of product supply constraints, which will not only improve equipment sales but equipment gross margins, as product mix normalizes.

Inflationary pressure is expected to continue in the near-term, but we will offset a large portion of inflation-related cost growth with price increases for our products and services. The effects of our price increases will compound

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over time, particularly for our contractual business, where price increases are enacted at specific times throughout the year, or upon contract renewal.

Further offsetting these cost pressures will be savings generated through Project Own It. We're on track to achieve our target gross cost savings of $450 million in 2022, the vast majority of which will be realized in the second half of the year.

Through this action, we expect to achieve a full-year adjusted operating margin consistent with that of the prior year. The benefit of this year cost reduction and price increases are expected to result in a sustainably higher operating margin in future years subject to improved supply chain and stable macroeconomic condition.

Turning to segment, FITTLE revenue declined 14.7% in Q2 mainly due to a reduction in operating lease revenue reflecting lower Xerox equipment installed. Segment profit increased by $2 million or 13% due to lower inter-segment commission on new lease origination, which were partially offset by incremental start-up cost. Segment margin of 11.5%, improved 290 basis points year-over-year and was higher than our full year estimate of 8% to 9%. We expect FITTLE margin to normalize as Xerox lease volume pickup, driving increase in inter-segment commission.

In Q2, FITTLE finance assets were down slightly quarter-over-quarter due mainly to unfavorable currency translation. On a constant currency basis, FITTLE asset balance was flat in the second quarter. FITTLE origination volume declined 7% year-over-year due to a decline in captive product origination of 25%, which were negatively affected by product availability constraint. Non-captive channel origination, which includes third-party dealers or non-Xerox vendor grew 22% year-over-year due to growth in new dealer relationship and third-party equipment origination volumes.

Print and other revenue fell 2% in Q2. Growth of post-sales revenue was more than offset by lower equipment sales. Print and other segment profit fell 84% year-over-year with a 580 basis point decline in segment profit margin, due to a lower revenue on gross profit.

As presented earlier, print and other segment profit margin was negatively impacted by the ongoing effect of supply chain constraints and inflation, as well as incremental costs associated with new business.

Turning to capital structure impacted by the ongoing effect of supply chain constraints and inflation, as well as incremental costs associated with new business. Turning to capital structure, we ended Q2 with a slightly positive net core cash position. $2.8 billion of the $3.9 billion of our outstanding debt is allocated to and supports FITTLE lease portfolio. The remaining debt of around $1.1 billion is attributable to the core business. Debt essentially consists of senior unsecured bond and finance asset securitization.

We have a balanced bond maturity ladder and no unsecured maturity for the remainder of the year. In the second quarter, we returned $42 million of cash back to shareholder in the form of dividend.

Finally, I will address guidance. We are maintaining our guidance of at least $7.1 billion of revenue at actual currency and free cash flow of at least $400 million. As a reminder, our free cash flow guidance excludes $41 million of cash costs associated with a one-time product supply contract termination charge.

Supply chain and macroeconomic conditions remained fluid, but momentum in demand, driven by favorable return to work trend, better supply chain visibility and line of sight to price increase and cost reduction in the second half of the year give us confidence to maintain our guidance.

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We will now open the line for Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] I show our first question comes from the line of Ananda Baruah from Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Good morning, guys. Really appreciate you taking the questions. Yeah. And just want to say our thoughts remain with you guys and John's family at this time as well.

Business-wise, yes, listen, congrats on the solid execution and the ongoing sort of solid outlook for the second half of the year, which also speaks to your execution. I guess just sort of starting there, any context, guys, you can provide with regard to what customers are actually communicating to you, sounds like this sort of order patterns [indiscernible] (00:34:36) to get. Any context that they're giving to around under what conditions may cause them to sort of get more cautious, rethink their order patterns, rethink their projects, anything like that? And then I have a couple quick follow-ups after that. Thanks.

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

A

Okay. Hi, Ananda. Ananda, what we see currently is that, as you see it from a near term point of view, our backlog remains strong and we still see demand that outpace the supply here. And clearly, customers are still planning gradual return to the office. And if I move now on to the post-sales element here, you saw that our strong post-sales revenue with a growth at constant currency of 5% across I would say the board. It's not only related to page volume and print-related activity, but IT services as well grew significantly during the quarter. So, what the customers are indicating to us is they are still relying on our technology and services, and the demand that we see currently for this remain strong and keep us positive for the remainder of the year.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

I got it. I got it. And so just to that, Xavier, can you give us any sense of how big the backlog is?

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

A

How big, sorry, Ananda?

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah, how large is the backlog? How big is the...

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

A

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Oh, the backlog. So, the backlog is $440 million, so backlog grew. It grew less than what we had from quarter one to quarter four, so we grew roughly 5% and we see, I would say, good sign of supply chain easing. But $440 million, as you know, it is more than a full quarter of equipment revenue sales here.

So, still strong. By the way, I should add as well, good quality of backlog. One question we have seen or one of the concerns you can see in the industry is, will this backlog last, that means, will the customer stop ordering. We see very, very minor cancellation and we are able to manage the aging of the backlog. So customer order can be fulfilled, I would say, on time and with the support of FITTLE, our leading financing business, we are able to extend some of the lease, so customers are not suffering from backlog here.

So, good confidence in the strength of the backlog and also we see line of sight during the second half of an ability to realize some of these backlogs during the second half of the year.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's really helpful. Thanks a lot. I appreciate it.

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

A

Thank you, Ananda.

Operator: Thank you. And I show our next question comes from the line of Erik Woodring from Morgan Stanley. Please go ahead.

Q

Hi, this is [ph] Maya (00:37:45), on for Erik. Thank you for taking our questions today. So, where are we along that path to reach 80% of pre-COVID page volume averages? Some of your peers have talked about returning close to that level. Are we at the point where page volumes have stabilized given the variability in working environments? Or are we still a little bit away?

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

A

So, it's a great question. So, we are monitoring that very closely. And if you remember, we observe and we carry on observing the straight correlation between vaccination rate, which is now raised all across the world, presence and return to the office and print volume. And what we have observed during quarter two is what we call the gradual recovery. So, we are on the trajectory to increase and to get closer to this 80%. So, geographies have different type of dynamic. So between EMEA and Americas, we see different type of dynamic with this segment there, but currently what we observe is that we are getting closer to the 80% and we are also expecting during the second half of the year a gradual recovery of the print volumes.

Q

Okay. Great. Thank you.

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Operator: Thank you. [Operator Instructions] And I show our next question comes from the line of Samik Chatterjee from JPMorgan. Please go ahead.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Great. Thank you for taking my questions. I had a couple. I guess firstly, if I'm looking at your revenue guide for the year, which you reiterated, there's a $300 million improvement second half to the first half, I think, in terms of revenues that you're guiding to. Was wondering if you can give me a breakdown of how much of that is supply improvement led sort of equipment revenue relative to some of the price increases on services that you talked about? If you can just give me a bit more of details around sort of the improvement that you're expecting in the second half? And then I have a follow-up. Thank you.

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

A

Yeah. Thanks, Samik. So, the three components that are the foundation of second half revenue improvement is number one, equipment sales improvement. In equipment sales improvement, this is mainly related to supply chain capacities and component availability. And the other line of sight based on the recent number from our OEM of improvement coming into the second half of the year. If you combine that as well with the price increase that we have enacted on the equipment sales there, you have a double effect, more products and products that could be sold at a higher price.

I will add as well and this is mainly related to margin. It will be done with a better mix and one of the challenges that we have had since the beginning of the year is a lack of A3 equipment with a better line of sight now of A3 product availability, driving profitability and margin improvement. So, that's the first pillar.

The second pillar is around the print volume and page volume improvement, and we are expecting here to double effect as well here, with a gradual recovery of price of page volume but also combined with the price increase that we have been able to apply across range of the contractual agreement with our customer.

And lastly, IT services and you certainly heard this year, in quarter two was an organic growth of more than 30% and we have also the benefit of inorganic growth there. IT services, both demand and availability, I would say, with some improved product availability will also drive the revenue improvement during the second half of the year. So the $300 million difference that you can see are based on these pillars here.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. And the second question is more of a follow-up on to the comments that you have on slide 6 about how the business fares in a recession. And just trying to understand those comments a bit better here where you say two-thirds of your business has contracted for multiple years and you go on to say that the contractual revenue risk in a near-term downturn. So maybe just if you can give more details there to help me understand that a bit better, do you expect some of the contracts to be paused by your customers in a near-term downturn or sort of downsize? How are you thinking about sort of the contractual revenue risk for what you mentioned is two-thirds of your business and has contracted for multiple years.

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

A

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Yeah. So, as you know it, our business model is made on the, I would say, two type of revenue simply, transactional type of revenue and a contractual type of revenue. And the transactional also – let's start with the contractual. So contractual is around two-thirds of the business. So when we enter into a period where a customer has a question around the future for Xerox, the benefit of our business model is a two-thirds of the revenue is revenue that is booked and this book on contract with an average length of the contract, which is between four to five years.

So this gives us as well here a confidence, on top of the demand that we see currently because when you look at what customers are asking us to deliver to-date, this is mainly related to the demand that they have, is mainly related to not only being able to support the processes with print and services here. But we have also IT and the digital services where usually this type of businesses have countercyclical aspect. When company goes to I would say a recession or try to generate savings, they will invest in this technology in order to improve their own productivity, reduce the cost base and deliver their own cash flow here.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Thank you.

Operator: Thank you. And I show our next question comes from the line of Jim Suva from Citi. Please go ahead.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Thank you so much, and for all the details, of course, our heart and thoughts go with Mr. Visentin and his family and loved ones and team members of Xerox. As we look ahead, the inflationary environment, both on labor costs and other things like that, I'm just kind of curious about how should we be thinking about your operating costs and your margins going forward? I know there's puts and takes about shipping costs, material costs or maybe operating margin is a better focus at. Can you give us any clarity? And also, I don't remember, are there like typical merit increases that falls into the Xerox employee base that we should kind of be mindful of as we look ahead for kind of either 2023 or believe it or not, we're starting to model and look at the 2023, just on the inflationary environment overall?

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

Yes, certainly, Jim. So, yes, we see in lot of businesses – see a pressure of inflation. However, as we mentioned it, some of the erosion that we are seeing currently on our business is mainly related to supply chain. The supply chain, if you look at the gross margin that we printed for this quarter, we have a gross margin, which is down 370 basis points this quarter versus last quarter. By the way, the numbers were roughly the same in quarter one with a sequential improvement. But 340 basis points out of the 370 basis points come from supply chain. Then we also, as you know, we make investment in our future businesses and to support the future growth, business growth outside of the print and services businesses here. And then we'll put on stake from last year number with lower royalty government subsidies and things like that.

But when you look where we are addressing the inflation challenges, it's quite simple. The first thing is to ensure that via Project Own It, we optimize and drive the cost base of the company to the level that we can afford. The second point after this is also to enact on the increase prices all across the board. When I say, all across the board, it has been done at Xerox since quarter three of last year where we increased prices on equipment but also on post-sales contractual agreement that we have with customer.

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So that's the way to look at it, employees on the specific, I would say especially on labor costs there are included within this. At the end of the day, what you try to drive is improve the productivity that you have on your labor cost and bring technology as well in order to I would say lean or simplify some of the processes and the offerings that we offer to customers.

But the key message, Jim, here is that we believe with this action here that we will drive margin improvement during the second half of the year, by the way, at the level that the company has been able to achieve during the second half of the year.

That traditionally specifically in quarter four with a strong finish depending on the supply chain and macroeconomic condition being as what we know today. We are confident that we will be able to drive the gradual improvement in gross margin and operating margin.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much.

Operator: Thank you.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

It's appreciated.

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

A

Thank you, Jim.

Operator: Thank you. I'm showing no further questions in the queue at this time. I'd like to turn the call back over to Mr. Steve Bandrowczak for closing remarks.

Steven John Bandrowczak
Interim Chief Executive Officer, Xerox Holdings Corp.

Thank you for listening to our earnings conference call this morning. We are seeing encouraging signs in the second half of 2022, growth to a stronger second half of the year. I am honored to lead this great company and team who collectively are resolved and primed to grow revenue and profitability in the second half of 2022 and beyond. Thank you for attending and have a great day.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect.

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