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XRX - Q2 2013 Xerox Corporation Earnings Conference Call

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OVERVIEW:

XRX reported 2Q13 revenues of $5.4b and GAAP EPS from continuing operations of $0.23. Expects full-year adjusted EPS to be $1.09-1.15 and 3Q13 adjusted EPS to be $0.24-0.26.

CORPORATE PARTICIPANTS

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Kathryn Mikells *Xerox Corp - CFO & EVP*

Jim Lesko *Xerox Corp - Head of IR*

James Lesko *Xerox Corp - VP - IR*

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Armando Zagalo de Lima *Xerox Corp - President, Xerox Technologies*

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Shannon Cross *Cross Research - Analyst*

Bill Shope *Goldman Sachs - Analyst*

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PRESENTATION

Operator

Good morning, and welcome to the Xerox Corporation Second-Quarter 2013 Earnings Release Conference Call hosted by Ursula Burns, Chairman of the Board and Chief Executive Officer. She is joined by Kathryn Mikells, Executive Vice President and Chief Financial Officer. During this call, Xerox executives will refer to slides that are available on the web at www.Xerox.com/investor.

At the request of Xerox Corporation, today's Conference Call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without expressed permission of Xerox.

After the presentation, there will be a question-and-answer session.

(Operator Instructions)

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

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

Ursula Burns - *Xerox Corp - Chairman, CEO*

Good morning, and thanks for joining us today. During the second quarter, we delivered results that reflect consistent progress on our strategy, and we improved on the key metrics that shape the future of success of our Business. First, our shift to a services-led growth portfolio is paying off. Services revenue represents 55% of our total revenue, up 3 points from the end of 2012. It's growing at a steady pace, contributing to annuity revenue stream that represents 84% of our total Business, and grew 1% this quarter. We're taking a disciplined approach to improving operating margins, so that our bottom line benefits more from top line growth in services.

In Document Technology, we're effectively managing the Business as a profitable, cash-generating operation. We're maintaining our leadership in Document Technology by holding and growing share. Through the launch of our ConnectKey platform earlier this year, and by offering more advanced color digital presses, we're maximizing our strength across the Business.

Plus, we're maximizing our profit by lowering the cost base. Margins trended better this quarter compared to Q1. All up and all in, we exceeded our EPS guidance for the second quarter, and generated strong cash flow. We're making the decisions to invest in growth and in building shareholder value. I feel good about our progress through the first half of this year, and I'm confident that we're positioned very well to deliver on our full-year expectations.

To give us a closer look at Q2 results, we reported adjusted EPS of $0.27. GAAP EPS from continuing operations was $0.23, which includes $0.04 related to the amortization of intangibles, and as I mentioned, exceeded our guidance. Revenue of $5.4 billion was up 1%.

During the first half of this year, we announced the sale of our North American and European paper businesses. So we've moved financial results from these businesses to Discontinued Operations.

Total revenue growth came from our Services business, which was up 5% in the quarter. Services operating margin improved sequentially, and is in our range of 10% to 12%. Our clients are increasingly expanding their partnerships with us to improve the effectiveness of their operations. As a result, we had one of our strongest year-over-year growth rates in signings and in the absolute TCB of deals. Renewal rate in BPO and ITO was an impressive 95%, and the pipeline is up double digits. So in Services, we had solid across-the-board results.

Revenue from Document Technology came in where we expected, which was down 5%. It's a significant sequential improvement, and it reflects a benefit from the full roll-out of our ConnectKey platform of printers and multi-function devices. We also signed and began installing our largest order ever for a fleet of Xerox iGen color presses. It was a huge win for our graphic communications business, and an indicator of the continued strength of our leadership in this market.

Segment margins also improved sequentially in Document Technology, coming in at the high end of our target range of 9% to 11%. In total, margin came in as expected, up 2 points sequentially. It's good progress, but we have much more work to do, and we have several initiatives under way that will deliver margin improvement.

Cash from operations was quite strong this quarter, and we're on track to deliver $2.1 billion to $2.4 billion in full-year operating cash flow. It was a quarter of steady progress. All the performance improvements aligned very closely with our growth strategy and resulted in EPS expansion.

During quarter two, we also welcomed Kathy Mikells as our new CFO. She's a quick study and already a strong contributor to our Business. So let me turn it over to Kathy, and then I'll wrap-up and we'll open the call to your questions. Kathy?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Thanks, Ursula, and good morning, everybody. I'd characterize Q2 as a very solid performance. Overall, Services performed in line with our expectations, and Document Technology came in a bit better. Our leading indicators were positive, and cash flow was strong.

Let's start with a look at overall earnings. Revenue was up 1%, with growth driven by Services, which was up 5%, or 6% at constant currency. We also had a positive contribution from equipment sale revenue, which was up 1%, our highest growth since Q3 2011.

Our gross margin of 31.4% was down 120 basis points, driven mainly by mix. The relative growth of our Services segment naturally dilutes gross margin. We also had some negative impact from business line mix within Services, and equipment versus supplies and financing mix within Document Technology. I'll cover this a little bit more when we hit the segment slides.

RD&E and SAG were both lower year over year benefiting from productivity initiatives as well as the greater mix of services. Operating margin trends improved, up 200 basis points sequentially, with year-over-year margin contraction slowing to down 50 basis points, versus down 110 basis points in Q1. Margin benefited from greater leverage on higher revenues, as well as productivity improvements. There's clearly more work to do, but we were pleased with the progress that we made this quarter, and we understand what's needed in order to keep up the positive trend.

Adjusted other net of $98 million and equity income of $36 million were both modest contributors year over year. Within adjusted other net, there's $33 million of restructuring, which is in line with our guidance, and up slightly year over year. As part of our ongoing productivity actions, we anticipate a similar level of restructuring in Q3, which is fully incorporated into our adjusted earnings guidance.

Our tax rate came in at 24%, which is 2 percentage points higher year over year, and below our guidance of 28%. Adjusted EPS of $0.27 was up $0.01 from 2012, and above our guidance range of $0.23 to $0.25. Relative to guidance, the over-achievement was driven by better operating results, as well as the $0.01 benefit from tax rate below our guidance. So in summary, a relatively clean quarter with good top and bottom line results.

Turning now to Services. Services revenue was up 6% overall, with BPO up 4%, Document Outsourcing up 6%, and ITO up 13%. BPO growth of 4% reflects strong growth in healthcare payer and pharma, and State government, partially offset by the elimination and run-off of our government and commercial student loan businesses. Document outsourcing growth of 6% was above expectations, supported by a very strong equipment sales growth as well as partner print services. Finally, ITO continues to grow at an accelerated rate, driven by the ramp of a couple of mega deals that we had in 2011. We expect ITO growth to taper off and return to low-single digits by the fourth quarter.

Segment margin was 10.2% in Q2, up 90 basis points sequentially, and down 40 basis points year over year. Margin was essentially in line with our expectations, reflecting the benefits of productivity initiatives, partially offset by the impact of less rich mix. As we look forward to the remainder of the year, we expect the pressure from weaker mix to continue, with the largest year-over-year impact from the government student loan run-off occurring in the fourth quarter.

Long term, we're taking a number of actions to improve the mix of our portfolio. We're accelerating investments to build more scale in competitively advantaged businesses with good secular and macro trends. We're adding to our suite of capabilities to create more value for our customers, thereby enabling higher margin. And we're deemphasizing lower-margin and low-return niche and non-core businesses.

Turning to our key performance metrics, signings were up 40% year over year, and on a trailing 12-month basis, turned positive for the first time in five quarters. We continue to have shortening contract lengths and smaller average deal sizes with no mega deals this quarter. New business ARR and NRR was up 5% year over year, and we had good signings contribution across the line of businesses. Our renewal rate was high at 95%, and our pipeline grew 10%, all positive indicators for our future Services performance. So, solid results from Services, which we expect to continue into Q3, with revenue growth in the mid-single digits and modest segment margin improvement year over year to roughly 10%.

Moving on to Document Technology. Our revenue was down 5% this quarter, improving as anticipated from the 9% decline in Q1. We saw a really good pick up in equipment sale revenue year over year, which was up 1% for the total Company, and down only 2% within Document Technology. This compares favorably to down 11% and 12%, respectively, in Q1.

The equipment improvement was driven by the success of our recently launched products in mid-range and high-end, and the related strong backlog we had entering Q2. Within mid-range, our recently launched ConnectKey platform has been very well received, and resulted in 16% growth in installs of mid-range color MFPs. ConnectKey refers to a software system that's embedded in 16 new multi-functional printers. It provides industry-leading security, more features for mobile users, as well as the ability to customize the MFP to link into business processes. High-end also experienced strong growth in both entry and production color, driven by recently launched products. We feel good about the improving trends in this segment, as color continues to become a larger part of the Business, and begins to offset the declines in black and white. Finally, in Entry, we continue to see good growth in color A4 MFPs, but in total, this segment was down, driven by weaker results in developing markets as well as OEM sales.

Overall, Document Technology margin showed a really nice recovery from Q1, up 200 basis points, and at 10.8%, it was at the high end of our target range. The year-over-year decline of 50 basis points was driven by a lower supplies and financing mix, with price pressure largely offset by cost and efficiency savings, and the modest currency benefit from the weak yen. Looking toward Q3, we're exiting Q2 with a strong backlog, albeit not as high as Q1, and we expect revenue growth to be down mid-single digits, with margins seasonally lower. So overall, good performance from both Services and Document Technology, which we hope to build on next quarter.

With that, let's turn to cash flow. Cash flow from operations was very strong in the quarter. The $533 million in Q2, and $446 million for the first half, compares to $228 million and $213 million, respectively, for 2012. Free cash flow was similarly strong at $426 million in Q2, and $232 million for the first half, which compares to a use of $30 million in the first half of 2012.

The Q2 improvement in operating cash flow year over year was driven by the following. $105 million was from lower defined benefit pension contributions. For the year, we expect cash pension funding to be about $170 million lower, so we saw the large part of that benefit in Q2. Working capital was also better this year, driven largely by accounts payable, which is basically intra-year timing differences. We also saw improvement in other assets and liability lines, which reflect some intra-year timing, as well as lower required services investments. Partially offsetting those positives was a lower source of cash from finance receivables, which was expected given the $600 million of finance receivables that we sold last year.

Moving down to the cash flow report, investing from cash flows was a use of $167 million in the quarter. We spent $107 million on CapEx and $81 million on acquisitions. Cash from financing was a use of $427 million, and included the retirement of our $400-million senior note in May, as well as $72 million of common dividends, which reflects the 35% increase in the dividend earlier this year. Given the timing of cash flows and the note repayment, we didn't repurchase shares during the quarter; however, we continue to plan on repurchasing at least $400 million worth for the year. Given our first-half cash flows and the historical cash flow seasonality of the Business, we're very well positioned to hit our full-year operating cash flow guidance range of $2.1 billion to $2.4 billion.

Moving to the next slide, I'll walk through our capital structure and capital allocation plan. With the $400-million May senior note repayment, we ended the quarter with $8.1 billion of debt, which is down $400 million from the beginning of the year. Applying the 7-to-1 leverage on financing assets, our allocated financing debt is $4.9 billion, leaving core debt of $3.2 billion. This debt reduction satisfies our minimum target for the year. We continue to expect $1.6 billion to $1.9 billion of free cash flow, and our capital allocation plans, including the debt reduction that I just talked about, remain the same as follows. Share repurchases -- we continue to view Xerox's shares as an attractive investment, and we plan to repurchase at least $400 million worth of shares this year. Acquisitions -- through the first half, we spent $134 million on acquisitions, and we anticipate doing between $300 million and $500 million.

Our pace of Services acquisitions has been slower than planned, which puts a bit of a damper on Services revenue. So this continues to be an area that we're focused on. I feel good about the quality of deals in our pipeline, but I believe it's really important that we remain disciplined in targeting businesses that are a really good fit and at reasonable valuations. And finally, dividends will be a use of about $300 million of cash, which factors in the Q1 quarterly dividend increase to $0.0575 per share. You can see our capital allocation plans are on track, and we remain committed to using our strong free cash flow to deliver value to our shareholders.

So before I hand it back to Ursula, I just thought I'd take a minute to give you my perspective on the Business with three months now under my belt. One of the reasons that I took this job was my perception of the tremendous opportunity that Xerox has in front of it. In Document Technology, we face a growth-pressured, competitive industry. That said, the industry is very profitable, and we have a good track record of maintaining our advantaged position and maximizing returns. In Services, there's been significant work done to address cost and execution issues, as well as evaluating our portfolio of businesses to shape our Business for the future.

So I feel like we're in a reasonably good place today. We understand our strengths and our weaknesses, and the work in front of us to further transform Xerox. I'm really happy to be on board, and you can count on me playing an active role to ensure Xerox is a success.

And with that, back over to you, Ursula.

Ursula Burns - *Xerox Corp - Chairman, CEO*

Thanks, Kathy, and here is a quick wrap-up. We saw good improvement in Q2, and I'm very pleased with how the fundamentals of our Business are performing. We delivered steady Services growth, improving trends in Document Technology, margins in line with expectations, and strong cash flow.

That said, our Business is still transforming, and we are planning for additional restructuring during the balance of the year to create a leaner, more flexible business model. At the same time, we'll continue to take a balanced approach to our capital allocation, investing in future growth and continuing our share repurchase program, high priorities as we build a sustainably successful business.

Considering our first-half results, there may have been an expectation that we raise our full-year guidance, however, as I mentioned, we are planning for additional restructuring in the second half of this year. We believe that we'll face other headwinds, including a higher tax rate, so we're taking a prudent approach to 2013 guidance.

For third quarter, we expect adjusted EPS of $0.24 to $0.26 per share. This includes approximately $0.02 of restructuring, and we continue to expect full-year adjusted EPS in the range of $1.09 to $1.15. By growing revenue, improving margins and controlling costs, we're confident that we'll consistently expand earnings per share and generate strong cash.

That's a good place for me to end. Before we open it up for questions, let me turn it over to Jim Lesko, who is the Head of our Investor Relations.

Jim Lesko - *Xerox Corp - Head of IR*

Thanks, Ursula. Joining Ursula and Kathy today are Lynn Blodgett, Head of Xerox Services, and Armando Zagalo de Lima, Head of our Document Technology business. Also let me point out that we have several supplemental slides at the end of our deck. They provide more financial detail to support today's presentation, and complement our prepared remarks.

For the Q&A, I ask participants to limit yourselves to one follow-on question so we can get to everyone. At the end of our Q&A session, I'll turn it back to Ursula for closing comments.

Operator, please open the line for questions.

QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS].

Your first question comes from the line of Ben Reitzes with Barclays.

Benjamin Reitzes - *Barclays Capital - Analyst*

Yes, thanks a lot. I think you said that for the year, you're thinking Services margins of 10%, and I think that's at the low end of your range. And if you could just confirm that for the year, that you think Services margins will be in that range, and when do you think you can at least get to 11% and maybe the higher end of the range now based on these new restructuring actions? Thanks.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Sure. This is Kathy. So when we look at Services margin, if you look through the first half of the year, year-over-year we're down about 20 basis points, and so as we look at the back half of the year, clearly we're targeting to make that up. On a year-over-year basis I'd say we're still striving to try and be up a little bit year-over-year.

Clearly in the third quarter we have an easier compare and we will be up year-over-year and we're looking to maximize that benefit, but overall if you look at the range for this year of 10% to 12%, we'll be at the low end of the range, still targeting to try and get a little bit of improvement year-over-year.

As you look forward to the different things that we're doing to really try and improve overall margin performance, I talked a little bit about the fact that we're focused overall on our portfolio in making sure that we're putting resources where we have advantaged businesses with good tailwinds and we bring good competitive advantage to the table.

We're building additional capabilities, so pointing to things like the acquisition of WDS, we did a couple small acquisitions this quarter, customer value group, as well as an E-learning-based acquisition. Those things are both in areas where we have good margins, and we're building capabilities to add additional value that we bring to our customers.

We've also talked a little bit about the fact that we're continuing to look at off-shoring, and I'll call it right shoring even within here in the US where we do work to get a better balance and a little bit lower cost labor overall and that work continues. So we have a number of different things under way. Clearly those things aren't going to take us to the higher end of the range overnight. It's going to take us a couple years to get there, but we're very confident that we're on the right path and we're confident with our overall guidance for the year.

Benjamin Reitzes - *Barclays Capital - Analyst*

Okay, so you said -- that was my follow-up, is that it's taking -- it's a couple years to get to the higher end of the range or the middle of the range? I mean, you don't give guidance for next year, but I think everybody on the call would probably like to see it at least go up a point next year.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Yes, we will give next year's guidance at our Investor Conference in November, so I think I give you a little bit of color about what we're working on, and we'll give you more about 2014 when we get to November.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Ben. If we could have next question please?

Operator

Your next question comes from the line of Shannon Cross with Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. Can you talk a little bit about the technology business in terms of the strength and equipment sales? Obviously you had the backlog going into the quarter. I'm curious as to the linearity during the quarter, and then if you can talk at all about geographic areas of strength and weakness.

Ursula Burns - *Xerox Corp - Chairman, CEO*

Yes, we saw the improvement in Document Technology throughout the quarter. As you recall, we exited Q1 with a strong backlog, and we started to benefit from that backlog immediately throughout the quarter, even at the tail end of quarter one. And we are pleased with that. We expected that to happen, and it actually delivered as we expected.

From a geographic perspective, I would say you should expect, you should -- you can characterize it as pretty much the same. So we continue to see a weak but steady US environment. We see Europe weak but not weakening, and our developing economies are pretty much -- they slowed a bit, but they are the strongest of the three. We did see a bit of a slowdown in Russia. We started to see that in Q1 and it continued in Q2, but we're managing that. So geographies are like that.

The high-end of our Business, particularly in the US, but even in Europe, the high-end of our Business is doing very well. So we're seeing that strength with new products and just good focus on the business and good competitive win. So from a line of business that's where we see the improvement.

Shannon Cross - *Cross Research - Analyst*

Okay, great, and then I was curious, Kathy. When you think about mix of revenue, how are you thinking about balancing it from a margin perspective, especially in services, because obviously ITO is a lower margin sale? Are you putting in place, I don't know, programs with the sales force, or what have you, to make sure that if you sign a BPO program, then you can maybe do a little more ITO? Or how can we stabilize some of the margin there and maybe just even in the overall portfolio?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

So I'm going to take that a little bit in two chunks. I'm a big believer that at the end of the day, we create mix. Mix doesn't just happen to us. Obviously changing mix takes a little bit of time.

If you look overall at ITO, yes, the growth has been a little bit higher there. That's coming from things that we signed in 2011 that we've just continued to implement, and as a result we've seen that tick up. ITO is a place where we're not a huge player in the market.

We really participate there, I think, very selectively, and we're pretty disciplined in terms of what we go after. So as we look at the overall portfolio of business, we're really focused on putting our resources and energy most in the areas where we bring competitive advantage to the table. We bring scale to the table; we bring capability to the table. We can move up the margin chain by penetrating and radiating at customers, and that's where we are really focused over the long-term.

I'd also tell you tactically, right, we're doing better blocking and tackling. I think when we talk about our confidence in terms of overall Services revenues, I'm sorry margins, we're really seeing that, and that's work that's got to continue. And so, day in and day out, making sure that we're doing everything we can both to reduce cost and to execute well because we know, especially on these larger contracts, if it takes us too long to stand them up, then we see margin pressure. So those are all the different things we're working on.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Shannon. Next question please?

Operator

Your next question comes from the line of Bill Shope with Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Okay, great. Thanks. On BPO specifically, what factors should we think about potentially to see some acceleration in growth here overtime? Is it simply a matter of getting past the student loan program running off by 4Q? Is it highly dependent on your picking up the pace of acquisitions? How should we think about some of those factors?

Ursula Burns - *Xerox Corp - Chairman, CEO*

Good question, Bill. I think that there are two things. I'll start, and then I'll have Kathy or Lynn comment. Clearly, we have to pick up the pace of acquisitions. Without those acquisitions we'll probably hover in the mid-range of the guidance that we give -- low, mid-single digit revenue growth. So we are focused on acquisitions.

We haven't not been looking. The good news is that we have been looking, but we are being very disciplined on both capabilities that we get, but also price that we're willing to pay, particularly in this kind of turbulent environment. So we'll get them. Kathy is focused on it; Lynn is focused on it. We'll get them.

The second thing which you mentioned, which is important is the student loan run-off. It is a big piece of the portfolio. By the way it's not new news. We knew it was coming. It's a hurdle that we have to overcome. It's very profitable.

At the tail end of this deal, the profitability is very high, and so we're going to have to manage our way over that, through that hurdle, and after we get through the compares on that, clearly we'll see a growth in revenue and in profitability, just because we won't have the negative on a sequential basis, sorry, on a year-over-year basis, because we won't have that negative comparative headwind for us. So those two things are important, but I'll let Lynn actually say a little bit more.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

As Ursula said, the acquisitions are really important to us. We're looking at, as we determine whether or not to do an acquisition, we're evaluating its benefit from a geographic standpoint. Does it further our global strategy? Does it meet our requirement, in terms of higher margin in services like data analytics?

And so, we're being careful and making sure that the acquisitions move us forward in those areas. And in terms of other growth and margin expansion, healthcare is an area of focus for us. It typically has after we get deals up and running. Those days tend to be healthy margin businesses, transportation. We have good activity in state and local last quarter, and those are all areas that over the long haul, will increase margins.

Bill Shope - *Goldman Sachs - Analyst*

And then just as a follow-up on the student loan issue, I want to make sure I fully understood this. I believe you said that the pressure on the margins is most intense in the fourth quarter, so is that the case, and could you clarify how material that is and how we should factor that into how we think about the margin passed from the third to the fourth quarter?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Sure. So yes, you heard us right. Overall, the margin impact has more year-over-year impact in the fourth quarter, but overall for the full year, no let's call it 35-40 basis points in negative margin impact, with that being a little bit heavier in the fourth quarter.

Bill Shope - *Goldman Sachs - Analyst*

Okay, great, thank you.

James Lesko - *Xerox Corp - VP - IR*

Thanks Bill. Next question please?

Operator

Your next question comes from the line of Keith Bachman with BMO Capital Markets.

Keith Bachman - *BMO Capital Markets - Analyst*

Hi guys, thank you. Could you talk -- you mentioned bookings and pipeline. Could talk a little bit about how you're thinking about bookings growth in the second half of the year?

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

Yes, we expect that we had a good -- we felt good about the bookings in the second quarter. We think third quarter are going to be strong. Probably not be -- we expect them to not be quite as strong as they were in the second quarter, but we expect healthy bookings to continue. Renewal rates were very high and that effectively has the same kind of impact as a good booking quarter. The fact that renewals were high, we expect that to return back more into the normal range of our 85% to 90% for the second half.

Bill Shope - *Goldman Sachs - Analyst*

Lynn would you expect bookings to be up 5%,10% any kind of -- I'm not expecting, and I don't think any investors are expecting, a sustained 40% year-over-year growth, but will they have 5%, 10% year-over-year growth as we look at the second half? Any kind of calibration?

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

I think that's a reasonable range.

Bill Shope - *Goldman Sachs - Analyst*

Okay, and then Kathy, for you. On the technology margins, could you give a little color there? I would have expected Technology margins to be a little bit stronger than I think you characterized given the Yen, number one, and then number two, I would assume that mix tilts a little bit more in your favor.

You had a lot of equipment that you did this quarter. I would assume that supplies and other kicks up a little bit in the second half of the year, but maybe just re-visit why Technology margins -- what you think the puts and takes there, and what investors should expect in the second half of the calendar year? Thanks.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Sure, so I would actually start by saying I was pretty pleased with where the Technology margins came out. I mean, 200 basis point sequential improvement, so overall, relative to what our expectations were, I feel like the Technology segment performed quite well in the quarter. So as I look towards the back half of the year, clearly on a full-year basis in 2012, we beat the range that we provide for Technology.

So we have talked year-over-year compares. We didn't have the kind of product introductions last year that we have this year. Obviously, that takes a fair amount of investment on our part and kind of priming the pump as we're launching those things, so we have tougher compares. I expect seasonally to be a little bit lower, kind of Q3 relative to Q2, but overall I was pretty pleased with the performance.

Bill Shope - *Goldman Sachs - Analyst*

But how should we be thinking about the change, though, Kathy, year-over-year, just if we look at calendar year '12?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

If you look we have exactly the same compare in Technology as we produced in 2Q, and so I'd say we expect to be seasonally a little bit weaker which is what we would typically see.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Keith. If we could have a next question please?

Operator

Your next question comes from the line of Ananda Baruah with Brean Capital.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Hey, thanks guys for taking the question, and congratulations on a really solid quarter across-the-board.

Ursula Burns - *Xerox Corp - Chairman, CEO*

Thank you.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Yes, first one, Kathy. So should we think of the core business operation tracking a little ahead of the original guidance at this point? I can appreciate kind of the restructuring remarks for the second half of the year, not as a reason not to raise the overall guidance, but it seems like you're tracking ahead from cooperations offset a little bit from the restructuring. There's numerous operational positives and not many operational headwinds, and you get some young benefit in the second half. And then I have a follow-up, thanks.

Ursula Burns - *Xerox Corp - Chairman, CEO*

I think you should look at the quarter, not for the quarter, but combine it with the first quarter and look at the half. And I think I would not characterize it as operating ahead. I think we're kind of operating on where we expect it to be when you average the half.

It caught up in Document Technology. We actually expanded our margins in Services. We stabilized revenue, and revenue came in on the average basis where we would have expected it to, which is in our range of flat to 2% up. So I think that you can look at it as the first half being what we would have liked to have happen.

We delivered it more in the second quarter than we did first to average that well. For the rest of the year, I think you should look at us continuing that disciplined pace. Quarter three will be weaker in margin; it generally is. Quarter four will be a little bit weaker in revenue because we have some compares to come over in Services, but I think on average, the second half will come out pretty much like the first half, and it's easier and better to look at it on a half basis than it is on a quarter basis. Anything else, Kathy?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Yes, all I'd add to that is we feel really good about the middle of the range of the EPS guidance that we provided. Obviously, we would like to come in better than that. We've only got 6 months under our belt. I think when I look at all of the gives and takes, we're being very prudent.

Ananda Baruah - *Brean Murray, Carret & Co. - Analyst*

Great, thanks. That's really helpful. And then my follow-up is just on share repurchase potential for the second half of the year. The guidance, you have the greater sign in front of the $400 million. This seems like you could have significant upside potential, depending on how the second half of the year comes in. So I just wanted to get a sense of how aggressive you might be willing to get if you don't get if the acquisitions come in at the lower end of the 3 to 5. I think you had a couple hundred million of unallocated dollars entering the year as well. Thanks.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Yes, so I think everything that you said was correct, right? You started with an, if the second half of the year comes in, because we are a second half of the year cash flow producer. We clearly started out by saying we expected to do at least $400 million worth of share re-purchases for the year. Cash flow comes in better than that, we would certainly be looking to do more.

We continue to look at our overall share price and feel like that's a good place for us to put capital, clearly looking to drive value for shareholders. But then at the end of the day, we are a back half of the year cash-flow producer, but at this point, I feel really good about our overall cash-flow guidance for the year.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Ananda. If we could have our next question please?

Operator

Your next question comes from the line of Mark Moskowitz of JP Morgan.

Mark Moskowitz - *JPMorgan Chase & Co. - Analyst*

Yes, thank you. Good morning. Wanted to kind of build off that last question around capital allocation and focus on acquisitions. So, Kathy, how should we think about over the next year or so, you guys talked about some restructuring here in the second half. I presume it's going to be more thereafter as you really try to focus on the better performing assets, and I guess the question is really around the cost savings.

How would they be redeployed? And if you can kind of give us a sense in terms of apportionments toward acquisitions versus increased stock buyback, versus growing the dividend, versus just dropping to the bottom line.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

So that was a lot. I'll try and piece that apart a little bit. I'm going to start with acquisitions.

Look, we've said we desire to do kind of $300 million to $500 million clearly through the first half. We're tracking at the low end of that. We would like to see more, but they have to be good deals, right?

We're disciplined; they've got to fit with our portfolio. They've got to be strategically aligned places where we think we're going to get good synergies. So at the end of the day, valuation also matters, and this is a little bit hard for us to predict.

When you take that into consideration and look overall in terms of our cash flow production so far, and we're very comfortable with the guidance that we've provided. Cash flow comes in well; we're very happy to do more than the $400 million worth of share re-purchases.

If you -- you talked a little bit, Ben, about restructuring. I think clearly we've pointed to both within the Technology business and within the Services business, the need for us to continue to work on productivity and efficiencies. That's what the restructuring dollars are targeted toward.

I talked a little bit about what we refer to as project compete and making sure that in the Services business, we've got people where they are optimized from a labor cost perspective, both in the US and outside of the US. We did a little bit of restructuring this quarter.

I'd certainly like to see us do, and expect that we will do, more during the remainder of the year. So I look at that as really looking at our overall income statement, core operating results, and wanting to reinvest a portion of that to make sure that we're continuing to get the restructuring we need to get the productivity that we need. And certainly, that's absolutely the case on the Technology side of the business and expect it will continue to be that case over time.

Mark Moskowitz - *JPMorgan Chase & Co. - Analyst*

And just a follow-up for Lynn. Lynn, can you talk about the conversion rate?

Obviously the signings are starting to show some signs of life again, but just kind of curious if you can give us your view in what you're seeing with respect to re-scoping or folks coming back to kind of negotiate the cost takedowns with deals that were signed previously. Are you seeing sort of headwind there, or are you actually seeing better improvement in terms of full conversion?

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

I think that the phenomenon that we saw a year-and-a-half, two years ago, where people were coming back and renegotiating out of cycle, we haven't --there's always some level of that, but I would say not as much as we saw a couple of years ago. The ramp as far as the ramp-up proportions are pretty typical. We're seeing first year contribution from bookings is pretty consistent.

One of the things that should actually work in our favor is that in the bookings, we haven't seen -- haven't signed any big Medicaid deals, and Medicaid deals typically ramp slower. So those were things that negatively impacted us. So I would say to that extent, we're going to see a little better ramp-up.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Mark. If we could have the next question please?

Operator

Your next question comes from the line of George Tong with Piper Jaffrey.

George Tong - *Piper Jaffray - Analyst*

Good morning. Great job on the quarter, and welcome to Xerox, Kathy.

Kathryn Mikells - *Xerox Corp - CFO & EVP*

Thanks so much.

George Tong - *Piper Jaffray - Analyst*

So Services signings this quarter were up an impressive 40% after being up 64% in the first quarter. How do you see this translating into revenue performance in the second half of the year, especially factoring in the expected deceleration in ITO growth in student loan run-off.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

Well as Kathy said, the headwinds that we're facing as you just pointed out in ITO were lapping the ramp-up of those mega deals that we signed in 2011. They're performing very well, so we're really happy with it, but as we said on the last call, we have not seen the kind of mega deals that we would like to see. Bookings are -- the positive of that is that we're seeing a smaller deals that tend to ramp quicker, so those things are positive.

I think the other headwind, as Ursula pointed out, is the student loan run-off. So those things are not trivial, and we're in the -- those run-offs tend to be more light switch. When you lap a contract, you see that impact immediately, and the student loan thing, that will be a bit of a light switch that we'll see at the end of the year. So the ramp up of the new bookings will feather in, whereas those are things that tend to drop off more quickly. So that's why we're being careful in terms of our revenue guidance for the second half, even though bookings are strong and we're pleased with that.

George Tong - *Piper Jaffray - Analyst*

That's helpful, and as a follow-up, can you give us a bridge of what actions will drive additional sequential margin expansion in the Services business this year, particularly given the negative impact from mix that you're seeing?

Kathryn Mikells - *Xerox Corp - CFO & EVP*

You know, look I think we talked a little bit about those already, so we're acknowledging the negative impact of mix. We obviously knew about that at the beginning of the year, so while we're pointing it out just so you understand the year-over-year compares, we're not suggesting as a result of that that we're not confident in getting to our full-year guidance in terms of overall margins there.

We have an easier year-over-year compare there for the third quarter, and so we talked about the fact that we obviously have an expectation given that easy compare, that we're going to see favorable year-over-year there. And really, I'd say execution and continuing to really work at getting cost down, getting G&A cost in the near term, are things we're very focused on and in insuring that we're going to hit the guidance we just talked about.

Ursula Burns - *Xerox Corp - Chairman, CEO*

So there's some tactics which we are well into. You've heard us talk about product compete. It's all about cost management tactically, and then more strategically, it is about driving advantage positions and places in the portfolio and being a little bit more directive or selective about where we want to grow our revenue. So that takes a little bit longer to do.

You do that incrementally. So that gives us -- the short-term gives us confidence that we'll get in the 10% to12% range at the lower end, and the longer term gives us a little bit more confidence that we'll be able to get to the higher end of the range. And that's how we're managing the Business.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

I think too, Ursula, if I can add, that we've done a lot of work over the last 18 months, or year to 18 months, on the portfolio in terms of areas that we should exit. Businesses that we should look at that don't fit our long-term growth profiles or margin profiles, and so over time, as Ursula said, you'll see us doing some work in that area, which will help, as far as margin.

James Lesko - *Xerox Corp - VP - IR*

Thank, George. If we could have the next question please?

Operator

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

Kulbinder Garcha - *Credit Suisse - Analyst*

Thanks, and just a couple of questions. First of all, just any comment you have maybe on the Technology side and the pricing environment and where we are on supplies, and channel inventories would be helpful. And then maybe a broad question for Lynn and Ursula.

Its been a few years now since MACS, and can you speak about the tangible revenue synergies that exist between Technology and Services? Maybe if we can get some examples of wins you've had over the last year where it's really coming together. Is there more that you can do here so in aggregate you could get both businesses growing one day, or is that just not the way you see it? Many thanks.

THOMSON REUTERS

Armando Zagalo de Lima - *Xerox Corp - President, Xerox Technologies*

Okay, so this is Armando. So on the pricing side, we don't see a consistent degradation of pricing in the marketplace at this moment. You always see the old case, particularly in mega deals, where competitors can become very aggressive, but generically speaking, we don't see any consistent degradation there.

So, in terms of inventory in the channel, there is no benefit that we have had in quarter two from an increase of channel inventory. In fact we are managing to reduce the level of inventories in the channel just as a way to manage our relationship with the channel on a more healthy way.

Ursula Burns - *Xerox Corp - Chairman, CEO*

And as far as revenue synergies go, some of the tangible examples, I won't give any customer names. I'll give more segments that we've seen this. Most of the synergies that are clear come in our document outsourcing ITO combination space, which is a space that we're trying to leverage even more as we go forward in both office equipment distribution market, in the personal care company market, and in the telecom space (laughter), are places that we are seeing the most leverage from the relationship between Xerox and the old ACS, and in ITO and document outsourcing, that leverage together is helping us position.

The other place that we're seeing it is literally in just our brand, carrying forward. Our branded technology carrying forward the ACS offers. This is a big deal and is kind of sprinkled everywhere.

Our engagement with the C-Suite is fuller and more impactful across-the-board when we go together with our full suite of offers. We see that in the United States, and we are clearly seeing that in our expansion outside of the US and Europe, as well.

We're using our infrastructure, using our reach, from a client perspective, and our brand name is helping this expansion. So if you look at our revenue growth in Services, you'll see that prior to the -- on average, prior to the acquisition, they were operating a certain space, not immediately prior to the acquisition, but on average, prior to it, and we've stepped it up by at least 2 points. So I think that it's clear that we're seeing that.

Our Document Outsourcing business is also doing better across-the-board. So I think that that's where we see the synergies coming through, the revenue synergies coming through.

We not at the end of this at all, by the way. The place we're focusing a lot, I think both Kathy and Lynn spoke about, is we have a particular focus on geographic expansion, and that geographic expansion would be almost impossible without the background on the backbone of our Xerox Corporation infrastructure. So, that's helping us, as well.

Kulbinder Garcha - *Credit Suisse - Analyst*

Thank you.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

I think that if you look at ITO, it continues to have such good growth. The main driver of the growth in ITO are the mega deals that we've referenced multiple times, and those are deals that have occurred precisely for the reason that Ursula described. We would -- I'm thinking of the two biggest deals, we just would not have played in those deals prior to having the Xerox brand and Xerox footprint globally.

So it helped us in ITO, areas like finance and accounting that we don't talk a lot about. Finance and accounting, it's just one of those businesses that runs, has strong growth, and most of the deals that we signed in that area are possible because of the relationship that the Xerox brand and the footprint and infrastructure there.

Ursula Burns - *Xerox Corp - Chairman, CEO*

I'd say financing and accounting and HR are the additional two places besides ITO.

James Lesko - *Xerox Corp - VP - IR*

Thanks, Kulbinder. Could we have the next question please?

Operator

Your next question comes from the line of Chris Whitmore with Deutsche Bank.

Chris Whitmore - *Deutsche Bank - Analyst*

Thanks very much. I wanted to ask about R&D. If I look at first half R&D, it looks like there's about 9% versus last year, and if you compare versus 2010, it looks like your R&D budget will be down about 20% to 25%.

A couple questions on the back of that. First, are you investing enough to maintain your competitiveness from an R&D standpoint in the core Technology business? And secondly, are you effectively becoming more dependent on acquisitions for the development of your IP base in your Services offerings on a go-forward basis?

Ursula Burns - *Xerox Corp - Chairman, CEO*

So the answer to the -- so let me answer the questions in the two pieces. From a R&D perspective in the Technology space, I think you have to look at it in the aggregate of what we invest in R&D here, what we invest in R&D in our -- with our partner in Japan, Fuji Xerox, and the acquisition that we made of the liquid ink company, Impika. So that shows up not as R&D; it shows up as an acquisition which will augment with our R&D. So you put those three things together, I would actually say we're not underspending at all in R&D from the Technology perspective.

We're doing it a little differently, so we took a point in time to actually augment with Impika, but we're actually now pouring forward the appropriate level of Research and Development to be sure that we can continue to expand the capabilities that we have in the Markets that are growing, so that's one point.

From a Services perspective, the R&D is just different. It's not that -- it requires less, some of the R&D that we would normally, like you would normally see from a technology company, get in the deal, build-up in the deal structure, and we then platform that and start to work on that platform from an R&D perspective. So it doesn't show up the same way.

I do not believe at all that we are underspending in R&D. We are continuing to be more effective, more efficient, all that stuff, and I keep a really keen eye to assure that we have the right level of investment in this space. It's not something I take lightly at all.

Chris Whitmore - *Deutsche Bank - Analyst*

Okay, thanks for that, and the follow-up, I wanted to get a sense on the bookings trend. The reported bookings number was quite strong. Can you delineate the trend of new business contracts, or new wins, or incremental business, versus renewals for first half, and how is that? And where have you been seeing success in terms of new customers and new wins? Thanks a lot.

Ursula Burns - *Xerox Corp - Chairman, CEO*

I'll just start with the overall, and then I'll get to whoever, Kathy or Lynn, both of you can talk a little bit. New business signings were strong. (laughter) New business signings -- so we saw total signings up 40%, new business signings were up as well, we don't give you the exact number, but they were strong.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

They were up.

Ursula Burns - *Xerox Corp - Chairman, CEO*

6%. I gave you the number just now. It's 6%, and our ARR and NRR from deals is also up. So across-the-board, we are seeing stock, future revenue, participation from all of the areas that it should, from renewals, from new business, from NRR deals. So across-the-board, we're seeing strength.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

And then you look at the -- when we report NRR and ARR, those are all new. That's all new business, and then when we talk about renewals, that's the Renewal business. So we try to give you color in both those areas.

James Lesko - *Xerox Corp - VP - IR*

We have time for one last question.

Operator

Your final question comes from the line of Jim Suva with Citigroup.

Jim Suva - *Citi - Analyst*

Thank you very much, and I'll squeeze in the last question here, which is kind of a bigger strategy question down the road. When we have the Obama healthcare item on the horizon, Ursula, can you let us know how you and your team are approaching that? What are the opportunities there? What are the costs?

I assume that could result in tremendous more processing, but I don't know as far as pricing and opportunity, does this disrupt other things? Is it all incremental? Do you have to start reinvesting early ahead of it? Can you help us, as CEO, how you're viewing the Obamacare continued impact and potential for Xerox?

Ursula Burns - *Xerox Corp - Chairman, CEO*

Yes, I think that healthcare in general, payer, provider, government infrastructure, is an opportunity, almost across-the-board in just about every way you can think about it, and very specifically, Obamacare is one. It's definitely going to be opportunity, primarily because it's forcing state governments to actually pay attention to this line item, to this portion of their budget, and they have to actually step back and think about what path forward they want to have.

It turns out that not every state is going forward the same way, and that's one of the things we learned is we have to actually manage it state-by-state. Some people -- some states are standing back and just waiting and doing nothing but having lots of conversations with us about what other states are doing and how we can help them.

Some states are going really fast, and when they're going really fast, we engage in just about every piece of that infrastructure in looking at what they did in the past and providing data analytics and actually standing up a solution for them. So across-the-board, it's an opportunity.

We have to be careful because I think what most people would have expected then, on Obamacare passes, everyone is going to be running towards a fixed solution. We're not finding that at all, so I'll let Lynn put more color on it.

Lynn Blodgett - *Xerox Corp - President, Xerox Services*

Yes, I think of course MMIF, the Medicaid systems, are still fundamental to the healthcare system exchanges, which we play, and the insurance exchanges, and that's an area, as Ursula said, we're seeing the different states take -- you know, some are standing pat, some are moving forward, but that's an area, a very important area, and we play there.

We're seeing the transition from fee-for-service to managed care, and that is a very important change because it affects the payers, Medicaid and the private payers, and it also affects the providers significantly. We're seeing a real, an interesting sort of melding of both the private payer and the government payers, where the big private payers are playing now in part of the playing with the government and Medicaid contracts.

Fraud and abuse is a huge area. It's -- we love it because we are -- we have so much transactional data. We're the holders of that transactional data, and adding analytics to that data to determine fraud and abuse, for example, is a tremendous value to our customers and it's an opportunity for us to capitalize on high margin work. So an awful lot going on there, and as Ursula said, some of it's easy to see and some of it we're having to just be careful and be conservative a little bit in what we do.

Ursula Burns - *Xerox Corp - Chairman, CEO*

And we are definitely doubling down in this area. There's not an area we can invest in that we have any capability in that we're pulling back. This is a space that we're going after pretty aggressively. As Lynn said, it's full of risk, but that's what we do for a living. We try to manage that well, and use our capabilities to do well. We're across-the-board payers, providers and lots of information, so we are using that as a leverage point for us. Thanks for the question.

James Lesko - *Xerox Corp - VP - IR*

Okay, that's all the time we have for questions today. Thank you for your interest, and Ursula, anything more to wrap-up please?

Ursula Burns - *Xerox Corp - Chairman, CEO*

Yes, we covered a lot of ground today, so let me bring it up several levels. Q2 results and our continued focus are creating -- are centered on effectively implementing a sound and consistent strategy, so let me remind you what that is.

First, it's Services-led growth. BPO, ITO, Document Outsourcing. Profitable leadership from Document Technology, investing where the markets have investment growth potential, cash generating annuity-based business model, consistent EPS expansion, and financial strength to invest in building value for Xerox and in building value for you.

James Lesko - *Xerox Corp - VP - IR*

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

Operator

Thank you for your participation. You may now disconnect.
