25-Jul-2024

Xerox Holdings Corp. (XRX)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation's Second Quarter 2024 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions] At this time, I'd like to turn the program over to Mr. David Beckel, Vice President and Head of Investor Relations. Please go ahead, sir.

David Beckel

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

Good morning, everyone. I'm David Beckel, Vice President and Head of Investor Relations at Xerox Holdings Corporation. Welcome to the Xerox Holdings Corporation's second quarter 2024 earnings release conference call hosted by Steve Bandrowczak, Chief Executive Officer. He's joined by John Bruno, President and Chief Operating Officer, and Xavier Heiss, Executive Vice President and Chief Financial Officer. At the request of Xerox Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox.

During the call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor, and we 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. Bandrowczak.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

Good morning. And thank you for joining our Q2 2024 earnings call.

Sequential improvements in adjusted operating income margin, cash flow and revenue validate the comprehensive and strategic organizational changes implemented in Q1. Reinvention is a multiyear strategy to simplify operations and reposition Xerox towards market opportunities in print, digital and IT services with the highest rates of underlying growth. With transformational changes of this magnitude, progress may not always unfold in a linear fashion. We experienced a short period of disruption in the first quarter during implementation of the redesigned operating model, but continue to execute Reinvention according to plan. Notable improvements in operating processes and financial results since the reorganization further our confidence in this strategy's ability to deliver a targeted $300 million improvement in adjusted operating income above 2023 levels by the end of 2026.

Summarizing results for the quarter. Revenue of $1.6 billion, decreased 10% in actual and constant currency. Excluding the impact of year-over-year fluctuations in backlog and reduction in nonstrategic revenue associated with the Reinvention, core business revenue declined only modestly. Adjusted EPS was $0.29, $0.15 lower year-over-year, primarily reflecting higher taxes and interests. Free cash flow was $115 million, an increase of $27 million compared to Q2 of last year and adjusted operating margin of 5.4% was lower year-over-year by 70 basis points due to lower revenue offset by operating costs reductions.

With the disruption in Q1 firmly behind us, the benefits of streamlined organizations with improved operating focus are materializing in the financial results. Q2 revenue was largely in-line with expectations marking an improvement in trajectory from Q1. Adjusted operating income margin improved more than 300 basis points on a sequential basis, and free cash flow grew sequentially and year-over-year. Momentum in equipment orders and pipeline, new product launches and improved sales processes are expected to drive stronger revenue growth in the second half of the year than originally expected.

Despite an improved outlook in the back half of the year, we lowered full-year revenue, adjusted operating income and free cash flow guidance. The reduction in full-year guidance primarily reflects the impact of incremental Reinvention actions, including geographic and offering simplification. The savings of which are now expected to be realized predominantly in 2025. Other impacts to margin, including higher freight and product costs, are also expected to be mitigated over time.

Accordingly, the reduction in 2024 guidance has no bearing on our confidence in the three-year $300 million adjusted operating income improvement target. In fact, our confidence in the three-year outlook has grown over the past quarter due to progress in the identification and estimation of Reinvention cost reduction initiatives now totaling more than $700 million, between 2023 and 2026 and the quality and rigor behind the management infrastructure recently put in place to execute those initiatives. John and Xavier will discuss the timing and consistency of future operating cost reductions in more detail.

I'll now turn to our strategic priorities, which continue to guide our decision framework as we execute the Reinvention. Starting with the stronger core, the change to the business unit led operating model in Q1 and related changes to the sales organization were designed to catalyze market share growth by bringing sales and operations in closer alignment with the economic buyers of Xerox offering while improving sales efficiencies. We are seeing early evidence of the success of both fronts now that our sales team has settled into the new operating model. The sales, marketing and pricing teams are working more collaboratively to design offerings and marketing strategies specific to client segments and routes to market. Sales efficiency has improved to enhance intelligence, better planning tools and optimized sales coverage models; and work continues to reduce administrative burden, given the sales team more time to focus on the highest quality opportunities and target new accounts.

These improvements are bearing out across top-line key performance indicators. Equipment order momentum continued in Q2 with orders and pipeline, both higher year-over-year. Supplies revenue also grew in the second quarter and the first half of the year. Services KPIs are similarly strong. Revenue renewal rates for large accounts remained above 100% in Q2 and for the last 12 months and across both print and digital services. New business signings are higher year-to-date, with renewal rates ahead of internal targets.

The benefit of improved sales operations will be augmented in the second-half with a refreshed A3 product lineup, our largest and most successful product category. The lineup features what we believe is the world's first AI-assisted multifunctional printers. The devices come with adaptive learning modules, which save clients time by suggesting new and optimized workflows using AI-based algorithms to analyze device use patterns and user preferences.

Also included are preloaded AI applications that enable users to summarize, convert handwritten notes and automatically auto-redact any scanned documents. More importantly, these AI-enabled devices serve as a platform for a broader range of AI-assisted workflows, including intelligent document processing currently deployed by Xerox as a digital service. The updated platform, combined with cloud-hosted AI applications and integration, opens the door for innovative new use cases.

The change to the business unit operating model has also brought increased focus on expanding digital and IT service penetration across our client base. Stronger alignment between product development, solutioning and sales teams is driving differentiated digital workflow solutions for traditional print clients who are increasingly looking to partners like Xerox to improve their most critical document workflow processes. Our strategy of expanding total addressable market with every print client is progressing accordingly.

In Q2, we signed a deal with an existing print client in the European telecom space to provide an end-to-end customer acquisition solution for the client's new home broadband service. With the help of a strategic partner, we sourced unique customer data and applied proprietary intelligence to identify an optimum set of customer targets.

We designed and executed an omni-channel marketing campaign across both digital and print media and are using the response data from the campaign to recalibrate the targeting strategy, improving marketing effectiveness for the client over time. This solution demonstrates our ability to integrate print with advanced digital capabilities to provide incremental value to our clients.

Increasingly, we are utilizing artificial intelligence to optimize our digital solutions. This past quarter, we signed a deal with an existing print client in the insurance industry to provide a digital workflow solution, leveraging AI and machine learning, which assists in the prevention of money laundering and financing of terrorism. This unique solution automates processes involved in the screening and detecting of fraud and other non-compliant activities, greatly reducing the need for manual processes and client risk.

The ability to sell advanced digital solutions such as intelligent document processing by leveraging print customer relationships is a key competitive advantage as we expand our digital services business. The new business signing for digital services are up double digits year-to-date and we expect increased demand for solutions utilizing AI to provide a tailwind to growth for our digital services businesses in 2025.

Moving to cost improvements, in Q2, operating expense decreased nearly $50 million year-over-year, reflecting the benefits of the strategic actions taken in the prior year, the use of AI to optimize internal processes and the planned reduction in head count associated with the structural reorganization.

With head count reduction largely behind us, our focus this quarter turned to identifying future cost reduction initiatives and developing the systems and processes required to ensure the successful delivery of those initiatives. Our Global Business Services organization or GBS is a key to the delivery of future savings as it enables continuous operating efficiencies through shared capabilities and platforms.

Louie Pastor, our Chief Administration Officer, leads GBS organization. He is also our Chief Transformation Officer, putting control of both the design and implementation of the end-to-end structural changes in the hands of one leader. I am pleased with the progress his team has made to identify more than $700 million of gross cost savings through Reinvention from 2023 to 2026.

Finally, balanced capital allocation. This quarter, we delivered year-over-year growth in free cash flow despite lower operating income and lower sales of finance receivables. We are in advanced talks to expand our forward flow agreement outside the US, which will enhance the company's free cash flow profile by reducing capital required to fund future lease originations in other regions.

Balance sheet health and liquidity improved this quarter through the reduction of $300 million of debt and expansion of the ABL facility by $125 million. We expect free cash flow in future periods to be sufficient to both fund value-accretive growth in digital and IT services and reduce debt.

Through Reinvention, we intend to reduce leverage below 3 times EBITDA by the end of 2026. The payment of our $1 per share dividend remains a key priority. Our dividend yield is well above that of our peers, but we fully expect our yield to return to more normalized levels as we execute our Reinvention.

I will now hand the call over to John to provide an update on specific Reinvention initiatives.

John G. Bruno

Chief Operating Officer, President & Director, Xerox Holdings Corp.

Thank you, Steve. As Steve noted, we made progress this quarter in a design, planning and implementation of structural changes expected to drive reductions in operating costs to meet our three-year $300 million adjusted operating income growth target. I'll spend time on today's call discussing the mechanics and assumptions underlining the target and key progress made in Q2.

Sequentially, higher operating income requires a leaner, less complex organization fit-for-purpose to the market opportunities available to us. The structural reduction in organizational complexity through Reinvention will be driven by three primary levers: geographic, offering and continuous operating model simplification. These savings unlocks require structural reduction in operating costs, which when combined with a more favorable mix of revenue towards markets with higher underlying growth rates will drive cash flow sufficient to fund growth while reducing leverage.

I'll start with an update on geographic simplification. We are currently executing a shift in how we distribute product in certain markets from a direct to an indirect model. This shift in distribution strategy does two things. One, it allows greater focus on providing print and digital service capabilities for channel partners who are best positioned to serve our clients within their region; and two, allocate more time and resources on being the leader in the markets in which we maintain direct operations. This quarter, we transitioned our operations in Ecuador and Peru from a direct to an indirect model, following a similar move in Chile and Argentina in the prior quarter. We continue to evaluate the optimal mix of direct versus indirect distribution by country across our operations in Western and Eastern Europe and we'll provide updates as transition decisions are made.

Offering simplification will narrow and optimize our offerings over time to those with the greatest levels of competitive differentiation and profitability. Last quarter, we announced our decision to exit the manufacture sharing of certain production print equipment. We did this to refine our focus to the submarkets within production that are growing fastest and put more resources behind the development of a services-led, software-enabled production print ecosystem, leveraging our FreeFlow and XMPie software as examples.

This quarter, we consolidated our remaining manufacturing operations globally and are ahead of plan in the sale of discontinued products. We continue to explore further rationalizations of our offerings to drive closer alignment with the needs of our clients and channel partners. One such example is the optimization of our A4 product for specific markets within distribution channel where we have the most opportunity to gain share.

As we discussed last quarter, operating model simplification will leverage the Global Business Services organization to drive long-term, enterprise-wide efficiencies and technology-enabled productivity gains. During the second quarter, the GBS organization began implementing 60 new initiatives to accelerate savings across key business functions, including report-to-report, order-to-cash, global spend management and the people operations. These efforts will help streamline and standardize global internal processes, making it easier to do business with and within Xerox.

Also in the second quarter, we entered into agreements with technology partners to transform our operations with enterprise-wide, technology-led process improvements. And in over the next few years, we plan to greatly reduce the technological debt associated with our legacy infrastructure by implementing a technology stack that mirrors the standardization of our global business processes. These agreements allow us to reduce the IT costs and improve business insights while providing greater flexibility and expanding our offerings and solutions.

Another win this quarter was the redesign of our transportation network. Our teams negotiated key transportation contracts to derive economies of scale savings through the optimization of our transportation cost across our carrier network, reducing supply chain costs in future periods. These unlocks are critical enablers of broad-based organizational efficiencies and the operating savings that accompany those efficiencies. And to-date, the Reinvention office has identified over 300 savings initiatives, resulting in more than $700 million in gross cost savings through 2026, across seven primary cost categories. In the second quarter, the Reinvention office implemented a new management operating system, including comprehensive change management and accountability structures, to ensure the successful realization of these initiatives and the continuous identification of further initiatives.

With Reinvention momentum and progress made thus far, we are confident in our ability to deliver $300 million of incremental adjusted operating income by the end of 2026. Even after accounting for the shift in certain markets from direct to indirect distribution, a narrow production equipment focus and potential erosion in our core print business and ongoing reinvestments in our growth businesses.

When we enter 2027, we expect Xerox to be a transformed business with double-digit operating margins and more than 20% of revenue coming from higher growth digital and IT services businesses, as we reinvest growing levels of free cash flow and are disciplined in our organic and inorganic investment opportunities.

I'll now hand the call over to Xavier.

Xavier Heiss

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

Thank you, John, and good morning, everyone.

As Steve mentioned, the benefits associated with this year organizational redesign are materializing in financial results. In Q2, adjusted operating income margin, adjusted operating profit, free cash flow on revenue all improved sequentially, while free cash flow improved year-over-year despite the lower contribution from finance receivables activity.

Total revenue declined 10% in actual and constant currency. Excluding the effect of backlog fluctuation, reduction in nonstrategic revenue on other Reinvention action, total revenue this quarter declined 3% in constant currency, a more than 200-basis-point improvement from Q1. Core revenue in the first-half of 2024 was below our expectations, mainly due to the first quarter's performance. However, continued momentum in equipment order and pipeline supported by the improvement in sales operations Steve noted earlier, new product launches on continued strength in signings activity give us increased confidence both core and reported revenue will grow in the second-half of the year.

Turning to profitability. Similar to Q1, we incurred inventory charge associated with the exit of certain production, print manufacturing operations. All profitability commentary to follow exclude this impact.

Gross margin declined 50 basis points year-over-year due to lower volume and higher freight cost, partially countered by favorable currency effects on revenue mix.

Adjusted operating margin of 5.4%, declined 70 basis point year-over-year, due mainly to lower gross profit, partially offset by the benefit of structural cost reductions. Total operating expense in Q2 declined $47 million year-on-year or close to 10%, reflecting head count reduction actions taken in Q1, non-labor reduction in overhead and the flow-through of cost reduction implemented in the prior year.

Adjusted other expenses net were $13 million higher year-over-year due to an increase in non-financed interest expense associated with our recent debt refinancing activities. While our debt balance is not significantly higher year-over-year, non-financed interest expense increased due to higher interest rates on the lower portion of debt being allocated to our financing business, reflecting lower finance receivable balance year-over-year.

Adjusted tax rate of 25.5% compared to a 20% tax rate in the prior year period. This increase in tax rate is a result of settling certain non-US tax audit.

Adjusted EPS $0.29 in the second quarter was $0.15 lower than the prior year, driven by lower adjusted operating income, higher interest expense on a higher tax rate, partially helped by a lower share count. GAAP EPS of $0.11 was $0.52 higher year-over-year as the prior-year quarter included a $92 million net after-tax charge associated with the donation of PARC of $0.58 per share.

Let me now review revenue and cash flow in more detail. Starting with revenue. On an actual and constant currency basis, Q2 equipment sales of $356 million declined around 15% year-over-year, compared to a roughly 26% decline in Q1. The effect of backlog fluctuation in the current and prior year, and Reinvention action, including geo simplification, accounted for most of the decline. Excluding this effect, equipment sales declined modestly, an improvement relative to Q1, which were negatively affected by the sales reorganization.

After a brief period of disruption in Q1, we have seen consistent improvement in equipment order velocity and pipeline, reflecting the intended benefit of closer alignment between our sales and offering teams on the economic buyer of our product. Easier backlog compare, continued momentum in order, and a refreshed A3 product line-up featuring a range of AI-enabled capability give us confidence equipment revenue will return to growth in the second half of the year.

Equipment revenue decline outpaced decline in installation activity in Q2 due to unfavorable product mix. Declining installation activity mainly reflects the prior period reduction in backlog on the slight increase in current quarter backlog. Order activity outpaced installations again in this quarter, providing a tailwind to equipment revenue for Q3. Post sales revenue of $1.2 billion declined approximately 8% in actual and constant currency. Excluding the reduction in non-strategic lower margin paper and IT endpoint device placement and other Reinvention actions including geo simplification, post sales revenue declined modestly.

Consistent with past quarter, I will provide additional commentary to help clarify underlying trends in our core businesses, which exclude the effect of backlog fluctuation and reduction in nonstrategic revenue, including Reinvention actions. For Q2, the effect of equipment backlog fluctuation in the current and prior year quarters contributed around 300 basis point to the year-over-year decline in total revenue. Additionally, lower sales of nonstrategic paper, IT endpoint device and decline in finance revenue, reflecting the change in our finance receivable strategy contributed more than 200 basis point to the decline. Finally, other strategic actions to simplify our business and improve profitability, including geographic simplification, contributed around 150 basis point to the decline.

When these impacts are removed, revenue declined low single-digit, primarily reflecting decline in printed page volume, partially balanced by growth in digital and managed IT services, as well as growth in supplies.

For the second-half of the year, we expect revenue growth on both reported basis, and when adjusted for Reinvention actions.

Let's now review cash flow. Free cash flow was $115 million in Q2, higher by $27 million year-over-year. Operating cash flow was $123 million in Q2, $28 million higher than the prior-year quarter. The increase was mainly driven by working capital benefit, partially counterbalanced by lower adjusted operating profit, lower cash from finance receivable, higher restructuring payment associated with Reinvention and higher pension contribution. Finance asset were a source of cash of $161 million, reflecting the benefit of our HPS Forward Flow program and lower origination year-over-year. This compared to a source of cash of $210 million in the prior-year quarter, which included a large onetime sales of finance receivable.

Working capital was a use of cash of $133 million, a $115 million year-over-year improvement, driven mainly by the timing of accounts payable. Investing activity were a use of cash of $2 million, largely consistent with the prior-year quarter. Financing activities consumed $336 million, reflecting the $217 million pay-down of the remaining 2024 unsecured senior notes along with the $82 million of secured debt payment, and dividend of $34 million.

Turning to segment, Xerox Financial Services or XFS origination volume declined 41% year-over-year, reflecting XFS change in strategy to return its focus toward captive-only financing solution. XFS finance receivable balance declined 9% sequentially in actual currency due to the run-up on (sic) [run-off and] sales of US XFS origination and existing finance receivable, and HPS funding of XFS origination. As previously highlighted, we expect our finance receivable balance to continue to decline and normalize closer to $1 billion by 2027, benefiting free cash flow in future period.

In Q2, XFS revenue was down 12% year-over-year due to lower finance income and other fees associated with the decline in XFS finance receivable balance, partially offset by higher commissions from the sales of finance receivable asset. Q2 XFS segment profit was $4 million higher year-over-year, mainly due to lower bad debt expense, reflecting lower origination and the lower finance receivable balance.

Print and Other revenue fell 10% year-over-year in Q2 due to lower equipment and post-sale revenue for the reasons previously mentioned. Print and Other segment profit declined $25 million versus the prior-year quarter, driven by lower revenue, partially offset by structural cost efficiencies.

Turning to capital structure, we ended Q2 with $551 million of cash, cash equivalents and restricted cash. Around $2 billion of the remaining $3.3 billion of our outstanding debt support our finance asset, with the remaining debt of around $1.3 billion attributable to the non-financing business. Total debt consists of senior unsecured bond, finance receivable secured borrowing, term loan and a convertible note.

During the second quarter, we repaid the remaining $217 million of 2024 senior note. As a result, we have only $67 million of secured debt coming due in the balance of the year.

Before addressing guidance, I want to provide additional details behind the more than $700 million of gross cost savings identified to-date through Reinvention. In the past year, we have implemented or are close to implementing initiatives that are expected to result in more than $425 million of run rate gross cost savings through 2026. We have identified around $275 million of additional savings opportunity to-date, including overhead savings associated with geographic and offering simplification that will be implemented in 2025 and 2026, bringing total realized and estimated gross cost savings to more than $700 million through 2026 and our work continues to identify additional savings opportunity.

We expect to realize close to $200 million of gross cost savings in 2024 and already have line of sight to nearly $100 million of savings in 2025 from projects either currently implemented or those that will be implemented shortly. We expect to realize additional savings in 2025 from initiative not yet implemented and we'll update investor each quarter as we move project through the stages of reimplementation.

As John noted, progress in the identification of structural cost reduction to-date give us confidence in our ability to grow adjusted operating income at least $300 million, above 2023 levels, by the end of 2026. To put this separated operating income improvement in context, assuming our adjusted operating income target is reached as planned, in 2026, we expect EPS of more than $3 per share, adjusted EBITDA north of $900 million and cumulative free cash flow from 2024 to 2026 of more than $1.5 billion.

Finally, I will address full-year 2024 guidance. For revenue, we now expect the decline of 5% to 6% in constant currency versus a decline of 3% to 5% previously. The entirety of the reduction in revenue guidance is attributable to intentional reduction in non-strategic revenue, including incremental geographic simplification action, the decision to exit the manufacturing of certain production print equipment and lower-than-expected revenue from financing income and low-margin IT hardware endpoint devices.

Full-year revenue guidance now include 550 basis points of FX from non-recurring headwinds, associated with backlog reduction in the prior year, reduction in non-strategic revenue and other Reinvention actions, including geographic and offering simplification. Excluding the cumulative effect of these items, expectation for core business revenue in 2024 is unchanged at roughly flat year-over-year. We expect revenue in the second half of the year to increase on both the core and reported basis, which reflect improvement in our print business and continued growth in digital and manage IT services.

For adjusted operating income margin, we now expect a margin of at least 6.5% versus our prior outlook of at least 7.5%. This reduction mainly reflects the effect of lower revenue guidance, including geographic and offering simplification actions as well as higher-than-expected freight and product cost. Over the course of Reinvention, reduction in non-strategic revenue, such as those associated with geographic and offering simplification are expected to improve total profitability and margin. However, the reduction in overhead cost associated with many geographic simplification action expected to be implemented in 2024 will not be realized until 2025, delaying the net savings benefit associated with this action to 2025.

As Steven just noted, despite the reduction to 2024 guidance, confidence in our three-year adjusted operating income improvement objective has increased in recent months, leveraging a strong managerial infrastructure to support the identification and delivery of cost reduction initiatives currently contemplated. We now expect free cash flow of at least $550 million versus prior guidance of at least $600 million. The reduction in free cash flow is in-line with the after tax reduction in adjusted operating income expectation. As a reminder, free cash flow guidance is inclusive of around $100 million of expected restructuring payment and $50 million of incremental year-over-year pension payment.

In summary, recent change to our operating model drove sequential improvement in results this quarter, and we expect a new product launch on growing demand for our equipment and service to support a return to top-line growth in the second half of the year. The reduction in full-year guidance mainly reflects the timing of incremental Reinvention actions taken in 2024 with the benefit of this action now expected in 2025. We remain confident in our ability to grow adjusted operating income by at least $300 million over 2023 level by the end of 2026, a view supported by observable momentum in our business, and a team and management operating system capable of delivering a successful Reinvention of Xerox.

We now open the line for Q&A.

QUESTION AND ANSWER SECTION

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

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah. Thanks, guys. Thanks for taking the question; a couple, if I could. And, Xavier, just picking up right where you talked – a moment ago, you talked about the Reinvention initiative being the catalyst for the guidance lower. Is it intra-quarter, you guys moved around some of the timing of the initiatives, and that's what's causing the impact, or is it you're just learning more the last 90 days about the impact of the initiatives, but the timing of the initiatives are relatively the same? And then I have a quick follow-up. Thanks.

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

A

Yeah. So, thanks. Thanks, Ananda. So, yeah, so we are executing the strategy as we've planned. And as you mentioned it, we go into the strategy, although we assess each of the initiatives individually here. As you know it, we have not changed the guidance that we have for the entire program. So we stick with this three-year guidance that we have there. Regarding the specific guidance for this year, if you look at the revenue guidance change, it is entirely related to the Reinvention action, specifically offering on geo simplification here. If you exclude these, the core business is behaving as we are expecting and as we mentioned it, it is like modest decline even with like flattish situation when you look at certain line of the revenue.

From a profit point of view, operating margin point of view, is simply the timing of the action. I can give you an example. When you do a geo simplification action here, you have the impact from a revenue immediately, you move from an indirect to a direct model and then comes the action of taking the cost out, out of the cost base in the country that are impacted, but also in our corporate overhead. It's just a timing point. The overall program is executive as what we're expecting and we are sticking to the three-year guidance.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay.

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

A

Hey, Ananda. This is Steve. Just a real quick reminder. One of the things that we talked about is we had to make very large structural changes going back to early 2023. So if you think about what we did with PARC, what we do with XRCC, our FITTLE change, implementing an operating model in the beginning of the year, what we did with production and manufacturing, now what we're doing in geo. It is a basket of activities that drives that end $300 million incremental operating improvement adjusted. And so what I want you to think about is this is not a linear, meaning that not every action drives a quarterly return, but the bucket drives what we want to do. And we've got enough in that bucket that makes us confident that we're going to be able to deliver the end results.

There are things that are out of our control. We talk about geo simplification. What happens with approval in a country? What happens with labor? What happens with the things that you need to do to get regulatory approval for the deal? So these are not straight where you can set-up a plan exactly what's going to happen in the quarter. However, with that bucket, we can feel confident that we're going to deliver over the next three years the exact financial results that we're talking about.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's super helpful. Guys, I'll just leave it there given the time. We can get it on via callback. I appreciate it.

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

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Thank you for taking my question. So if I can start off with following up on the question that Ananda had but partly on sort of timing here. I heard you say that the 2Q revenues were largely in-line, if I heard you correct. So my question is, when we think about this incremental lowered guide for the full year, the 1.5% roughly sort of change, is it primarily in the second half in terms of rebase in the second half, is that impact going to be more in the second half than the first half or rather second half versus 2Q? How should we think about timing?

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

A

So, timing-wise. So just to go back to Q2 and give a little bit more detail on the impact in quarter two here. So if you look at – our total revenue decline was 10%, including all the impacts that we mentioned. Now, to give more clarity on what we have mentioned in our script there is 300 basis point of this impact come from backlog. So if you remember, year-over-year backlog last year was very strong because we were refreshing backlog. If you think about the second-half, we won't have this impact anymore. And this is the reason why we are saying second half will be in a growth mode here.

The second point was relative to 200 basis point. So 300 basis point on backlog, 200 additional basis point related to what we call the end of nonstrategic revenue paper, endpoint devices, and some were related to the forward flow agreement, which is generated less interest income there. And lastly, 150 basis point was related to a geo simplification and offering simplification. So when you take all of these there; so 10% revenue decline at the same time, 650 basis points are rationally explained and driven by this [ph] section here (00:41:14).

When you look into the second-half now, you won't have the backlog flush anymore. We will still apply our decision on nonstrategic revenue, and the geo simplification impact, we still continue. But when you look at this year, and this is the reason why commented there the backlog flush on the ability for us to drive the equipment [indiscernible] (00:41:34) give us the confidence that will drive revenue growth during the second-half of the year.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. Xavier, I guess, I'll just rephrase that in the sense what I'm trying to get to is, did Q2 have an incremental impact in revenues coming in below consensus on account of the changes that you decided to do in between intra-quarter and is that the – and is more of or is more of the impact really more in the second-half from these incremental changes? And secondly, maybe just for my follow-on like...

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

A

Yeah. Go ahead.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

...it seems like you're waiting for the deals to be finalized before you incrementally account for them in the revenue guide, full-year revenue guide. So how do we get confidence that there's no more some of these deals in the pipeline in terms of which geographies you want to exit subsequently in the year? Thank you.

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

A

Yeah. So, I will answer the first question. So on the consensus, I don't think the consensus was taking into account some of the action because as we said it, every time we would have action related to geo offering simplification, [indiscernible] (00:42:38) investor and call them out. This is what we are doing here with [ph] 150 basis point (00:42:43) here.

Now, regarding the second point on the second half there, we are executing as we plan the strategy here. I won't say the vast majority, but with some of the action are already at play, as we describe it here. And if there are additional output, major significant action during the second half, we will inform the investor during our earnings calls.

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

I do think – It's John. I do think it's a fair point. And I think to just kind of add something to that. It is about not only the mix, the mix of the types of geographies that we're looking to exit, the timing and the pacing, the sequencing, but also the mix of the revenue types and the deals that we look at and some of the lower profitable deals and some of the areas of low hardware. We're just being very disciplined with regard to balanced execution across both geographic mix shift and products and offerings. And because we're at the halfway point of the year, it's not as if that there's things in the back end part of the year that we're very concerned about to answer your question directly. It's actually the opposite. It gave us all the information in our learnings through Q1 and Q2, give us a good guide of what's in the pipeline and how we pace and sequence them. So it's definitely is a timing and a mix issue.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Thank you. Thanks for taking my questions.

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

You're welcome.

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

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Hi. This is Maya on for Eric. So I think just to start, if we think about, let's say, roughly a $6 billion revenue base and with services being less than 10% today, that means it's maybe around $500 million to $600 million in annual revenue, roughly. You think about that mix more than double by 2026, but what's your assumption about your total revenue base at that point? Meaning, are you telling us services revenue is going to double in two years or how should we be thinking about that? Any color will help.

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

I think it's a combination of both. So, yes, you do have to think about the broad-based services, big asset services as a growth business for us. We really see an opportunity, a very good one in the middle market across our IT services business because our brand is very well-recognized. Those environments are dealing with lots of issues on technological upgrades. We're in there having conversations with customers and we think that that IP services part of our business has very good growth in the SMB space. We're seeing similar items in digital services, but they're not as mature, and that is absolutely offset by the declines that we've shared with you over the same period of time on print.

So we want to make sure that we get the print mix right, both in production, in the enterprise, and on the low end. So it does – you will see a mix shift within our print portfolio between our low-end A4, our A3 and our production. At the same time, you'll see an increase of our IT services and digital services. And that's the whole point of ensuring that the geographies we position these offers and the offers themselves and how we grow them is how we're getting to this mix shift changes over time and the savings that we're driving through them gives us the ability to invest in them.

So, yes, that's why it's complex by its very nature and it's a multiyear program over a period of time, as both Steve and Xavier pointed out to. But, yes, you are thinking about it correctly with regard to growing the services business, offsetting the declines in print.

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

A

Yeah, I want also just to highlight there. So, when you do the compare, when you look at Q1 or Q2 revenue on the sales guidance is like a double-digit revenue decline. So, is it like or is there a future trend? We should not forget that, last year, we had significant backlog flush there and we know that starting Q3 and Q4, we will be in a more apples-to-apple compare. And that's the reason why we are saying for the second half, our view is that there will be on a growth mode on both this adjusted revenue taking into account, all the different strategic actions that we're doing. But also if you look at the different line of revenue that we're driving here, the outcome will be positive. So, we should not forget, last year, the backlog had an impact in the first half.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful to remember. And so, I guess, when we talk about kind of this business being a significant growth business, the digital and IT services, are you looking at breaking services out? When should we kind of expect that to become a part of your regular disclosures?

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

A

Yeah. So, this is a good question on the – this is one of the most demanded question we have from investor here. So, our plan, so far, is that beginning of next year, we would like to present the company result in two segments. So, we are working on this one currently, two businesses. One will be in print or core print and the other one will be IT and digital services. I'm not committing to this area, because it's worthwhile for us to work on the reporting, so we can be compliant with the reporting requirement. But we understand that this is clearly a requirement. So, you have a much better understanding of the hydraulics between these two businesses.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Thank you. And then, I just have one last question. We've heard in a few different tracks about some potential product or supply shortages potentially being caused by the Reinvention and actions you're taking internally. Do you think this could have an impact on customer spending or purchase intentions or even channel partner behavior?

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

A

We don't...

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

No.

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

A

We've got no issues with supply internal shortages. So I don't know where that's coming from.

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

Yeah.

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

A

We're fine with inventory and we're fine with supplies.

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

Not an issue.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you so much.

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

A

You're welcome.

Operator: Thank you. And our next question comes from the line of Asiya Merchant from Citigroup. Your question, please.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Q

Great. Thank you for the opportunity. Good morning. Just at a high level, I guess, I wanted to dig into the revenues that you guys are thinking about over this next three-year period. How you guys are thinking about the operational improvement that you've already discussed, but what's kind of the revenue trajectory post 2024? And to what extent is that baking, whether it's print market decline, your own market share position within that?

And if I can double click on the digital and IT services areas which are – which you present are growth opportunities, where are you seeing success in those? If you could double click on those in terms of drivers of growth there, whether it's geographical, vertical. I know you talked about the mid-market. So, if you could just double click a little bit on that, that would be great.

And lastly, the operational investments that you need to do in order to drive growth there, if you could double click on that as well, that would be great. Thank you.

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

A

Yeah. Great question. Let me start with the strategy as we've been talking about, as part of the whole Reinvention. First of all, we believe that the existing TAM inside of existing clients and accounts is a great opportunity for us, very specifically in mid-market and helping a lot of our mid-market clients being able to absorb new technology, whether it's AI, RPA, intelligent document flow, looking at IT services and how do they embed it. So, we are perfectly positioned as a trusted partner in that ecosystem to be able to bring products and services and we're seeing that across our offerings.

In addition to that, if you think about what's happening today in the world of AI and the world of intelligent documents, you take a look at RPA, we are greatly positioned because we are already behind our clients' firewall. What does that mean? That means we're embedded in their security. We're embedded in their business processes. And therefore, we can create capabilities and solutions that brings client success and client value.

We talked about changing and really focusing on client outcomes, about a year and a half ago, and that really means how do we bring more value to our clients through our technology and not just bring solutions from a product standpoint. So, that's where we get services and that's where you saw some of the things that we highlighted in the opening comments around the things that we're doing for our clients.

John, you want to go through some specifics?

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.

A

Yeah, for sure, Steve. So, I'd like you to think about digital services in two ways. For large enterprise clients, they look at work streams like invoice processing, invoice accuracy, the types of things that are both ingested via scanning and things that are printed, PDFs and their formats, the from, the two and all the handling of all of that, robotic process automation and all the types of advancements in that space is just helping clients be much more efficient. And that's kind of more of a larger play in that space.

You're seeing in the graphic communications and in the marketing space, Chief Marketing Officers are trying to understand the efficacy of both print and digital ads. That's why you see barcodes embedded on so many index cards around various different offerings and physical items are watermarked or they're trying to understand what the effectiveness is on a printed page, on a digital page, on programs overall and make better decisions in that space. These types of things are the types of current today's issues.

The advancements in AI and some of the areas that both Steve talked to and Xavier talked to earlier, in GenAI depending upon good data and good data from documents. The repositories that these documents have to be scanned, have to be indexed, have to be redacted. You need to understand chain of custody across these items. So the whole digitization of a document, the origination of the document, the ability to redact, the ability to secure are these types of digital services. And they are combined. It is very much a kind of a multi-prong approach because there is no one particular area. That's why people say omni-commerce, omni-channel, that's what they mean. It's coming both physical, both digital, but the processes are the same.

So we're seeing both these types of things emerge in digital services. And the IT services around it is managed cloud, just like our managed print, manage IT security and those things. And we believe that that's an SMB opportunity for us more than the large market because that's where we see the market need. That's where it's very highly fragmented. It's very geographically put in place, really like NFL cities, if you will, in the US. And we have an opportunity to do some consolidation in that area and extend our services through our brand and through our distribution easily without having to invest a lot more in that space. And so that's how we're balancing those issues.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.
Q

Okay. And to what extent – what about this the broader print market? I mean, to what extent is your operational income improvement speaking in just secular challenges in the overall print market?

John G. Bruno
Chief Operating Officer, President & Director, Xerox Holdings Corp.
A

Yeah. So in the overall print market, it's pretty simple. If you look at our positions across the three main categories, more broadly, it is a gain share program in a secular challenged markets, right? So that means refactoring our offers in each of those three pillars. So it's a grow our market share position in the low end in the A4 in our offerings and expanding in that space and creating more opportunities mostly through our indirect channels. As we look at this mix shift and you look at our geo strategies, these are tied together. We want to build more channel-ready products, higher velocity and capabilities across our A4 portfolio, and that's a gain share program.

We are the leader in A3. That's a hold share and continue to differentiate. That's why you hear all the issues. We're talking about AI and enhancements and we focus on that. That's the reshaping and we continue to be competitive in the leader in that space because we are the leader. This is why we want to make sure that the places in which we're direct. We're surrounding that A3 market of more value-added services to continue to enhance and protect print.

And then on the production side, those are areas if you break the production market down, there's parts that are growing in that space. You see cut sheet inkjet, we see specialty labels and really all the productivity that surrounds the presses, all the pre-press, post-press items and making the presses run more efficiently because runtime and optimization for our large production clients is critically important. Down machines aren't making money for them. These are complex ecosystems. So you're seeing advancements on our side. We want to gain share in the software and services. That's why it's services-led, software-enabled program there. We have to bring more capabilities to our print clients to help them as the digital divide there, which is very much a laggard. A lot of that stuff are still analog processes. We want to make sure that we're bringing productivity tools and we're making these print shops or these embedded print customers inside the large enterprises more practical.

So it's different for each of the main three categories. It's gain in the low end; it's hold and surround and strengthen in the mid; and it's entering new segments by repositioning our production portfolio to where the markets moving versus where it has been and where we've been in previously.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Q

Okay. Thank you.

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

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

Recapping today's call. Structural changes implemented in Q1 resulted in a short period of disruption, but are driving notable improvements in operating efficiencies and sales effectiveness. The sequential improvement in financial results observed in Q2 and improvements in underlying processes designed to enable future cost reductions, gives us confidence the Reinvention strategy is working and will deliver the targeted $300 million of improvement in adjusted operating income by the end of 2026. I thank you for joining the Q2 earnings call and I wish everybody a great day.

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