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XRX - Q3 2015 Xerox Corp Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2015 / 2:00PM GMT

OVERVIEW:

XRX reported 3Q15 total adjusted revenue of \$4.4b and adjusted EPS of \$0.24. Expects 2015 revenues to be down approx. 3% at constant currency and adjusted EPS to be at low-end of previously-guided range of \$0.95-1.01. Expects 4Q15 adjusted EPS to be \$0.28-0.30.



CORPORATE PARTICIPANTS

Ursula Burns *Xerox Corporation - Chairman & CEO*

Kathy Mikells *Xerox Corporation - Corporate EVP & CFO*

Jennifer Horsley *Xerox - Director of IR*

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

CONFERENCE CALL PARTICIPANTS

Shannon Cross *Cross Research - Analyst*

George Tong *Piper Jaffray & Co. - Analyst*

Tien-tsin Huang *JPMorgan - Analyst*

Keith Bachman *BMO Capital Markets - Analyst*

Brian Essex *Morgan Stanley - Analyst*

Jim Suva *Citigroup - Analyst*

Ananda Baruah *Brean Capital - Analyst*

PRESENTATION

Operator

Good morning and welcome to the Xerox Corporation third-quarter 2015 earnings release conference call hosted by Ursula Burns, Chairman of the Board and Chief Executive Officer. She is joined by Kathy Mikells, Executive Vice President and Chief Financial Officer.

During this call Xerox executives will refer to slides that are available on the web at www.xerox.com/investor. At the request of Xerox Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox.

(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 Ms. Burns. Ms. Burns, you may begin.

Ursula Burns - Xerox Corporation - Chairman & CEO

Good morning and thanks for joining our call. Today we reported our third-quarter results and provided an update on the fourth-quarter and full-year outlook. During this call we will update you on our strategy, provide details on our third-quarter results and share the actions that we are taking to improve our business.

So let me begin with a look at our priorities. In Services, our goal is to lead in attractive segments of the business services market. And throughout the year we've taken steps to strengthen this business, including acquisitions to build our commercial healthcare offerings and the divestiture of ITO.



As we announced two weeks ago, we are also taking action to improve our future financial performance and significantly reduce the volatility of our results with the update to our Government Healthcare business strategy. With these strategy changes to our Government Healthcare business, we are more clearly focused on the most profitable segments of our Services business.

In Document Technology, our efforts are focused on continuing to lead the market. We maintained our number one market share position in equipment sales revenue for a 23rd straight quarter closing in on six years, a solid record of leadership. We're seeing good demand from some small and midsize businesses - an important growth segment - through Global Imaging Systems and with the growth of our partner print solutions sold through our channels.

Also in the third quarter, we launched our new communication platform, "Work Can Work Better." And we're pleased with the reactions so far. Our new advertising and digital content highlight how we're enabling businesses and governments to achieve better results by helping them work better.

For our shareholders we have returned more than 50% of our free cash flow to them over the last four years and we're on track to do even more this year. Through September we completed \$1.3 billion in share repurchases, achieving our full-year expectations.

Although we have already taken steps to accelerate cost reductions and prioritize investments to drive improved revenue, productivity and margins, we announced today that the Xerox Board of Directors has authorized a comprehensive review of structural options for the Company's business portfolio and capital allocation, with a goal of enhancing shareholder value.

Let's look at the third-quarter performance. During the third quarter, we delivered adjusted earnings per share of \$0.24 - that's in line with our guidance - which excludes \$0.05 related to the amortization of intangibles and \$0.23 from the previously announced Health Enterprise charge.

Because the circumstances in Health Enterprise are unique, I will speak to our adjusted results in the quarter which better reflects our underlying operating performance. Total adjusted revenue was \$4.4 billion, down 4% in constant currency. On an adjusted basis, Services revenue was consistent with the same period last year and we delivered sequential improvement in our Services margin.

Document Outsourcing continues to perform well overall and BPO was down 1%, which was consistent with previous quarters.

There are a few highlights in Services that I would like to share. Acquisitions remain a key aspect of our portfolio management strategy and in the third quarter we acquired RSA Medical and iPAS, expanding our fleet of healthcare-related offerings.

Our new go-to-market teams are establishing leadership roles in their industries. As examples, our Retail team convened top clients and thought leaders at a Xerox Retail Industry Summit, and, Xerox Analytics were demonstrated at the grand opening of MCity, the University of Michigan's one-of-a-kind test site for connected and automated vehicles.

And, a number of Services offerings received external recognition. We retained a top position in Quocirca's Managed Print Services Landscape Report for the sixth consecutive year. And for the third year running, Everest Group rated Xerox as a leading service provider for Contact Center Outsourcing BPO.

Now moving on to Document Technology. Document Technology revenue was down 9% in constant currency, which is lower than we had expected and mostly was driven by increased pressures in developing markets. Excluding the impact of developing markets, the revenue trends in Document Technology remain stable.

Document Technology margin of 12.8% was strong and within our guidance range of 11% to 13%. Some additional Doc Tech highlights, we're seeing the benefit of recent product launches with strong demand for our new entry production color devices. We showcased the best of Team Xerox at Graph Expo, the largest US tradeshow for the Graphic Communications market including two new Xerox digital production color presses, the Xerox iGen 5 Press and the Xerox Rialto 900 Inkjet Press.

We also rolled out FreeFlow Core Cloud, which is the latest release in our leading workflow automation portfolio. In total the Company generated operating cash flow of \$271 million and we returned \$774 million to shareholders through dividends and share repurchases.

Now I will turn it over to Kathy to provide more details on the quarter. I'll be back later to share fourth-quarter guidance and wrap up. Kathy?

Kathy Mikells - Xerox Corporation - Corporate EVP & CFO

Thanks, Ursula, and good morning everyone. I'll start with an overview of our financial performance before moving into a more detailed discussion of the segments.

As announced two weeks ago, this quarter we recorded a pretax charge of \$389 million or \$241 million after-tax, reflecting that we no longer expect to fully complete the Health Enterprise platform project in California and in Montana. This decision will improve Xerox's future financial performance as these implementations were generating losses and will remove an element of risk and volatility in the business.

Accordingly, I'll provide results and growth rates adjusting for the charge to give better visibility to the underlying business performance in the quarter. Our bottom-line results were within our third-quarter guidance with revenues a bit softer and profitability generally in line with our expectations.

Total revenue in the quarter was down 7% at actual currency and 4% at constant currency. Services was flat at constant currency as growth in Document Outsourcing offset a 1% decline in BPO. Document Technology declined 9% in constant currency and was impacted by increasing weakness in developing markets.

Gross margin of 30.9% was down 130 basis points year over year driven by a lower technology equipment gross margin as well as a greater mix of Services which carries a lower margin. RD&E was slightly lower year over year.

SAG in absolute dollars was down 9%. SAG as a percent of revenue was better by 40 basis points, helped by currency and our ongoing productivity initiatives as well as lower compensation and benefit expense.

Our third-quarter operating margin of 8.7% decreased 90 basis points year over year and operating profit declined 16%. Over 40% of the operating profit decline was driven by currency and developing markets.

Moving down the income statement, Adjusted Other, net expense was \$8 million lower year over year driven by lower restructuring costs. Equity income was \$40 million in the quarter, down \$4 million year over year driven in part by the continued impact of negative translation currency.

Our third-quarter adjusted tax rate of 24.6% was at the low end of our guidance range of 25% to 27%. Our third-quarter adjusted EPS was at the top of our guidance range at \$0.24.

I will now move on to discuss our operational performance in Services. Services revenue declined 3% and was flat at constant currency. BPO was down 1%, consistent with the second quarter reflecting the headwind from last year's larger contract losses, lower inorganic contribution as well as lower new contract ramp from softer signings in previous quarters.

Good growth continues in Document Outsourcing up 3%, driven by strong Xerox Partner Print Services growth as well as good equipment revenue growth in Enterprise accounts from recent strong signings. Total signings in the quarter were down 7% but are up 5% on a trailing 12-month basis. New business signings were down 9% year over year as growth in Document Outsourcing was more than offset by declines in BPO.

Our go-to-market investments and move to industry business groups are beginning to result in good growth in shorter sales cycle offerings such as customer care. But we have yet to see a pickup in higher value, longer sales cycle offerings.

Our renewal rate in the quarter was 89%, which was at the high-end of our target range of 85% to 90% and reflects continued overall good customer retention.

Turning to margin, segment margin was 8.1%, in line with our expectations for sequential improvement from 7.5% in the second quarter. Margin was down 100 basis points year over year, reflecting investments in resources and in our new Services operating model, negative business mix within BPO as well as higher overhead as we work to lean out cost following the ITO divestiture. We continue to expect productivity from operational initiatives and our recent restructuring to yield increasing benefits in the fourth quarter.

I'll now turn to Document Technology. Document Technology revenue in the quarter was down 9% at constant currency. Developing markets weakness, including negative currency, accelerated in the third quarter, contributing more than one-third of the constant currency revenue decline.

Also contributing to the decline in the third quarter was high-end revenue. After good equipment growth in the second quarter, high-end was weaker in the third quarter, reflecting in part timing of product launches including our recently announced iGen 5 which should help us drive improvements in the fourth quarter. From a total printing perspective combining Document Technology with Document Outsourcing, revenue has been fairly stable, down 5% in the third quarter and down 4% year to date at constant currency.

Turning to activity, we saw strong growth in Entry A4 color driven by new products, relatively stable results in midrange but weaker installs and mix of products in high-end. Document Technology margin of 12.8% was down year over year but within our full-year guidance of 11% to 13%. Year-over-year drivers include negative equipment mix given better A4 results and the anticipated higher pension expense, partially offset by lower compensation and benefit expense.

We continue to actively manage our cost base to ensure alignment to revenue trends. So in closing, Doc Tech revenues were slightly lower than expected but profitability remained strong.

Turning now to cash. Cash flow from operations was \$271 million in the quarter which was lower than prior-year cash flow of \$595 million. The decline year-over-year reflects lower profits in Document Technology with the two largest drivers being continued negative currency impacts and developing markets weakness, lower profits in Services driven by margin decline as well as the expected loss of cash flow from the ITO business following the divestiture.

Additionally working capital was a use of cash due to timing of vendor payments as well as lower demand and timing of shipments impacting inventory. The Health Enterprise charge in the third quarter had a negligible impact on cash in the period and we anticipate the approximate \$225 million of cash outflows will be spread over time.

Moving down the cash flow statement, investing cash flows were a \$206 million use, driven by \$65 million spent on CapEx and \$153 million on acquisitions. Cash flow from financing was an \$888 million use which included \$691 million spent on share repurchases and \$90 million used for preferred and common stock dividends.

And our cash balance at the end of the quarter was just over \$800 million. So cash flow in the third quarter was impacted by lower operating profit as well as working capital timing.

Now I will review our capital structure. We ended the third quarter with \$7.6 billion in debt. Applying 7 to 1 leverage on customer financing assets, our allocated financing debt at the end of the third quarter was \$3.9 billion leaving core debt of \$3.7 billion.

In the fourth quarter, we are now anticipating an additional \$200 million debt reduction which will bring our year-end debt level to approximately \$7.4 billion, a \$350 million debt reduction for the year. This reduction will help offset the impact to our credit metrics from lower earnings and the reduction in our financing assets. Overall we continue to manage our capital structure to maintain credit metrics consistent with our investment grade rating.

I will now hand it back to Ursula to discuss capital allocation and guidance.



Ursula Burns - *Xerox Corporation - Chairman & CEO*

With less than a quarter left in the year, we can be more definitive on our remaining uses of capital. As Kathy just mentioned, we have spent about \$200 million on acquisitions year to date and we don't anticipate closing any large acquisitions before year-end.

We now expect to deploy an additional \$200 million of capital toward debt reduction. We will spend \$300 million on dividends.

And lastly, our share repurchase, we reached our full-year target of 1.3 billion in quarter three. This represents a 115 million share reduction in shares year-to-date and a 10% reduction of our share count this year.

I will now discuss guidance. Starting with revenue we expect improvement in the fourth quarter but considering current trends we now expect full-year revenue will be down approximately 3% at constant currency, in line with year-to-date results, with Services flat to up 1% and Document Technology down 6% to 7%.

From a margin perspective, in Doc Tech we expect continued strong margins with quarter-four and full-year margins in the middle of our full-year range of 11% to 13%. In Services we anticipate sequential improvement and for margins to be approximately 9% in quarter four. So we're making progress in Services but we do not expect to get to the 8.5% margin for the full year. For earnings we expect quarter-four adjusted EPS to be between \$0.28 to \$0.30 and for full year we anticipate being at the low end of our previously guided range of \$0.95 to \$1.01.

Lastly, we expect free cash flow in the range of \$1.3 billion to \$1.4 billion with modestly lower operating cash flow of between \$1.6 billion to \$1.7 billion and CapEx that is now also expected to be lower.

So in summary for the third quarter, we achieved adjusted earnings in line with our guidance, but we have come through the nine-month point and we're not satisfied with our performance. We are sharpening our focus on execution across the enterprise. We continue to lead an aggressive agenda to strengthen our offering portfolio and target segments where we are best positioned to compete and differentiate.

Across both Services and Technology we are prioritizing investments, taking actions to improve revenue and margins and managing cost in Doc Tech to maintain our profitability. And as previously mentioned, we are reviewing structural options for the Company's business portfolio and capital allocation with the goal of enhancing shareholder value. As we undertake this activity we are focused on the execution of our strategy and remaining fully committed to our customers, partners, suppliers and employees and to delivering strong financial results.

Finally, before we go to Q&A, as you know, this is Kathy Mikells's last earnings call. I'd like to thank Kathy for her financial leadership and contributions to Xerox during her time with us.

Leslie Varon will be stepping in as the interim CFO, a position that she has held previously. Leslie has deep experience and great connections throughout the business, so I know we won't miss a beat with this transition.

With that let me turn it over to Jennifer.

Jennifer Horsley - *Xerox - Director of IR*

Thanks, Ursula. Joining Ursula and Kathy today is Bob Zapfel, head of our Services business, as well as Jeff Jacobson, head of Technology.

Also let me point out that we have supplemental slides at the end of our deck. They 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-ons and multipart questions so we can get to everyone. At the end of our Q&A session I will turn it back to Ursula for closing comments.

Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Shannon Cross, Cross Research.

Shannon Cross - Cross Research - Analyst

Thank you very much. Ursula, can you talk about your Services and Doc Tech business have been under pressure for some time, so I'm curious as to what specifically is behind the decision to look at structural options? And as Chairman and CEO can you talk a bit about what types of actions you would say would constitute a structural option?

Ursula Burns - Xerox Corporation - Chairman & CEO

Thank you Shannon for the question. The Board and the management, we look at the business portfolio at the Company strategy on a continuous basis. We consider a range of opportunities regarding the business and the operations and it's always focused on increasing shareholder value.

So this type of activity for example led us to look at ITO and to divesting that and to take a fundamental change in our Government Healthcare strategy, particularly around Health Enterprise. So the structural options that we're looking at is both portfolio and capital allocation options and it's at an early stage so I really can't get into more details about that, about what is happening because we haven't really progressed it that far.

Shannon Cross - Cross Research - Analyst

And I guess what made the change, like in your mind looking at how the businesses, what made it happen or be announced this quarter versus prior? Is there anything significant that changed or how did this come about?

Ursula Burns - Xerox Corporation - Chairman & CEO

I think that the Board decided and I'm a member of the Board, obviously the Chairman of the Board, we decided to make it public. We decided as a group to make it public. I think that the review process, though, is an important thing to keep in mind.

It is a fairly broad-based review. It is not, one of the things that we are not currently considering is the sale of the Company. But all other options will be looked at as we progress through this review.

We're not going to actually speak a lot about timing of it. We're not going to make a lot more public statements about it, so I understand you have a lot of questions but we have to go through the process. And we have to go through the process before we can say anything more.

Shannon Cross - Cross Research - Analyst

Okay, thank you. Then just one other question.

You've taken down 2015 cash flow guidance a bit given some of the pressures in emerging markets on that. How are you thinking about 2016 as we look, forward just maybe even if you can't give us specific high-level puts and takes on how we should think about cash flow?



Ursula Burns - Xerox Corporation - Chairman & CEO

Let me start with the top line and I will start with revenue and then I'll turn it over to Kathy and myself to talk about cash flow. I think that we will see continued pressure in developing markets.

I don't expect to see any turnaround there and maybe even a little bit more headwind than we've seen so far there. Doc Tech margins we expect them to remain strong. We're going to do a whole review of what's happening in 2016 at our fourth-quarter earnings call in January.

So these are just high-level comments. Why don't you go into it Kathy?

Kathy Mikells - Xerox Corporation - Corporate EVP & CFO

Sure. So other things I would just point to, currency has been a huge headwind for the Company this year. If we had to call currency today, which by the way we don't, but if we had to call it today we would call it looking fairly neutral in 2016.

Another driver overall of cash flow is pension and our approach there really hasn't changed. So I wouldn't expect any kind of big changes year over year in terms of what we're trying to do in pension. And then obviously one of the big things that we've got to continue to execute on is just managing working capital.

That was a particular headwind for us in this quarter and something that we'd expect actually we'd improve on as we get through our fourth quarter and something we'll be very mindful of as we look forward to 2016. And then the last thing I'd mention, Shannon, is we sold these pieces of our financing portfolio in 2012 and 2013. The impact of that diminishes over time and so that gives us a little bit of a natural uplift in 2016.

Ursula Burns - Xerox Corporation - Chairman & CEO

One last point. On the Health Enterprise charges that we took for 2016 actually for the fourth quarter and 2016 will have a little bit of headwind in revenue the first half of 2016.

It will reduce our volatility which is one of the things that we really suffered from in 2015. That's the good news there, and we should be able to see some improved profitability as these contracts were at a loss. That's the other thing we can see in 2016.

Operator

George Tong, Piper Jaffray.

George Tong - Piper Jaffray & Co. - Analyst

Thanks, good morning. First off Kathy, wish you well in your new endeavors.

Kathy Mikells - Xerox Corporation - Corporate EVP & CFO

Thanks very much.

George Tong - Piper Jaffray & Co. - Analyst

I guess, Ursula, can you discuss whether you see strategic value in having the Services business together with the Document Technology business?

Ursula Burns - Xerox Corporation - Chairman & CEO

The answer is that my position on that hasn't changed to date and that's the strategy that we're executing on which is yes, we do see to date strategic value in having these two businesses together. As we go through the review that's one of the things that we'll validate.

George Tong - Piper Jaffray & Co. - Analyst

Got it. And Bob in the Government Healthcare space can you give us an update on New Hampshire, Alaska, North Dakota and New York and what implementation milestones and costs might be coming up?

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

Sure. So the first three, New Hampshire, Alaska and now North Dakota are all live. We went live in North Dakota two weeks ago, early October.

So they're in operate mode, so we would not expect then to have new development expenses where we've had the unpredictability that had been an issue in both California and Montana has been on a new system build as opposed to operate. In New York we are building the new system. As you'll remember the big difference with New York was it was bid after the move to the system we had already implemented in New Hampshire.

So we we're not building from scratch. They were buying something that the Health Enterprise platform that we had built and we're still in the front end of that development but optimistic that we will be able to drive that within the costs that we've modeled.

George Tong - Piper Jaffray & Co. - Analyst

Great, thank you.

Operator

Tien-tsin Huang, JPMorgan.

Tien-tsin Huang - JPMorgan - Analyst

Great, thank you Kathy, I also want to wish you the best in the next gig. Just wanted to I guess for Ursula, obviously a lot's going on with the CFO transition and then you mentioned the review and the capital allocation and portfolio retrenching in government as well. I think you said you don't have a timetable but I'm curious how do you expect to address and update us on some of these big items?

Ursula Burns - Xerox Corporation - Chairman & CEO

I think that any normal operational item we'll update you on quarter calls like we generally do. As far as the portfolio, business portfolio and capital allocation review we don't intend to give updates through the process. So we're not even sure, we're not assuring that there will be any outcome of that process that's something we'll make public.

So I think what we have to do is when we're ready to speak to you about it, if and when we'll speak to you about it, business update, normal business and operational update you'll get through interactions with us on a normal basis.

Tien-tsin Huang - *JPMorgan - Analyst*

And then timetable and the CFO transition --

Ursula Burns - *Xerox Corporation - Chairman & CEO*

As far as the CFO transition goes you know it's always unfortunate to see a CFO leave, particularly someone with the quality and caliber of Kathy. So we are wishing her well as you guys do but we're disappointed in that transition.

The good news is that I have a compatriot who has been with me for been with me and this Company for 30 years or more who has done this acting CFO thing once before. The community knows her outside the Company, the community knows her and loves her inside the Company, so I don't expect to miss a beat at all.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *BMO Capital Markets - Analyst*

Hi, I also wanted to start at the strategic level. If I think back about what's happened this year, the buyback has been call it over \$1 billion, \$1.3 billion and M&A has been a couple hundred million dollars. So the portfolio has actually decreased or it really hasn't increased through M&A and the Company has been buying back aggressively on stock and I'm just wondering how you're thinking about that as you look forward?

In other words the stock really hasn't done much. It's down a little bit this year, down actually a decent amount yet you have been buying back and really haven't added to the Services portfolio.

I'm not suggesting that you go out and buy aggressively at any price. But the capital allocation strategy combined with weak markets really hasn't seemed to create value and I'm just wondering how you're positioning that as part of your strategic decision-making process here as you look out of the next couple of months?

Ursula Burns - *Xerox Corporation - Chairman & CEO*

I think that for the remainder of this year as I said in my remarks we don't expect to actually to complete any significant M&A at all. I think where we are on M&A is where we are.

We've already met or reached the share repurchase hurdle that we had set for the full year. So I think that both share repurchase and acquisitions and M&A is kind of done for the year, maybe a little bit more.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes, I'm thinking about more over the next six to 12 months.

Ursula Burns - *Xerox Corporation - Chairman & CEO*

Yes, so let me go forward. I just wanted to state that. Thank you, Keith.



On a go-forward basis our strategy remains to return at least 50% of our available cash to shareholders and we'll continue to do that through share repurchase and through dividends in 2016 at the current plan. We will update you more on that in the fourth-quarter earnings in January.

As far as M&A it's one of the integral pieces of the expansion of our Services business. And so we'll continue to look for accretive tuck-in acquisitions in Services, particularly around the areas where we see differentiation and strength in transportation, commercial healthcare, these areas.

So we'll continue to look for M&A in 2016 and we'll continue our return to shareholders strategy in 2016. If anything changes from that we'll update you when appropriate.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. If I could just sneak in a follow-up then, as you think about strategic alternatives on the printing side of the business, is there more that could be done and more could have many definitions but associated with your partner in Japan, Fuji, to leverage that relationship?

Ursula Burns - *Xerox Corporation - Chairman & CEO*

I think that as we look at structural options for the Company's business portfolio and capital allocations we will look at all available levers there. I'm sure the Company will do that, the Board will do that.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay, thank you. Best of luck.

Operator

Brian Essex, Morgan Stanley.

Brian Essex - *Morgan Stanley - Analyst*

Good morning and thank you for taking the question. I was wondering if I could pose a question to Bob.

I guess given the recent announcement that you're deciding to shorten the contract implementation dates for both California and Montana, I was wondering if you could maybe highlight a little bit what to expect on the margin front and how much would of those contracts could potentially be? And I guess what I'm getting at is realizing that you have an operational overhang, as you're implementing those contracts might we see a little bit better margins sooner and what might that timeframe be once those contract implementation processes end?

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

Yes, if I can I will start first by explaining where we are in both California and Montana and then I will try to be on point with the question. So really in both states we and they, this was a mutual process, looked ahead and said given everything that had changed in terms of what they would want and where we were on the development that there was still a long way to go and it was better to call an audible than continue to develop the systems.

So they and we were with us on for us to stay in a substantive long-term role as a fiscal agent operator which is the primary component of our operating revenue in both states. Now what that will mean to us going forward is we will have as Ursula briefly mentioned we'll have some revenue



pressure. It's about a point on the Services segment revenue dynamics for the next three quarters and it was also roughly a point, not quite but roughly a point, last quarter.

So that's a little bit of downside. The upside is that we had been very unpredictable, as you know our Services margins have not been -- we have not been as consistent as we need to be because we had been recognizing more cost to development would hit the period I&E because of percentage of completion accounting.

So because of the change that we have made with them we expect to take that unpredictability out of our model and we should have year-to-year improvements in 2016 because we were losing money. But we're not already laying out next year's segment model until the January earnings call. Sorry about the long answer but hopefully that's --

Brian Essex - *Morgan Stanley - Analyst*

Okay, that's very helpful. So if I were to take California and Montana contracts, is there any way to outline a revised timeline for those contracts? It sounds like California ending after stage 2, is that relatively close and then Montana I know that was pretty faraway completion timeframe.

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

Both of them from again separate the new system development from the ongoing operation. The ongoing operations we expect to have for an extended period. The new system development in both cases will be inside 12 months and maybe inside a much shorter period of time.

Ursula Burns - *Xerox Corporation - Chairman & CEO*

And the financial implications of that have been comprehended in the charge that we took a couple of weeks ago. So we are -- we have captured to the best of our ability and knowledge the financials including the balance sheet impacts. We did that a couple of weeks ago and we will implement that the end of that those development activities with the states in the next couple of quarters or so.

Operator

Jim Suva, Citigroup.

Jim Suva - *Citigroup - Analyst*

Thanks very much. I have two questions and I will just mention them at the same time.

So first of all on the announcement you made about the Board of Directors authorizing a review, can you confirm that it's just your Board of Directors and internal doing it or did you hire somebody external or plan to external? And the reason why I ask it isn't the Board of Directors supposed to always review the Company's business and capital allocation? And so if it's internally you kind of really wonder what type of meaning this information is.

Second question is or the follow-up is during this review process does your stock buyback or capital allocation get put on hold until you get the conclusion of it? Thank you very much.



Ursula Burns - *Xerox Corporation - Chairman & CEO*

As far as your first statement about the Board's interaction with strategy development, etc., etc., you are correct that this is a continuous activity with the Board. This is what we talk about all the time with the Board, our strategy as well as our operations.

We've told you that what we're doing here is we're looking at structural options for the business portfolio and capital allocation is something that they always do. We've just decided to announce this to you this time. And we are not disclosing any advisors if we have advisors or who they are.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital - Analyst*

Hi guys, thanks for taking the question and Kathy, good luck in your future endeavors. I guess really I have a question and a quick follow-up. Really for Ursula and Bob, I guess in the context of how you talked about your capital allocation going forward but given also the new context about looking at strategic options, philosophically how do you guys think about doing not tuck-ins but larger Services deals?

And it sounds like you're going to have maybe \$700 million left over after capital allocation of generative cash annually to do deals. I don't know that could get you without leveraging up something significant. But clearly there is some sort of intent behind making this announcement the way that you guys have announced it.

So I'd love to just get your thoughts on philosophically your view on making larger Services deal. And then really I've to get your broader take on the degree to which you think that actually is necessary given the fragmented nature of the BPO market?

I will let you leave it there. That will be my question. Thanks.

Ursula Burns - *Xerox Corporation - Chairman & CEO*

Okay great. By the way I didn't answer the second part of Jim's question which is basically the first part of your question. So sorry, Jim and Ananda I'll capture that.

Our capital for this year we have essentially completed our share repurchase activities as I said earlier. And we are still active in the market in M&A but we have a pipeline and that pipeline doesn't lead to anything significant for the remainder of this year.

So from a capital allocation on those two items, I think that we're really pretty much settled. CapEx we talked about, we talked about the fact that it's coming in a little bit lighter that will help us. We're focused on remaining investment grade.

That's one of the things that you know that we think for both our Services and Tech business. And we'll continue to make sure that we manage our capital to assure that we fall inside there. That's one.

The second is the fragmented nature of the Services market and our therefore M&A activities for the future. One of the things that we will continue to need to do in the Services business is to consolidate some of this fragmentation, particularly in areas that we have strengthened and I would suspect I would plan to and you should expect that we will continue to do that type of activity as we go forward in the business as usual kind of a matter.

I didn't quite get to the \$700 million that you got to because we haven't quite done 2016 yet which I think is what you are looking towards when you were making those numbers, those projections. But as I said earlier I don't think that we see in the business as usual a lot of change in returning



value to shareholders to an M&A structure that continues to strengthen our Services business and to a debt structure that allows us to remain investment-grade.

So those of the three tenets that we're sitting on right now. And therefore I intend to come out as well -- we'll see if there's anything that changes as we go forward, we'll tell you about it but it won't be before January -- the January call.

I hope I answered everything that you had, it was kind of a long question. I hope I got all of it.

Ananda Baruah - *Brean Capital - Analyst*

It was. That was very helpful.

I guess just one quick follow-up is do you think you can accomplish the kind of I guess consolidation in this key BPO areas that you want to, continuing with the small tuck-in approach as opposed to stepping into doing some larger deals and getting some bigger scale? That'll be it then.

Ursula Burns - *Xerox Corporation - Chairman & CEO*

It's something that it is a great question and it's one that it's going to be hard to answer, not for any reason except for that we have been trying to do the small tuck-ins. And we find some good ones and they, they come we compete for them and we win some. You saw iPAS and RSA this last quarter.

And we'll continue to try to push on that area. We're not going to -- we still have the same disciplined approach.

We have a great re-up in that approach with the hiring of a great executive who's kind of an M&A expert. So we'll continue to look at that type of M&A for sure and when we look in that type of M&A if we find something that's even more exciting we're not going to close our eyes to it.

But we're not looking for massive companies to buy. We're trying to actually stay in the ranges that we've been talking about, a little bit bigger than small and definitely smaller than large.

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

And trying to stay where we're really looking at the places where we think we're advantaged so that we're not looking broadly across the whole BPO portfolio but on a select set of areas where we think we can even further differentiate the firm for our clients.

Ursula Burns - *Xerox Corporation - Chairman & CEO*

One of the areas that we didn't get into at all but I think it's good to bring up now is that we are heavily concentrated -- we have a heavy concentration and strength in customer care and call center operations. And we have a problem right now with the business mix. It's one of the challenges that we had in the third quarter and that we are working hard to try to overcome.

As we go forward, as we mix more towards customer care it's a lower margin business that we're trying to mix up towards more, towards higher margin, more innovative solutions while we try to actually innovate in customer care. So the reason why I bring it up is our M&A strategy is going to be towards these types of areas where the margins are stronger, where we don't continue we want to stay a leader in customer care, we want to walk away from that business.

But we just are not selling enough of the higher-margin businesses, business areas and that's one of the things that we have to fix and we haven't quite cracked that nut yet. So we're going to continue to acquire in those areas so that we can actually move away from the more commodity-based customer implementations.

Operator

Kulbinder Garcha, Credit Suisse.

He has not responded.

Jennifer Horsley - Xerox - Director of IR

All right, so that's it. We will wrap up.

Thanks for your interest. Ursula, anything more to wrap up?

Ursula Burns - Xerox Corporation - Chairman & CEO

Yes, I just want to close with a thank you for listening. And while the third-quarter adjusted earnings were in line with our expectations we know that we have a lot of work to do.

I talked about some of the areas. Mix is one, we have to make sure we manage our cash well for the remainder of the year and we will be focused on that. So thank you for joining our call today.

Jennifer Horsley - Xerox - Director of IR

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

Operator

Thank you. Ladies and gentlemen, thank you for your participation in today's conference.

This does conclude the program and you may now disconnect. Everyone have a good day.

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