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XRX - Q2 2016 Xerox Corp Earnings Call

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PRESENTATION

Operator

Good morning and welcome to the Xerox Corporation second-quarter 2016 earnings release conference call hosted by Ursula Burns, Chairman of the board and Chief Executive Officer. She is joined by Leslie Varon, Vice President and interim 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 Miss Burns. Miss Burns, you may begin.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Good morning. Welcome to the Xerox second-quarter 2016 earnings conference call.



On our first-quarter earnings call, I laid out three priorities for the year -- achieving our 2015 financial plans, implementing our strategic transformation, and executing the separation of the Company. I also committed to you that we were pulling all the available levers and taking decisive action to achieve these objectives.

Today, I am pleased to report strong second-quarter results and significant progress on all of our priorities. We delivered substantial EPS growth, adjusted EPS above our guidance, and margin expansion in both our business segments, putting us on track to achieve our full-year guidance. We also reached major milestones in our separation process and for our strategic transformation program and remain on track to meet our targets for both initiatives. I am more confident than ever in our ability to create two companies better positioned to compete in their respective markets and capture opportunities to enhance shareholder value.

Today, I will begin the call with an update on our separation and strategic transformation before moving to the quarter's financial and operating performance.

As you know, in January, we outlined a two-part plan to create shareholder value and best position our businesses for the future which we call our new path forward. The plan includes separating into two Fortune-500-scale independent publicly traded companies by year-end and implementing a three-year strategic transformation program to deliver \$2.4 billion in total cost savings over three years from ongoing and incremental productivity and cost reduction initiatives across our businesses. We are already seeing benefits as some of the margin expansion we realized in the second quarter was a direct result of these activities.

All in all, we made a great deal of progress on the Company's new path forward during the quarter and I want to thank the strategic transformation and separation process leaders, along with the Xerox management team, for their efforts.

Now I'll provide a high-level overview of our second-quarter results before I pass it over to Leslie for additional details. In the second quarter, we delivered adjusted EPS of \$0.30, representing a 30% year-over-year increase and coming in well above our guidance range of \$0.24 to \$0.26. GAAP EPS from continuing operations was \$0.15, up \$0.06 compared to prior-year quarter. Year-over-year EPS growth reflects fewer shares, a lower tax rate and higher operating profits.

Total revenue of \$4.4 billion was down 4% with minimum currency impact, reflecting a modest revenue decline in Services and improvement in the technology business revenue trend.

Operating margin expanded 80 basis points year-over-year to 9.3%, led by a 240 basis point improvement in our Services business. Margin gains reflect sequential cost and productivity improvement across our businesses, including benefits from our strategic transformation program.

We generated cash flow from operations of \$177 during the second quarter and ended the quarter without a healthy cash balance of \$1.2 billion.

During the quarter, we also had exciting wins in our businesses brought several innovations to market. This was an important quarter for our technology business with drupa, the biggest printing industry tradeshow, which occurs every four years, taking place this June. We recorded strong sales in the production equipment showcased at the event. In addition, we shared details of our partnership with Koenig & Bauer Sheetset Solutions group, which we believe will be a game changer for digital carton printing, a growing area of the printing market.

On the Document Outsourcing side, Xerox Managed Print Services business was named the Services Quality Supplier of the Year by CF Chrysler Automobiles US based on the success of the global NPS program we implemented for the automaker over the past year. We also launched 50 new automated workflow solutions for the manufacturing retail and higher education industries.

In our Services business, Everest Group ranked us as the top business process services provider in its BPS Top 50 Report just this week. The group also named our contact center outsourcing business an industry leader for the fourth year in a row.

Analyst firm HFS Research also recognized Xerox, placing us in the high-performance category for contact center operations and financed an accounting as a service. And just this week, we were named to the HFS Winner Circle for human resource operations as a service.

In transportation, our work for SEPTA, the Philadelphia area mass transit system, went live last month. The program, which runs on a new platform developed by Xerox, is a major undertaking, bringing transit riders a new modern payment system. The first phase offers 10,000 riders the opportunity to buy cards for weekly or monthly rides on the subway, trolley and buses.

Our healthcare Services business introduced a new offering, Virtual Health Solutions, allowing providers to integrate a comprehensive telehealth strategy within their mainstream care delivery system.

And Xerox Litigation Services introduced a new analytics as a service platform. The analytics hub provided corporate counsel and law firms real-time visibility into the big data that they manage every day.

As you can tell, our industry experts are hard at work building next-generation solutions and capabilities and successfully implementing businesses -- business that we have one.

I will now turn it over to Leslie who will provide more detail on our financial results and 2016 guidance.

Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

Thanks Ursula and good morning everyone. I'll start with the earnings slide and cover the rest of the financials as well as our guidance before handing it back to Ursula to wrap up.

Overall, Quarter 2 was strong. Operating profit and earnings both grew with EPS above our guidance range. DocTech trends improved and we are building momentum in our cost initiatives. We have more work to do to capture greater productivity and turn around the revenue trajectory as we prepare to separate our two businesses, but Quarter 2 was a very positive proof point and keeps us on track for the year.

Total revenue of \$4.4 billion was down 4% at both actual and constant currency, benefiting from a market improvement in Document Technology revenue, which was down 6% in constant currency, while Services revenue declined 1%. I'll speak more about both segments in a moment.

Adjusted gross margin of 31.4% was up 20 basis points year-over-year, driven by improvements in both segments, partially offset by a greater mix of services, which structurally has a lower gross margin.

Adjusted RD&E was lower by \$19 million year-over-year and adjusted SAG was down \$53 million, or 6%. These expense reductions combined with the gross margin improvement resulted in an operating margin of 9.3%, up 80 basis points year-over-year, and a 5% operating profit growth.

Adjusted other net expense was better by \$15 million year-over-year, driven by lower interest expense, while equity income of \$22 million in the quarter was down \$7 million year-over-year.

Our second-quarter adjusted tax rate of 17.8% was below the guidance range of 26% to 28%, benefiting our earnings by \$0.025 due to higher foreign tax credits and the successful resolution of several audits.

Bottom line, adjusted earnings of \$0.30 was well above our guidance range of \$0.24 to \$0.26 and was \$0.07 higher year-over-year driven by the lower tax rate, fewer shares and higher operating profit.

Turning to Services, segment profit was up \$55 million or 30% year-over-year as significant margin improvement more than offset revenue pressure. Services revenue was down 2% at actual currency and 1% at constant currency. Document Outsourcing grew 2% year-over-year and reflects continued good growth in Xerox Partner Print Services. BPO declined 3% driven by known headwinds, including the impact from last year's health enterprise strategy change, as well as lower volumes and lost business as we continue to focus on turning around some underperforming areas. Our drive to improve profitability also factored into a lower than target renewal rate of 82%, reflecting our decision not to renew several underperforming contracts.



Total signings in the quarter were down 7% year-over-year, but up 2% for the trailing 12 months. The year-over-year decline was driven by lower new business signings, which reflects a tough compare due to last year's New York MMIS signing. We've strengthened our signings criteria setting the bar higher on price, margin and deal terms, particularly in customer care.

Margin and related improvement actions have been an area of intense focus, and we were really pleased with the 9.6% segment margin. That is a considerable improvement of 190 basis points sequentially and 240 basis points year-over-year.

Benefits from restructuring and cost actions flowed through and we saw good contribution to the margin increase across most business areas, including Document Outsourcing, where margins are similar to Document Technology. These areas of improvement more than offset continued revenue and margin pressure from customer care, where we are taking action to turn around this set of capabilities.

So, key take-aways on services. Document Outsourcing performance continues to be solid on both the top and bottom line. The set of strategic decisions we made in BPO last year combined with our strategic transformation initiatives are beginning to be reflected in our results, yielding improved profitability. This has impacted revenue growth. We will continue to focus on improving our operational foundation and cost structure, and then begin to put in place growth initiatives for the BPO business.

I'll now turn to Document Technology. Document Technology had a very strong quarter with both revenue trend and margin improvement. Revenue was down 7% at actual currency and 6% at constant currency, with equipment and annuity each down 6%. The equipment revenue trend improved, driven by midrange, reflecting new product launches as well as better sales to small and medium-size businesses. Supplies revenue was down 6% year-over-year, slightly better than Quarter 1 results.

When we include Document Outsourcing with Document Technology, revenue declined 3%, a significant improvement from Quarter 1. This largely reflects the current revenue profile of the new Document Technology company post-separation.

Turning to activity, within entry, A4 color MFD installs were down 9% driven by declines in developing markets. Midrange color MFPs grew 6% driven by the new I series products launched in March. High-end color was up 14%, driven by growth in entry production color products.

Following a very successful showing at drupa, we expect a greater weighting toward higher in production presses in the second half. This doesn't necessarily translate to better install growth as it will drive fewer units but at higher value, which should result in good revenue and annuity growth over time.

Document Technology margin of 12.6% was up 10 basis points year-over-year and 240 basis points sequentially. This is in line with our historical and full-year margin expectation. We knew that Quarter 1 was an anomaly resulting from the lack of restructuring in the second half of last year, exacerbated by transaction currency headwinds.

Quarter 2 margin reflected the initial benefits of the restructuring actions we ramped over the next two quarters and more modest transaction currency impact as well as equipment price declines at the lower end of our historical 5% to 10% range.

So, overall, a very good quarter for Document Technology. We are maintaining our strategic cost transformation focus and we expect continued good profitability in both Document Technology and in Services as we capture additional savings moving through the year.

Moving next to cash flow, we generated \$177 million of operating cash in the quarter, reflecting net income and the strong underlying cash generation profile of our business model. Year-over-year, cash flow was lower driven by working capital usage due to a reduction in payables related to lower purchases and payment timing, a \$62 million health enterprise settlement payment resulting from last year's strategy change, initial separation related payments as well as higher restructuring payments, and approximately \$50 million due to last year's ITO divestiture.

It's important to note that Quarter 2 and first-half cash generation are consistent with typical seasonality and position us to deliver our full-year expectations.



Investing cash flows were a use of \$67 million and included \$73 million spent on CapEx. Cash flow from financing was an \$87 million use and includes \$84 million for preferred and common stock dividends. Our cash balance at the end of the quarter was \$1.2 billion and continues to provide us flexibility as we move through 2016.

Turning to our capital structure and capital allocation, we ended Quarter 2 with \$7.4 billion of debt, roughly in line with our year-end debt level. Applying 7-to-1 leverage to our customer financing assets, our allocated financing debt at the end of Quarter 2 was \$3.9 billion, leaving core debt of \$3.5 billion. We continue to manage our capital structure to maintain credit metrics consistent with our investment-grade credit rating.

While it's premature to discuss the capital structure of the two future companies, all the financing assets and financing debt will go to the new Xerox company while the core debt will be split with Conduent. We will share with you more about the capital structure and capital allocation strategies of Conduent and the new Xerox as we approach the separation. You should expect a continued focus on driving long-term shareholder returns with a strong alignment to each company's financial profile and market opportunities.

And to touch on capital allocation, we have a strong shareholder returns track record and in April, we increased our common dividend by 11%. As we prepare for our separation later this year, and as we have said previously, we are not planning to repurchase shares as we focus on launching the two companies with the most optimal capital structures.

Before I move to guidance on the next slide, I want to mention that, while we are not planning to preview the Q2 Conduent results today, we will be filing them in a few weeks as part of the Form 10 amendment. I would note that Conduent carveout financials will also reflect margin improvement, although not to the same degree as the Services segment.

Conduent results include the student loan business, which resides in our other segment. That business is in runoff and declined profit year-over-year, as anticipated.

I'll now share with you our Quarter 3 and our full-year expectations. For the third quarter, we expect adjusted earnings in the range of \$0.26 to \$0.28 and GAAP earnings of \$0.14 to \$0.16. We are reaffirming our full-year adjusted earnings guidance of \$1.10 to \$1.20 and our revenue guidance of a 2% to 4% constant currency decline. We are maintaining our segment revenue growth and margin guidance ranges for both Services and Document Technology, and anticipate for Services that we will be at the high end of the segment margin range and at the low end of the revenue range.

For the full year, we continue to expect GAAP earnings of \$0.45 to \$0.55. We continue to anticipate full-year restructuring of \$300 million, including approximately \$40 million in Quarter 3.

Last quarter, we told you that we expected pretax separation costs would be in the range of \$200 million to \$250 million. We are deploying the same cost discipline in this area as we do across the rest of the business and have therefore refined our range down by \$25 million to \$50 million. We now expect to spend \$175 million to \$200 million in pretax separation costs. We've also now scoped the tax related friction costs associated with reorganizing our domestic and international legal entities to affect the separation, and estimate them to be between \$40 million and \$50 million.

Turning to cash flow, we are maintaining our full-year expectations of \$950 million to \$1.2 billion for operating cash flow, and \$600 million to \$850 million for free cash flow. This anticipates both our second-half net income acceleration and the strong Quarter 4 working capital performance we have historically delivered. And finally, our capital allocation expectations remain the same.

So, in summary, Quarter 2 solidly puts us on track to deliver our full-year guidance and we are confident on our trajectory entering the second half.



Ursula Burns - Xerox Corporation - Chairman, CEO

Thank you Leslie. In summary, we are very pleased with our second-quarter performance, which demonstrates our focus on execution and provides good momentum as we enter the second half. We exceeded our adjusted EPS guidance, made progress on margins, and reaffirmed our full-year targets, all while executing our separation and strategic transformation, which will together strengthen Xerox and the post-separation companies.

Moving to the second half of the year, our priorities remain unchanged. We will deliver our 2016 guidance, successfully complete our separation by year-end, and meet our cost savings target for 2016 for our strategic transformation program. You will be hearing more from us over the balance of the year as we continue to hit critical milestones.

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

Jennifer Horsley - Xerox Corporation - IR Representative

Thanks Ursula. Joining Ursula and Leslie today is Jeff Jacobson, head of our Document Technology business, and Bob Zapfel, President Xerox Business Services.

Before we get to your questions, let me point out that we have several supplemental slides at the end of our deck which provide more financial detail to support today's presentation and complement our prepared remarks.

For the Q&A, I would ask participants to limit follow-on and multipart questions so that we can get to everyone. At the end of our Q&A session, I will turn it back Ursula for closing comments.

Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Matt Cabral, Goldman Sachs.

Matt Cabral - Goldman Sachs - Analyst

Thank you. Ursula, can you give us an update on your thoughts around M&A heading into the split, both in terms of your desire to do acquisitions as well as if anything has changed around the view that you had previously that both businesses are not up for sale post-split and that both make the most sense as independent public companies going forward?

Ursula Burns - Xerox Corporation - Chairman, CEO

Let me start with the middle -- the middle question, which is the potential for sale of the businesses post-split. I think that we should probably wait until split to talk to the new leadership of those two companies to figure out what their plans are as they proceed forward.

As far as our plans for M&A, we have still \$100 million in our plan for M&A, fairly modest plans for 2016. We acquired \$18 million so far this year. We are still in the market and still have plans to try to spend the \$100 million, both in DocTech distribution primarily and in Services small tuck-in acquisitions. We can find them in the areas that are important for us. I think I answered all of your questions.



Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

It's Leslie. I would just add a couple of things. Obviously, with the focus on separation, you can appreciate we are focusing less on acquisitions in the near term, but for sure it is important longer-term for each of the businesses. So Ursula said that we have been light in the first half having spent \$18 million. We do have our sights set on some opportunities in the second half.

Matt Cabral - Goldman Sachs - Analyst

Thank you. That's very helpful. And then on the third-quarter guidance in particular, could you just drill down a little bit more and help us understand the puts and takes around both revenue and the margin profile for both segments in the September quarter?, particularly following the strong performance that you saw in Q2?

Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

Yes. You know we have stopped giving quarterly revenue and margin guidance. We stick to full-year guidance at the segment level although we do continue to provide earnings guidance on the quarter.

I think what you saw in Quarter 2, and I'll start with DocTech, is an important improvement and moderation in the rate of revenue decline, both for the technology segment down 6% versus down 9% in the earlier two quarters, and importantly as well, down 3%, including Document Outsourcing, which is an indication of what the new Xerox will look like going forward. We continue to expect that revenue trends for the second half of the year will enable us to be in line with the full-year expectation for the tech segment of down 5% to 7%.

On the margin front, you saw important improvement in the margin in Quarter 2 and you saw a margin that's in line with our full-year expectation of 12% to 14%, and that's what has underscored our confidence in reiterating the full-year margin.

On the Services side, we've said that we expect margin will be toward the high end of the 8% to 9.5% range, but revenue will be somewhat more muted. In the first half, revenues were flat at constant currency. Our full-year range for the Services segment is flat to up modestly, and we've said we would be at the low end of the range.

So we believe that Quarter 2 was an important proof point, and you will see continued progress in Quarter 3 and for sure in Quarter 4, which is typically our seasonally strongest quarter.

Jennifer Horsley - Xerox Corporation - IR Representative

Operator, next question?

Operator

Shannon Cross, Cross Research Group.

Shannon Cross - Cross Research - Analyst

Thank you very much. I wanted to talk about currency and more from a DocTech perspective in terms of both what you are seeing from a pricing perspective, because, given where the yen has gone, one would assume that maybe pricing will be a little bit better this year since the Japanese competitors won't be able to be quite as aggressive.

And then also from a Fuji Xerox perspective, clearly it hit you below the line, but just how we should think about COGS and movement. And I know there's a lot of restructuring that can offset it, but I am just trying to gauge it as we go through the year.

Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

A few things on currency. What we said about Quarter 2 was we did see equipment price pressures at the low end of our historic 5% to 10% range, so we saw that as a positive signal. Obviously, the strength of the yen helps us in the competitive arena in the marketplace.

Importantly, on transaction currency, what we saw in Quarter 1 was it was a significant pressure on DocTech segment margin, and in fact pressured margin by about 100 basis points. That margin pressure in Quarter 2 was much, much more modest. It was about 20 basis points.

And I think you recognize that, in terms of the yen, we have both the currency risk sharing arrangement with Fuji Xerox, so it means that we see more modest impact as we go through the year, both when the yen strengthens as well as when it weakens, and we have hedging in place which also mitigates some of the impact. So, we are pretty pleased with how we are positioned as it relates to the yen vis-a-vis our Japanese-based competitors.

Shannon Cross - Cross Research - Analyst

Okay. And then so if it stays at JPY1.03, do you feel pretty good about sort of everything that's in place because it's obviously moved a lot in the last few weeks?

Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

It for sure has. And so once again, we have hedges in place. They obviously run out over time, and so it will mitigate impacts -- and a currency risk sharing agreement with Fuji Xerox. And as you pointed out, to the extent that the yen is stronger, it actually benefits our translation of Fuji Xerox equity income.

Shannon Cross - Cross Research - Analyst

Okay, great. And then maybe one for Ursula. Just as you think about -- and not specific cash flow generation numbers obviously -- but the cash flow generation characteristics of the two businesses, and as you start to sort of pull the companies apart, has anything sort of changed in the way you're thinking about it, or how we should think about it as I guess all the restructuring comes through? I guess I'm just kind of struggling with trying to find out what the right split is between the two businesses, both sort of now and then when we get through or you guys get through the significant restructuring you are doing.

Ursula Burns - Xerox Corporation - Chairman, CEO

I think you can think about these two businesses in the following way. The technology business is a strong cash generating business, it's in a very strong annuity-based model. While we will be investing more actively in the technology business, it will not substantially have significantly changed the ability for us to generate cash in that DocTech business with DL.

In the BPO business, its cash generation ability is a little bit weaker than the tech business. We will be investing more actively in that business as we separate and they go into Conduent. So nothing has changed from -- our perspective hasn't changed on those two businesses and how we view the cash movements there.

Leslie Varon - Xerox Corporation - Corporate VP, Interim CFO, VP IR

The other thing I would mention is that 2016 is not a "normal year" for operating cash flow generation at Xerox. Our cash expectations of \$950 million to \$1.2 billion are muted by three things.

Number one is the impact of the separation costs, which is a couple hundred million dollars. Number two is the impact of higher than normal restructuring, which is probably worth another couple hundred million dollars. And number three are the health enterprise settlement payments which should pressure cash flow this year by about \$100 million.

Operator

George Tong, Piper Jaffray.

George Tong - Piper Jaffray & Co. - Analyst

Thanks. Good morning. Ursula and Leslie, you've reiterated guidance for Services revenue growth of 0% to 3% constant currency. Given the deceleration in constant currency Services revenue growth you saw in the quarter, what factors in the back half the year will help you weigh in within your range?

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

It's Bob. So, I would say we had a couple of pressure points in the second quarter that will moderate as we go forward. And we were at minus 1%, as you know, in constant currency for the second quarter. To be at the low end of the range, we need to be above zero as we close out the third and the fourth.

The pressure points in the second were really around we have a very tough compare in public sector. The help -- in terms of some equipment sales that we had had in the prior year, we have the health enterprise Montana, California, things have changed. That will dissipate as we go through the back half of the year.

And then we also got out of some kind of revenue flow that was not profit-producing that won't really moderate, but we'll basically be able to cover for with our signings. So we do expect that we can meet the range that we had established. And as you know, we have really been able to translate some of that revenue thoughtfulness in terms of what we want and what we don't want to a pretty solid margin improvement, in the 240 basis points that we delivered year-to-year in the second quarter, we see the ability to continue to drive at the top end of the margin range.

George Tong - Piper Jaffray & Co. - Analyst

Got it. That's helpful. And then as a follow-up, can you describe how your pipeline in BPO is performing, and whether you see any large deals or initiatives that can serve as a near or intermediate-term catalyst for bookings and revenues?

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

I would say our BPO pipeline has improved sequentially during the year. So the good news is that we do see some potential pipeline improvement, both in Document Outsourcing and in BPO, in all honesty a little bit more aggressive on the Document Outsourcing side. But from a signing standpoint, we expect to drive new business growth in the third quarter. From a signing standpoint, we have seen a little bit of headwinds in terms of with the separation, decisional delays, and we are just working through that. So, we expect to deliver better results in the third quarter year-to-year, but I wouldn't say that there is now some next New York MMIS that is so large that it would dramatically change the signings trajectory.

Operator

Tien-Tsin Huang, JPMorgan.

Tien-Tsin Huang - JPMorgan - Analyst

Thanks, good morning. Good to talk to you guys. Just on the Services margins, they are obviously good. IT seems like there's a prioritization of margins over revenue growth. I'm curious if there's a lot more that can be done here in terms of moving away from some of the lower margin business if things are coming up for renewal or what have you. Is there more or is this -- was there anything unusual that we saw this quarter?

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

No, I think -- I'm sorry, it's Bob again. I think there wasn't anything particularly unusual. We are being more stringent as we look at new opportunities or renewals. If we are not able to make reasonable margin and it's time for renewal, we've got to convince the client that the service is worth more and they should pay more. And if we are unsuccessful with that, then we would rather move in different directions. So, I do think that we will see that.

We'd still like to drive more new business growth, though. This is not a one-dimensional play. We're trying to not grow and improve margins. We are trying to and expect to see some improvement in the second half the year in terms of our constant currency revenue growth dynamics.

Ursula Burns - Xerox Corporation - Chairman, CEO

And the margin improvement is not solely from the fact that we've made decisions on business, on new business, or re-signing of contracts. It's also pure operational management, literally looking at the cost base and managing the cost base downward independent of signing or not signing new business.

Tien-Tsin Huang - JPMorgan - Analyst

Understood. That's good. Just really quickly, the sales cycle, just to be clear, just on the BPO front, any big changes in the sales cycle from the past quarter?

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

I would say we did see some extension, especially in June, where not only separation but where some of the clients where the Form 10 didn't come out until June 30 wanted to -- Ashok is now the name, so that's very helpful in terms of clarity on the new CEO, but we did have a little bit of push out in June. But as you saw, our overall results were still reasonably okay on a trailing 12-month year-to-year basis. But I would say we did see a little bit of extension in June on some of our pursuits.

Operator

Jim Suva, Citi.

Jim Suva - Citigroup - Analyst

Thank you and congratulations to you and your team at Xerox. A lot of work I'm sure. I have to questions, and they are kind of related. I'll ask them at the same time.

First, on the lower renewal rate, it sounds like, from your prepared comments, that it was a decision not to go after lower profitability of work. Should we expect that to continue, and is that kind of one of the main reasons why the service profitability is underperforming so much, it's just a legacy of bidding too low or going after too low products or contracts? Or is it more that your costs are misaligned or things like that?

Then the second question is you just mentioned an extension of some deals did not close in the June quarter. Did they close in early July? It kind of seems hard to believe that someone would wait to close it based upon the new name of the Xerox or who the new CEO is. And if that's the case, it seems like there's a risk that they maybe actually went away to a competitor. So did they close or did they go away? Thank you.

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

We had a good start in July in terms of conversion of opportunities that we had initially been targeting in June, in fact a very large contract signing just yesterday. So, I would say that piece.

And on the renewal rate, we are 85% year-to-date. We were a little bit lower in the second quarter. And I think that we still see the ability to run in the 85% to 90% range, and if you get the right ones. So I would rather be 85% with the right mix that we re-won than be 90% with the wrong mix. And so I think we will be able to deliver in the ranges as we look forward in the third and fourth quarters.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - Brean Capital, LLC - Analyst

Thanks guys for taking the question. Two if I could. The first is can DocTech actually get close to flat revenue in the second half of the year? The reason I ask is because you are talking about seeing pretty solid momentum through the June Q, and you just put up -- you have new products that are going to ramp I presume through the second half of the year coming out of drupa. And you just put up a 3% decline up from 3% comp, and the comps get pretty easy in the second half of the year. You have 4% to 5% decline constant in the second half of the year. So I'd love to hear your thoughts there. And then if it can't get back to down close to flat, maybe it's down 1% or something like that, not totally flat. I'd love to hear why that can't happen. And then I have a follow-up. Thanks.

Jeff Jacobson - Xerox Corporation - Corporate EVP, President of Xerox Technology

This is Jeff. Good to hear from you. Yes, I think we have to remember, so, first, from the tech segment standpoint, we reported guidance of 5% to 7% (technical difficulty) constant currency. We are stating with that. I think you're talking more about when we but Document Technology and DO together where we did improve from a negative 5% sequentially to a negative 3%.

The thing you have to remember is annuity is over 70% of our business, so to turn that ship takes some time, so you certainly -- we won't be seeing that in the quarter or even next year. It's going to take a big part of the ESR turning. We do have plans in place for when we come out as Xerox, the new company, for things we will do. We will certainly be a little more aggressive in M&A, appropriately so. But it will take some time to turn the 70% annuity to where we need it to be to get to where you are pointing.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Okay, got it. Yes, you're right. I did read that wrong.

So I have a follow-up on that. I'm going to hold that follow-up though because I want to ask this next one.

So clarification on my math here, if you use the midpoint of the September (technical difficulty) the low end of your 2016 guidance, I think by my count (technical difficulty) \$0.30 Q-over-Q in December Q, which, if I recall correctly, is kind of the highest end of what you guys have done historically.

So the question is, number one, given the strength of the June Q, is there some services in any context baked into the September Q? And number two, if there's not, then how do you actually -- just walk through the mechanics of how you use the \$0.30 to get to the low end of the guidance range for the December Q.

Leslie Varon - *Xerox Corporation - Corporate VP, Interim CFO, VP IR*

It's Leslie. First of all, it's been really hard to hear all of the elements of your question, but I think that the gist goes like this. To get to the low end of our guidance using the midpoint of our Quarter 3 guidance looks like our typical Quarter 4 seasonality, and we would say agree. So the way we are thinking about this is that we will have the normal second-half over first-half uptick in profitability, and that will enable us to get, at a minimum, to the low end of the guidance.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Thanks so much.

Operator

Brian Essex, Morgan Stanley.

Brian Essex - *Morgan Stanley - Analyst*

Good morning. Thank you for taking the question. I have a question for Bob, maybe if I could follow on to the question that Tien-Tsin asked, and maybe dig in a little bit more into the margins side of the Services business. And I think we are relatively comfortable with some of the services. One of the double-edged sword in the Form 10 is you saw how well some businesses were performing but certainly the commercial business stuck out kind of like a sore thumb.

So, with regard to improving the performance of that business, I think you focused on a little bit signing better and more profitable contracts, but how much can be done on the cost side and what might be the trajectory of the margin improvement as you kind of work to improve that business? And then I have a follow-up.

Bob Zapfel - *Xerox Corporation - Corporate EVP, President of Xerox Services*

Yes -- I'm sorry. It's Bob. On commercial, as you know, kind of the largest component from an offering standpoint of our commercial business is customer care. The other components -- HR outsourcing, learning, litigation, F&A -- are largely making good progress and are reasonable from a margin standpoint. So a big piece of our margin turnaround for the commercial customer set, because it really is a customer set that buys a portfolio of offerings, is really around the recovery plan that we are driving in customer care. We brought in from the outside a couple of exceptional leaders. We've got a big team over this. And we think it's not going to be an immediate that next month we go from 0% to 10% margins, but we think we've got a set of actions in place that will really lift the margin profile of that component of commercial.

We are honestly kind of blessed here. We've got a great client set who are ranked in the top quartile. So our problem is more our internals. Have we got the cost management crisp enough? But that's a business that we are able to win in, and we've got a set of actions. And I do believe that we can then elevate back to reasonable margins in the commercial component of our BPO (technical difficulty) not as high as we get in public or healthcare where we've got a lot of separate industry-based IP and solutions, but reasonable within the portfolio of BPO Co. or Conduent going forward.

Brian Essex - *Morgan Stanley - Analyst*

Got it. Maybe as a follow-up -- I appreciate the color. As a follow-up, the stuff that's bucketed into other, some of the legacy run-off like student loans and other that are in that "other category", how much of a drag on consolidated corporate margins can we expect from those business? When might that stuff go away and at what rate might we see that decline?

Leslie Varon - *Xerox Corporation - Corporate VP, Interim CFO, VP IR*

It will be a significant drag on Conduent's Quarter 2 financials. So when you see the Form 10, student loan, as anticipated, is in run-off and declining significantly year-over-year and we expect that will continue throughout the rest of this year, but by 2017 should no longer be an issue.

Brian Essex - *Morgan Stanley - Analyst*

And how much is student loan? What else is in there?

Leslie Varon - *Xerox Corporation - Corporate VP, Interim CFO, VP IR*

As it relates to Conduent? Student loan.

Brian Essex - *Morgan Stanley - Analyst*

Perfect. Thank you.

Operator

Keith Bachman, BMO.

Keith Bachman - *BMO Capital Markets - Analyst*

I wanted to ask about the BPO question. If I look really in two vectors, if I look longer-term post-separation, Bob, if you just think about the pipeline now, is there enough to generate year-over-year growth in that business on an organic basis? And related, if the cash flow -- all BPO businesses have a lower cash flow, and M&A is clearly a big part of the industry right now and has been for some time. What is going to be the ability of the Services business to leverage M&A to try to not only increase your growth rate but, more importantly, to increase the capabilities and skill sets and reach and all that goes with it?

Bob Zapfel - *Xerox Corporation - Corporate EVP, President of Xerox Services*

Let me start with the pipeline and the organic growth component. I would say the pipeline is sufficient to get to modest organic growth, and we need to do more to build the pipeline to elevate that growth rate to what would be our more likely long-term targets.

I think, on the M&A component, it's a little bit too early. We are going to be in this cycle as we get ready for investor day to talk more about the capital structure, debt, everything else. So I wouldn't want to comment at this point relative to what the M&A prospects would be for Conduent.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Let me make something very clear. The strategy for this business, BPO, before we decided to separate and co-separation, one plank of the strategy is going to be acquisitions. It is a business that has to acquire to fill out capabilities and to grow revenue, and that will continue to be the case as we move into the Conduent business.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. Ursula, my question was more philosophical. Is there going to be enough free cash flow to support that strategy post-separation was really the nature of the question.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

That's the question. I mean that's the strategy. That's the plan. That's how we're trying to structure these businesses and how we are trying to lay the foundation in 2016, and a capital structure that allows us to operate Conduent strategically to win. And one of those elements is clearly to acquire, is to have an active M&A business.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay, great. Just one clarification I wanted to follow up with. Could you remind us what the limitations -- one of the first questions was will they remain independent entities post-separation. But what are the limitations from a tax basis on the ability to complete a transaction post-separation, the tax-free nature of the spin?

Ursula Burns - *Xerox Corporation - Chairman, CEO*

I think that's something that you should probably call us and talk to Jennifer about later. We have it all comprehended and Jennifer can bring you through the details. I think it would be a little bit too complicated to go through right now.

Keith Bachman - *BMO Capital Markets - Analyst*

Fair enough. I'll cede the floor.

Operator

James Friedman, Susquehanna.

James Friedman - *Susquehanna Financial Group - Analyst*

Good quarter here. Congratulations on the improvement in the margins. I just wanted to kind of dimensionalize what the possibilities are for the Services margin in particular. Bob, I was wondering if you might have any metrics you could share about utilization. You don't disclose that in the Form 10, or at least in the preliminary Form 10. How should we think about that going forward? Your headcount is down a lot. I would think the utilization would be up. Anything you want to quantify if you could qualify it.

I'll just do my follow up now. Could you share what percentage of your contracts were -- as either a percentage of contracts or percentage of your Services revenue are losing money? Some of your competitors disclose that. It is just very hard to model the services going forward. Clearly great progress but without those two elements. Thank you.

Bob Zapfel - Xerox Corporation - Corporate EVP, President of Xerox Services

So first, on the utilization question, you are right to notice that our headcount dynamics have turned favorable. That is related not only to utilization. Honestly, we've probably gotten more of the headcount reduction out of nonproduction workers more in the way of middle-management, if you will, than just purely on the production worker component.

We don't disclose utilization, mostly because it's different in every business, the targets between customer care and transaction processing and HR outsourcing. But a big component of our strategic cost transformation play is around robotic process automation and trying to leverage technology to then increase that utilization rate.

So, we are managing. We are really, really trying to be very, very disciplined on headcount management, and that will clearly be a component of the ongoing margin lift that we need to drive, both in Xerox Services and then downstream in Conduent.

Relative to what proportion of the contracts are below water, we've really gotten a lot more sophisticated in looking at fully allocated P&Ls, which has helped us in kind of identifying something that maybe didn't look so bad from a contribution margin standpoint we really need to do even better on. I wouldn't want to give you a hard figure, but it's not a high proportion of the contracts. It's not as though out of our -- out of all of our contracts that there is a big number of them that are below water. And the ones that are, we are on kind of very aggressive active recovery plans.

Jennifer Horsley - Xerox Corporation - IR Representative

That's all the time we have for questions today. Thanks for your interest. Ursula, anything more to wrap up?

Ursula Burns - Xerox Corporation - Chairman, CEO

So as Jen said, thank you for your questions. This was a strong quarter for Xerox with margin improvements across our businesses and encouraging signs of improvement in the technology revenue trend. Going into the second half of the year, we are highly confident in our ability to deliver our three priorities, which are meeting our financial guidance, creating two strong companies, two strong independent companies, and driving our strategic transformation. We look forward to providing you with updates on our progress and more detailed looks at the post-separation Company financials and business strategies in the coming months. Thank you, everyone, for joining our call.

Jennifer Horsley - Xerox Corporation - IR Representative

Thanks Ursula. That concludes our call today. If you have further questions, please contact me or any member of our Investor Relations team.

Operator

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



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