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Xerox Holdings Corp. (XRX)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation First Quarter 2023 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions]

At this time, I would like to turn the meeting 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 First Quarter 2023 Earnings Release Conference call hosted by Steve Bandrowczak, Chief Executive Officer. He is joined by Xavier Heiss, Executive Vice President and Chief Financial Officer.

At the request of Xerox Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the expressed permission of Xerox. During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor and 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'd 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 Q1 2023 earnings call.

I would like to start by complimenting the Xerox team in its execution of another solid quarter. We delivered another quarter of revenue and profitability growth in what continues to be a dynamic and challenging operating environment. Some of the challenges we faced in prior quarters such as supply constraints and elevated logistics cost, have receded but new challenges have emerged as central banking policies remain restrictive to global economic growth. Against this backdrop, we, at Xerox, remain focused on the execution of our 2023 priorities and the goal of delivering client success through products and services that address the productivity challenges of today's hybrid workplace. In other words, we are focused on making work work for our clients.

Summarizing results for the quarter. Revenue of \$1.72 billion grew 5.5% in constant currency and 2.8% in actual currency. Adjusted EPS was \$0.49, \$0.61 higher year-over-year. Free cash flow was \$70 million compared to \$50 million in the prior-year quarter. And adjusted operating margin of 6.9% was higher year-over-year by 710 basis points.

Demand for our print equipment and related services remains resilient, as evidenced by another quarter of constant currency growth in both equipment and post-sale revenue. This quarter, we also observed a pickup in office-related print activity. As a result, we continue to expect a stable revenue and demand outlook for the year. Consistent with recent quarters, we are seeing isolated pockets of softer installation activity, often the result of delays in project deployments rather than order reduction.

This softness, however, is being offset by continued strength in our office print business, particularly for state and local government, education and mid-market accounts, as well as strength in our print and digital service offerings. We believe current secular and macro business challenges such as hybridization of the workplace, higher inflation, labor shortages and liquidity constraints play to our service offerings strength, particularly those that utilize AI, machine learning, augmented reality, and other leading technologies to help optimize our client workflows and improve workplace productivity.

Xavier will cover results for the quarter and guidance in more detail. I'd like to focus my comments on our strategic priorities. Our team continues to work diligently on the development of a long-term plan for generating sustainable growth in profits. For this year, we remain focused on executing against our three strategic priorities: client success, profitability, and shareholder returns. I am pleased to say we are making progress on each measure.

Starting with client success, it is clear from our market research and client conversations that the success of any strategy we deploy will be measured against our ability to enable positive business outcomes for our clients. Critical to enabling these outcomes is the delivery of products and solutions that solve our client's most challenging hybrid and workplace productivity needs before they need them.

One such solution is the recently launched CareAR Instruct app, which leverages CareAR's augmented reality technology and allows users of our entry printers to self-troubleshoot machine disruptions wherever they happen to be working. Much like CareAR's field service solutions, the app uses augmented reality to provide an immersive self-support experience, complete with step-by-step guidance, instructional content and interactive 3D visualization to help users solve common issues quickly.

When combined with another recently launched service, the Easy Assist app, Xerox users can walk through a machine setup, perform routine maintenance tasks, and order supplies on their own through the convenience of their mobile devices. CareAR Instruct is also available to support our existing and future client field service management requirements.

Another example is the expansion of our digital services offerings to the mid-market, bolstering our TAM opportunity in the largest print marketplace we currently serve. We now provide clients in this market the same types of accounts payable, digital mail and intelligent document processing capabilities we provide to our largest enterprise and government clients. We see particularly high levels of demand for these services among our mid-market clients in the public sector, healthcare, education and financial services industries.

Our digital services, security and productivity solutions provide us with a true competitive advantage in an industry most think of as being mature. In recognition of these advantages, Keypoint Intelligence awarded Xerox the BLI 2023 Smart Workplace Software Line of the Year for the fifth consecutive year, acknowledging our diverse portfolio of applications, software and services that help solve that helps solve modern workplace challenges. This technology advantage is driving an expansion of wallet share with existing clients.

For example, this quarter, we sold an expansion of services to a large British telecom client. The initial mandate involved helping this client optimize their print needs for direct marketing campaigns. Under the new agreement, we are moving up the value chain to provide services such as customer acquisition database hosting, data analysis and marketing consultation services. In total, the addition of these services drove total contract value higher by 20% and further solidifies an already strong business relationship.

Moving forward, we see an opportunity to standardize these successful business outcomes by verticalizing workplace productivity solutions across industries. One such example is the health care industry, where our motto is patients, not paperwork. Three years of intense collaboration with health care providers, we have developed a suite of digital solutions that drive synchronicity between inbound and outbound communications. More specifically, we have helped clients in the health care services industry transition patient records from paper to digital systems, added intelligence to paper and digital inbound communications, and helped automate certain types of outbound communications like clinical outcomes and guidance.

Additional industries with identified verticalization potential include consumer goods, banking and insurance to name a few.

Our second strategic priority is profitability. In the first quarter, we delivered the second consecutive quarter of growth in operating profitability. Lower transportation and logistics costs, and lower bad debt expense contributed to the year-over-year improvement in profitability. But the bulk came from operating efficiencies driven by the management system put in place under Project Own It, including the implementation of new technologies to simplify and streamline operations, as well as specific actions taken to implement a more flexible cost base.

One such action that will drive profit improvement in the remainder of the year is the donation of PARC to SRI International, which, like PARC, is one of the world's leading research institutions. The donation and resulting research partnership provide Xerox greater capacity to focus on our innovation efforts on projects in print, IT and digital services. It also supports a more flexible and focused approach to R&D spend by lowering our run rate R&D costs and preserving access to SRI and PARC's leading research capabilities.

Innovation is in Xerox's DNA and will continue to be a priority for the company going forward. Importantly, our relationship with PARC is not ending; rather it is being extended through a new technology exploration and innovation program with SRI and PARC. Through this program, SRI and PARC scientists, engineers and researchers will work with us and our clients to pioneer new technologies that are closely aligned with our print, digital and IT services focus.

Finally, shareholder returns. Our capital return policy is designed to provide shareholders a means of participating in our success through the distribution of at least 50% of our free cash flow. We will update investors on specific plans for distributing free cash flow and excess cash as it builds throughout the year. In Q1, we decided the most responsible use of cash was the pay down of \$450 million of debt.

To recap, we got off to a strong start for the year. The operational discipline instilled in our organization by Project Own It and other specific actions recently taken are driving more margin improvement than expected. As a result, we increased our profitability outlook for the year. Despite a challenging and fluid business environment, the resiliency of demand for our products and a demonstrated ability to control costs leave us confident in our ability to achieve updated guidance.

I will now hand it over to Xavier.

Xavier Heiss

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

Thank you, Steve, and good morning, everyone. As Steve mentioned, we delivered another strong quarter of growth across all key metrics due to a stable demand environment for our equipment and services, improvement in product supply and supply chain-related costs and benefit of price and cost actions taken last year.

Starting with revenue, the momentum in sales growth we experienced in the second half of last year carried over to start this year. In Q1, we posted the fourth consecutive quarter of constant currency growth in total revenue and the third consecutive quarter of constant currency growth in both equipment and post sales revenue. Revenue growth this quarter of 2.8% at actual currency was negatively impacted by 270 basis point of currency headwinds and reflected improved product supplies, healthy equipment order flows and growth in contractual print and digital services.

Turning to profitability, we delivered a second consecutive quarter of year-over-year improvement in gross and operating profit margins driven by higher equipment sales and favorable mix, price increases, lower logistics costs and a reduction in operating expense, including a \$23 million reduction in bad debt expense.

Gross margin improved 250 basis point over the prior-year quarter, mainly driven by lower supply chain related costs, benefits associated with price and cost action taken in 2022, currency and improved product mix. These benefits were partially offset by ongoing product cost increases. Adjusted operating margin of 6.9% increased 710 basis points year-over-year, driven by 380 basis point from cost reduction actions, 250 basis point of supply chain related cost improvement, 130 basis points from lower bad debt expense, and 90 basis points from price increases. Partially offsetting this benefit were effect from currency.

Adjusted other expenses net were \$10 million lower year-over-year due to lower net interest expenses associated with lower core debt, partially offset by \$11 million of currency losses in the current quarter. Adjusted tax rate was 15.5% compared to 52.9% in the same quarter last year. The decrease in tax rate reflects benefit in the current quarter from the redetermination of certain unrecognized tax positions and nonrecurring benefit in the prior-year quarter.

Adjusted EPS of \$0.49 in the first quarter was \$0.61 higher than the prior year, driven by higher adjusted operating income, lower net interest expense and a lower tax rate, partially offset by currency. GAAP earnings per share of \$0.43, was \$0.81 higher due to the same factors, as well as a contract termination expense in the prior-year quarter.

Let me now review revenue, cash flow and profitability in more detail. Turning to revenue, equipment sales of \$391 million in Q1 grew 27% year-over-year in constant currency or roughly 25% in actual currency. Growth was driven by better availability of products in both the Americas and EMEA, particularly for our higher margin A3 device and color production equipment.

Backlog declined for the third consecutive quarter as supply chain conditions further normalized. We expect our backlog to return to typical levels, which range from \$100 million to \$125 million by the end of Q2. Equipment revenue outpaced installation this quarter due to a greater mix of office A3 and production equipment, as well as the continued benefit of price increases.

Installation growth was strongest for our high-margin, mid-range product and color production equipment. Entry for A4 installations were done slightly year-over-year due to the stoppage of shipment to Russia and the ongoing normalization of work from home trends.

Post-sales revenue of \$1.32 billion grew 0.5% in constant currency year-over-year and declined 2.2% in actual currency. Post-sales growth in constant currency was driven by growth in consumables and contractual print and digital services, including the acquisition of Go Inspire, partially offset by lower sales of IT hardware.

Contractual print and digital services, our largest and most stable source of revenue, has grown at a consistent pace at constant currency for more than a year despite only a modest return of worker to the office and macro uncertainty, due in large part to the expansion of our digital services offerings and price increases. Growth this quarter was further aided by an improvement in office related print activity. Geographically, both regions grew mid-single digit in constant currency. EMEA grew slightly faster than the Americas due to stronger per sales growth, including the prior year acquisition of Go Inspire.

Let's now review cash flow. Free cash flow was \$70 million in Q1, higher by \$20 million year-over-year. Operating cash flow was \$78 million in Q1 compared to \$66 million in the prior year. Working capital was a use of cash of \$66 million, resulting in \$159 million year-over-year decrease in cash flow, driven by a reduction in accounts payable and a larger use of cash for inventory, reflecting greater product availability, strategic buying actions and positioning ahead of Q2.

The unfavorable timing of other liability payments also resulted in a greater use of operating cash this quarter. Positively offsetting this effect were higher operating income and the net source of cash from finance receivables. Finance asset activity was a source of cash this quarter of \$120 million compared to a source of cash of \$5 million in the prior year, reflecting the benefit of our recently signed receivable funding program with HPS, partially offset by higher operating lease placement.

Investing activity were a use of cash of \$17 million compared to a use of cash of \$75 million in the prior year due to lower M&A activity and lower CapEx. Financing activity consumed \$505 million of cash this quarter, which includes the payment of the remaining \$300 million of 2023 notes and approximately \$150 million of secured debt. During the quarter, we paid dividends totaling \$45 million and did not repurchase any share.

Turning to profitability. Q1 adjusted operating profit margin expanded 710 basis points year-over-year for reasons previously discussed. We are carefully monitoring our cost base in the context of macro uncertainty. As Steve mentioned, profitability improvement this quarter reflects the ongoing benefit associated with operating discipline instilled by Project Own It in prior years. We also benefited from strategic actions taken in 2022 to make our cost base more flexible.

While we are not providing an official cost savings target for 2023, we do expect to deliver a low- to mid-single digit of gross operating cost efficiency for the year, driven by our culture of continuous improvements and specific cost reductions. These efficiencies are expected to support margin growth in 2023, despite an expected increase in product costs. We are confident in our ability to more than offset future product cost increases through ongoing contractual price increases, a more flexible cost structure, future business simplification effort, and greater diversification of product sourcing.

Turning to segments. FITTLE origination volume grew 57% year-over-year. Captive product originations were up 59% on higher Xerox equipment revenue, particularly in the mid-market. Non-captive channel origination, which includes third-party dealers and non-Xerox vendors, grew 55%, a function of growth in new dealer relationships and third-party equipment originations. Despite the continued growth in origination activity, FITTLE finance asset were down 3% sequentially in actual currency due to the run-off of existing finance receivables and HPS's funding of close to 50% of FITTLE Q1 origination.

FITTLE revenue declined 3% in Q1, mainly due to a reduction in operating lease revenue, which reflect lower Xerox equipment installs in prior-year period. The decline was partially offset by higher fees, including those associated with the new receivable funding agreement. Segment profit was \$12 million, down \$5 million year-over-year due to a decline in revenue, higher inter-segment commission and higher borrowing cost, partially offset by lower bad debt expense. Segment margin was 7.9%, down 310 basis point year-over-year.

Print and Other revenue grew 4.1% in Q1. Print and Other segment profit improved \$126 million versus the prior-year quarter, resulting in a 810 basis point expansion in segment profit margin year-over-year, driven by improved product supplies, lower logistic costs, mix and the benefit of price and cost action taken last year.

Turning to capital structure, net core cash of around \$200 million was down from the prior quarter. We ended Q1 with around \$700 million of cash, cash equivalent, and restricted cash, a reduction from Q4 level, mainly due to the \$300 million repayment of our 2023 notes and roughly \$150 million of secured debt. \$2.8 billion of the remaining \$3.3 billion of our outstanding debt is allocated to and support FITTLE lease portfolio, with the remaining debt of around \$500 million attributable to the core business. Total debt consists of senior unsecured bonds and finance asset securitization. We have a balanced bond maturity ladder over the next few years with no debt coming due over the next 12 months.

Finally, I will address guidance. Our outlook for revenue remains unchanged at flat to down low-single-digit and continue to reflect a stable demand environment with some contingency for potential macroeconomic weakness. Regarding operating margin, Q1 operating profit margin benefited from a favorable equipment revenue mix, which is expected to normalize across Q2 and future quarter. Q1 profit margin also benefited from a credit to bad debt and lower labor cost associated with a higher than expected number of open positions. This benefit may not repeat in future quarter.

That said, we are increasing, adjusting operating income margin guidance from at least 4.7% to a range of 5% to 5.5%. The increase in margin guidance reflects better than expected Q1 profitability, even after excluding the previously mentioned item, as well as the success of ongoing efficiency programs, partially offset by greater than expected unfavorable currency, which mainly affect profit in Q2. The indicated range of profit margin outcomes largely reflect the degree to which macroeconomic uncertainty could affect our operating profit for the year.

We did not change free cash flow guidance, but no changes were made to our assumption of free cash flow conversion, which is still expected to be 90% to 100% of adjusted operating income, excluding finance receivable activity.

We'll now open the line for Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] One moment for our first question. And our first question comes from the line of Ananda Baruah from Loop Capital. Your question please.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Hey. Thanks for taking the question and good morning. And, yeah, just congrats on a solid execution and the solid results. A couple, if I could. First one is could you sort of highlight for us like any of the remaining sort of expansion of services that you guys are continuing to provide to customers. And just any distinction between enterprise customers [indiscernible] (00:26:57) customers, that would be helpful as well.

But any – you spoke some, at least some on the call about 3D expanded services offerings. But if there's any that you haven't spoken to, could you give us some sense of what those are and what your philosophy is around the services expansion and how those are resonating. That would be super helpful, and then I have a follow-up. Thanks.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah. Ananda, good morning. Steve. A couple of things on the services. So, as we've been talking about for a while now, we're trying to help and focus on client success, really looking at the headwinds that our clients are dealing with in terms of inflationary headwinds, labor, et cetera; and the hybrid workforce, right, really trying to help them with productivity. So with that said, we're taking things that we've already implemented internally to help ourselves, like Robotics-as-a-Service, artificial intelligence in and around document, document flow and taking those and bringing them both to the enterprise customers, which we've been doing with things like digital mail, helping with things like accounts payables and workflow, now bringing it to our mid-market customers.

So taking a lot of the things that we've been doing internally and now turning them externally and helping out both our enterprise customers and more importantly, where we have mid-sized customers that have enterprise needs but don't have enterprise solutions. We are bringing those to our customers.

So a couple of examples, Robotics-as-a-Service in law firms, really helping law firms with clerical and with things around paper and workflow and document flow; helping in hospitals and in schools and universities around administrative tasks, around digital services, and very specifically, helping them with document flow, helping them with driving more productivity.

So we're seeing more of that. And especially as we see the macro trends, more and more of our clients are asking us to help them to offset the macro trends and the headwinds they're seeing in the industry with our technology and services.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Yeah. That's helpful, Steve. And are you – how would you sort of describe the manifestation [indiscernible] (00:29:15) relative to your initial expectations? Is it as planned? Is it a little bit stronger? Given what's going on with macro, any color there would be helpful just to get the sense of resonation.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

A

I would say a little mixed, right, where – we talked about the enterprise customers just slowing down a little bit and installs but not backing off. And then we're seeing acceleration in other areas where customers are asking us to accelerate so that we can drive their cash flow and drive their productivity. So, it's a little bit of mix.

I think in state, local government, in mid-sized customers, we're seeing opportunities to grow the TAM in existing accounts that we're in. I've talked about this before, how do we take our current products and services and really expand it inside of existing customer base and really focusing on this client success. That's a big shift for us and really focusing on how do we help clients succeed in the macro environment and the challenges that they're seeing; and we're seeing some success in those areas.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Cool. Cool. And then the follow-up is can you sort of just update us on how you view – how incremental you guys view the potential for the small and medium business hardware opportunity? It's been a meaningful part of the company's narrative over the last few years. But would love to get – now that you've been in the seat for a few quarters, love to get your sense of how material you think hardware – and then the broader services portfolio to follow from that can incrementally be to the company? Thanks.

Xavier Heiss

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

A

Yeah. Good morning, Ananda. I will take these questions there. So, regarding SMB hardware, so the interesting part of, as you know, it's, we attract higher margin on this type of sales, specifically on the A3 devices and [indiscernible] (00:31:14).

But we have seen and we are still seeing quite a resilient demand of this type of hardware. We also position pricing and price increases in the past to offset some of the cost increases that we were facing. So currently, this is one of the strong driver of the profitability improvement. And we're quite positive around the rest of the year with product availability normalizing and the ability to keep the margin at the expected level of margin that we have in our assumptions.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

And, Steve, Xavier, do you – like structurally speaking, in coming years, do you believe there's a meaningful share gain opportunity? It's really share participation opportunity for the company in small and medium business hardware.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah. I think, Ananda, it's not just the hardware. It's going to be the solutions and services we provide around that hardware. You think about our A3 devices, think about it as a engine that we can bring products and services in and around, so things like language translation, things like being able to help universities and help hospitals in

administrative tasks, not just around the hardware but around the software that we can provide around things like ConnectKey, things like print in the cloud and then adding AI to it.

So, it's really how do we advance those other digital services in and around our hardware that I think is going to be the differentiation. And the more we focus on client success, meaning the more we drive customer outcomes help them with their P&L, the more successful we're going to be. And do I see that as an opportunity for growth, absolutely.

Ananda Baruah

Analyst, Loop Capital Markets LLC



Appreciate it, guys. Thanks so much.

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

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC



Hey, guys. Good morning. Thank you for taking my questions. I have a few as well. And then really nice operating margin expansion, so congrats on that. I just want to kind of double click on some of your [ph] guides as (00:33:29) macro comments or spending comments. Obviously, last week, there were some, let's call it, [indiscernible] (00:33:36) from some hardware companies that seemed to expose some potential deterioration in enterprise spending patterns, perhaps mid-March and beyond and maybe even to April. Can you maybe just address kind of linearity in the quarter for you, guys, how your client conversations are trending, how that's trended into April? Just to give us a little more comfort around of maybe what you're seeing compared to maybe what perhaps others outside of the print world but still exposed to enterprise are seeing. And then, I have a follow-up. Thanks.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.



Yeah. Let me start, Erik, and I'll turn it over to Xavier. So I think, if you look at the macro trends over the last 24 months in the hybrid workforce, we saw a lot of placement of end devices in the homes, whether it's laptops or whether it's printers. And that cycle, as we all know, is very cyclical. And so, I think, what we're seeing in the hardware space, certainly on endpoints, is we're now seeing that refresh cycle has ended and now, you'll see the low like we normally see in most laptops and most of those technology life cycles.

What we have seen, though, is we hadn't seen that big up in COVID. And so now, what we're seeing is an opportunity to expand on the base that we have with products and services in and around how do we help client's success and productivity in and around things like digital services, software. And so, for us, it's an expansion on the base that we have and we have an opportunity to bring new products and services into existing client base.

Xavier?

Xavier Heiss

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



Yeah. Erik, I would add as well that, as you know, we have quite a resilient business model. The resilient business model is based on, I would say, some simple pillars. The number one is our contractual revenue base, what is contracted for four or five years, even more in some cases there, represent two-third of our revenue. So

we are less subject to the bumps and the highs and lows that some of our traditional hardware competitor are facing. So, the second point is we still see a strong demand, the demand for equipment, the demand for service. You have noticed we have reduced our backlog, but we still have some backlog to clean during quarter two here with a good mix.

The third item and to close on this one, price increases. We have been able to enact during the prior year, at difficult time, price increases. And the price increases that we apply not only on the equipment revenue and the hardware, but also on the contracted revenue will be now with us for three, four, five years, depending on the customer contract.

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's super helpful. Thank you, guys. Thanks for all of the color. And then maybe, Xavier, just to touch on a point you just made. You were obviously – or maybe over the last two quarters, you've been able to work down backlog. It looks like you ended at \$180 million versus \$435 million a year ago.

So, I know you made the comment about backlog being normalized. I think you said around \$225 million. But shouldn't we interpret this as backlog being below normalized or maybe just help me square that and then help me understand kind of as a result of that point, if we should still think about a stronger first half of equipment sales relative to maybe a weaker second half just as a result of working down that backlog, if that's still the same view you take today.

Xavier Heiss

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

A

Yes. So, it's quite simple. Backlog normalized value is around \$100 million to \$125 million. So, I would simplify it by saying around one month to one month and a half of equipment revenue. So, currently, we are running above. I believe and this is our assumption that in quarter two, we will clear the backlog.

The backlog is solid. That's another point I want to share here. We are not seeing backlog cancellations. And the second point, the aging of the backlog; more than 50% of the backlog is less than 90 days hold which means that during quarter two, these backlogs should reduce and will be at a normalized level here.

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Q

And then, maybe just the last part in terms of does that – should that still imply a weaker second half of equipment sales relative to the first half? I think that's what you guys said 90 days ago. I just want to see if that's still how you're thinking about the world today?

Xavier Heiss

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

A

No. The way we see it – because this backlog is refilled every quarter and it's refreshed. The way we would see it is on – back to the prior comment. We still see a strong demand of our equipment. We have orders from customer not only for next quarter but also that will be deployed during the rest of the year. So, I'm not looking at the backlog being like a way to hide a slower demand or more of a recession. I mean you know our total revenue guidance that we published here; we are still sticking with this guidance, which is flat to low mid-single digit decline. We had, obviously, a strong quarter. The compare versus last year is definitely easier but, so far, we are still sticking with the guidance here.

Erik W. Woodring*Analyst, Morgan Stanley & Co. LLC*

Q

Perfect. No. That's very helpful. And then, Steve, maybe last question for you was I think the licensing agreement with the existing Fuji Xerox entity has now expired as of the end of last quarter. How should we think about your opportunity to go after the Asia Pacific market? I know you didn't mention that. Is that a focus? Is that not really a focus? Maybe help us understand, yes or no. And then second to that, why it would or would not be a focus for potential growth going forward. And that's it for me. Thank you so much.

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

A

Yeah. I think it's a couple of things. One, focusing on profitable growth and an expansion in our existing accounts and on our existing regions, we see more than enough opportunity to expand the TAM within IT services, digital services and software and services in and around the products that we already have. If you think about the amount of capital of what it takes to go put in to a new region, building a supply chain, building services, building inventory equipment and that ecosystem, it's a pretty long part in terms of setting that up and the costs associated with that. So, right now, we see the regions that we're in as an opportunity to expand profitable growth and expand inside the existing accounts. So at least short term, we have no desires to go and spend a whole lot of money to start up and spin up in a new region.

Erik W. Woodring*Analyst, Morgan Stanley & Co. LLC*

Q

Super. Very helpful. Thank you, guys.

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

Samik Chatterjee*Analyst, JPMorgan Securities LLC*

Q

Yes. Thank you. Thanks for taking my questions. And I have a couple. The first one was really on operating margin guide that you are issuing or raising today and congrats on the strong execution here to set that up. But I'm also trying to think about the reasons that the operating margin has to moderate into the second half, particularly, if you go back and look historically, your first quarter margins are typically the lowest and your OpEx is typically the highest in 1Q. Even if I keep some of the macro headwinds and some of the one-offs you called out like seems like OpEx and there's probably more room on the OpEx to grow in the second half to drive the margins to remain at these levels or even higher.

So, I'm just maybe – maybe more for Xavier, just to sort of outline why should we expect margins to moderate materially in the second half because typically that hasn't happened in the prior years. And I have a follow-up.

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

A

Yeah. Good morning, Samik. Good question. So this is very simple. The margins for quarter one was a strong margin for the reason we explained. It was helped by mix, product mix, a little bit like what we had in Q4 that was more favorable. We expect this mix to normalize. If you look at the chart, the high-end equipment was higher, the A3 equipment was higher, A4 was a little bit lower; so this helped the equipment margin.

The other items is, in Q1, we had some one-off benefit specifically a bad debt benefit here but we are not seeing this as recurring item here. So, when you normalize here, we are in the range for this quarter of something which is around 5.5% here. That's the reason why when we guided for the rest of the year, we are not expecting a deterioration of the margin. If you look at the implied gross margin for the rest of the year, it is around 4.7% to 5.1% or a little bit higher here. So, we are not expecting like a margin deterioration, but we have to take into account some of the items that I mentioned for Q1.

And also, we want to consider potentially what we call macro headwinds. There are some uncertainties around still some cost items and how some normalization of the cost base will happen here.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Thank you. And, Xavier, just to quickly follow up, the \$471 million in OpEx that you have in 1Q, what's the best way to think about the run rate exiting the year, particularly with the PARC benefits coming in as well?

Xavier Heiss

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

A

Yeah. So, on PARC, on that, we – I think we commented that or we put that in the press release there. On PARC, PARC was included in our guidance, so we were working on this transaction, on the one in January, we have given the guidance there. So, the PARC benefit, the flexibilization of the RD&E cost base. By the way, we started this last year, if you remember, with Mojave and also with Novity, when we spun these businesses to be more flexible [ph] on this year (00:43:15). We've got some of this benefit in quarter one. And obviously, in quarter two, quarter three, quarter four, we will have further benefit from PARC, but you should consider this being already included in the guidance there.

From an OpEx point of view, I believe I mentioned that in my script, we're expecting around, overall – it's not only OpEx, but cost base there – around low to mid-single-digit growth cost efficiency which is the Own It engine and the traditional way of looking at how we address the cost base and we make it flexible. I won't regardless, but taking into account potentially some of the macro headwind, that some of the economies are indicating for the back end of the year.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Okay. And last question, if I may, and sorry for the multiple questions here, but just what we've heard from general distributors and VARs, there's a lot more pressure in the financial services, customer verticals since the headwinds on the banking side. Any sort of way to ballpark what your exposure to that customer vertical is? And if there's been a more sort of bucket of softness there since what's happened over the last couple of months. And that's it for me. Thank you.

Xavier Heiss

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

A

Yes. This is a good question. And I will look at it in two ways and FITTLE will be at the core of the answer. The first way is if I look at – what we call a bad debt situation for Xerox, bad debt related to FITTLE here; it's quite steady; it's quite strong. We have not changed any way we do credit or risk weighting for our customer. So, our own performance from a financing point of view with our own customer remain resilient and strong.

The other point and I think you have also this in mind there, is the fact that some of the SMB business and potentially some of these bank difficulties here could drive more business for FITTLE. This is the way we look at it. So there is an opportunity. But I want to be very clear on this one. We won't do that at the detriment of the quality of our leasing portfolio. And the team is very stringent on this.

Samik Chatterjee*Analyst, JPMorgan Securities LLC*

Q

Thank you. Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Shannon Cross from Credit Suisse. Your question, please.

Shannon Cross*Analyst, Credit Suisse Securities Research*

Q

Thank you very much. Steve, can you talk to us a bit about your decision regarding donating PARC? I mean, I've worked with multiple CEOs over the years who all expected to monetize PARC and generally were unsuccessful. So, I'm not sure – I think that's probably the right decision. I'm just curious, as you looked at it, can you maybe talk a bit about why you think that was the case? And then, are there any other benefits? Just I understand on R&D savings, but in terms of tax benefits of that? Maybe, Xavier, you could touch on it? Thanks.

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

A

Let me go back to when I took the CEO role, Shannon, I took very specifically about a shift in two areas. One was a focus on R&D that was a little bit nearer to our revenue horizon and very specifically we took actions around Novity and Mojave, as Xavier talked about a little bit earlier. And that was, we weren't going to continue to use our cash as those particular products and those particular businesses were growing.

And so as we looked at PARC, we saw significant shifts in the industry in terms of valuation of startups and products, etcetera. And we've decided that we were looking at too long a horizon and too big a spend and continue to invest in those things. However, it was very important for us to be able to see insight to that innovation and have the ability to take advantage of that innovation going forward with our overall strategy around R&D.

So, the PARC SRI donation fit perfectly into what we were trying to do, meaning, that we could still have insight to innovation, still have insight to technology, by the way, have the greatest researches in the world focused on some of the toughest world's challenges and very specifically, some of the challenges that we see in cleantech, etcetera, etcetera.

And we have the ability to be able to take our long-range plan, meaning our R&D and our business strategy, work with PARC SRI in the future to help us to develop our strategy and get insights to those technologies. So, I see it as an expansion of our PARC capabilities in terms of seeing insights to technology and getting access to longer term development, while we can focus our capital resources on more near-term revenue. So, that's why we made the decision, Shannon.

Shannon Cross*Analyst, Credit Suisse Securities Research*

Q

Okay. Thank you. And then, I guess, Xavier, anything from a tax credit benefit with charity? I don't know if there's a benefit there down the road.

Xavier Heiss

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

A

Yes. So there is a tax credit. We do not disclose the number precisely there. More to come when the overall credit will be enacted there. We will disclose when the amount will be published there. But, so far, we are not disclosing any specific figure regarding the tax credit.

Shannon Cross

Analyst, Credit Suisse Securities Research

Q

Okay. Thank you. And then my final question is just you made a number of comments about flexible cost structure. I'm wondering how we should think about fixed versus variable. I mean, traditionally, copiers had a pretty high fixed cost structure because you had to go out and maintain them. You had to drop – you can drop ship them; you had to bring them to a loading dock; all of that. So how do you see your cost bases maybe over the next couple of years shifting? What's fixed versus variable now and where do you think you can get to over the next few years? Thank you.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

A

Shannon, let me start and then we'll turn it over to Xavier. So, we've been focusing on driving operational efficiencies and driving sustainable change in terms of a management operating system within the company. And so, that was the foundation of Project Own It. On top of that, it was the constant utilization and embedding technology inside of our overall processes.

So, simple example is what we talked about with CareAR. We now launched products with CareAR automatically as part of when a customer receives a box, they see CareAR in terms of how to unbox and actually install. That CareAR session helps us to reduce service calls. We can do more things remotely.

We talked about artificial intelligence and helping and using artificial intelligence to help our service delivery team and help them resolve problems quicker and in fact, sometimes, not even have to go to a customer's site. So, we have been embedding technology inside of our processes, inside of Xavier's area using technology, artificial intelligence, business intelligence and how we run our management operating system.

So, we have been very systematically over the last couple of years with Project Own It. Now, we're putting management operating system in place, putting discipline in place for our people, but more importantly, using technology that drives sustainable and continuous improvement. And we're on that journey. We'll continue that journey. That's why we lost Project Own It, the name, because it's now embedded in the culture of the company and we'll continue to do that. Xavier?

Xavier Heiss

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

A

Yeah. And, Shannon, just to build from a pure financial [indiscernible] (00:50:52). So, we focused, obviously, on gross margin expansion. Pricing is a driver and we are also, as Steve mentioned, attacking any cost of goods sold opportunities that we have. We have some headwinds with raw material increase and some material increase here. But if you notice it, our gross margin is still expanding and this is not related specifically to one-offs type of item; it is structurally done with what Steve mentioned.

The order ratio that we are monitoring constantly is the ratio of OpEx, so RD&E plus SAG versus total revenue. And if you noticed it, year-over-year, this is a ratio that we are pushing to improve. If you exclude also the benefit

on, in cases impact of bad debt, just looking at selling and G&A plus RD&E, all these metrics, this is a focus of the management team to drive them down and to make the cost base flexible. Thank you. That was very helpful.

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

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

Yeah. Thank you for listening to our earnings conference call this morning. Demand for our products and services remains resilient amid a challenging macroeconomic background and we are making progress in our effort to improve profitability. Our performance is a credit to our hardworking team who've embraced our strategy, strategic priorities by developing customer success while focusing on profitability. I thank you for attending today's call.

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

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