

THOMSON REUTERS

EDITED TRANSCRIPT

Q3 2018 Xerox Corp Earnings Call

EVENT DATE/TIME: OCTOBER 23, 2018 / 12:00PM GMT



CORPORATE PARTICIPANTS

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

Jennifer Horsley *Xerox Corporation - VP of IR*

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

CONFERENCE CALL PARTICIPANTS

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

Jim Suva *Citigroup Inc, Research Division - Director*

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

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

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

PRESENTATION

Operator

Good morning, and welcome to the Xerox Corporation Third 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 expressed 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 thank you all for joining us for our third quarter 2018 earnings call. We are progressing on our priorities to optimize our operations for greater simplicity and reenergize our innovation engine while focusing on cash flow to drive increasing shareholder returns. In the quarter, we delivered operating margin expansion of 100 basis points year-over-year and a strong cash flow that is enabling us to raise our full year cash flow expectations for 2018.

Work remains on all fronts. However, clearly, our priority to drive revenue requires the most effort. We were disappointed in the revenue in Q3. We have an action plan to improve revenue that includes, among other things, simplifying the organizational structure, improving alignment of compensation and evaluating contracts that are not profitable. We will go through each of the priorities in more detail, but I will start with a closer look at our results.

Revenue in the quarter was down 4.7% at constant currency, with equipment revenue performing better, down 2.7%, while post sales declined 5.2%. Both A4 and A3 equipment revenue grew at constant currency, up 9% and 1%, respectively, showing the continued momentum from our ConnectKey products.

While high end declined 5%, we did improve from Q2, [when it was down 10%] (added by company after the call) and we saw good market demand for our new Iridesse printing press. Iridesse hits a sweet spot within the high-end market, (enabling both better productivity with a single pass technology and differentiation with the gold, silver, white and clear dry ink capabilities). Post sales will take time to improve. We need to build back our machines in field after ceding share for multiple quarters leading up to the ConnectKey launch and penetrate further our offerings into our customer base.



Operating margin of 13.1% in the quarter increased sequentially 120 basis points and 100 basis points year-over-year driven in part by our work to simplify our business, reduce management layers and eliminate resources in areas where capacity or scales were suboptimal.

Overall adjusted earnings per share of \$0.85 reflected the work of the team. Operating profit increased as margin expansion, including the impact of higher equity income, more than offset the revenue declines. A higher tax rate and lower gains on asset sales, however, resulted in a year-over-year EPS decline. On a GAAP basis, earnings declines were greater, driven by a onetime noncash tax act-related true-up.

On cash, we delivered \$274 million in operating cash flow and \$251 million in free cash flow, an increase of \$157 million year-over-year on an adjusted basis for both measures. This strength, as highlighted, gives us confidence to raise our full year free cash flow guidance. We now expect free cash flow to be in the range of \$900 million to \$1 billion versus the previous range of \$750 million to \$950 million.

Lastly, we are delivering on our commitment to return over 50% of free cash flow to shareholders through share repurchases and dividends. Through the end of September, we repurchased \$284 million in shares and distributed \$204 million in dividends, which, in the aggregate, represents approximately 75% of September year-to-date free cash flow.

With the strength of our cash flow and our significant cash balance of over \$1 billion, along with our continued view that repurchasing our stock provides an attractive ROI, we are increasing our 2018 share repurchase expectations. We now expect to opportunistically repurchase up to \$700 million [in shares this year, which compares to our previous expectations of] (added by company after the call) up to \$500 million. This will put us well above the commitment to return at least 50% of the free cash flow to our shareholders.

During the quarter, we launched project "Own It," which is focused on simplifying the business to drive end-to-end transformation of our systems and processes to create greater focus, speed accountability and effectiveness. This will deliver superior customer experience while setting the company up for growth. In Q3, we identified the actions and work streams while also capturing some early wins.

Optimization actions will expand in Q4 as we complete the "Own It" design phase for initiatives such as establishing more effective shared services centers, rationalizing our IT infrastructure and real estate footprint, creating greater velocity in our supply chain and unlocking greater productivity in our supplier base. And this is where the experience of key hires with expertise in these areas will be instrumental in driving change, leveraging strategies proven out in other enterprises.

Establishing effective shared services centers is one example of an opportunity to improve the way we work to create an agile, frictionless business that delivers enhanced performance for our customers.

Xerox has moved some functions to lower-cost locations in the past. However, we see significant potential in creating world-class centers of excellence, which will result in greater quality, speed and productivity. We will do this by measuring and improving year-over-year performance through the introduction of standardized processes and metrics.

Automation, real-time analytics and robotics process automation will be another key strategy to drive efficiency and quality. RPA will be embedded in our new design as we simplify and build new end-to-end processes. For instance, RPA can be used in our order-to-cash process to validate data quality as well as scan, post and match purchase orders and invoice processing.

Through all of these, we are also looking at ways to improve the efficiency of our business through simplification. An example of this is our initiative to rationalize our number of SKUs and product offerings with a goal of eliminating numerous configurations of essentially the same product and by employing a better design for efficiency through an increased number of common parts. The focus of our optimization efforts is on delivering greater customer value and translating actions into profitable revenue growth.

We are putting in place actions to sustainably improve our revenue performance. These start with building a more simplified, agile organizational structure and include;

[Better aligning sales compensation metric and global sales enablement tools



Improving go to market penetration including:] (added by company after the call)

further expanding our channel presence, including independent dealer coverage to go after the SMB market.

enhancing our e-commerce capabilities, this is an area where we will be making investments and changes, including investment in our partner e-commerce portal for order management, inventory availability, shipping status and much more functionality that makes it easier for partners and our end customers. We will also invest and grow our direct e-commerce portal for product information, order placement and shipping status.

leveraging more digital demand generation inside sales lead generation to help capture new customers

As well as improving deal pricing and contracting while turning around unprofitable contracts.

In addition, to drive long-term growth, we need to increase our focus on software innovation to deliver differentiated value to our customers and expand into adjacent markets.

Changing the top line trend won't happen overnight, but we have the products, the innovation, the talent and the customer relationships to do it. We are early in our "Own It" initiative, and we expect momentum to build over time.

We had some notable recent achievements that will help build the foundation for better future revenue performance, including:

Becoming the first and only MPS vendor to receive security authorization for cloud-based Managed Print Services from the U.S. government. This is a significant accomplishment that sets Xerox apart from our peers and allows federal agencies to utilize Xerox for services without going through a lengthy security vetting process. Security is one of the biggest concerns for corporate America, and receiving FedRAMP helps not only penetrate the nearly \$100 billion annual federal IT market but it is also a validation of our leading-edge security capabilities that companies of all size are looking for. Additionally, we further solidified our leadership in MPS, achieving for the ninth straight year the #1 position in Quocirca's worldwide MPS market landscape report. This will continue to provide us the runway to gain wallet share, enabling expansion into digital workflow services, which can help business drive further efficiency and productivity improvement.

At the beginning of October, we announced further enhancements to our ConnectKey software, and we launched an embedded e-commerce platform that will allow us and our partners to monetize apps more easily. As I visit with customers, I have seen the unique ways in which the ConnectKey software and apps are positively contributing to their business. For instance, one design and engineering company saved 25% by automating a document-laden process, accelerating the speed at which products get out the door. We also expanded our App Gallery. We populate it with apps such as those that can support the K-12 education sector by taking time-consuming tasks like grading tests and proofreading papers away from teachers, thereby allowing them to focus on students.

In the high-end graphic communication area, we had a strong showing at the recent Print 18 trade show. We came away with 11 show awards, including a Vanguard award for the new Iridesse Production Press, and 5 awards relate to our industry-leading XMPie personalization and communication software. The new Iridesse press is truly a game changer. It is the only digital press that can print in one pass with 6 colors, including gold, silver, white and clear dry ink. This allows our customers and partners to perform the same task at pennies of the cost of having to run multiple machine passes and offset processes. This opens up a huge opportunity for Xerox and our print-provider customers in the lucrative print embellishment market and supports the movement of more pages from offset into our digital space. It is also driving new business for us. In our international operations, over 50% of our installs are new placements, generating new print volume. And 90% of our Iridesse customers invested in the optional specialty dry ink print station to capture new applications with gold, silver, clear or white to grow their business. As one customer indicated, this press gives possibilities like no other digital printer on the market.

As we previously communicated, we are revamping our innovation business model. This is essential to returning Xerox to technology

leadership, positioning us for long-term success and ensuring proper monetization of our innovation. We have begun a thorough review of our software businesses to consider how we can better position them for growth, both as part of our core document business and on a stand-alone basis. We are examining our RD&E investments in xerography and inkjet to ensure that we maintain technology leadership and that we have the best approach to realize the high rates of return we require.

Our leading expertise in technology in printing uniquely positions us to move into adjacencies that share similar core technology requirements. For instance, we are developing a road map to participate in 3D printing. We currently manufacture 3D print heads that we OEM, where we have differentiated capabilities around print technologies, materials, toner and software that will enable 3D printing to move to the next level of adoption for the production of end-use industrial parts.

We are also accelerating market growth in emerging innovation areas to more quickly decide whether and how to incubate and scale opportunities for monetization. One example of this is the work we are doing around smart tags and printed electronics. This revolutionary technology has the potential to change how we store, sense, compute and communicate information. Real-world applications would include cold chain monitoring to ensure food traceability or the smart mouth guard that athletes could wear to monitor their health and fitness. This is just one of the ways we are looking to extend our existing IP to bring disruptive technologies into new industries.

When appropriate, we will invest in our capabilities as well as in M&A through a revitalized process to enable commercialization of the technologies we create. A recent highlight where we have not only ramped up the visibility of an offering but also honed our market positioning is the latest version of DocuShare Flex 2.5. DocuShare historically has been an asset that was underappreciated within the corporate complex and thus, not optimally distributed.

DocuShare Flex 2.5 helps companies solve their document-intensive workflow and file management challenges through a flexible cloud-based solution. Key upgrades include more seamless integration with the commonly used applications such as Salesforce and DocuSign, workflow solutions to streamline accounts payables and receivables as well as enhance mobile capabilities.

There is a lot of excitement amongst the Xerox team around our innovation opportunities. We look forward to better capitalizing our innovation capabilities and investments to capture the full value of this critical element of our business strategy.

A top priority for us is making sure we have strong sustainable cash flow generation. In conjunction with our "Own It" initiatives, we are focused on improving our cash flow model through tighter management and improving the net working capital pillars. Cash flow was very positive in Q3. During the quarter, we implemented tighter controls around working capital. From this increased focus, we grew cash flow \$157 million on an adjusted basis year-over-year, and as a result, we are increasing our full year free cash flow range to \$900 million to \$1.0 billion from our previous range of \$750 million to \$950 million.

We know it is very important to effectively deploy cash to provide good returns to our shareholders, both through improving our profit trajectory organically and inorganically as well as through direct returns to shareholders through dividends and share repurchases. During the quarter, we began to work to rebuild our M&A pipeline and to begin to frame out the investments that we'll be making in the future to drive improved profitable revenue growth. In terms of direct returns of capital, as I indicated earlier, we repurchased \$284 million worth of shares in the third quarter, which translates to approximately 10.5 million shares or 4% of shares outstanding. And given the strength of our cash profile, we are increasing our full year repurchase expectations from \$500 million to \$700 million opportunistically. We will provide further updates on our priorities during Q4 earnings in January followed by a more in-depth review of the company's strategy and the "Own It" program during an Analyst Day in the first 2 weeks of February of 2019.

I will now turn it over to Bill to review in more detail our financial results for the quarter.

William F. Osbourn Xerox Corporation - Executive VP & CFO

Thanks, John. Let me start with a review of the income statement. Overall, we were pleased with the performance within the cost and expense lines, especially G&A, that resulted in operating margin expansion despite revenue headwinds and delivered adjusted earnings per share of \$0.85.

Revenue, as John highlighted, clearly remains a challenge. Overall, revenue declined 4.7% at constant currency while actual currency was down 5.8%. Currency went from being a benefit of about 2 points last quarter to now a headwind of approximately a point. Within revenue, we had growth in Workplace, A3 and A4) equipment, and overall, equipment revenue would have grown 1.7% at constant currency if it had not been for the impact of lower OEM sales.

Post sale, however, continues to be pressured. Specifically, we saw weaker supply sales as well as a slowdown in Managed Print Services post sale. I'll spend more time on these dynamics when I cover the revenue slide. However, as noted last quarter, to stabilize revenue, we need our market share (and placement growth) to recover over multiple quarters to drive increases in machines in field and page volumes to help improve trends in post sale.

Turning to profitability. Adjusted operating margin of 13.1% improved 100 basis points year-over-year. The improvement came from a 40 basis point improvement in our SG&A ratio, driven by actions to reduce spans and layers and gain greater efficiency in our operations. Gross margin of 40.1% was flat year-over-year, a good result as the impact of higher revenue declines was offset by benefits from productivity initiatives, including greater price discipline and controls.

From a stream perspective, we saw positive mix within equipment from lower OEM sales where we lose money on the upfront sale while, within post sale, mix was a negative factor given the higher declines in supplies. Also contributing to the improvement in margin was higher equity income, which increased \$14 million year-over-year on an adjusted basis. Drivers of the equity income improvement include benefits to Fuji Xerox from their recent cost actions as well as an easier compare given prior year higher bad debt provisions.

Turning to below-the-line items. Adjusted other expenses net of \$24 million were \$7 million worse year-over-year, driven by lower gains on asset sales as the prior year included a (\$13 million) gain associated with the sale of our Grenoble research center. Adjusted tax rate of 24.5% increased 5.2 points year over year, resulting in a negative \$0.05 impact to EPS as the prior year rate was lower from a tax reserve reversal.

Overall, adjusted EPS of \$0.85 was down \$0.04 from the third quarter of 2017, driven by the higher tax rate. On a GAAP basis, we had \$0.34 of earnings per share, which was down \$0.33 in the quarter, driven by a \$0.37 or (\$95 million) noncash charge associated with the change in the provisional estimated impact from the U.S. tax act, which was partially offset by \$0.09 or (\$33 million) in transaction and related cost reversals. 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 aforementioned transaction cost reversal and U.S. tax act charge.

Moving on to revenue, where I'll break down our revenue decline of 4.7% at constant currency. Looking first at the geographic sales channels. North America revenues were down 4.2% at constant currency, with equipment revenue flat, driven by good growth in enterprise. Post sale in North America, however, was pressured with higher supplies and Managed Document Services declines year-over-year.

International declined 2% at constant currency, an improvement over the 3.9% decline in Q2, driven by growth in equipment. Within international operations, we continued to see growth in developing markets while Europe's rate of decline improved sequentially. Our highest area of decline was in Other, driven by the OEM business, which had an overall negative 1-point impact to total revenue.

Turning now to a closer look at equipment revenue. Equipment revenue declined 2.7% at constant currency. However, as highlighted earlier, it grew 1.7% excluding OEM. Entry equipment revenue made up 11% of equipment and was up 9.1% at constant currency, driven by growth in developing markets and U.S. channels. From a product perspective, black and white entry A4 products continue to show strong growth while color multifunction installs declined.

Midrange equipment revenue comprised 69% of equipment revenue and grew 1% in constant currency. Areas of growth included U.S. enterprise, driven by large account sales, and continued growth across developing markets. Partially offsetting this growth were declines in Europe, reflecting in part a more challenging compare, given higher channel purchases in the prior year associated with building up



sufficient supply of newly launched products. Install growth in midrange overall outpaced revenue, driven by a mix towards mono and lower-end color devices, in part from the better growth in developing markets where installs weigh to the lower end.

Midrange A3 is a key leadership segment for Xerox, and overall, it is midrange that has driven our equipment revenue share gains over the past 3 quarters. We have not yet gotten back the MIF lost prior to the ConnectKey launch, so growth needs to continue to get higher MIF and drive post sale improvement.

Lastly, our results in the high end were very mixed. High-end equipment revenue made up 18% of total equipment revenue, and the decline improved sequentially, down 5.1% at constant currency versus down 9.9% in Q2. We saw strong demand for our new Iridesse press that exceeded our expectations. However, this growth was not enough to offset the impact of the lapping of the Versant product launch and declines in iGen.

Turning to post sale. Post sale revenue comprised 78% of total revenue and declined 5.2% at constant currency. As discussed earlier, we have not seen the contracted post sale revenue trend improve, (which is dependent on growing our machines in field and page volumes). And in the third quarter, we also experienced higher unbundled supplies revenue declines, which (went from down 2.4% June year-to-date to down 7.7% in Q3). The supplies declines were driven by lower indirect channel sales, which were impacted by lower demand, including large customer order timing and economic uncertainty in certain developing market countries.

To close on revenue, Managed Document Services comprised 36% of total revenue and continued to grow, up 0.9% at constant currency. This was a deceleration from the second quarter growth of 2.3%, driven by the impact of lower renewables in prior periods as well as timing of new business ramp. Positives within Managed Document Services include continued growth in partner print services to the SMB market as well as a second straight quarter of new business signings growth and a 4-point sequential improvement in the renewal rate to 79%. Renewal rate, however, was below our target of 85% to 90%, and overall renewal signings were lower than the prior year and drove a total signings decline of 2.8% at constant currency. As John indicated, we need to leverage our strong market position and new accreditations like FedRAMP to drive improving results in this segment of the market.

Looking forward, we are not giving specific revenue guidance. However, I would like to highlight that, as indicated earlier, it will take time before we see revenue begin to improve. And secondly, although we expect to see improvement in some areas such as supplies, overall, the fourth quarter compare is the most difficult of the year, considering the timing of last year's ConnectKey product launch.

Turning now for a closer look at Xerox' profitability performance. Operating margin of 13.1% increased 100 basis points year-over-year while adjusted EPS of \$0.85 declined \$0.04 year-over-year. Overall, we view both operating margin and earnings per share as positives in the quarter.

Looking at the profitability walk year-over-year. Within our operations, the impact of revenue declines were only partially offset by cost productivity benefits, resulting in a negative \$0.02 year-over-year impact to EPS. However, our operations did drive a 40 basis point improvement in margin as we reduced costs at a higher rate than revenue decline. The remaining 60 basis points of margin improvement came from the increase in equity income that I highlighted earlier. This increase also was an approximate \$0.05 benefit to EPS.

In terms of unique items in the year-over-year quarter compare, there were 3 that we believe to be highlighted, (2 negative and 1 positive). They include:

a year-over-year negative impact of approximately \$10 million or \$0.03 per share associated with the gain we realized last year on the sale of our Grenoble research center;

a \$0.05 negative impact associated with a higher adjusted tax rate in Q3 2018 of 24.5% compared to a 19.3% tax rate in the prior year when we benefited from the conclusion of several audits.

partially offsetting these impacts was an approximate \$0.01 benefit from lower shares, driven by the resumption of our share repurchases during the quarter. (The benefit is not higher as we only realized a partial quarter of lower shares. As well, shares had

modestly grown since the prior year from compensation).

So good results on profitability.

Turning now to cash flow. Operating cash flow was a source of \$274 million in the quarter and we are at \$725 million through 9 months while free cash flow was a source of \$251 million in Q3 and \$652 million year-to-date. Both operating cash flow and free cash flow were up \$157 million year-over-year in the quarter on an adjusted basis, (adjusting for the \$500 million in incremental pension contributions and the GAAP change this year that required the reporting of deferred proceeds and beneficial interest from sales and receivables in investing cash flows instead of operating). September year-to-date operating cash flow is up \$85 million and free cash flow is up \$82 million year-over-year on an adjusted basis. So overall, very positive results.

I'll now take a few minutes to highlight some of the year-over-year drivers in the quarter.

Working capital was a use of \$47 million in the quarter, an improvement of \$32 million over last year, driven by an improvement in inventories from improved supply demand process as compared to the prior year when we experienced inventory buildups associated with the ConnectKey product launch.

Finance receivables were a source of \$39 million in the quarter compared to a source of \$75 million last year. So although it was not as big a help to cash flow, as indicated last quarter, this is an area where we would trade it being less of a source for higher equipment sales.

Pension contributions were \$36 million this quarter, which compare to \$671 million in the prior year when we made the incremental \$500 million in contributions. Adjusting for the \$500 million, pension contributions were lower by \$135 million, so a positive year-over-year contributor that more than offset the lower source from finance receivables.

Lastly, CAPEX in the quarter was \$23 million and \$73 million year-to-date. This is an area, as highlighted last quarter, where we are placing greater scrutiny. And we now expect CAPEX for the year to be approximately \$100 million versus the previous guidance of \$150 million.

To conclude, this solid cash flow performance gives us the confidence to increase our full year cash flow guidance, narrowing our operating cash flow to the high end of the range, so now we expect \$1.0 billion to \$1.1 billion of operating cash flow; and narrowing and increasing our free cash flow range to \$900 million to \$1 billion, (which also incorporates the lower CAPEX expectations).

If we turn to the next slide, I'll speak to our capital structure. The third quarter ended with \$5.2 billion of debt and \$1.2 billion of cash on the balance sheet. We break down the debt between financing and core by first calculating the financing debt by applying a 7:1 leverage to our financing assets, (finance receivables and equipment operating leases), with the remaining debt assumed to be in support of the core business. In Q3, this calculation resulted in assumed financing debt of \$3.4 billion and core debt of \$1.8 billion. As the debt ladder 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 compare to \$2.2 billion as of December 31, 2016), and includes approximately \$850 million of 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.

To wrap up, we saw progress in the quarter across our profitability and cash flow measures and ended the quarter with a cash balance of \$1.2 billion. Project "Own It" will drive long-term sustainable improvement across the business. And although revenue will be challenged in the near term, there are detailed actions underway to improve that trend over time.

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

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

As I have said to our employees, we own our destiny. We have everything we need today to improve our performance. Our leadership is engaged and working with speed to transform our business. We have a lot more work to do, but I am pleased with the early progress we are making.

We will now open up the line for questions. Jennifer?

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, John. Before we get to the 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 an overview of our third 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 Paul Coster of JPMorgan.

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

John, you outlined a lot of initiatives that might turn the company towards growth. Can you give us some sense of what the easiest and shortest time line initiatives might be so that we kind of get some sense of what to look out for in the next few quarters perhaps?

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

Yes, Paul. Project "Own It," as we had said earlier, focuses on simplifying the business, driving end-to-end transformation of our systems and processes. And really, what the greater focus is, is on speed, accountability and effectiveness. And we're looking forward to take you through all of what project "Own It" is in early February when we do our Analyst Day.

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

Okay. So we need to be a bit patient, I suppose. The other thing I observed is that you're just doing an awful lot, whether it's on the expense side, the balance sheet side, the growth initiatives and internal organizational transformation. I mean, could you talk to us about the risk mitigation here when you're doing so many things at once?

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

I would say the experience of our key hires is instrumental in driving this change. We have key executives with extensive background in technology transformation and service delivery and supply chain and logistics, shared services. And Paul, while it seems like it's a lot, we're soloing it and ensuring that we have the right expertise and focus on it.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, Paul.

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 had a question on revenue and then one on Fuji Xerox. Can you talk a little bit about the -- on the revenue side, there were a couple of comments: one, evaluating contracts that aren't profitable? I was curious if those are in the MDS business or where that sort of fits and if



it's something that's going to be kind of a longer-term pressure on top line. And then I'm just curious within your shrinking install. Like, in terms of the pressure in post sale, is that just a factor of your shrinking installed base? Or are you finding that customers are actually printing less on a like-for-like basis? And then I have a question on Fuji Xerox.

William F. Osbourn Xerox Corporation - Executive VP & CFO

All right. Thanks, Shannon. So from -- evaluating from a profitability perspective, we've always done that as a company. I would say that in recent months, there is clearly a lot more scrutiny. We're looking for strong margins throughout the life of longer-term, 4-, 5-year MDS arrangements and just making sure that from the get-go, the initial year and over the life of the contract, that there's an appropriate amount of margin on those contracts. To say -- have we lost any specific contracts because of that or not? That's really hard to tell. But there is clearly an emphasis on making sure that all the arrangements that we're entering into are profitable not only in the initial year but over the life of the arrangement. As far as the post sale and the shrinking installed base, I'd first like to say that the new product launch that we did last year is having an impact to offset, to get back the machines in field that we had lost in anticipation of that product launch. We're not fully back to where we were since the beginning -- on machines in field in the beginning of 2017, but we certainly have made progress with our ESR in recent quarters. There is also an impact from page volume declines, a smaller impact. But the big thing for us is to get those machines in field continue with strong ESR we've seen in recent quarters.

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

Okay. And then, I don't know, John, can you talk a bit about the relationship with Fuji Xerox right now? And any thoughts on litigation strategy given the recent appellate court decision?

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

Yes. Like I said in the past, look, we're -- first and foremost, we're focused on doing what's right for Xerox. But we've had continued communications with Fuji and with them as a JV partner. In fact, they were here recently for discussions on how to -- how, as a prospective, they can provide and earn our business. We have regular Fuji board meetings, which we have representation. As for the appeals court favor, like we don't believe it means very much for Xerox because Xerox terminated the transactions for reasons unrelated to the injunctions.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, Shannon.

Operator

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

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

Why do you think renewal rates are tracking so far below your target? And then a follow-on is, when do you think -- or do you have line of sight into signings growing again?

William F. Osbourn Xerox Corporation - Executive VP & CFO

Yes. So -- Katy, it's Bill. So a couple of things. So you're right, renewal rates during Q3 were at 79%, still below our 85% to 90% target, an improvement from the 75% in Q2 but, clearly, not where we want to be. Part of that, factoring into that is looking at just the profitability of all the contracts and making sure, as I was responding to Shannon's comment, that we're getting strong margin not just over the total life but also in the initial year. From a new business signings perspective, we were actually up 15% during the quarter. So overall signings were down about 2.8%. But new business signings were a good story, and it's clearly an area of focus for us.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, Katy.

Operator

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



Jim Suva Citigroup Inc, Research Division - Director

And continuing the focus a little bit on the renewal rate. Does any of it have to do with all the sales force realignment and a little bit of dislocation in the marketplace? Because you have new ConnectKey products out there that one would think would actually be helping your renewal rates.

William F. Osbourn Xerox Corporation - Executive VP & CFO

Yes. I mean, they're -- really, from a sales force realignment change, we do believe we are putting programs in place that are more appropriately incentivizing our salespeople as part of our overall project "Own It" to make sure that people are being compensated on the right metrics, not just the total value in dollars but the margin and profit on the contracts. So I guess, at high level, we don't think it's having much of an impact. It's more of us just making sure that we're putting in the right effort and making sure that we're getting the right profitability on the contract.

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

Yes. What I would add, Jim, is that we're also looking at investing more in independent channels. And as we're transitioning, we're implementing a safe passage process, which allows us to measure performance before and after transition. So this is key because, in any transition, to quickly recognize the variations so that we can be able to improve SF. So it's not -- so as we're making the changes, we have a whole process in place to ensure that it goes smoothly.

Jim Suva Citigroup Inc, Research Division - Director

And then as a quick follow-up, you mentioned on your prepared comments Managed Print Services saw some challenges. What's going on there? And are those longer-term challenges or just something behind us now?

William F. Osbourn Xerox Corporation - Executive VP & CFO

Yes. Specific to the Managed Print Services, I was really talking to contracted revenues both from a rate-fixed services and Managed Print Services or outsourcing. And really, the declines were a little bit, about 1 point, worse than we've seen in recent periods. And that's partially reflective of lower signings and renewals in recent periods, but nothing significant.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, Jim.

Operator

Our next question comes from the line of Ananda Baruah of Loop Capital.

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

Just 2 for me, if I could. The first is, Bill, with regards to kind of moving parts on cash flow as we think about going into '19. And not looking for a guide, but just what you guys see as the things that could be the bigger influences on the cash flow from the base -- from the guide that you are at right now. And then I have a follow-up.

William F. Osbourn Xerox Corporation - Executive VP & CFO

Okay. Thanks, Ananda. Cash flow, clearly, a very good story for us. Xerox historically has been a strong cash flow producer, and we continue to expect that to be the case. From a -- specifically, rationale and reasons to why we are upping to the higher part of our range from an OCF perspective and free cash flow perspective, first of all, as you saw during the quarter, better cost controls, better margins we have in place. And more increased focus -- not that we weren't before, but there's really a really increased focus on working capital. And we saw improvements there when you compare the third quarter this year to the working capital impact in the third quarter of last year. And then lastly, as I mentioned in my prepared remarks, from a CAPEX perspective, we're not a very CAPEX -intensive company, but a lot would be in the IT spend area. And we had originally projected this year around \$150 million. And we're just being more careful, in particular, at making sure that we're spending those dollars in the right area where we'll get a payback on them, and right now, we're estimating that we'll be about \$50 million less or about \$100 million for the year on CAPEX .



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

And do you anticipate opportunity for improvement in those areas going forward as well? It seems like you're at the beginning stages of your initiatives here.

William F. Osbourn Xerox Corporation - Executive VP & CFO

I don't want to comment too much on '19 yet, but this is -- suffice to say that we believe the cash flow is a strength and will continue to be a strength for the company.

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

Got it. And then just my follow-up is just with regard to the comments around revenue. And John, you mentioned that -- you sounded like you were somewhat disappointed with the revenue. The question is, to what degree do you think sort of just the public dynamics of the last 12 months may have had, could be having an impact on the go to market such that the settling down could reduce the impact and there just may be some natural reversion back to friction reduction there? I appreciate all the initiatives you're taking, but just sort of natural friction reduction from the last 12 months, getting slightly improved -- get back to normal like that.

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

Yes. Ananda, I wouldn't -- look, what I have told the team -- so kind of what I've told my team is we're not going to use excuses of what's happened in the past 12 months, past 6 months. We're back to work. So when we think of revenue, we have a comprehensive plan to improve revenue. And it's not easy, it's going to take time, but we have the foundation and we have leading positions in key market segments. We have strong innovation capabilities, and we have deep customer relationships. And so that's really -- and as part of our project "Own It," we're going to start by building a more simplified agile structure, which will include better aligning sales, account metrics, global sales enablement tools, and I can go on and on. But I would say that's behind us. And one thing we do here is communicate, communicate, communicate with our teams. In fact, tomorrow, I'll be talking to all 35,000 employees again and taking them through what we're doing. So we're off to the races here.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, Ananda. That's all the time we have for questions today. We appreciate the interest from everyone. John, back to you for some closing remarks.

Giovanni G. Visentin Xerox Corporation - Vice Chairman & CEO

Yes. First of all, thank you for all of you to be on the call. But look, we have work to do. And as I said last quarter, we're going to focus on the 4 core priorities. We're going to drive revenue. We're going to optimize our operations for simplicity, which is key to delivering value to our clients. Now we're going to reenergize our innovation engine, and we're going to focus on cash and increasing capital returns.

We've taken the necessary first steps to lay out the objectives that will be the foundation for creating value for all our stakeholders. And with the team that we have in place, I'm fully confident that we will build on our third quarter momentum and be successful. Look, we look forward to presenting our full long-term strategy in detail at our Analyst Day in early February.

Thank you all for joining the call.

Jennifer Horsley Xerox Corporation - VP of IR

Thanks, John. That concludes our call.

Operator

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



DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS THOMSON REUTERS'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2018 Thomson Reuters. All Rights Reserved.

