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Xerox Holdings Corp. (XRX)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Xerox Holdings Corporation Third Quarter 2020 Earnings Release Conference Call hosted by John Visentin, Vice Chairman and Chief Executive Officer. He is joined by Xavier Heiss, Interim 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 Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the expressed permission of Xerox. After the presentation, there will be a question-and-answer session. [Operator Instructions]

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

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

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

Good morning and thank you for joining our Q3 2020 earnings call. I hope everyone is safe and healthy. For the third quarter, revenue totaled \$1.77 billion, down 19.7% in constant currency year-over-year and up \$302 million from last quarter. Free cash flow was \$88 million, down \$243 million year-over-year and up \$73 million from the second quarter. Adjusted earnings per share totaled \$0.48, down \$0.32 year-over-year and up \$0.33 from the second quarter. Adjusted operating margin was 7.4%, down 460 basis points year-over-year and up 320 basis points from the second quarter.

I couldn't be more proud of our team. With all this year has thrown at us, the team has remained steadfast and determined to provide exceptional support to our clients while driving our transformation forward. The third quarter results reflect the agility of our business and the team's laser focus on Xerox's four strategic initiatives: optimize operations, drive revenue, re-energize the innovation engine, and our focus on cash flow and increasing capital returns. Let's walk through each area.

Project Own It has instilled a strong sense of discipline and responsibility throughout the company. Employees at all levels understand the need to make smart decisions that drive continuous operational improvements while preserving cash. That's been especially true during the pandemic. This foundation enabled us to react quickly to the business impacts while continuing to invest in the future. Project Own It provides the framework to strike that balance while positioning us to deliver at least \$450 million in gross savings this year. We have taken and will continue to take actions focused on discretionary spending as needed. The company's flexible cost structure gives us confidence we are well positioned to manage the business through the pandemic's uncertainty.

We're investing in a number of areas that are making us more efficient and better able to serve our clients including supply chain, robotic process automation and analytics. For instance, we use predictive analytics to anticipate customers' future print needs and ensure devices and services are optimally positioned. In the third quarter, our robotic process automation team oversaw 1.5 million transactions. That's up 300% year-over-year. We expect to see a similar increase over the next 18 months.

The pandemic has spurred new opportunities for growth across our portfolio as businesses balance their workforce needs. While companies plan to return many of their employees to a workplace once it's safe, they are adopting more flexible work policies and the technologies to support them. The office has never been a stagnant place. It has evolved over the decades and will continue to do so in the future. And Xerox will remain an important partner in that evolution, focused on providing security, collaboration, and productivity for businesses, big to small.

Highlights from this quarter included as more businesses reopened in Q3, we saw print volumes and demand for printing devices increase compared to Q2. A sign, pre-pandemic behaviors resume as people return to the workplace. This uptick helped drive the improvement in our rate of revenue decline compared to the last quarter.

In the Americas, we maintained overall market share leadership for equipment sales revenue according to the most recent IDC data. In production, we grew market share in the areas Xerox serves. Our Baltoro inkjet press remains unmatched in the marketplace. Demand for this press is strong with installs up year-over-year. Demand by customers who provide essential services such as the government healthcare organizations and schools remained strong.

IT services grew year-over-year in the third quarter, demonstrated the increased need of SMBs to protect their infrastructure and customers' critical data. Within our service portfolio, we grew new business signings and renewals year-over-year. Digital Hub and Cloud Print and Capture & Content are key drivers of this growth as they allow clients to manage content no matter where they are working. There's a strong pipeline for these services for the remainder of the year.

Security and investments in new technology are helping drive demand for Xerox products and services as companies support remote workers and business increasingly is conducted online. Cybercriminals are seeking to exploit security gaps at enterprises and small and medium sized businesses during the pandemic. For employees working remotely and using their own personal devices, companies often don't know what is being printed and whether that device is secure.

Xerox devices add an additional level of security as they are armed to help detect and prevent malicious attacks, the proliferation of malware and misuse of unauthorized access to printers. By expanding our Intelligent Workplace Services to the home, we are providing existing clients with the protection they need. Similarly, investments in software such as DocuShare Go are bridging the home and office.

Go is a new cloud-based content management platform that uses artificial intelligence and machine learning to organize content, allows users to collaborate on files and optimize workflows. With enterprise grade security, it's designed with the small business user in mind. It uses a simple SaaS pay-as-you-go model and can be set up within minutes.

Enhancements to the DocuShare portfolio have earned Xerox Industry recognition. Most recently, DocuShare received a gold award in the Enterprise Content Management category from Info-Tech Research Group. This award is determined based on end user feedback on the software's features, service, and innovation among other things.

We expect to build momentum within our software portfolio as companies increasingly need tools to support a hybrid work environment. Monetizing innovation remains a key focus and the team continued to make progress across the innovation pillars with 3D printing, IoT sensors and solutions and cleantech.

In 3D, we are on track to launch the first version of the liquid metal 3D printer. This product will print aluminum 4008, which is an alloy used in multiple industries and will produce prototyping, pre-production and specific end use parts. Our road map includes expanding the range of metal alloys that we can print, enabling us to meet the needs of a broader set of applications and parts over time.

We are making progress in IoT and have been awarded contracts for external pilots with select customers. For example, we are working with the Defense Advanced Research Projects Agency known as DARPA on the Ocean of Things, a project to expand what scientists know about the seas. DARPA is deploying small, low-cost drifters in the Southern California Bight and Gulf of Mexico to collect data on the environment and human impact.

PARC builds drifters for the first phase of the project and will deliver up to 10,000 more that are more compact and cost effective for the next phase. Data gained in this round will help further optimize the final design, at which point DARPA expects to deploy large volumes of these drifters.

In cleantech, the team is on track to complete the prototype in 2021 that has the potential to cut energy consumption of air conditioners by up to 80%, reduce greenhouse gas emission, and improve indoor air quality in the buildings. This is all while reducing energy bills for businesses and individuals.

In healthcare, we assess the demand for hand sanitizer, disinfectant solutions and ventilators on a quarterly basis. All require little CapEx. As we said at the onset of the health crisis, these initiatives are about helping save lives and we will keep doing this as long as there's a need. While investments in our innovation pillars are longer term plays, the revenue and client engagements are promising.

In the third quarter, we strengthened the company's liquidity, ending the quarter with approximately \$3.3 billion of cash, cash equivalents, and restricted cash, and a \$1.8 billion undrawn revolver. In the quarter, we refinanced all of our outstanding 2020 debt maturities and in October, we prepaid a portion of our 2021 debt. We did this using proceeds from issuing \$1.5 billion of new senior unsecured bonds and a receivables securitization. As a result, the company has only modest debt coming due for the next two years.

We continue to evaluate acquisition targets, large and small, using our established M&A playbook that focuses on ROI and IRR amongst other things. We completed a \$150 million of share repurchases in the third quarter and plan to complete at least another \$150 million in the fourth quarter. We remain committed to our shareholders return policy of returning at least 50% of annual free cash flow to shareholders and maintaining the company's current dividend rate.

I covered many of these frequently asked questions in my earlier comments. But I will recap a few key points. Our financial results improved sequentially. While this isn't a measure we generally use, it is another data point to understand how we are managing through the pandemic and its impact. While we can't reliably predict what happens next, we have modeled numerous scenarios. The company's flexible cost structure and discipline allow us to manage the business smartly through this crisis. Strategic investments in Xerox's core, adjacent and new areas are focused on addressing client needs today and tomorrow. These and other actions position Xerox to emerge from this time in a position of strength.

I want to spend a moment on corporate social responsibility. While managing the effects of the pandemic, we raised the bar on ourselves to contribute to a better, more sustainable future. Xerox has long been recognized as a leader in diversity and inclusion. Knowing there's more all of us can do, we created a new diversity and inclusion road map to increase our impact both within Xerox and our communities.

Another area we committed to do more was on greenhouse gas emissions. Having reached our 2025 goal six years early in 2019, we plan to achieve carbon neutrality no later than 2040 and reduce emissions by at least 60% by 2030. The team's work earned Xerox the title one of the most sustainably managed companies in the world by The Wall Street Journal. Additional information is available on Xerox's recently published CSR report on xerox.com.

Before asking Xavier to review the financials, let me share some details on his background. The veteran of Xerox, he's held a number of leadership positions in finance, business transformation and sales. In fact, before his promotion to President of EMEA Operations, Xavier served as our Corporate Controller and CFO of the Americas Operations. Xavier worked closely with Bill and served as an executive committee member. He is well positioned to lead us through this transition. Xavier?

Xavier Heiss

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

Thank you for the introduction, John. Although, our business continues to be impacted by COVID-19, revenue improved compared to the second quarter in all regions as businesses began to gradually reopen and employees returned to the workplace, resulting in more of a hybrid work environment. This increased activity enabled higher equipment installations and contributed to a lower rate of decline in print page volume sequentially.

Adjusted operating margin and EPS improved compared to the second quarter as a result of increased revenue and continued cost savings from our Project Own It transformation program, as well as savings from dedicated actions to preserve cash that focus on discretionary spend item in response to the pandemic. We generated \$88 million of free cash flow in the quarter and \$253 million year-to-date, and we maintain our commitment to shareholder returns with \$150 million of share repurchases and \$61 million in dividend paid in quarter three.

We ended the quarter with \$3.3 billion of cash, cash equivalent and restricted cash. We also strengthened our balance sheet on improved liquidity in the quarter by refinancing approximately \$1 billion of debt that mature in

2020 and in October, we prepaid \$750 million of \$1.1 billion bond that matures in May 2021. Our \$1.8 billion revolver that mature in August 2022 remains undrawn.

Looking at our third quarter financial result, total revenue of approximately \$1.77 billion in the quarter declined 19.7% at constant currency year-over-year and is \$302 million above second quarter. So, \$412 million decline in revenue year-over-year reflects the impact of COVID-19, which has resulted in business closure and has limited the number of people returning to the workplace. The decline in revenue has moderated compared to the second quarter, which I will speak about in more detail shortly.

Looking at profitability, the year-over-year ratios and measures presented here continued to be impacted by the decline in revenue resulting from COVID-19. Adjusted operating margin of 7.4% was 460 basis point lower year-over-year and 320 basis point above second quarter. We continue to partially mitigate the impact of revenue decline with cost reduction from Project Own It and from other actions implemented as a result of the pandemic, which include cost relief from temporary government assistance programs that were available to us in quarter three.

Gross margin was 36.8%, a decrease of 320 basis point year-over-year. The decline reflects lower revenue, price promotion investment, transaction currency and tariffs that were partially offset by benefit from Project Own It, government assistance program and additional cost action.

SAG as a percentage of revenue increased 170 basis points year-over-year as accelerated revenue declines from the pandemic more than offset the productivity benefit from Project Own It and other discretionary expense reduction.

Bad debt expense increased by \$3 million in the quarter compared to third quarter 2019. Current bad debt reserve for our trade and finance receivable are in line with our models. RD&E as a percentage of revenue was 30 basis point lower year-over-year. RD&E cost reduction included savings from action taken to simplify our core technology portfolio, benefit from temporary cost reduction action, and the favorable timing of investment. These savings were partially offset by higher investment in our focused innovation area where we continue to make progress.

Other expenses, net, was a credit of \$15 million, which was \$14 million better than prior year, primarily due to a gain from an asset sale as well as a lower non-service retirement-related cost, reflecting lower discount rates on the decrease in pension settlements.

Our third quarter adjusted tax rate was 21.1% compared to 27.3% in the prior year, primarily due to the geographic mix of profit as well as the impact of discrete items on lower pre-tax income. Adjusted EPS of \$0.48 was \$0.32 lower than the same quarter last year driven by the impact of COVID-19, which more than offset the benefit from cost reductions, a lower tax rate and lower shares. This was a \$0.33 increase compared to second quarter. GAAP EPS of \$0.41 per share was \$0.27 lower year-over-year, including the \$0.32 decline in adjusted EPS and the year-over-year decline in non-GAAP adjusted item.

Non-GAAP adjusted (sic) [Non-GAAP adjustments] to EPS include restructuring and related cost, the amortization of intangible assets, non-service retirement-related cost and transaction and related cost, net, as well as the income tax on those adjustments. In quarter three, we recorded \$20 million of restructuring and related cost compared to \$27 million in the third quarter last year.

Next, I will discuss cash flow. In the third quarter, we generated \$106 million of operating cash flow from continuing operation, which was down \$242 million from prior year and up \$72 million from the second quarter. The year-over-year decline is primarily driven by lower net income and the use of cash from working capital, which was partially offset by an increase in cash from lower finance asset. Cash from working capital was \$143 million lower than prior year due to the lower cash from accounts receivable and inventory that was partially offset by an increase in cash from accounts payable. The change in cash from accounts receivable is primarily a result of higher quarter-over-quarter revenue compared to last year, while the change in cash from inventory reflects lower sales volumes, delayed equipment installation and lower purchases from indirect channel partner. We'll continue to manage our liquidity as we work through the pandemic.

While our indirect partner increased the level of purchases compared to last quarter to meet their demand, they are managing inventory level closely. The increase in cash from accounts payable is primarily due to the timing of payments to vendor.

Restructuring payment of \$11 million were \$6 million lower than prior year. CapEx was \$18 million in the quarter and free cash flow was \$88 million. We expect CapEx to be in line with prior guidance for full year 2020, supporting our strategic growth program, including continued investment in our IT infrastructure.

So we have no acquisition in the quarter. However, we continue to assess our pipeline of tuck-in acquisition and strategic M&A. As a reminder, we spent \$193 million in Q1 to expand our SMB strategy internationally, and we expect full year spend for tuck-in M&A will be in line with prior guidance.

Within financing cash flow, we issued \$1.5 billion of unsecured bond in August and closed a \$340 million securitization of finance assets in July. Proceeds from the bonds and securitization were used to refinance our 2020 debt maturities of approximately \$1 billion. We returned \$211 million to shareholders in the quarter, including \$61 million in dividends and \$150 million in share repurchases, and we will repurchase at least \$300 million of share this year.

We ended the quarter with \$3.3 billion of cash, cash equivalent and restricted cash, which include \$750 million of cash proceeds from our August bond issuance, which was used in October to prepay a portion of our \$1.1 billion bond that mature in May 2021.

Turning to slide 8, I will review revenue in more detail. Third quarter revenue declined 19.7% at constant currency. The impact of COVID-19 on our business is still sizable, but less profound compared to Q2. Total revenue was approximately \$300 million higher sequentially, with improvement in the rate of decline in equipment sales and post-sales revenue in both the Americas and EMEA. This is consistent with a gradual reopening of business and employee returning to the workplace that enable equipment sales and installation and drove an increase in print volumes sequentially.

In addition, we had a 52% increase in install of our low-end black and white Entry A4 MSP devices, which is partly driven by print demand in the hybrid work environment. In EMEA, which has a larger indirect channel compared to the US, we saw an increase in purchases from channel partner, however, they continue to monitor their liquidity and are closely managing inventory levels. In North America, we also saw sequential improvement within XBS and in indirect partners. Our performance remain strong in government customer within large enterprise.

Equipment sales revenue was down 16.1% in constant currency compared to a decline of 38% last quarter. Improvement in EMEA reflects increased demand of Entry product and sales of Mid-Range office products, including inorganic revenue from the UK-based dealers acquired in the first quarter of this year.

In the US, there was a softening in the decline in revenue within our XBS and indirect channel due to the opening of more business in the quarter compared to last quarter. While large enterprise continued to see year-over-year growth in sales to federal government customer, we had been less impacted by the pandemic compared to commercial customer. Within the Americas, Latin America continues to suffer as lockdown persists more broadly.

Looking at product categories, activity improved in all segment compared to second quarter. Mid-Range product are mostly used in shared workplaces and therefore were most impacted by office closure in quarter two and in quarter three. However, in quarter three, we did see strong demand for our recently launched PrimeLink devices and our new-generation AltaLink connected devices and higher sales to government customer in the US in this category.

In the High-End, COVID-19 continues to impact demand for our production color product, including the Versant entry production color system and Iridesse production press where installs declined year-over-year. These declines were partially offset by continued strength in demand for cut-sheet inkjet system, Baltoro, which is doing well in EMEA and the Americas.

In Entry, we saw strong demand for our A4 black and white devices in both EMEA and the Americas, which is in part a result of the hybrid work environment. Post-sales revenue declined 20.7% in constant currency in the quarter compared to 33.6% last quarter, reflecting the pandemic's impact on business opening and employees gradually returning to the workplace. Our post-sales revenue is largely contractual and most of our contract include a minimum fixed charge and a variable charge based upon print volume. We saw sequential improvement in the rate of decline in post-sales from Q2, which is in part due to a moderation in the rate of decline in page volume as more business reopened.

Post-sales also include unbundled supplies, paper and other sales, which are largely sold through our indirect channel. Sales of unbundled supplies, paper and other declined 20.2% in the quarter compared to a decline of approximately 48% last quarter when inventory purchase from indirect channel were greatly reduced in response to lower demand as a result of the pandemic. We expect channel partner will continue to closely monitor their purchase until there is a stable recovery in page volume.

Revenue from IT services are also recorded in post-sales and grew during the quarter in both our XBS channel in the US and from recently acquired dealer outside of the US. Xerox Services revenue declined 21.3% year-over-year in constant currency compared to a 28.2% decline last quarter. COVID-19 continued to impact the timing of customer purchasing decision, but we are seeing positive sign in our Services business, including an increase in new business signing and an increase in our renewal win rate in quarter three, specifically for Digital Hub and Cloud Print Services and Content Management. Our new business pipeline remains strong and is up in both the Americas and EMEA, which continues to give us confidence that our business will continue to improve as the economy rebounds.

Next, turn to slide 9 on our profitability and earnings. Adjusted operating margin was 7.4% in the quarter, which was 460 basis point lower year-over-year but improved 320 basis point from the second quarter. The sequential improvement reflect a moderation in the rate of decline in revenue as well as continued focus on cost reduction through our Project Own It program and cash preservation action focused on discretionary items that are helping to mitigate the impact of COVID-19. We expect Project Own It will deliver at least \$450 million of gross cost savings this year in addition to around \$1 billion of gross cost savings since its inception in mid-2018.

The actions developed and executed under Project Own It have helped to transform our business to be in a position to react quickly to this year's events, which contributed to delivering positive earnings. In addition to Project Own It, we are continuing actions focused on discretionary spend, which includes the use of certain temporary government program to provide cost relief while minimizing the impact on our employees. We will continue to utilize assistance as available in the fourth quarter.

Adjusted EPS of \$0.48 declined \$0.32 year-over-year, a sequential \$0.33 improvement from last quarter as a result of the impact of COVID-19 on our operation, which more than offset the benefit from cost reduction a lower tax rate and lower shares.

Let's turn to slide 10 on the review of our capital structure. In the third quarter, we took actions that significantly increased our liquidity position. We refinanced approximately \$1 billion of 2020 debt maturities with new five and eight-year senior unsecured bonds and \$340 million private securitization of our US financed receivable.

Our bond issuance was very well received and we raised \$1.5 billion in proceeds. In October, we used the remaining bond proceed to prepay \$750 million of the \$1.1 billion bond that matures in May 2021. Following this prepayment, our debt balance remains \$4.3 billion, flat from year end and we now have only around \$300 million of senior unsecured debt maturing in 2021 and modest debt maturities for 2022.

\$3 billion of our total debt supports customer financing activities and therefore, we break down our debt between financing debt and core debt. Financing debt is allocating by applying a 7:1 leverage to our finance receivables and equipment on operating lease which together, comprise our total finance asset. So, remaining debt is our core debt, which was around \$2.1 billion at that time of the quarter, and we ended the quarter with around \$3.3 billion of cash, cash equivalent and restricted cash, which put us in a net cash position of around \$1.2 billion when netting cash against core debt.

Our pension funded status is updated annually, and as of December 31, 2019, our net unfunded pension liability was \$1.2 billion, which include around \$850 million of unfunded pension liabilities for plan that by design are not funded. In 2019, we contributed \$141 million to worldwide pension plans and expect 2020 contribution will be in line with prior guidance. We have a \$1.8 billion bank revolver, which is fully available to us, and as I just mentioned, we ended the quarter with approximately \$3.3 billion of cash, cash equivalents and restricted cash.

Last, turning to slide 11, I will wrap up. We expected a slow gradual recovery in the second half under our base scenario. While our business improved quarter-over-quarter, we remain cautious modeling multiple scenario, given the uncertainty around the pandemic and its recent surges around the globe. We do not anticipate a recovery in our revenue to pre-COVID-19 levels this year.

Having said that, we have identified levers that can be actioned to manage through an elongated recovery, if required. Under the numerous recovery scenario we have modeled, we expect to deliver positive free cash flow and earnings in the fourth quarter. But given the level of uncertainty around the pandemic, we are not providing more specific financial guidance for 2020.

Regarding capital allocation, we strengthened our balance sheet in the quarter and improved our liquidity by refinancing near-term debt, resulting in modest debt maturing in 2021 and 2022. Our cash position supports our shareholder return policy to return at least 50% of annual free cash flow to shareholders, including dividends and share repurchases, and we plan to repurchase at least \$150 million of share in the fourth quarter in addition to the \$150 million repurchased in the third quarter. These times are unprecedented, and the entire Xerox management team is focused on cash and cost management in order to anticipate scenarios that may develop.

I will now turn it back to John.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

Thank you, Xavier. Now, let's open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from the line of Ananda Baruah from Loop Capital. Your question, please.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Hey. Good morning to you guys. I really appreciate you taking the questions and congrats on continued progress. I know there's probably a lot of questions, so I'll try to keep it brief. I guess, the first is that could you talk – you gave good detail about the GOs and sort of high level on the environment. Could you give a little more context on some of the comments that you made around sort of adding and renewing contracts in Fortune 500? Do you think this is something that has legs or are people genuinely looking at sort of putting on projects and doing refreshes that are put on the side and things like that? And then, along with that is, you've talked of growing market share in production and growing share in three segments. And could you talk to why that is or why you believe that's the case and are there any structural shifts going on there that are leading to that? And then, I have one quick follow-up. Thanks.

Xavier Heiss

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

A

Okay. So good morning, Ananda. So regarding the environment, in terms of renewal contracts there, as you know, Xerox is focused on the selling, what we call added-value contract to our customers there. And what we see from a renewal point of view is, first, our renewal win rate improved sequentially quarter-over-quarter. And we saw as well an uptick in what is our new offering supporting COVID-19, specifically all offerings around software and the digital transformation, including Digital Hub and Cloud Print Services there. So, good traction. Company are still looking at transforming some of their processes and leveraging our offerings there.

Regarding market share, yes, this is IDC data, quarter two data. We are quite proud of having maintained our production leadership on both region, America and EMEA, with, I would say, significant improvement there. We are also seeing and this is related to the, I will call, that hybrid work environment, we are also seeing a lot of activity around Entry product A4 printers there. And we are quite unique here by providing under a safe, secure control on cost competitive environment. We are providing offerings to customers that match their requirements.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

That's super helpful. And then just quickly on free cash flow for December, what are the different sort of levers and offsets that could have the free cash flow not be positive? It's usually your strongest free cash flow quarter and you're positive this quarter. And so what would cause it? What are the different levers and what would cause it not to be?

Xavier Heiss

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

A

Yeah. So, as you know it, Ananda, we have put in place the cost discipline. And I would put that finance flexibility in our model that give us, I would say, confidence that we can deliver positive earnings and free cash flow during quarter four.

One key lever within this is around first de-levering our earnings. And second point is on working capital and we have levers here that we have identified under the team. We're currently putting a lot of discipline around improving some of the working capital lever.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Okay. Appreciate it. Thanks, guys.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

A

Ananda, thank you.

Operator: Thank you. Our next question comes from the line of Matt Cabral from Credit Suisse. Your question, please.

Matthew Cabral

Analyst, Credit Suisse Securities (USA) LLC

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Yes. Thank you. As you guys are starting to see customers return to the office, wonder if you can talk about what page volume or usage trends have looked like for those customers compared to pre-pandemic levels. And then looking forward, just curious if you think the sequential improvement in revenue continues into Q4 and into next year or if you've seen things start to slow down a little bit as cases have begun to pick up again around the world?

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

A

Yeah. Ananda, Sorry, no Ananda. Matt. Sorry about that. Good morning, Matt.

Matthew Cabral

Analyst, Credit Suisse Securities (USA) LLC

Q

Good morning.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

A

As we look at it, as we do our modeling, we're modeling a modest improvement quarter-over-quarter. And again, we can't model the uncertainty of the pandemic. We really can't predict what it's going to look like. But I can say that our strategy continues to capture the top line opportunities and I think of how we go about doing it. As you know, as companies are in a hybrid environment today, they're requiring technologies that increase productivity and that's a discussion that goes on while maintaining security. Security is becoming a big issue in this hybrid environment as well as cost effectiveness. And we've been investing in these offerings in IT services and

DocuShare Go, our Intelligent Workplace Services, our Capture & Content. And that's a bit what's allowing us to capture not only renewals but also new deals going forward.

Matthew Cabral

Analyst, Credit Suisse Securities (USA) LLC



And then as my follow-up, circling back to the prior answer on working capital, just wondering if you can talk a little bit more about when you think that'll start to reverse, particularly on inventory given some of the revenue dynamics. And thinking about capital allocation more broadly, wonder if you can talk about your ability to maintain this level of buybacks as we head into next year and how you're sort of weighing M&A versus repurchases going forward.

Xavier Heiss

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



Okay. Good morning, Matt. So regarding working capital, as I mentioned it here, this is our area of focus in quarter four. You know that usually sequentially, our quarter have like those seasonality. I don't know if you noticed it there. But in quarter three, quarter three was our highest quarter from a revenue point of view this year, where usually quarter two came as the second and quarter four is the best quarter here. So we expect and we have modeled, we have different models here managing the – or modeling the different outcomes that could happen during the quarter there. But we expect quarter four to be a stronger quarter from a revenue point of view versus quarter three sequentially and this will help some of the lever that we have on working capital and specifically on inventory.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.



And the only thing I would add is that we continue to be opportunistic about M&A despite the COVID-19 crisis and we evaluate our pipeline with a disciplined approach, looking at IRR, ROIC, cash flow yields and we're looking both at tuck-ins and strategic acquisitions. That's ongoing. That hasn't stopped there.

Matthew Cabral

Analyst, Credit Suisse Securities (USA) LLC



Thank you.

Operator: Thank you. Our next question comes from the line of Shannon Cross from Cross Research. Your question, please.

Shannon Cross

Analyst, Cross Research



Thank you very much. John, I was wondering if you could talk a bit about how you're thinking about the various scenarios you're modeling and what I'm trying to get at is, is there an opportunity for maybe some fundamental changes in how Xerox approaches business? You've done certain things. You outsourced obviously with Global Imaging, to HCL for back office. I'm wondering thinking back to some of the things that maybe Pitney Bowes has done over the years and therefore, face some pretty significant revenue challenges maybe moving more to inside sales, I don't know, changing the way that you approach from a technician standpoint and a maintenance standpoint. I'm just curious as to maybe if you can give us an idea of the scope of what you're looking at and how much flex you do think there is in the model. And then I have a follow-up. Thank you.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

A

Yeah. So, as we're modeling, we're modeling all scenarios if you can imagine. And if we look at what happened in Q2, we still managed to deliver a positive free cash flow, but we're modeling – going forward, we continue to make sure that as part of our modeling, we're continuing investments.

So if we think of just inside of our business, I spoke briefly about RPA and robotics. And in the quarter just our robotics process automation, we saw over 1.5 million transactions across the organization. That's like 300% increase year-over-year, and that's in everything from order to cash to supply chain to human resources to sales. We're also focused on this whole DocuShare GO. I come back to the hybrid environment and what we're seeing is a trend of clients asking for security and cost effectiveness because we're not modeling everyone going back to the office in the near future, because if that happens, we don't need to model it. We have it. But what we are modeling is how we're helping our clients' transition and assure that their employees are secure and productive going forward.

And finally, I would say in innovation. We continue to invest in innovation. We're continuing to invest in monetizing the long-term innovation and in areas that gives us a little bit of confidence as we're starting to see contracts like the DARPA contract that we just explained. In cleantech, we'll have the prototype in 2021. That seems to be on track right now. So there's a lot of exciting coming into innovation. While we're not anticipating the revenue this year, it helps us with the future.

Shannon Cross

Analyst, Cross Research

Q

Okay. Thank you. And then, I'm curious from an equipment standpoint, clearly, there was some pressure on margins I assume because of the mix shift more to the lower end devices. But just in general, as you've talked to your suppliers and think about where pricing is in the environment, how should we think about the ability to hold margins and also on page volume, how should we think about or cost per page, I guess, how should we think about the pricing environment there too given the weak environment that we're in? Thank you.

Xavier Heiss

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

A

So, good morning, [ph] Shannon (00:47:01). So as you know, we managed very carefully the margin here. And we are not, we call that like a me-too environment where we just have two-thirds the price of the box. Usually, the equipment that we have come with services there and we brought as well with the ConnectKey environment a lot of functionality that our customer required currently into the new work environment. So, all the abilities, the ability to manage workflow and digitalization of the document helps them in the current environment here.

So the mixed change that you mentioned there is one of the things that we observe there. But at the same time, we manage this there. Just for you maybe to get insight on those this quarter, currently, has a little bit of an impact there on the margin from the pressure and a little bit of tariff. When you speak about year-over-year but also quarter-over-quarter, some of the tariff had an impact there. So we still continue to manage margin very strictly there and we want to be certain to get the right offer at the right price in front of our customer.

Shannon Cross

Analyst, Cross Research

Q

Great. Thank you very much.

Operator: Thank you. Our next question comes from the line of Paul Coster from JPMorgan. Your question, please.

Paul Coster

Analyst, JPMorgan Securities LLC

Q

Yes. Thanks for taking my question. Just, first of all, on the black and white Entry level product, which seems to be doing quite well at the moment owing to the hybrid work model, how much – do you feel like that's got legs to it? And how has it changed your sort of go-to-market motion? I mean, some of the fulfillment obviously is going to be to the home. And I imagine some of the purchase decisions have shifted to employees at least in some businesses. Perhaps you can just talk us through that a bit.

Xavier Heiss

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

A

Yes. So, good morning, Paul.

Paul Coster

Analyst, JPMorgan Securities LLC

Q

Good morning.

Xavier Heiss

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

A

The first thing you said there, the – what you call the Entry model there, so A4 black and white is now becoming part of the new hybrid model there. And as you know it, employee could be asked to work from anywhere and working from home is also a trend that we are seeing there. However, we are not like in a personal printing model there. So we are speaking here about literally what enterprise customer ask us to deliver, which is secured. By secure means a bulletproof environment from a security point of view. So company knows that what is being printed or being sent to printer is safely printed there.

On second point of cost competitive set of machines there, by cost competitive, it's not only the price of the equipment but it's also the post-sales and the cost of consumable coming with the equipment there. So we see progressively the shift, this is complementing the offerings that we have currently with our existing set of products there.

To answer to your second point regarding channel inventory, the good point is that the channel inventory, weeks of inventory has improved from quarter two to quarter three. And we see as I mentioned it, our channel partner making wise decision on cash management there. And we are supporting their purchase there and we are clearly driving the activity when they have the end point demand with them there. So, channel inventory is not a concern and we have the route to market to enable these new ways of working in this hybrid environment.

Paul Coster

Analyst, JPMorgan Securities LLC

Q

Okay. Quick follow-up for John. I mentioned your uncertainty is really an expression of your customers' uncertainty. And in the enterprise space, I mentioned most of them are sort of making things up as they go along here because we all are. But have any of them said to you, we've had a fundamental rethink about the way in which we use printers, good or bad. So a strategic level decision that you think we should be aware of.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

No. I would say that the discussion is more based on I have this workforce today that's remote, how do I keep it secure, how do I assure what they're printing is not going to get me in trouble in the future because there's a lot of information that's out there. Secondly, the conversation that happens, at least at my level and below, is the cost.

So, while at the beginning everybody went running home and acquiring printers and PCs and all of that, everyone's pretty much acquiring their own supplies and there's really no control. So those are the two things they're looking at. So this hybrid environment, we don't know how long it's going to be. We don't know what percentage is going to come back to the office, Paul. But we do know that as this goes on, productivity becomes important, security becomes important, workflows – understanding where the workflow is becomes important. And that's where we've been focusing on with our clients in the large enterprise.

SMB, same conversation, slightly different where they're looking at virtual prints and they're looking at ways that if they have to work from home, how do they know what's being workflow-ed at home and how to do they assure they keep their information. That's a little bit where we're seeing upticks and we look at IT services and our softwares and all of them growing quarter-over-quarter and year-over-year.

Paul Coster

Analyst, JPMorgan Securities LLC

Thank you very much.

Q

Operator: Thank you. Our next question comes from the line of Jim Suva from Citigroup. Your question, please.

Jim Suva

Analyst, Citigroup Investment Research

Thank you very much. First, one clarification question, then kind of a more detailed question. On the clarification question, on your prepared comments, you mentioned keeping the dividend rates where it is. Some people interpret rates in two different manners. One is a payout rate like as a percent of cash flow generation. Some people consider it as a rate like a yield percent. And some people consider the rate like you currently have. I think it's about \$1 per share. Look, you can just maybe clarify that.

Q

And then the more detailed question is, can you talk about the innovations coming out our Research Park. It sounds like the liquid metal is the kind of one that's coming out more sooner. And I don't recall hearing a lot more about the HVAC system. Is that still in the works? And it sounds like that's kind of a little bit of a longer term one, but just update us on Research Park. Thank you.

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

Good morning, Jim. No change on the dividend amounts. So that's really no change. It's what it's always been, okay? So, just to answer that.

A

And then on innovation, it's really – we're still on track. So we're looking at monetizing. We've talked about 3D IoT. And in 3D, we're on track to launch the first version of the liquid metal 3D printer. It'll print [ph] aluminum 4008

(00:53:59) which is one of the alloys we're working on and it's in multiple industries. We'll produce prototyping. We're having conversations now with possible clients on utilizing it before we formally announce it. And our road map includes expanding the range of metal alloys. So as we're looking at these offerings in innovation, it's important to have road maps that go across the next two to three years.

In cleantech, we're excited, like, it's science, but the team right now is on track to complete a prototype in 2021. And that – it has the potential to cut the energy consumption of air conditioning of up to 80%. So it's not just – it's reducing greenhouse gas emissions, indoor quality in the buildings and frankly, it's going to be reducing energy bills for businesses and individuals. So we're excited about that, but it's science and we're looking – right now, we're on track to develop a prototype by 2021.

Jim Suva

Analyst, Citigroup Investment Research

Q

Great. Thanks so much for the details. It's greatly appreciated.

Operator: Thank you. Our next question comes from the line of Katy Huberty from Morgan Stanley. Your question, please.

Katy L. Huberty

Managing Director-Research, Morgan Stanley

Q

Thank you. Good morning. Just looking at segment performance, those with more channel exposure like EMEA and supplies and paper improved faster than the rest of the business. So, I guess, the question is whether you view that restocking as a one-time benefit or could we continue to see restocking as we go into the fourth quarter and early 2021?

Xavier Heiss

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

A

Good morning, Katy. So, first of all, yes, EMEA had a little bit more pickup there. You know that the COVID-19 had an impact as well. The business reopened a little bit earlier than in other geography, specifically compared well to Latin America which is one of our large channel area out there. We're getting supplies, papers, or everything which is around inventory management. As I mentioned earlier, our partner distributor and reseller manage their cash currently very wisely. And clearly, we do not expect like a big stocking activity happening there. What we expect is just a seasonality, the quarter four seasonality where we see an uptick on sales, but we do not expect the partner to go back to a high level of inventory or higher level of inventory as they are managing their cash very wisely currently.

Katy L. Huberty

Managing Director-Research, Morgan Stanley

Q

And what do you view as normal seasonality in 4Q sort of up 8% to 10% sequentially or something like that?

Xavier Heiss

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

A

So, usually, we do not provide you this number, Katy, as you know, it's out there. But if you look at historically, our quarter four is a stronger quarter. But let's be also here – let's face the facts there. The ability for certain customer at the end of the year to use their budget and to close their fiscal year there, we certainly be different this year compared to former years there. So I won't use a pure reference point. We are modeling all potential scenarios

here in order to ensure that, as we mentioned it, we will deliver positive earnings and positive free cash flow in the quarter.

Katy L. Huberty

Managing Director-Research, Morgan Stanley

Q

Okay. And, Xavier, you walked through the dynamics around the year-on-year decline in gross margin. Can you walk through what drove the 170 basis point sequential decline in gross margin given the revenue improvement?

Xavier Heiss

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

A

Yes. So, it is mainly on the – if you look at this, I explained it high level there, but we had a little bit of tariff impact on the – some, I'll call that tech – not technical items, but items related to the mix that we have in the business. But I would say not so significant here. What we have seen elsewhere there is that from a gross margin point of view, we have had some, I'll call that, subsidies or money being given by government here. Quarter two over quarter three, this amount was less. So I won't give you precise number there, but it was significantly less. As well, if you model quarter four, in quarter four, we do not expect this amount to be as strong or as big as what they were in quarter two and a little bit less money in quarter three.

Katy L. Huberty

Managing Director-Research, Morgan Stanley

Q

Okay. Thank you.

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

Giovanni John Visentin

Vice Chairman & Chief Executive Officer, Xerox Holdings Corp.

Thank you for your time today. Look, we continue to be guided by the strategic imperatives we've laid out. The strong fiscal policy instilled throughout our company provides the flexibility to increase investment or dial back spending where necessary. Behind every challenge is an opportunity. And we have taken this opportunity to speed our transformation and invest in our future. Be safe and be well.

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

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