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XRX - Q2 2017 Xerox Corp Earnings Call

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OVERVIEW:

Co. reported 2Q17 revenues of $2.57b and adjusted EPS of $0.87. Expects full-year 2017 adjusted EPS to be $3.20-3.44.

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PRESENTATION

Operator

Good morning, and welcome to the Xerox Corporation Second Quarter 2017 Earnings Release Conference Call hosted by Jeff Jacobson, Chief Executive Officer. He's joined by Bill Osbourn, Chief Financial Officer.

During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor. At the request of Xerox Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox. After the presentation, there will be a question-and-answer session. (Operator Instructions)

During this conference call, Xerox executives will make comments that contain forward-looking statements, which, by their nature, address matters that are in the future and are uncertain. Actual future financial results may be materially different than those expressed herein.

At this time, I would like to turn the meeting over to Mr. Jacobson. Mr. Jacobson, you may begin.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Good morning, and welcome to Xerox's Second Quarter 2017 Earnings Conference Call. During today's call, we will provide an update on the quarter as well as our expectations for full year 2017.

In the second quarter, we delivered earnings, operating margin and cash flow that were all in line with our expectations. Additionally, with the progress we are making on the rollout of our ConnectKey products, we are better positioned to capitalize on the strategic growth areas in the market. With 2 quarters behind us, we continue to be on track to deliver on our full year commitments.

Let me walk you through an overview of our second quarter financial results. Second quarter GAAP EPS was $0.63 and adjusted EPS was $0.87, which reflect our 1-for-4 reverse stock split effective June 14, 2017. Revenue of $2.57 billion was down 8.1% year-over-year or 6.4% on a constant currency basis, driven by equipment revenue. We had anticipated lighter second quarter equipment revenue given the timing of the new product launch, but it was softer than expected as we saw some delays transitioning to the new products. This also affected our Managed Document Services business, where sales cycles are longer and all the Q2 declines were driven by the equipment shortfall. The transition to the new products impacted our overall revenue by about 1 point. We expect to see new equipment flowing through as we move through Quarter 3 and building more strongly in the fourth quarter and into 2018.

Post sale revenue was 79% of total revenue and declined 5.7% or 3.9% at constant currency, consistent with the first quarter and in line with our expectations. We expect continued stable post sale revenue, with improvements coming over time as equipment revenue improves and placements grow.

Adjusted operating margin was 13.3%, an improvement of 40 basis points year-over-year. We continue to realize productivity benefits from our strategic transformation initiatives, which are helping maintain our strong margins while offsetting 100 basis points of currency as well as our revenue decline.

Operating cash flow remains strong and was a solid $343 million in the quarter, driven by working capital initiatives as well as the fact that pension contributions are expected to be heaviest in the latter half of the year. We ended the quarter with a healthy cash balance of $1.25 billion.

The second quarter was highlighted by the introduction of our new ConnectKey-enabled portfolio, 29 AltaLink and VersaLink printers and multifunction devices. The launch of the new products has been a huge effort that has spanned the entire Xerox team, and I am extremely proud of what has been accomplished and what is yet to come. Most of these products are available now, and the balance will be available in the third quarter.

On March 29, we kicked off a series of 16 launch events, from New York City to London, Toronto to Milan. We were pleased to host over 100 prospective channel partners, along with 1,500 customers and prospects. We also used these events as an opportunity to demonstrate the extensive capabilities of the new portfolio to our direct and indirect sales resources and educate them on the new offerings. Customer and partner feedback has been overwhelmingly positive. The capabilities of our new smart workplace assistants resonates, addressing the need for security, reliability, solutions, mobility and a simple user experience.

The ability to use apps to simplify common processes and even build unique apps tailored to an individual customer's needs has extended the role of our technology in the workplace. The positive feedback is starting to translate into orders, from single devices going into an SMB to large contracts with enterprise customers.

Here are a few examples. A large U.S. energy company ordered more than 150 ConnectKey devices. A channel partner in Turkey signed a deal with a retail chain for 160 ConnectKey devices. A partner in the U.S. was selected to provide managed print services to a school district with more than 1,800 devices, including 330 ConnectKey MFPs. And the last example, a government ministry department signed a 3-year contract renewal and expansion worth over $15 million for managed print service for over 9,000 devices, the majority of which are the recently launched ConnectKey devices.

The increased functionality, the apps and the competitive cost has opened up new opportunities for us. We are capitalizing on the ConnectKey launch to amplify our channel expansion efforts. In the second quarter, we increased our distribution capacity through acquisitions and channel partner signings. In May, Global Imaging acquired multi-brand office equipment dealer, MT Business Technologies of Ohio. MT was the largest independent reseller of Ricoh products as well as a partner of HP. And as I mentioned, we hosted over 100 channel partner prospects at our launch events. We're over halfway to our full year goal and have added over 30 independent multi-brand office equipment dealers on a global basis.

We are equipping our channel partners with tools and training they need to create new and accelerated revenue streams and closer, more lasting relationships with their customers. For example, we introduced 2 new marketing kits to help our partners generate awareness in local markets and drive demand for Xerox's broad technology portfolio as well as their own complementary services, custom apps and deep expertise.

Another way we are positioning partners for success is with the introduction of Productivity Packs for our ConnectKey multifunction printers. The Productivity Packs are prepackaged, high-value turnkey apps designed to help channel partners capture revenue beyond hardware and supplies. Targeted at industries such as education, health care and finance, the apps eliminate manual, time-consuming and error-prone tasks by converting paper-based processes into automated digital workflows.

In addition, we have just announced the Xerox MPS Accreditation Program in the U.S. This is a recognition program for a select group of our most strategic Xerox channel partners, who have demonstrated the desire and capacity to substantially grow their MPS business. The program represents a significant investment by Xerox in the tools and training to help these high-profile partners find new revenue streams, which is core to our SMB market strategy. The press and industry analysts have taken notice, and their feedback has been very positive. 400 articles have been written about the launch. There have been 20-plus product reviews, most focused on our entry-level A4 products. The reviews, including PC Magazine, ChannelProNetwork, Buyers Lab and Better Buys have been overwhelmingly positive and will help drive awareness of our entry-level products.

We have also collected a series of industry awards for our new products. Our VersaLink B7000 series and AltaLink C8000 series were named by Better Buys as its Editor's Choice Award in the A3 black-and-white MFP and high-volume machines categories, respectively. In its annual Summer Pick Awards, Keypoint Intelligence - Buyers Lab recognized 4 Xerox printer and multifunction printer lines, including 3 from the ConnectKey portfolio, based on the productivity-boosting capabilities. We followed that up by winning the Buyers Lab Pacesetter award in all 3 categories: MFP platform and apps ecosystem, document imaging security and mobile print. While other vendors won some awards, we are the only vendor to sweep the awards and win in all 3 categories. And Quocirca again positioned Xerox as leader in worldwide managed print services for the eighth consecutive year. As you heard in the customer wins I mentioned, the ConnectKey products are an integral part of our MPS solutions.

So all in all; we're pleased with the reactions to our new portfolio and the early successes we've had. Our sales teams and channel partners are now equipped with an outstanding set of products and solutions, and we expect to see a favorable impact on our revenue later this year and into next.

I'll now turn the call over to our CFO, Bill Osbourn, to cover our financial results in more detail. Bill?

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

Thanks, Jeff, and good morning, everyone. I will start on Slide 6 with an overview of our financial performance. Overall, I would characterize Q2 as demonstrating operational progress, realized expanding margins and cash flow with a mixed story on sales, where we had significant amount of foundation-building revenue-generation activities, but we have not yet seen the benefits come through in the top line.

Revenue in the quarter was down $226 million or 8.1% in actual currency, 6.4% at constant currency. We had anticipated, as stated during Q1 earnings, that Q2 revenues would be the weakest of the year given product launch timing coupled with Q2 having the most challenging compare. That played out, driven by equipment revenue declines that were weak given the significant product transition. Post sale revenue decline of 3.9% in constant currency was in line with the first quarter rates and our expectations.

Turning to the cost ratios. We continue to see good progress. Savings from our strategic transformation program during the quarter more than offset the impact of revenue declines and a negative transaction currency impact of 100 basis points or $27 million, resulting in adjusted operating margin expansion of 40 basis points. Within that, gross margin expanded 50 basis points. R&D as a percentage of revenue was flat, and SG&A as a percentage of revenue was up 10 basis points as a result of the higher revenue declines.

As stated last quarter, within our definition of operating income is equity income, almost entirely related to Fuji Xerox, which was down year-over-year. I should note that equity income in Q2 did not include any out-of-period impact from the resolution of the Fuji Xerox accounting practices review. It was determined that our share of the final Fuji Xerox adjustment of approximately JPY 40 billion was approximately USD 90 million, which was higher than the original estimate of $30 million and deemed to be material to our current year financial results. Accordingly, we will be revising prior period results, including Q1, when we booked the estimated $30 million charge for this matter. We have provided in our materials the revisions for the past 3 years.

Turning to the below-the-line items. Other expenses, net, of $34 million was $14 million better year-over-year, driven by lower interest expense. Tax rate of 27% was within our full year range of 25% to 28% and was higher by 8.5% year-over-year, an approximate negative $0.09 impact year-over-year in the quarter to adjusted EPS. Overall, adjusted EPS of $0.87, which reflects the 1-for-4 reverse stock split, was down $0.11 from the second quarter of 2016, driven by the higher tax rate and lower equity income as cost and expense declines, including lower interest expense, roughly offset the impact of lower revenues.

GAAP EPS was $0.63 in the quarter. The difference between GAAP and adjusted EPS includes our normal adjustments around restructuring and related costs, non-service retirement-related costs and the amortization of intangible assets.

Turning to the next slide, I will drill down more on revenue. Starting with total revenue. From a geographic sales channel perspective, North America was down 7.3% or 6.9% in constant currency and represented 60% of our revenues. International represented 35% of total revenues and was down 8.9% or 4.6% in constant currency, reflecting higher declines in Europe that were partially offset by growth in developing markets as we continue to see overall improvement in developing markets. The remaining 5% of our revenues are in other, with the largest piece, over 50%, being our OEM business.

As I highlighted earlier, the driver of the higher declines in the U.S. and Europe was equipment revenue as post sale revenue trends were stable. Within total revenue, equipment sales were down 16% or 14.6% in constant currency, with the highest declines coming in Managed Document Services and in the public sector, where sales cycles and product transitions and certifications are longer.

From a product offering perspective, entry equipment sales were down 9.8% or 8.6% in constant currency, reflecting a higher mix of lower-value products as the strongest activity was in the developing markets and in the lower A4 product classes as well as continued high OEM equipment declines. Mid-range was down 17.6% or 16.3% in constant currency, and this is where we saw the impact of not having the new A3 ConnectKey products available for the entire quarter. Lastly, high-end equipment sales were down 15.9% or 13.9% in constant currency as the growth at the high end in color aqueous inkjet was not enough to offset Mono declines.

Moving on. Post sale revenue was down 5.7% or 3.9% in constant currency, which was consistent with Q1. We continue to see softer Managed Document Services revenues following weaker signings in 2016 and the first half of 2017. In Q2, Managed Document Services was 32% of our revenues and was down 6% in actual currency and 3.9% in constant currency, with $32 million of the $34 million decline driven by lower equipment sales, reflecting the timing of the new product launch, which could amplify in MDS given the longer sales cycles and the natural lag for realizing signings and subsequent installation of the equipment. Declines are driven by the more mature, large enterprise segment of the market as our SMB-focused channels, Xerox Partner Print Services and GIS, which comprised almost 25% of our MDS revenues, were growing mid-single digits.

I'll now shift to discuss our key performance metrics, a few of which I have already touched on. Strategic growth areas to date are down 0.7% in constant currency and comprised 39% of our total revenues year-to-date, a 2-point mix shift from the year-ago period. Growth areas were impacted in the quarter by lower equipment sales and MDS revenue. Jeff highlighted earlier the headway we're making in advancing our strategic growth areas, and we continue to target to shift our revenue mix to these areas by approximately 3 points this year.

Turning to installs. Installs grew in entry, although at a weaker mix, given the better developing market performance, where units tend to weigh towards the lower end of the portfolio, and given the new ConnectKey A4 products that currently are available are at the lower end of the portfolio. Mid-range installs declined given the new product transition timing and more challenging prior year compare. At the high end, installs were down in Mono and within color, results were mixed, with growth in aqueous inkjet offset by softer iGen activity, driven by last year's drupa-related partner sales and a mix down within entry production color, where we didn't get a full quarter's benefit of the new Versant product.

Signings in the quarter of $643 million were down 6.5% year-over-year and down 5% on a trailing 12-month basis at constant currency. We had strong contributions from renewals this quarter at a renewal rate of 86%. This was more than offset by lower new business signings.

So we have work to do to improve the growth rates in MDS, especially in large enterprise. We have recently changed the leadership in MDS, and we expect investments, which include our new products and SMB expansion actions, will drive improvement in revenues over time.

The last key measurement area is strategic transformation. We're very pleased with our results today, and we are on track to deliver our target $600 million of gross savings in 2017. This is an important element of our strategy to drive both expanding margins and support investments to improve our revenue trajectory.

I get a number of requests from investors to expand on some of the actions we're taking under the program and would like to take a minute to describe a few of the initiatives. Within facilities, we are consolidating locations, 79 thus far, with more planned at the balance of the year. As an example, we moved our headquarters to a smaller location at favorable terms, resulting in a couple million in annual savings.

Within service delivery spend, about 30% of our savings program, we are consolidating our service delivery for MDS and break/fix technical service under one management umbrella and optimizing our resources. We are leveraging more remote solve and self-help technologies, which are further enabled by each new generation of product. This will result in, among other things, greater dispatch efficiency and also enable greater machine uptime, leading to better customer satisfaction and more pages printed and more revenue.

In supply chain, we're negotiating with vendors for better terms and have outsourced activities. We've closed 5 major warehouses and a number of district parts centers, which, combined, will drive around $24 million in annual savings once fully implemented.

Within IT, we are consolidating vendors in areas like mainframe support, moving to shared environment and leveraging more cloud tools to enable greater customer self-service in areas like billing to collection.

And within SG&A, we are matching our resources to the smaller size of our business following the separation and driving to get some functional spend areas closer to benchmark. We reduced spans and layers in a number of areas, and we're leveraging more technology to become more efficient in how we get work done. We're also tackling legacy infrastructure areas like Europe, where historically, it's been more difficult to make changes, to streamline our operations and create more shared services in areas like selling support.

Lastly, our transformation program is not limited to costs. We're applying the same program diligence to drive better revenue performance. Examples of some of these initiatives include using inside sales personnel to call on under-penetrated accounts and improving pricing tools and resources to give selling hours back to reps and minimize revenue left on the table.

So all in all, a very broad, company-wide program with a rigorous process that we work at every day, with the goal of not only driving margin expansion but also in making us more efficient and competitive.

Before covering cash flow, I'll cover the trends we're seeing and how we anticipate they will play out in the back half of the year. The total revenue decline of 6.4% in constant currency in Q2 was below trend, as discussed, driven predominantly by equipment sales. We continue to expect full year constant currency revenue declines in the mid-single digits, with about 1 point of negative translation currency, a modest improvement to our previous assumptions. Looking at the second half, consistent with our previous commentary, we expect improving equipment revenue trends. Q3 should improve over Q2, although we won't get the full quarter's benefit from all the new products or realize larger deal (mostly MDS) benefits given the inherently longer sales cycle in these deals. Thus, Q4 will represent peak revenue performance for the year, with further benefits extending into 2018, when post sale, which lags, should also begin to reflect benefits from our initiatives.

Operating margins showed good sequential and year-over-year improvement in Q2. Transaction currency, again, dampened margins in Q2 by about negative 100 basis points year-over-year. At current rates, we expect more moderate impacts in the second half, especially in Q4. Overall, we anticipate continued strong margins in Q3, although seasonally, Q3 is not as strong as what we'll see in Q4, when typically, margins peak for us. For the year, we continue to expect adjusted operating margin between 12.5% and 13.5%.

Lastly, in looking at the trends for adjusted EPS, with 2 quarters left, we are narrowing our full year adjusted EPS to be between $3.20 and $3.44, essentially chopping out the top end of the range as that relies on a more rapid rollout of the new products. We expect EPS to follow the trend in revenue, with peak performance in Q4. Q3 is seasonally the second weakest quarter of the year after Q1 and historically has made up about 24% of full year EPS.

I'll now shift to discuss cash flow. Operating cash flow generation coming in from continuing operations in the quarter was strong again at $343 million, up $84 million year-over-year. And free cash flow was $322 million, up $101 million year-over-year. Cash flow was driven by working capital timing and improvements, including in accounts payable related to timing of supplier and vendor payments; the impact of lower equipment sales, a benefit to both accounts receivable and finance receivables; as well as the weighting of pension contributions to the second half of the year. Through the first half, we have contributed $46 million of a planned approximate $350 million for the full year.

Investing cash flows were a use of $77 million and included $65 million related to a GIS acquisition and CapEx spend of $21 million. Cash used in financing was $80 million and reflected $68 million in dividends, both common and preferred. So overall, we continue to feel good about cash flow and are maintaining our full year guidance of $700 million to $900 million in operating cash flow from continuing operations.

Turning now to the capital structure slide. I will spend a few minutes on debt. We ended Q2 with $5 billion in debt, which is consistent with Q1 ending debt balance and lower than 2016 ending debt balance of $6.3 billion, reflecting the $1.3 billion of senior note debt repayments we did in the first quarter. As we highlighted previously, a focus area for us in 2017 is getting our capital structure aligned to the new Xerox. We have made good progress, and we continue to look to ways to optimize our balance sheet. Of our $5 billion in debt, $3.6 billion is allocated to financing debt, calculated by applying a 7:1 leverage ratio to our customer-financing assets of $4.2 billion, which are comprised of $3.7 billion of finance receivables and $464 million of equipment on operating leases. And I'll remind everyone that this financing debt is adjusted out in one form or another by rating agencies when calculating our core leverage.

So to summarize, we continued to make operational strides in Q2 with strong margins and cash flow and a good setup on revenue for the balance of the year.

With that, I will hand it back to Jeff.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Thank you, Bill. Let me wrap up the presentation with a few closing remarks. We are pleased with our earnings, margin, cash performance and the continued progress on our cost and productivity initiatives during the second quarter. Equipment revenue was softer as we work our way through the expansive product transition. We are laying the foundation in our strategic growth areas, and we expect to see overall revenue improvement build towards the end of Quarter 3 and then more strongly in Quarter 4 and into 2018. Our new products have been well received and will support our pursuit of the growing A4 and managed print services markets while positioning us to enhance our share position in A3. The ConnectKey portfolio appeal to the SMBs who are supported by our growing ranks of channel partners, and it favorably faces off against our competitors, enabling us to maintain our leadership across the board. And we're not taking our eye off the high end, where we're seeing good demand for our aqueous inkjet devices and new Versant products, while gearing up for PRINT 17 in the fall. Our strategic transformation program remains a critical focus too and continues to yield, supporting strong margins and cash flow while also enabling investment in the business.

Additionally, as Bill mentioned, we're applying our proven process discipline to drive revenue improvements. Our progress through the first half, along with the work underway for the second half, gives me confidence in our ability to meet our 2017 commitments.

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

Jennifer Horsley - *Xerox Corporation - Vice President Investor Relations*

Thanks, Jeff. Before we get to your questions for Jeff and Bill, let me point out that we have a number of supplemental slides at the end of our deck, which provide more financial details to support today's presentation and complement our prepared remarks. (Operator Instructions) Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Kathy Huberty of Morgan Stanley.

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

I appreciate why you'd narrow the top end of the range just given you would need to see well above normal seasonality in the back half to hit the prior top end of the range. But curious why you didn't also narrow the bottom end of the range, which would require weaker seasonality despite the product cycles. And maybe just speak to the factors in the back half that would put you closer to $3.20 versus the upper end.

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

Katy, it's Bill Osbourn here. Thanks for the question. So let me just give some thoughts to you on all the 4 measures that we give a little guidance on, particularly on the adjusted EPS. But first of all, adjusted operating margin, we gave guidance of 12.5% to 13.5%, reaffirming that. We're very comfortable with where we're at year-to-date, 13.3% in Q2, first half at 12.2%. And just to remind everyone, the third quarter is typically our -- seasonally our second weakest quarter of the year, but Q4 is our strongest from an operating margin and from a revenues perspective. But we're still very comfortable with the 12.5% to 13.5% range. We believe we're set up pretty well for that. Revenues, mid-single digits down at constant currency for the full year. First half, we are 5.4% down. We believe the second half will be better than the 5.4% down at constant currency, with, once again, Q4 being the strongest quarter of the year and Q4 being better than Q3. From an operating cash flow perspective, once again, as I said in my prepared remarks, we're very pleased with where we ended for Q2 at $343 million, $533 million for the first half of the year. And I think most everybody knows by now, but just to remind everyone, the timing of our pension payments, we gave guidance towards $350 million in pension payments for the full year, which is still on track, but only $46 million were made in the first half. So a lot of the pension payments are backloaded. There's also some timing of payables with payables management that was a help in the first half that won't necessarily repeat in the second half. So then after all that, getting to your question regarding the adjusted EPS, and really, there are a lot of factors, as you can imagine, that go into it. There were some favorable things. In particular, currency, we think based on current spot rates, will be a little bit better than we had expected as far as a headwind at the beginning of the year, in particular, in Q4. Q3 will probably be similar as far as the negative impact to the first half of the year. But Q4, we expect to have a more modest negative impact from a currency perspective. The Fuji Xerox revision is clearly a favorable item. And in the first quarter, we took that $30 million hit on that, and that was revised $24 million -- or most of it was revised out. So some favorable items there. But to get to the higher end of the range, a few things. We had -- everything had to go right regarding the product transition, and Jeff, a lot in his comments, talked about that. A lot of things have gone right but not everything as far as the exact timing. There have been some delays. Also, we still plan -- we've done a lot of investment year-to-date in the A4 area, which everyone knows has a negative margin upon the initial sale, in most cases, but is profitable over the life of the equipment. We plan to have -- want to have flexibility, continue to do as much of that as we can. We've done a fair amount in the first half. We want to continue doing that in the second half of the year. And this, leaving -- to answer your question specifically, leaving the lower end of the range open or not adjusting that leaves new opportunity to be flexible, where opportunities arise in the A4 area. And then one of the bigger things is from a tax perspective. We gave guidance range of 25% to 28% for the full year for our effective tax rate. And year-to-date, we've been in the 27% range. We think that might be lower a little bit with some things we see maybe in the second half. But still, it is higher than the midpoint of the range so far this year. All those things factor in. We thought it was prudent to narrow the range given half the year is up, and we basically removed the top 25% or $0.08 from it.

Operator

Our next question comes from the line of Shannon Cross of Cross Research.

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

Can you talk a bit more about the pipeline that you have? I understand things have been pushed back, and MDS is taking a while to train and a longer sales cycle. But I'm trying to figure out if this is a change to sort of the typical sales cycles or if this is just more with regard to your product launch. I'm trying to figure out how this delay that we've seen is either going to sort of just continue on and impact next year or if you think that the weakness now is probably going to lead to some upside in 2018.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Shannon, this is Jeff. Yes, so let me take that one. So as Bill indicated, we thought that Q2 for us was a bit softer by about 1 point. So if you were to take our total revenue and say 1 point, it's about $25 million, so finishing the first half on a total revenue decline basis at constant currency of negative 5.4%. If you were to ask Bill and I at the beginning of the year, that's kind of about where we thought we would be. As we look back, we said Q1 probably ended up a little stronger than we thought it would be. Q2, a little weaker. If you put the 2 together, it would be right where we thought we would be. Getting to the backlog, the reasons we feel more confident, especially in Q4, because -- as we all know, Q3 is seasonally weaker. July and August is more difficult. From a direct backlog standpoint, we actually -- from end of March to end of June, we see that up around 17%. We also look at the new business pipeline in Managed Document Services, which also gives us confidence of why that will turn probably more starting in fourth quarter. The Managed Document Services, 180-day new business pipeline is up about 35% sequentially from Q2 to Q3. And again, that's the 180-day pipeline, which I say will -- why it will benefit us more in Q4. If I look at the renewal pipeline for Managed Document Services, that's also up about 13%. So when I look at those things -- and when I see the equipment this quarter for us, down negative 14.6% constant currency, which is something we had not seen. And I get even more confidence in addition to the backlogs when I look at Managed Document Services alone because if I go to the last 4 quarters, equipment would have been in the range of, let's call it, flat to up 1%. This quarter, it was down 24%. It was a real anomaly. And when I look at the pipelines, it gives me good confidence again for Q4 and then into 2018. It might also help, although I know this really wasn't the question, but probably if I lay out the product introductions for everybody, I think that would probably be a little helpful. So in February, we introduced the 4 lower-end A4 products, okay? That would be 2 color, 2 black and white. And that's why you saw the installs in entry multifunction devices up 24% in color and 10% in black and white. And that's really where our developing markets benefited the most because we grew the entry level of A4, and we got a nice bump from that. In Q3 -- in Q2, really end of May and throughout June, we launched all 17 A3 products, but they came in so late that it really didn't benefit Q2 at all, obviously. Because those are products that typically would go with Managed Document Services or have longer sales cycles. And we think as the third quarter progresses, we'll get some benefit, but again, really more of a benefit -- more fulsome benefit across in Q4 and into 2018. In July, we will introduce the 4 A4 color products, okay? And then in September, we'll introduce the last 4 A4 products, which will be the 4 black and white. And by the end of third quarter, all 29 products will be launched, which is why we believe Q4 will be our most fulsome for this year, and then 2018 will get the benefits of that. And certainly, from a rollout standpoint, you get the fastest rollout through your indirect channels, and your rollouts through Managed Document Services and some of the enterprise customers due to testing, certifications and the government take a little longer.

Operator

Our next question comes from the line of Kulbinder Garcha of Credit Suisse.

Kulbinder S. Garcha - *Credit Suisse AG, Research Division - MD*

Just a couple of questions. The first one is given all the initiatives that you have with respect to -- on the revenue side, whether it's the product or portfolio upgrade, the backlog that you mentioned, the initiatives with the channel, it sounds like, correct me if I'm wrong, year-on-year growth should start to improve from Q3, get better in Q4. And does this product cycle -- these initiatives drive fairly equally through 2018 as well? Or are there factors that we should think about apart from just the secular challenges? And the second question is I think we're halfway through this cost-reduction program, and there's been talk of having greater than $1.5 billion of cost savings as you go through. Your margin's performance is obviously quite good in this quarter just gone. Do you -- when will you revise up, if you will at all, and when will we be told about that? Can you give us any insights to the timing as to when you will assess whether you should be doing $1.7 billion, $1.8 billion or whether this is enough and to what degree that depends on revenues?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

This is Jeff. I think I got most, but we had a little bit of a difficult time hearing you. So if we don't get all of your questions, just let me know, and we'll be happy to do so. So from an overall rollout, from a revenue standpoint, we would expect in Q3 -- well, certainly, for the half year, as Bill said before, we expect to see improvements, second half versus first half. In terms of Q3 versus Q2 sequentially, we would expect to see an improvement in revenue declines on a constant currency basis, Q3 versus Q2, with the bigger impact being in Q4, which would be the seasonality but also having the benefit of the new -- all the new products for just about a quarter then. Some of the last A4 products will be coming out in September, so that might lag a little bit. But we do believe that will also help us then into the first half of 2018. With regard to the strategic transformation, I'll let Bill get into that in a little more detail, but we'll certainly update that as we get into the 2018 Investment Day. But as we've been saying all along and as evidenced by the 13.3% operating margins, even despite the 100 basis point currency headwinds, that's something we work hard at every single day, and we'll update where we are at the investor conference. I should also mention, and Bill did mention that in his remarks, we do are starting similar types of what I'll call operating initiatives on the revenue side to make sure we have the same diligence in introducing all these new products and rolling them out to the field. Bill?

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

Yes, just a little bit on the strategic cost transformation. As everyone knows, last year, we overachieved with respect to the $500 million target, achieved $550 million in 2016. We stated a goal for $600 million this year. We are very pleased with where we're at year-to-date and believe we are firmly on track to meeting that target and hopefully exceeding it, which would lead to, obviously, if you're $1.15 billion, if I'm doing my math right, that we're likely very much on the plus side of the $1.5 billion for the 3 years when you factor in '18. But as far as formally giving an updated number, it'll probably be later this year. But we are very confident in being -- hitting the $600 million this year and overachieving on the $1.5 billion. But to give updated 3-year number later this year, we'll give that.

Operator

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

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

A couple for me as well. Just sticking with that cost saves topic, guys, I believe of the $1.5 billion cumulative 2018 target, $500 million was incremental and $1 billion was sort of your business-as-usual saves. So my question is, of that $500 million, in the context of the ongoing -- sort of the net new investments you've been making, how should we think or how would you like us to think about potential for drop-through to the bottom line over the next couple of years? And I have a follow-up as well.

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

Yes. A couple of thoughts. So yes, I'd agree that's incremental, about $500 million, over the 3 years versus what was more BAU already on the cost reductions. But one of the main reasons why was to allow for investment, and investment includes things like the A4s, being able to sell A4s upfront, which are the negative margin or a loss initially but profitable over the life. But it also offsets other headwinds such as currency. We've had significant currency headwinds, both last year and this year, and the incremental amounts over the BAU allowed us to still increase margins despite those currency headwinds and, like I said, allows us to do investments, so the investment in selling into some A4s or investments in the way we are doing things internally.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes. And thanks, Ananda, and good to hear your voice again on these calls. I should mention that when Bill talked about the investments, it's not just the new products, but it's what we're doing with the SMB expansion. We've brought on more than 30 new partners, and it's almost evenly split between our financial operations in North America, but it requires investment there. It's demand generation. We hired dozens of new logo hunters. And as the year goes on, we hope to even do more A4 investment because as we see the success of this -- and as you know, that's an investment putting those devices in, but we'll get the benefit on the post sale. So we can see ourselves doing more and more of that once we get even more comfortable than we are with where we are for the full year.

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

Okay. And just a quick follow-up on that. That's really helpful, guys. So as we move through the next kind of 2.5 years here -- well, let's call it 1.5 into '19, is the success, the return success, I'll call it, kind of the op income dollar growth impact from the incremental cost saves, the EPS growth impact from the incremental cost saves, will that be generated by the success of these new initiatives? Or will there be some portion of incremental cost saves that will not be reinvested back into new initiatives and it could be just -- it's a drop-through to the bottom line?

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

Yes. I would say clearly, it would be a mix, that there would be a mix of investments. But some would continue to drop to the bottom line. And we're not giving guidance in out years, but I would expect cost transformation, although maybe not at the same levels that you see in these 3 years, will continue as a significant part of this company's future.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes. And another way, Ananda, I'd look at this, and this is, I think, where we laid out the investor conference. Just to make the math easier, let's just say on an $11 billion business or $10 billion business, mid-single-digit declines would be 5%. So let's take $500 million. Until you turn the revenue trajectory -- and we should not lose sight of the fact that when we started this 18 months ago and announced this program, it was not just to drive cost out, but it was to be able to reinvest back in so that we can change the revenue trajectory so that we're not declining at that mid-single-digit level in the outer years. So right now, the cost transformation program is being used to offset the revenue declines, and it's not just putting the margin, the 40% gross margin on the revenue declines. You have some price erosion in the industry, et cetera, which drops 100% to the bottom line. As we're able to take those declines from mid-single digits to something better, we'll have more opportunity to drop more to the bottom line as we also continue to reinvest.

Operator

Our next question comes from the line of Matt Cabral of Goldman Sachs.

Matthew N. Cabral - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Jeff, just in terms of the competitive landscape, just wondering how you'd characterize the current pricing environment and if you've seen any response from any of your competitors just as your product launch continues to roll out.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes. Matt, thanks for the question. Competitive reactions have been very stable. Pricing has been, for us, at about the same level that it's been, really, for the last couple of years. If anything, where we're feeling really good is -- although the products are just coming out now and, again, will be coming out in Q3 but more fulsome in Q4, as we're speaking to the channel partners to bring on the SMB expansion, the reaction we're getting not just from the industry analysts or the awards we're getting but from the resellers, the multi-branded resellers who are looking at these products and saying, we now understand that Xerox is very serious about going into the multi-brand channel, they've seen the hires we've made. And we've hired gentlemen named Pete Peterson, Jim Morrissey, 2 people who are pretty well-known in these channels, that they're going out and speaking to people. And where we have seen some competitive reaction and saying, we now see the multi-brand channel speaking to Xerox now. We actually like it to be a little more low-key because we'd like to stay below the radar as we bring on these multi-brand channel partners. And again, we're not getting out ahead of our headlights. We're also making investments in our mono-brand channels. These are the resellers who've been extremely loyal to us. We're continuing to invest with them. And we're also streamlining what we do in the enterprise. We're getting much more focused by saying, for years, there have been a number of customers that we've had -- that we've called on directly that, quite candidly, we shouldn't. We're going to work with our mono-branded resellers, our multi-brand resellers to have them call on them, do it more through telesales as we change our model so that the new logo hunters can focus on the largest enterprise customers in the industry.

Operator

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

Jim Suva - *Citigroup Inc, Research Division - Director*

I have 2 questions. I'll ask them both at the same time. First, you mentioned Q4 will be stronger than Q3. I wanted to get a little clarity about why are you calling that out when isn't that normally always the case? Or is there something special? Because with the product ramps, I would think that Q4 would always be the strongest regardless of product ramps or not. And are you actually implying that maybe year-over-year sales could be flat to up in Q4? Or are you just kind of reminding people of what's normal? And then my second question is you narrowed your EPS guide by taking the high end down, but the operating cash flow and free cash flow didn't change at all. So what causes the bridge to where there was no impact to operating cash flow and free cash flow?

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

Jim, it's Bill. Thanks for the questions. So yes, regarding the Q4 versus Q3 from a revenues perspective, a couple of things. You're right that Q4 is seasonally our strongest quarter from a revenues perspective each year, and that normally occurs. This year, we expect there to be even more of a ramp. The degree of it, we're not giving that specificity, but more ramp than normal because of the new product launch. I'm not giving specific guidance as to flat or positive for Q4, but as far as Q4, it's owned. But we do expect there is the normal ramp from Q3 to Q4 that occurs. We expect there to be more of a ramp this year than in prior years just because of the full availability of our products at that point in time. As far as EPS and operating cash flow, once again, there are a lot of variabilities, as you know, that go into operating cash flow. And one of them, in particular, is the pension contributions, and we've said $350 million. It's an area that we look at closely as far as our funded pension status. And we just want to leave things open from the perspective of whether we want to have flexibility for maybe additional funding there. But yes, normally, all else being equal, you would -- you could have slightly less, actually, operating cash flow because taking off the top. But it's not that significant compared to all the variables that go into determining it.

Operator

And our last question comes from the line of Paul Coster of JPMorgan.

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

It's a 2-part question. First of all, you mentioned some successful contracts at the beginning of the prepared remarks, Jeff. Were any of them competitive wins? And unrelated question, but as you move through the remainder of the year, is there anything you can share regarding channel and your own inventory mix to what extent you have some visibility into the 4Q ramp owing to a sell-in to distributors and resellers?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes. So certainly, some of those wins were competitive wins, no question about it. And we're putting even more and more of a focus on it. Part of the reason, in our Managed Document Services, that our Q2 to Q3 sequential 180-day new business pipeline, which would all be new, is up 35%, it's these new logo hunters that we're hiring, many from the outside, some just targeting them on the inside. So they're building a competitive pipeline. Again -- and because it's a 180-day pipeline, we'll get some benefit from that in Q4 and then certainly some in the first half of next year as well. From an industry standpoint, we've been very -- from an inventory standpoint, we've been very stable. That's something we watch very tightly. When Bill talked about working capital improvements on our cash flow, it's part of the rigor with the way we manage our business. And that's even with having -- we just made the Global Imaging acquisition, where we actually build up some inventory for that. When Bill talked about some of our closures of facilities or whatever, some of those could even be manufacturing facilities, where we'll actually have a little -- we built some inventory for that to manage through that. So even despite all that, we manage it very well and still with pretty significant cash flow improvements.

Jennifer Horsley - *Xerox Corporation - Vice President Investor Relations*

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

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes. Thanks very much for all your questions. And as I mentioned last quarter, we are keenly focused on the work ahead of us. We are positioning ourselves to reverse our revenue trajectory trends. We understand the market, and our success will come by methodically, laying the building blocks to capture growing share of the workplace market and increase our participation in the expanding high-end color market. We continue to make headway on our strategy, and we're confident in our ability to meet our full year commitments. We look forward to continuing to update you on our progress, and I thank you all for joining our call.

Operator

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