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XRX - Q2 2014 Xerox Corp Earnings Call

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OVERVIEW:

XRX reported 1H14 adjusted EPS of $0.54. 2Q14 YoverY revenue decline (at actual currency) was 2% and adjusted EPS was $0.27. Expects full-year 2014 adjusted EPS to be $1.09-1.13. Expects 3Q14 consolidated revenues to decline about 2 points and adjusted EPS to be $0.25-0.27.

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PRESENTATION

Operator

Good morning, and welcome to the Xerox Corporation's second-quarter 2014 earnings release conference call, hosted by Ursula Burns, Chairman of the Board and Chief Executive Officer. She is joined by Kathy Mikells, Executive Vice President and Chief Financial Officer.

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

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

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Good morning, and thanks for joining our call. Today, we are reporting second-quarter 2014 earnings that continue to reflect the benefits of our diversified portfolio and strong cash flow. We remain focused on our priorities and we are making progress.

This quarter, we saw a return to growth in services, and the business is well-positioned for sustained improvement. Services is now 57% of revenue and we are on track to reach our target of two-thirds by 2017. This important shift will drive overall revenue growth.

Our Document Technology business drove strong profits again this quarter, and continues to be an important business for us, generating cash and profits above expectations. And we continue our initiatives to improve services profitability. We are seeing good profitability improvement, especially within areas like document outsourcing, our commercial BPO business, and ITO businesses, including healthcare and international services.

We know that more needs to be done, especially in government healthcare, where we continue to stand up a new Medicaid platform and deal with a couple of challenging contracts. So this remains a top priority. And across both segments, Services and Technology, we remain focused on our important stakeholders, with a keen attention on supporting our customers, delivering value for our investors, and making Xerox a great place to work for our people.

In the quarter, we invested $227 million in acquisitions, welcoming into Xerox the employees and customers of Smart Data Consulting and ISG Holdings. ISG is a leading provider of Workers' Compensation software in the US. This acquisition will expand our significant presence in the healthcare payer and insurance BPO markets. And we continue to invest organically in areas where we see good market opportunities, such as in private healthcare exchanges, where we have a differentiated offering for large employers through Buck Consultants at Xerox.

We have a business that delivers strong cash flow. This gives us flexibility to not only invest for growth, but also builds short and long-term shareholder value through a balanced approach to capital allocation that includes share repurchases and dividends.

To execute on our direction, we have a strong team. Jeff Jacobson was recently named the President of our Document Technology business, taking over from Armando Zagalo de Lima, who is retiring after 31 years of Xerox. I want to thank Armando for everything that he has done for Xerox. He has put our Document Technology business on a solid foundation by transforming the organization to be more customer-focused, profitable, and well-positioned to adapt to changes in the market.

And here's a look at our results and my perspective. As I mentioned earlier, there are bright spots and positive trends, but we still have more work to do. We reported adjusted EPS of $0.27, which is at the high end of the range that we set. In the quarter, we saw improvement in services revenue growth. Services revenue was up 2% -- that's up from flat growth last quarter; and the business is trending well.

Document Technology revenue had higher declines in the quarter as expected, given timing of last year's product launches. It is in the range of expectations for the first half, and we are very excited about upcoming product launches. Our operating margin is up year-over-year, driven by strong margins in Document Technology -- the results of continued good operational discipline and focus on productivity.

As anticipated, though, we did see margin decline in Services, due to the pressures that we are experiencing in government healthcare. We took a non-cash charge in the quarter and are making progress transitioning out of some challenging contracts. Kathy will provide you with more details in a few minutes.

We are continuing our activities to create shareholder value using our strong cash flow, which is up over $150 million for the first half, to repurchase shares at a steady pace, supporting a growing dividend, and acquiring companies that enhance our services capabilities. We have a talented and dedicated team, and we are keeping our stakeholders at the center of all that we do. Our goal is to provide excellent products and services, and deliver the operational results that are expected of us.

With that, I'll turn it over to Kathy. Then I will wrap up and we will open the call to your questions. Kathy?

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

Thanks, Ursula, and good morning, everyone. Overall, we feel good about our sequential progress, with a number of the themes from quarter-one carrying through to quarter-two. We continue to show operating profit growth, driven by strong margin expansion in Document Technology. And we had good operational performance in the majority of our services businesses.

As expected, the government healthcare business continues to pressure services margin, as we invest in rolling out our new Medicaid platform. Additionally, we took incremental non-cash impairment charges, driven by the transition out of the Nevada health insurance exchange. I will cover all of these dynamics in much greater detail when I review segment performance.

First, though, I'd like to begin by walking through our earnings. Revenue in the quarter was down 2% at actual currency and down 2.5% in constant currency. Segment revenue trends were as expected, with Services revenue growth improving and Document Technology weaker, as we faced a challenging year-over-year compare due to last year's product launch timing.

Gross margin of 30.8% was down 70 basis points year-over-year, driven by the services margin decline as well as the greater mix of services. We again saw significant improvement in both SAG and RD&E, as we benefit from productivity initiatives as well as lower pension expense. These improvements more than offset the lower gross margin, and resulted in operating margin expansion of 30 basis points year-over-year, and 110 basis points sequentially, and enabled higher operating profit year-over-year.

Moving down the income statement, adjusted other net was $14 million higher year-over-year. The increase was split between OID, which was $9 million higher year-over-year, reflecting a real estate gain in the prior year; and restructuring, which at $38 million, was $5 million higher year-over-year and in line with our guidance. Adjusted tax rate of 27.7% was 360 basis points higher year-over-year, and just above our guidance range of 25% to 27%. So, overall, there was a modest year-over-year headwind below operating profit.

Adjusted EPS of $0.27 was flat year-over-year and at the high end of our guidance range of $0.25 to $0.27. Looking at the first half, adjusted EPS of $0.54 was also flat year-over-year. Operating profit grew 6% in the first half, despite the pressure we are seeing in our government healthcare business. And when combined with lower share count, more than offset higher restructuring costs, OID, and a higher tax rate. So, all in all, I believe we are making progress, obviously, with more work yet to do.

With that, I will move to the Services segment slide to review those results in a little bit more detail. Services revenue growth once again improved sequentially and was up year-over-year 2%, or 1% at constant currency, driven by a pickup in BPO, which went from down 2% in Q1 to up 1% in Q2. Good growth in commercial healthcare and internationally, and better inorganic contribution, was partially offset by a negative 1 point impact from the continued student loan runoff, as well as headwinds from lower customer care volumes. Trends in document outsourcing up 3%, and ITO up 1%, were largely consistent with prior periods.

Turning to signings. Signings were lower year-over-year, especially renewals. The combination of a low renewal rate that was below target, due to the Texas Medicaid loss, and a lower overall renewal opportunity, resulted in renewal signings' contract value down more than 35% in the quarter. New business signings were a better story, up double-digits sequentially but down 4% year-over-year, and flat on a trailing 12-month basis.

It should be noted that we did see some contracts shift to the second half and we had a couple of large contract awards that won't be closed until later this year. New York Medicaid, for instance, is not in these numbers. Our new business pipeline remains healthy, up 4% year-over-year, and we expect better signings results in the second half.

Shifting to profitability, segment margin was 8.6% in the second quarter, which was flat sequentially and down 160 basis points year-over-year. A year-over-year decline was expected, but we were below our guidance of sequential margin improvement. The miss was due solely to the impairment charges we took in the quarter associated with our health insurance exchange platform, including non-cash charges related to the Nevada contract. We didn't formally adjust out the $20 million net impairment charges, but if we exclude it, our segment margin would be 9.2%, which is in line with our expectations for continued sequential improvement.

So we are beginning to get closure on our Nevada HIX contract, and will be working with the state to continue to support their 2014 enrollees, and comply with their decision to transition to the federal exchange for the next year's open enrollment.

Turning to our Medicaid business, the second=quarter performance was largely in line with our expectations, as we continue to incur higher costs associated with launching our new Medicaid platform and getting it to operational maturity. We are making progress. We have positive references and we are winning new business in the market. This is an area where we expect lower margins in the intermediate term, as we drive improvements in our other implementation.

Within the rest of services, we are seeing improved performance. I was very pleased with our margin performance in areas like commercial healthcare, document outsourcing, and ITO, so our five-plank strategy and cost initiatives are driving improvements in many parts of the business, and should continue to ramp as we move through the second half of the year.

Turning to Services guidance, on revenue, second-half growth will be negatively impacted by the loss of the Texas Medicaid contract, which is worth roughly 1.5 points of revenue growth. The rest of BPO improved and will also benefit by greater inorganic contribution. We now expect to exit the year with a low-single-digit growth rate.

On margin, our expectations are largely intact. We expect sequential improvement through the year, putting aside the non-cash impairment charges. The third quarter should come in above 9.2%, and we expect to exit the year comfortably above 10%. In terms of full-year Services margin, we expect to come in at the lower end of the 9.4% to 9.8% range, reflecting the non-cash charges that we took in the second quarter.

I will now turn to Document Technology. Revenue in Document Technology was down 6% at actual currency and 7% at constant currency. This was higher than last quarter's rate of decline. And, as we highlighted during our first-quarter earnings call, this was anticipated, given the timing of last year's product launches. That impact drove the higher rate of decline for equipment revenue, with annuity revenue showing a consistent 4% decline in both quarters. Looking at the first-half, Document Technology revenue was down 5%, or 6% at constant currency, which is in line with our expectations for mid-single-digit declines, and includes an approximate 1 point negative impact associated with our previous finance receivable transaction.

From a geographic perspective, trends were generally consistent with our last quarter, with the US stable, Europe improving, and developing markets still weak. Looking at our product groups, activity levels were lower, as we faced the challenging ConnectKey compare, and some large wins in the prior year in graphic communication. In addition, the timing of this year's product launches are more back-half weighted, which we believe will position us well later in the second-half and into 2015. Planned launches include the recently announced Versant's entry production color product, extensions of our ConnectKey platform within our midrange portfolio and into entry, as well as a refresh of a number of entry desktop products.

Document Technology margin in the quarter was 14.4%, which was 360 basis points higher year-over-year, and continues to run above our long-term expectations. Our strong profit performance reflects ongoing benefits from restructuring and cost initiatives. In addition, transaction currency and lower pension expenses boosted our performance by a couple-hundred basis points. This quarter, we also experienced more favorable mix and lower pricing impact. The strong margin performance resulted in operating profit growth of 25%, despite the revenue decline; so, overall, it was a good quarter for Document Technology.

Looking toward the third quarter, we continue to expect Document Technology to have revenue down mid-single-digits with good margins, although below the first-half, as we invest in the launch of new products that I mentioned earlier, and also expect to have a less favorable impact from mix and some of the other variable factors.

With that, let's turn to cash flow. Cash flow from operations was strong at $325 million in the quarter, following a good Q1 result. For the first-half, cash from operations was $611 million, which was $165 million higher year-over-year. Underlying cash flow, which excludes the impact from prior-year finance receivable sales, was $437 million in the second quarter and $846 million for the first half.

It should be noted that the timing of operating cash flow generation was more balanced between Q1 and Q2 for the first-half of this year versus last. And we are continuing to work to smooth out our working capital flows. The drivers of the higher year-over-year first-half cash flow improvement include lower uses of cash for accounts receivable and inventory, and higher cash earnings. Partially offsetting this positive is less contribution to cash flows from finance receivables, which reflects the negative impact of the prior-year finance receivable sales.

Moving down the cash flow statement, investing cash flows were $326 million used in the quarter. We spent $123 million on CapEx and $227 million on acquisitions. We closed in May on ISG, which complements Xerox's current business with the top 20 US property, casualty and commercial health insurance companies. The acquisition pipeline continues to look good, and our full-year expectation to spend up to $500 million in 2014 is unchanged.

Consistent with our portfolio management strategy, this quarter, we divested Truckload Management Solutions, a small non-core business within Services Transportation. Cash from financing was a use of $561 million in the quarter, and included $299 million in net debt payments, $204 million in share repurchases, and $79 million in preferred and common stock dividends.

Wrapping up cash flow, we had a good first-half, and our full-year guidance remains at $1.8 billion to $2.0 billion of operating cash flow, with a more even distribution through the year. Second-half cash flow will be down year-over-year, as the prior-year included $384 million in proceeds from finance receivable sales in the third quarter and $270 million -- and $247 million in proceeds in the fourth quarter, with no sales activities planned in 2014. That said, second-half underlying cash flow should be more consistent on a year-over-year basis.

Now I'll walk through capital structure. We ended the quarter with $7.7 billion in debt. And in line with our original guidance, we continue to expect to end the year with about $7.8 billion in total debt. Applying 7 to 1 leverage on customer financing assets, our allocated financing debt is $4.4 billion, leaving core debt of $3.3 billion. We managed our core debt to maintain a leverage ratio consistent with our investment-grade rating, while financing debt has come down the past few years, driven by the finance receivable transactions, as well as lower origination.

So we feel good about our stable capital structure. And if we move to the next slide, I will review where we are at on share repurchases and dividends. With a strong first-half cash flow performance and relatively high beginning-of-the-year cash position, we've been able to steadily repurchase shares during the first half for a total of $480 million or 42 million shares. We continue to view our shares as a good investment, and anticipate doing at least $700 million in share repurchases for the year.

Our full-year guidance for dividend payments remains $300 million in 2014 and reflects our current quarterly dividend of $0.625 per share. When combined with the share repurchases, we expect at least $1 billion to be returned to shareholders this year.

Before I turn it back to Ursula, I would just like to summarize our expectations for the third quarter and the full year. We were once again pleased with the performance of Document Technology. And for the third quarter, we expect margin to be at the high-end of our target range, with mid-single-digit revenue declines. Given the strong first-half profit performance, we expect full-year margins to be at least a point above our target range of 9% to 11%, and up a similar level year-over-year.

Within Services, we expect to make further gains in the second half. The Texas Medicaid contract loss temporarily flows sequential revenue growth improvement, and results in an exit revenue growth rate for Services in the low-single-digits. We feel good about delivering sequential margin improvement and exiting the year comfortably above 10%. And as I mentioned earlier, we expect full-year Services margin to be at the lower end of our 9.4% to 9.8% range as a result of the non-cash charges that we took in the second quarter.

At the consolidator level for the third quarter, we expect revenue to decline about 2 points and adjusted earnings per share of $0.25 to $0.27, which includes approximately $0.02 of restructuring. And for the full year, we are narrowing our adjusted EPS guidance range to $1.09 to $1.13.

And with that, I'll hand it back to you, Ursula.

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Ursula Burns - *Xerox Corporation - Chairman and CEO*

Thanks, Kathy. I want to get to your questions, so I will summarize quickly. Our second quarter shows progress -- growing revenue in our Services business, operating profit in our Technology business, and reaping the benefits of our strong cash flow. Our profits in Document Technology help offset the headwinds that we are seeing in some of our Services businesses. Our focus on implementing the Services strategy is showing positive results, and we are seeing good progress internationally and in areas like document outsourcing and commercial healthcare.

Our strong cash flow allows us the flexibility to make strategic investments that will enhance opportunities in the future. Our 2014 priorities and focus are consistent: in Services, improving growth through portfolio management and profitability by driving cost efficiencies through the business; in Document Technology, capitalizing on the most advantaged segments of the business to maintain our leadership position in the industry, while maintaining strong profitability. And we will continue to generate healthy cash flow to deliver shareholder value.

Thank you. And now I'll turn you over to Jim.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Ursula. Joining Ursula and Kathy today are Bob Zapfel, Head of our Services business, and Jeff Jacobson, Head 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 please limit follow-on and multi-part question so we can get to everyone today. 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 now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Brian Essex, Morgan Stanley.

Brian Essex - *Morgan Stanley - Analyst*

Good morning and thank you for taking my questions. Maybe start off with a question for Bob. So you had some nice sequential margin improvement; ex the restructuring or ex the charge-off, it was 9.2% over 8.6% last quarter. What kind of -- I guess the first part of the question is, what kind of milestones do you need to hurdle for the remainder of the year to exit the year at a 10% or better than a 10% margin run rate? And then I have a follow-up.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Yes, I -- Brian, thanks. I appreciate that we did make progress. I think we've got a good clear game plan relative to cost management. We have moved to a capability-centered organization, which has allowed us to look at our businesses and where we have a chance to leverage some cost advantages across businesses. So I wouldn't view it necessarily as some key milestone to jump over. It's really more executing our overall plan. And I think we've got a very clear line of sight to the track that Kathy laid out that gets us to comfortably at 10%-plus as we exit the year.

Brian Essex - *Morgan Stanley - Analyst*

Okay. And I understand when we had the call last quarter, you'd only been there for about 21 days. Since then, I imagine you'd have the opportunity to peek under the covers to a little bit greater extent.

If you look at the guidance prior-quarter of exiting the year better than a 10% run rate, have you been able to identify additional low-hanging fruit? And is that going for -- I guess along the lines of cost improvements, or operational improvements? And would that potentially lead to upside to that number? And then following in at 2015, do we expect sequential improvement again through the year? Or are there certain factors that could lead to additional lumpiness in margin performance in 2015?

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Well, we'll do more on 2015 at the Investor Day session in November. But again, I would say our track through year-end, we've got a pretty clear line of sight -- I wouldn't call it low-hanging fruit, but I would say that -- that never feels that way when you're operating the business -- but I would say we've got a very, very clear plan that is broadly owned by the team. And some of this is bad news that we've had that's affected our margins that won't repeat.

So, we've -- we get a little bit of lift in the second-half versus the first-half because of some of the challenges that we've specifically called out. But we've got a good solid operating plan to deliver those kind of margins as we exit the year. And we certainly aren't looking at next year as though now we want to fall back in the wrong direction. But we will give more detail on the 2015 roadmap when we are together for the investor session in November.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Brian, if you think about -- this is Ursula -- all the business lines that Bob manages, and he's been digging into in the last couple of months, we manage all of them to try to show us margin expansion on a business-by-business basis. And in the second quarter, we saw that. And we expect -- and literally, the plan is to continue to drive those actions through the businesses so that we see the same kind of margin expansion the third quarter and in the fourth quarter.

So, just reiterating what he said, there is no miracle here. It is literally just operating the business on a line-by-line basis -- and getting better control over government healthcare, which I think we have good foundation for today. (multiple speakers)

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Thanks, Brian. (multiple speakers)

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Can we have the -- can we go to the next question, please?

Operator

Ben Reitzes, Barclays.

Ben Reitzes - *Barclays Capital - Analyst*

I just want to kind of go on to the margin question a little more, and ask about the two segments as we go throughout the year in maybe a little bit of a different way. In Services, you mentioned renewals down quite a bit, and the bookings look like they are below your expectations. So, I wanted to just -- I was under the impression renewals probably have a higher margin than new business. And in light of that, just how that plays out on the margin line with you guys getting above 10%.

And then on the technology side, I just wanted to know -- you guys talked about margin coming down from 14.4%, just how abruptly -- like, does it stabilize in the 12-ish type range? Because the upside there was about $0.05 in the quarter on that technology margin that was quite staggering. So I just want to see how much that comes back in and why. So it's just a little more detail in both margins in the big segments.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

Sure. So, then I'll start with just talking about overall kind of bookings and how we see bookings impacting our margins. If we look forward to the second-half, clearly, we are expecting bookings to improve in the second-half fiscals, because we've got bigger renewal opportunity as well as additional new bookings expected on top of that.

In terms of renewals versus new -- we wouldn't expect to see a negative mix implication overall. We always anticipate that in renewals, we have price-downs; we're anticipating that overall. And so we don't see any negative mix. And overall, if you look at how the mix of the portfolio is changing, our ITO growth has slowed a little bit, BPO growth is picking up, that's generally a positive for us on mix overall.

If I flip to the second part of your question, which was really about technology margin, if we look at what happened in this quarter, I'd say three months ago, we underestimated the level of pension improvement we were going to get; we got a little bit more currency improvement. And overall, mix turned out to be more favorable, and we had a little less pricing pressure than we would typically see.

If I go to talk about then, in the second-half, our expectation for technology margin, we will see a dip in the third quarter because we've got a lot of new product launches. And so that's mainly the impact there. We don't get quite as much pension benefit in the third quarter. So pension benefits are a little bit lumpy for us, because we have pension settlement costs.

But overall, if you look at the second-half, and certainly, the guidance we gave for the full-year, at least 100 basis points above the high-end of our 9% to 11% range, I feel really good about technology margins. I feel great about our ability to continue to well-manage this business, to produce very strong profit and very strong cash flow.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Ben. If we could move to the next question, please?

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Jeff, I had a question for you. Could you talk a bit about what you are seeing in the printing market? I mean, you've got the rollout of significantly more product in the second-half of this year. Do you expect market share gains? What markets are you sort of focused on? And if you can give any color in terms of geography, because it seems like Europe was pretty strong. And then I had a quick follow-up. Thanks.

Jeff Jacobson - *Xerox Corporation - Corporate EVP and President of Xerox Technology*

Yes. Sure, Shannon. So, let me just say in terms of our activity, our activity has been strong for the past year and we gained a share point in 2013. And in Q1, and as Kathy said, we knew we would have a tough Q2 compare, due to ConnectKey, our entry production color high launch. However, Kathy mentioned our product launches coming in the second-half, which I think we'll really start seeing more of a benefit in Q4 and certainly into 2015, where we have about 20 new launches in the second-half.

They'll benefit the entire Company, but I think they will especially benefit our developing markets, our channels organization, and certainly document outsourcing. And I think it's also important to mention that, even in this quarter where we had a tough compare, in our mid and high segments, we had sequential growth in both color and mono; and in entry, we were essentially flat in color.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

(multiple speakers) Let me take some of the geographies. We are seeing pretty stable business environment in the US, fairly predictable for us to manage it well. And so you were right -- Europe, last quarter, we saw improvement this quarter. Europe is hanging in there for us and doing well.

Developing markets just continues to be a pressured place for us. My expectations is that US and Europe will continue the trends that they're on. And, unfortunately, developing economies will continue the trends that they're on and be tough for us. The product launches that Jeff talked about should help us with giving them more optionality to sell and deal, but it's not clear that the environments there will actually pick it all up.

Shannon Cross - *Cross Research - Analyst*

Okay, great. And then just my follow-up question for Bob or Ursula, I'm not sure which. When you think about New York State in the contract that you've -- I know it's not finalized, but it appears you're going to be awarded -- how do we think about that in light of some of the startup costs that we saw with California Medi-Cal? I mean, is this something where you're going to be able to leverage some of your newer platforms, so perhaps not as many startup costs? Or just how do we sort of think about that as we look through the year?

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Bob will take it.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Yes. Shannon, I think the way to think about New York is, obviously, first we have to move from award to contract. So we are excited for the opportunity to do that after the protest cycle. And our view would be, we've really learned a lot through the prior implementations. We think that we will be able to execute New York well for the citizens in the state and for us. It won't be -- all of these new implementations start with not-huge margins. You make your money over time, but that's the way we built it into all of our guidance.

So that's the plan for us. We understand -- we don't expect to have big unrecovered costs, but we do know that they don't start at high-margin, that that's the business model design. That's not unique to any individual state; that's services broadly. And that's part of what we have accounted for in our commitments as we go forward.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Shannon. If we could have the next question, please.

Operator

Jim Suva, Citigroup.

Jim Suva - *Citigroup - Analyst*

Thank you and congratulations to you and your team there at Xerox. If we were to look at several of the metrics such as signings and bookings and margins -- and I'm looking more forward-looking -- should we then expect them to no longer come up? Or, given the timing of when the decisions were made from Texas, Nevada, California and New York, that there might be some impact to those? And I think that maybe help us filter through the magnitude of what we should expect.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

So, on signings, the loss of Texas is basically behind us. It was reflected overall in our renewal rate. What we are expecting going forward, as we talked about, is signings improvement in the second-half. And so, New York isn't included in our numbers today, but we would expect to see that in the future.

We have another award that's under protest for a tolling deal that we did in Florida -- again, not included in our numbers; part of the reason why we have a good amount of optimism in the second-half. So, overall, we feel good about looking forward and signings improvement in the second-half.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

And our renewal rate without the Texas loss would be in the range that we wanted to be in the 85% to 90% range. So, the Texas loss is a singular event, but our business flows are fairly consistent with all of the quarters previously -- particularly on renewals.

Jim Suva - *Citigroup - Analyst*

Great. And as a quick follow-up, when we think about there's been a lot of public information about the New York contract and the California contract, when those are ramping, are those fully considered in your margin profile outlook? Or are you building in a little additional stand-up costs? I at least want to make sure that we're just not then going to be seeing some additional pressure from those ramping.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

Both of those are fully contemplated in the guidance.

Jim Suva - *Citigroup - Analyst*

Great. That's good to hear. Thank you and congratulations again.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Jim. If we could have the next question, please.

Operator

George Tong, Piper Jaffray.

George Tong - *Piper Jaffray - Analyst*

Thanks for taking my questions. I'll just start out with Kathy. Could you provide the impact or expected impact on the various government healthcare contracts you have rolling on and off over the next several quarters? Specifically what the timing is for when New York MMIS will come online? And whether the expected impact for Texas and MMIS will be a very consistent 150 basis points year-over-year. Then I have a follow-up. Thanks.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

And so, I'll take New York first. You know, our -- New York is a little bit hard to call perfectly, right, because we are going through a protest period and we then have to contract. Our expectation would be that we start to see a little bit of New York coming on towards the tail end of this year, but it has a more material impact in 2015.

And then with respect to Texas, Texas is going to tail off pretty quickly. And so, we have a little bit of transition in Texas, but we expect to see Texas tail off pretty fast.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

But Kathy, if I could add, so that 150 basis points on the top line, we would be dealing with that, if you will, for roughly four quarters. So that is -- it will hit us to start, as Kathy has mentioned, as we kind of go through the third and fourth quarters. And then on a quarter year-over-year basis, we would be looking at that still in the first-half of next year as well.

George Tong - *Piper Jaffray - Analyst*

That's very helpful. Thanks. And lastly, Ursula and Bob, could you share color on how the other parts of the Services business is performing? So, commercial BPO, commercial ITO and document outsourcing?

Ursula Burns - *Xerox Corporation - Chairman and CEO*

I'll start at the highest level. Let's say I'm pleased with all of them. But let me let Bob go into a little bit more color.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Yes. I would say we really had -- we've got the challenge, obviously, that we've talked about in government healthcare. But if you look at the rest of the portfolio, our business in Europe was up double-digits organically, even more sizably with the benefit of an acquisition earlier in the year. Our commercial healthcare business is growing at double-digit rates with very strong margins. Our HR and learning business is performing very well. For the most part, the mix -- I mean, not everybody is perfect, but the mix across the rest of those businesses in aggregate, we are very pleased with.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

And one -- if I could add one point on ITO very specifically, our revenue growth in ITO is -- had, for the last few quarters or two quarters at least, flowed to low-single-digits. And we spoke about this in last year's investor conference, and I'm sure in some calls before, about how we look at our ITO business.

It's a good business for us. It is a relatively small business for us and it operates at the lower end of our margin range. And so, we are focusing on margin expansion and improvement in ITO, and not so much on revenue growth there. We are putting most of our bullets or guns or bullets in the gun around BPO and document outsourcing from a revenue growth perspective. And that will continue.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

And that's part of the portfolio mix strategy that the team covered last November at the investor meeting. So that's part of our five-plank strategy, is really around trying to grow more rapidly in our most quote/unquote "advantaged" businesses. And Ursula's comments are right to that point.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, George. If we could have the next question, please.

Operator

Keith Bachman, BMO Capital Markets.

Keith Bachman - *BMO Capital Markets - Analyst*

I have two questions as well. The first is philosophical growth rate. And what I mean by that is, Bob, I was hoping you could address BPO and ITO. The recent data points around BPO have been very mixed. A lot of your competitors and even some of the leading consulting organizations have suggested that the BPO market has indeed slowed. Now Xerox is in a slightly different segment, or at least a slightly different segment than some of the leading organizations.

But I was hoping you could address on the market level, if you are seeing a slowdown in BPO? Related to that is the ITO side. Ursula just mentioned -- your strategy is different, which I think is completely appropriate. But can you grow the ITO side? Or does that become a negative growth rate as you look out? And then I have a follow-on question on margins, please.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Yes. I would say on the BPO market, we are in the middle of our strategy cycle. We see that market -- obviously, it's a broad $200 billion-plus market; it breaks into horizontal, multi-industry components, and industry-specific components. Overall, we see it at mid-single-digits. And there's a little bit different mix depending on what area, but it's a very attractive market from our standpoint.

And I would view it as a more favorable -- from a market dynamics standpoint -- more favorable than ITO, which is -- was, earlier in the maturity cycle, grew to be a very large market more rapidly. So we still feel very good. Obviously, segment by segment, we look at each of them. But if you just macro to BPO broadly, we see mid-single-digit growth through the strategic horizon in that business area.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. Well, I'll transition to my second question -- although, Bob, I'd love you to come back on and say can ITO grow, or does it go negative? But my second question is for you, Ursula, as well as for Bob. You seem -- you do seem to be doing well in the commercial side of your Services business, which -- the healthcare or government side -- more specifically, the government side of healthcare -- continues to struggle. Why not deemphasize that business?

Nobody makes any money who serves the healthcare industry in the government side, it doesn't seem. CSC has been pretty vocal that they did not follow-up with a bid for the New York side because they didn't think they would make money in it. So, just philosophically, why not focus more on the commercial side and deemphasize the government healthcare-related activities, and thereby improve your sustainable profit levels?

Ursula Burns - *Xerox Corporation - Chairman and CEO*

I don't think that we are not focused more -- or focused a lot on the commercial side; we are. But we also -- the government healthcare market is very attractive -- is a very attractive market. We went through one cycle when this market started many, many years ago, that showed that we could invest in the new platforms, stand that platform up, and have it last for many, many years, and continue to drive growth on the topline and profitability on the bottom line. That remains our expectation.

And if you look at some of the contracts that are more mature, moving towards more maturity -- California, for example -- we have been able to literally move that contract from investment phase to flat profitability, now to looking for growing profitability, in a very predictable kind of a standard way. It took a little bit longer, but on a go-forward basis, California is going to be beautiful. And we expect, as we implement New York, to be beautiful as well. So we are not deemphasizing commercial in favor of government; not at all. We are focused on all of them. And the demographics show that we should be focused on them as well.

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

If I could just add one point of color. We're above 10% operating margins on the majority of roughly 70% of our government healthcare business.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Right. (multiple speakers)

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

So our experience, I can't speak to the competitor, but our experience is once you get these stabilized, you can have a great value proposition for the client and good for the shareowners. And one of our clients just yesterday came out and referenced that, you know, we've been working through some issues, but they expect the system to have a 20-year longevity. So, that's the reason that we don't view it as an area to exit or deemphasize.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Keith. If we could move on to the next question, please.

Operator

Tien-Tsin Huang, JPMorgan.

Tien-Tsin Huang - *JPMorgan - Analyst*

Great. Thanks for sharing that commercial margin in the size. I didn't realize how big it was. Actually I just wanted to ask first about signings and the outlook for the second-half. Can you be more specific there? Can you get to a book-to-bill north of, say, 1 in the second-half without New York?

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

Yes. So, I'll get a little more specific. When we look at the second-half, we are expecting improvement, and we think, roughly, we should end the year flattish on a 12-month trailing basis. So, we clearly have expectations to make up for some of the softness in the first-half.

Tien-Tsin Huang - *JPMorgan - Analyst*

Understood. And then just my follow-up, the outlook on Document Technology margins, same question there. Maybe you can be a little more specific. It sounds like you could stay above your target range in the second-half. You called out the 2 points around pension and transaction effects, but it feels like, with some of the changes, is it possible we can assume that your longer-term margin target 9% to 11% could be elevated, given the run rate?

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

So I'm going to put aside sort of 2015 and long-term, but if you just look at the second-half, we guided specifically to being at, call it, the high-end of that 9% to 11% target range for the third quarter. We typically are a fourth-quarter stronger, just from a seasonality perspective in the Technology business.

And if you look at some of the kind of year-over-year things that are going on, one of the things we had last year were these receivable sales, our financing receivable sales. And so, year-over-year, we have a little less headwind in the fourth quarter from that than we do in the third quarter. So, we would expect a seasonally better performance in the fourth quarter there.

Tien-Tsin Huang - *JPMorgan - Analyst*

Yes. That seems like it's in a good place; that's why I asked. Thank you. (multiple speakers)

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

(multiple speakers) Great.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Okay, thank you, Tien-Tsin. If we could have the next question, please.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital, LLC - Analyst*

Thanks for taking the question. Hey, two, if I could. The first is on Services rev growth. Bob, can you just kind of walk through what -- given that there's been some choppiness this year in both revenue growth and in signings, can you give us a sense of what the headwinds are going into 2015? And how we should think about those kind of like layering in and falling off as we exit the year?

Bob Zapfel - *Xerox Corporation - Corporate EVP and President of Xerox Services*

Yes, I guess from a headwind standpoint, we're still -- we are still have the student loan run-off; that's more of a factor in the second-half of the year then next year. Texas will be a headwind, as we've talked about; more in the first-half of next year than as we exit the year.

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We've got -- as we've referenced, we've got some substantial contract award potential for us as we close out this year, that will then lead to filling in some of those gaps. And we view the market, as I briefly said earlier, at a mid-single-digit growth rate. And we think that we can get roughly that range as part of our overall sales strategy. So, there are a few headwinds. They are not unknown headwinds, though. And we've got a team that wants to be successful in the marketplace. And that's our focus.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

If I can just put an umbrella on top of that. So BPO -- Bob has talked about it; I have mentioned it -- higher growth rates. Document outsourcing, higher growth rates. The part of the market that we are -- that will continue to have the lower growth rates for us is the ITO business. That is not something that the market should panic on; that is literally the strategy. We want to actually focus on profitability there, be very selective with our contract signings. And we are doing that.

Our renewals and our renewal rate continues to be strong, north of 85%. We continue to have that as an expectation. Decisions are slow a little bit -- well, they were a little bit slower in the second quarter. A lot of them have moved to the third quarter and fourth, and we expect to sign the ones that are coming up then. We have a very good win rate on new business there, the 10 or so that we were pursuing in the quarter. We lost two and signed eight. We expect to have that kind of a flow going forward.

So, I think that the revenue portion of the picture, there are puts and takes; and, of course, some ups and downs -- Texas down, et cetera, et cetera. But I think on a macro basis, it looks good.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

(multiple speakers) Thanks, Ananda. If we could have the next question, please.

Operator

Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

My first question is on Services. So you have the Nevada issue out of the way, which obviously gives you room for improvement into the back-half. But given some of the other contract challenges you've had and some of the unexpected challenges in recent months, is there a risk that we could see further write-downs in the second-half? Or do you feel like the model is pretty fully scrubbed at this point?

And then my second question, a broader question would be -- on your restructuring plans, how's it going relative to your original targets? And as you refine the Services strategy, are you finding any new opportunities arising in the restructuring category? That's it for me.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

So, overall on the first piece, the impairment charges that we took in the quarter were associated with our state HIX platform, right? And we basically completely cleansed our balance sheet with regard to that.

As you look then at our Medicaid platform, I mean, we are winning new business in the marketplace, so we don't really see any issue there in terms of some future shoe to drop type of thing. Overall, I would also mention in this quarter that we settled with another state in terms of just our execution plan associated with their implementation, and more specifics around the design and functionality. And so, that's another one that I would say we really kind of tucked away in this quarter.

So we feel pretty good about our grip on what we need to do in order to continue to mature the implementations. And I would say kind of kudos to the Government Health Solutions group in terms of pretty well predicting, outside of the impairment charge, what we were going to see in this quarter -- which is why, when I exclude the impairment charge, we really had the profitability and margin progression that we were expecting.

On the second question on restructuring, we have been very consistent about restructuring. I would expect to continue to see about $0.02 a quarter. At the very beginning of the year, we said we expected restructuring charges to be pretty similar to year-over-year. And I think we did about $115 million in total in restructuring charges last year. So, maybe we would be a tad higher this year. But we are going to continue to be pretty consistent in our overall approach to restructuring.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

And one of the things that we've talked about in this infamous or famous five-plank strategy, one of the major things we talked about was cost improvement in Services. So we have a lot of focus on restructuring in the Technology business and have a good root in there. And Bob is developing that same level of discipline and rhythm in the Services business. So I expect the restructuring to participate and drive margin expansion -- a portion of the margin expansion that Bob is counting on, and continue to be strong margin contributors in the Technology business as well.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Bill. And, operator, I think we have time for one last question.

Operator

Certainly. Our final question for today comes from the line of James Friedman from Susquehanna.

James Friedman - *Susquehanna Financial Group - Analyst*

Thanks for sneaking me in and I'll ask my two upfront. First for Ursula, second for Kathy. Ursula, when you look across the Services portfolio, which do you emphasize more? Is it revenue growth or margins? And then, Kathy, I'll just ask you upfront -- could you share some color on the margin characteristics of ISG and Smart Data? And are there other dispositions, meaning asset sales, that you have planned in the second-half? Thank you.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

By the way, your first question is a good question, and unfortunately, doesn't have a singular answer. It depends on the section of the business and market that we are speaking about. I just talked about ITO, for example. And in ITO, I emphasized margin expansion over revenue growth. That doesn't mean I want them to walk away from good business that we can get, and we can stand up with in a margin-expanding way. But I'd actually tell them more margin -- focus on margin than on revenue.

In government healthcare, it's both. I want to make sure we do not lose any large contracts, and in places like an MMIS, where we have a platform, go hard towards growing that business while you expand margin. So it's a mix of discussions, and it's different across the world transportation revenue growth [a year], et cetera. Our advantaged businesses revenue growth and our businesses that are not performing at the level that we want from a margin perspective, it's margin focus. So it's a mix of things. And the good news is that Bob can actually walk and chew gum at the same time, so he can actually manage the many different signals that I give him.

Kathy Mikells - *Xerox Corporation - Corporate EVP and CFO*

And then just on the second question, you know, generally, as we talked about one plank of our overall Services strategy as just portfolio management. And we are trying to improve the overall mix of our business. Right? So as you look at the things that we are acquiring, they're very strategically aligned with that strategy. And I would say ISG and Smart Data absolutely fall into that category. Smart Data gives us a little bit of added scale in the litigation space -- litigation services, which is a great business for us. It's a high-margin business. And ISG got added into our insurance overall portfolio. And so, again, looking to mix up; not looking to dilute margin.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Great. Thank you. That's all the time we have for questions today. We genuinely thank you for your interest.

Ursula, anything more to wrap up?

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Yes. Thanks, Jim. And I'm confident that we have the right strategy and the right team in place to deliver on that strategy. We're making progress. We have a lot of work to do to continue to create greater value for our employees, our customers, and our shareholders. And we are up to the challenge.

Jim Lesko - *Xerox Corporation - Corporate VP and VP of IR*

Thanks, Ursula. That concludes our call today. If you have any further questions, please contact me or any members of our Investor Relations team. Thanks so much for joining us today.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a good day.
