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Xerox Holdings Corp. (XRX)

Q2 2021 Earnings Call
CORPORATE PARTICIPANTS

Giovanni John Visentin  
Vice Chairman & Chief Executive Officer  

Xavier Heiss  
Executive Vice President and Chief Financial Officer  

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Ananda Baruah  
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Shannon Cross  
Cross Research  

MANAGEMENT DISCUSSION SECTION

Giovanni John Visentin  
Vice Chairman & Chief Executive Officer  

BUSINESS HIGHLIGHTS

Revenue, FCF and Adjusted EPS

- I hope everyone is safe and healthy  
- We saw growing demand for our products and services in Q2  
- Revenue totaled $1.79B, up 22.4% y-over-y or 18.1% in constant currency  
- FCF was $198mm, up $183mm y-over-y  
- Adjusted EPS totaled $0.47, up $0.32 y-over-y  
- And adjusted operating margin was 7%, up 280BPS y-over-y  

Equipment Sales and Print Volume

- Increased equipment sales and print volumes are consistent with the continuing gradual return to the office, and give us confidence to reaffirm our revenue and FCF guidance for the year  
- In Q2, we increased investments in our operations and targeted growth areas, while generating greater FCF
Cash Flow Guidance

- Our reaffirmed full year cash flow guidance reflects our commitment to fund initiatives that will return Xerox to long-term growth
- Our four strategic initiatives – optimize operations, drive revenue, re-energize the innovation engine, and focus on cash flow and increasing capital returns – continue to guide us and serve us as the foundation of our transformation

Global Supply Chain

- The operating discipline instilled through Project Own It has enabled our team to navigate through an unprecedented level of uncertainty, including a pandemic and the resulting disruption of the global supply chain, while continuing to deliver value to our clients
- Increased demand and material shortages impacted the supply chain of certain products to our customers this quarter, creating a backlog of equipment, including IT products, that is nearly double that of last year’s
- Despite these constraints, we delivered strong equipment sales results in Q2
  - We expect that supply chain challenges to persist through at least Q3 and possibly through the year
- We are working with our global suppliers and transportation partners to mitigate the impacts to both Xerox and to our clients

Project Own It

- The team remains committed to further optimizing operations to make it easier for customers and partners to work with Xerox, while reducing costs
- Project Own It is on track to deliver $375mm of gross cost savings this year
- At the same time, Project Own It has freed up cash, allowing us to reinvest in targeted growth areas and digital transformation technologies
- Robotic process automation and analytics were our initial areas of focus for digital transformation
  - Bots are now managing increasingly more complex transactions across the enterprise in every business and function, completing 4mm transactions per quarter, up 300% y-over-y
  - We have expanded our investment focus to include augmented reality and artificial intelligence
- Utilizing these technologies internally will improve the service experience for customers, make us more efficient and create additional opportunities for Project Own It related savings in the future

Page Volume and Post Sales Revenue

- The gradual return of workers to the office, combined with strong demand for our products and services, positions Xerox to return to growth this year
- The correlation between greater levels of in-office work and increased page volumes continued in Q2 as page volumes increased slightly compared to Q1
- Based on what we know today, more customers are planning to bring employees back on site beginning in Q3, building to a more fulsome return by the end of the year
- With this, we expect page volumes and post sales revenue to improve, driving higher margins in H2
ESR

- In preparation for bringing more employees back on-site, customers are investing in more office technology
- This is demonstrated by our y-over-y growth in equipment sales revenue for office-centric devices
- ESR in every category grew compared to Q2 2020

Market Share

- In print, taking market share is an important part of our strategy to return to growth
- Enhancements to our print portfolio, coupled with investments in security, cloud and automation are enabling us to capture share
- According to the latest data available from research firm IDC, our market share performance for Q1 was our best in the past three years, having taken share in all product segments in the regions Xerox serves

Managed Print Services

- Managed print services also benefited from these investments
- According to the most recent IDC MPS 2020 market share report, Xerox continues to be the global and US leader, and we expanded our lead in the US where we grew our share to 21%
- In fact, we were the only provider to grow market share in 2020
- MPS remains an attractive market for Xerox
- MPS spend in both the enterprise and SMB markets is projected to grow over the next three years

SMB Market

- The SMB market continues to play a key role in our strategy to return Xerox to growth
- To accelerate our expansion in this market, we acquired two document solution providers in Q2, one in the US and one in Canada
- Each acquired company is well established in a growing local market, giving us an opportunity to knock out competitors and provide MPS and adjacent offerings such as IT services
- In Q2, IT services sales and signed deals continued to be strong

Managed IT Services

- Our managed IT services includes high growth offerings such as advanced security services and RPA
- RPA launched in February, and is already seeing early success with SMBs in various industries including legal, healthcare, and financial services

Xerox Financial Services

- Earlier in the year, Xerox Financial Services expanded its leasing platform to provide customers and OEMs with a total solution for financing equipment, software, IT services, and other office needs
- In the quarter, we used $60mm of cash to fund originations growth
- XFS grew originations compared to last year and Q1, up 54% y-over-y and 7% compared to last quarter
  - We expect XFS to carry this momentum throughout the remainder of the year
Software

- In software, we are revolutionizing the way service technicians and customers solve technical challenges.
- At the same time, we are helping businesses solve three of their biggest challenges: the skill gap, talent shortages, and greenhouse gas emissions.
- Companies are looking to technology to overcome these challenges, which is why the total addressable market for next-generation service delivery software is expected to reach $80B by 2027.

PARC

- Our software solution makes expertise instantly accessible for customers, employees, and field workers through live visual interactions, instructions, and insights as part of a seamless digital workflow experience.
- To deliver this experience, we integrated augmented reality from CareAR, DocuShare’s content management system, personalization software from XMPie, and artificial intelligence from PARC to create the industry’s first service experience management platform.
- Making any user an expert capable of solving technical issues means companies can service their customers with fewer dispatches of highly experienced technicians.
  - This is why blue chip companies such as Verizon are starting to use our service experience management platform.

Strategy

- PARC continues to execute on its commitment to monetize innovation.
- Part of our strategy includes working with strategic partners to accelerate the commercialization of new technologies in our focus areas: 3D printing, industrial IoT, and clean tech.
- Collaborating with partners provides several benefits from speeding up product development to expanding our reach.

Partnership with VicTrack

- One example of this is our partnership with VicTrack, a state-owned enterprise in Victoria, Australia.
- Together we announced Eloque, a joint venture to commercialize PARC-developed industrial IoT technology that will remotely monitor the structural health of critical infrastructure assets such as roads and railway bridges.
  - This solution tackles a global secular challenge, the world’s crumbling infrastructure.
- In the US alone, 42% of bridges are at least 50 years old and nearly 231,000 bridges are in immediate need of repair and preservation work.

Mississippi River

- The recent closure of the I-40 bridge over the Mississippi River demonstrates the fragility of the world’s aging bridges, the safety issues and the economic impact that results when they fail or need to be closed.
- The bridge has now been closed on an emergency basis for more than 75 days since a cracked steel beam was first discovered, and there is no reopening date yet set.
- The US trucking industry loses $2mm every day the bridge is closed.
- And this ongoing closure further strains the country’s already fragile supply chain.
Eloque Solution

- Our Eloque solution uses tiny fiber optic sensors that attached to a bridge to accurately measure its structural health
- Advanced analytics are then used to evaluate the sensors’ data and deliver insights directly to the bridge owners and operators in real time, revealing if the bridge had structural problems or damage that needs repair
- As a result, infrastructure operators can rely on technology and data to prioritize repairs rather than waiting until a physical inspection reveals a major problem

Eloque’s Technology

- The Victorian Government has already committed AUD 50mm to deploy Eloque’s technology on bridges across the state, including several of its high priority bridges by year end
- The team is now engaging public officials and infrastructure managers in the US and other countries about deploying this new technology elsewhere

FCF

- For the quarter, FCF was $198mm, up $183mm y-over-y
- We delivered strong improvement in FCF, while investing in our operations and our targeted growth areas such as XFS, software, PARC innovation
- In the quarter, we also repurchased $251mm of outstanding shares, demonstrating our continued commitment to shareholder returns
- In H2, we expect FCF to grow as revenue and margins improve
  - This gives us confidence in our ability to generate at least $500mm of FCF for 2021, while we continue to make investments that position the company for long-term sustainable growth

XFS, Software, and PARC Innovation

- Before turning it over to Xavier, let me recap a few key points
- We expect the return to the workplace around the world and increasing demand will enable Xerox to return to growth in 2021
- Along the way, there will be challenges we can predict, such as supply constraints, and challenges we cannot predict, such as the impact of the Delta variant
- But the Xerox team has demonstrated it can navigate through difficult periods full of unanticipated challenges
- Long-term sustainable growth will be driven by taking share in print and growing our adjacent offerings as well as XFS, Software, and PARC Innovation
  - We plan to provide more details on our strategy at our November Investor Day

Xavier Heiss

Executive Vice President and Chief Financial Officer
FINANCIAL HIGHLIGHTS

Performance

- We are pleased with our Q2 result
- We experienced significant y-over-y growth in all key financial metrics and sequential improvement in revenue, FCF and earnings
- Revenue growth reflected strong demand for both equipment and supplies
- And page volume, which grow sequentially from Q1 to Q2, continue to demonstrate a high degree of correlation with the gradual reopening of workplaces

Gross Margin

- Strong demand, along with ongoing supply chain disruption, resulted in an order backlog for equipment, including IT product that is significantly higher than last quarter
- Higher revenue and operating leverage drove significant growth in our profitability in Q2
- Gross margin declined 290 basis point y-over-y due to higher mix of equipment sales, lower government subsidies net of Project Own It savings, lower FUJIFILM Business Innovation royalty revenue and higher freight and delivery costs

Adjusted Operating Margin

- Adjusted operating margin of 7% increased 280BPS y-over-y, reflecting the flow through of higher revenue, lower bad debt expense on savings from Project Own It, which were partially offset by the impact of lower government subsidies, increased R&D investments supporting our targeted growth areas and higher compensation accruals

SAG Expenses and RD&E

- SAG expense of $434mm increased $8mm y-over-y, including $15mm negative impact from translation currency
- This increase was partially offset by lower bad debt expense of around $10mm, which included $6mm reserve reduction
- RD&E grew y-over-y, yet improved 80 basis point as a percentage of revenue
- We remain committed to investing in PARC’s Innovation towers, [ph] CareAR (16:32) next generation service experience management platform and enhanced product and solution for our print and IT services clients
- Other expenses, net of $1mm, was $6mm lower y-over-y, primarily driven by a reduction in non-service retirement-related costs, partially offset by higher net interest expense

Adjusted Tax Rate

- Second quarter adjusted tax rate was 9.7% compared to 23.4% last year, a 13.7% y-over-y decrease primarily reflect a 16 percentage point benefit from a change in tax law, resulting in the remeasurement of deferred tax asset as well as a geographical mix of earning
- Adjusted EPS of $0.47 in Q2 increased $0.32 y-over-y
  - This increase reflect higher profit from operation, lower taxes, reduced share count and lower bad debt expense, partially offset by higher net interest expense
GAAP EPS of $0.46 was $0.35 higher y-over-y, due to a decrease in adjusted items, including lower y-over-y non-service retirement related costs, partially offset by higher restructuring charges.

Revenue

- Turning to revenue, we continued to see improving trend across geographies on customer segment and solid demand drove increased sales in the quarter.
- Sales were particularly strong through indirect channel partners, which have begun rebuilding inventory level in anticipation of a recovery.
- EMEA has a larger indirect channel compared to the US, and grew 33.2% in constant currency y-over-y compared to 12.7% in the America.

Equipment and Supply Sales

- Most geography had strong growth in equipment and supply sales.
- Despite growth in revenue, we, like many other businesses, have experienced supply chain challenges.
- As a result, our backlog for equipment, including IT products, in the June quarter was almost double that of the prior year, and our equipment backlog is well ahead of pre-COVID levels.
- We expect supply chain disruption to continue in Q3, but we’re actively working with current and alternative suppliers to mitigate any potential disruption to our customers.
- Equipment sales of $429mm in Q2 increased 38.4% y-over-y or 34% in constant currency.
- Similar to Q1, sales increased across entry, mid-range and high-end product and in both North America and EMEA.
  - This quarter, sales of office-centric devices led the increase, indicating a trend toward businesses planning for a return to work.

Post Sales Revenue

- Post sales revenue of $1.4B increased 18.1% y-over-y or 13.8% in constant currency.
- Page volume modestly increased sequentially in quarter two, with economies such as UK, France, and Germany beginning to come out of partial lockdown in the quarter.
  - While we are seeing a correlation between return-to-office trend and print volume, the pace of employees returning to office has been gradual.
- We expect continued improvement in page volume throughout the remainder of the year consistent with the pace of workplace and school reopenings.

IT Services

- Post sales also include unbundled supplies, which grew significantly, reflecting increased demand particularly through resellers.
- IT services, which is included in other sales, was impacted by global supply constraints that affected hardware technology installed.
- Demand for our IT services offerings, including our RPA solutions for the small and medium-sized business is growing across industry verticals, and signings continue to be stronger.
- Last, our services signings grew in the quarter as did our renewal win rate.
- Our services pipeline is strong.
CASH FLOW ITEMS

FCF

- Next, turning to cash flow, we are pleased with our FCF result
- FCF grew significantly in the quarter from $15mm in the prior year to $198mm this year
- Importantly, we generated a solid growth in FCF, while continuing to invest in our operations and targeted growth area
- We generated $214mm of operating cash flow in the quarter, which was an increase of $180mm compared to prior year

Working Capital

- Working capital was a use of cash of $35mm, but was $12mm better than prior year
- This reflects y-over-y improvement in inventory and accounts payable, which was partially offset by an increased use of cash from accounts receivable driven by revenue growth
  - However, DSO was significantly better than Q2 2020

FUJIFILM Business Innovation

- Other notable cash-related items in the quarter include $100mm one-time payment from FUJIFILM Business Innovation related to the two-year extension of a license for the continued use of our brand in Asia Pacific
- This increase was partially offset by $60mm use of cash to grow the lease portfolio of our XFS business
- I will talk more about XFS shortly

CapEx

- Cash from investing was $55mm use and includes the acquisition of dealers in Canada and the US to support our SMB growth strategy
- CapEx was $16mm in the quarter
- CapEx primarily support our strategic growth program and investment in IT infrastructure
- Within financing cash flow, $115mm of securitization debt was repaid
  - This debt amortized monthly and we expect to issue additional securitizations in support of XFS growth in 2021
- Finally, in the quarter, we repurchased $251mm of share and paid $54mm in dividend, resulting in a return of cash to shareholder of $305mm, well in excess of FCF of $198mm

Profitability

- Looking at profitability, Q2 improvement in adjusted operating margin reflects the flow through of higher revenue, disciplined expense management on cost savings generated by Project Own It, which is on track to deliver $375mm of gross cost savings this year

Price and Cost Perspective

- Further, we are managing supply chain disruptions impacting our business, including increased delivery on freight cost
- We are confident in our ability to mitigate this impact from both price and cost perspective
We expect continuing improvement in operating margin in 2021, driven by improvement in revenue as more people return to the office, and we execute on our strategy to gain share in print, and grow our XFS, IT services and Software businesses.

XFS

Turning to XFS, we are progressing on our growth plan and look forward to providing more financial and operating detail about this business at our Investor Day in November.

XFS lease origination increased in the quarter, both sequentially and y-over-y, mainly driven by XBS. We expect the portfolio will continue to grow throughout the year, and we execute on our strategy to expand XFS presence beyond Xerox equipment and services.

Cash wise, XFS portfolio growth created $60mm use of operating cash compared to a source of cash of $74mm in the prior year’s quarter.

Continued growth of XFS portfolio is included in our cash flow guidance for 2021.

Capital Structure

Next, looking at capital structure, we ended June with a net core cash position of $1B. $3B of the $4.2B of debt outstanding is allocated to and support the XFS lease portfolio.

So, remaining debt of around $1.2B is attributable to the core business.

Debt primarily consists of senior unsecured bonds on asset securitization.

We have a balanced bond maturity ladder with no bonds maturing in 2021, and $300mm maturing in 2022.

We also had $2.2B of cash, cash equivalent and restricted cash at the end of the quarter.

We have spent [ph] $413mm (25:59) on share repurchase since the beginning of the year, which contributed to the $300mm decrease in net core cash since the end of 2020.

GUIDANCE

Finally, we will move to guidance.

Growth in install activity, our backlog and print volume indicate our customers are planning for broader return of employee to offices in the back half of the year.

Accordingly, we expect to see an increasing level of in-office work more weighted to the end of Q3 and Q4 and a gradual recovery in our business.

We remain focused on executing our strategy to grow revenue and cash flow.

We are maintaining our full year guidance of at least $7.2B of revenue.

And despite the ongoing supply chain disruption, we'll remain confident in our ability to generate at least $500mm of FCF in 2021.
QUESTION AND ANSWER SECTION

Ananda Baruah
Loop Capital Markets LLC

Q

Just two quick ones, if I could. I guess the first is on the FCF. You guys are tracking, I think, $300mm YTD, and typically H2 the year, particularly December quarter, is stronger than H1 the year. So, is it just a healthy dose of conservatism? I know the guidance is at least $500mm, but it would seem like you guys are set up to do probably more than $600mm, unless there are some puts and takes. And I have a quick follow-up. Thanks.

A

Xavier Heiss
Executive Vice President and Chief Financial Officer

Yeah. Thanks, Ananda. So, yes, we are pleased with a result we delivered in quarter two both from a revenue, but specifically as well from a FCF point of view. As you know it, we have a plan to invest in the business in our different [indiscernible] (28:16) including XFS. That’s the reason why we keep this guidance to $500mm. So, it’s important for us to leverage this strategy including the investment, not only cash but also P&L that we’ll have for the rest of the year.

Ananda Baruah
Loop Capital Markets LLC

Q

Got it. And then just with regard, John, to your remarks around the business environment, now that we’re half way through the year, how would you characterize sort of the tracking of the business environment to what you guys are anticipating? Is it relatively in line or are there any meaningful differences, positive or negative, at this point?

A

Giovanni John Visentin
Vice Chairman & Chief Executive Officer

Yeah. Good morning, Ananda. I would say that, look, June had an uptick on – in Q2 in terms of employees going back to the office. And as we look at the rest of the year, you’re hearing a lot of CEOs saying that in Q3 everyone’s going back to the office, the vaccination going on. And the way we see it is that – the way we’re projecting it is probably near the end of Q3, and then we’ll start seeing more and more folks coming to the office in Q4. What gives us confidence is our ESR and our pipeline and our backlog in that area. So, you can see that a lot of companies are setting up for this. And the fact that we’re gaining market share in that area gives us confidence, but yeah, that’s how we see it, Ananda.

Matthew Cabral
Credit Suisse Securities (USA) LLC

Q

I want to actually follow up on that last question. I guess, as we think about the correlation you guys called out between usage and the return to the office, just wondering if you could be a little bit more explicit on what you’re seeing in terms of usage relative to the pre-COVID baseline, both overall within the base and then, within areas that have been a little bit quicker to return back to the office. And as we start thinking out longer term, just curious for your impact on what COVID has done to this [indiscernible] (30:27).

A

Xavier Heiss
Executive Vice President and Chief Financial Officer
Okay. Hi, Matt. So, as you know it, we are monitoring it [indiscernible] (30:35) and we observe a strong correlation between vaccination, people returning back to the office, and print volumes. We track it day by day, month by month. We have a data point showing how is this data correlate here. So, as you observe it, we don’t have it yet, full population being vaccinated here. But we are encouraged by the progress that we are seeing.

And we are seeing sequentially progress in print volume directly related to the presence in the office. We’re not the only one reporting this type of indicator, but this give us confidence that for back end of quarter three, specifically September and for quarter four, we will return to better print volumes that we have here.

Regarding your second point on the trend on how people are working, what we observed today is that, there is a mix of different approach company by company around bringing employees back to the office certain number of days, but what we see that when employees are back to the office, they print, and some of the volume they print up, some of the volume they usually do not print at home are volumes that could be printed on, I would say, lower type or lower – different types decentralized solution. I won’t call it the hybrid work, but what we see currently is that the overall, the print volume 100% office remains strongly correlated.

Matthew Cabral
Credit Suisse Securities (USA) LLC

Okay. That’s helpful. And then, shifting over to gross margins, just wondering, if you could dig a little bit more into – some of the pressure points that you’re seeing – and I know you got called out supply chain issues is one of the factors. I’m wondering if you could quantify that impact.

And I guess similar to my last question is as we look out longer term, historically, this business had been one that supported gross margins kind of around that 40% range prior to COVID. I guess I’m curious, do you think that’s still an achievable level going forward or has something structurally changed as we think about emerging on the other side of COVID from a profitability standpoint?

Xavier Heiss
Executive Vice President and Chief Financial Officer

Yeah. So, I will start with your first question which is around what has driven the gross margin difference in this quarter here. So, as you have seen it, the product mix which is a more equipment sales revenue – by the way, we have very strong renewals on equipment sales revenue here. John mentioned it, but we gained market share on both our, what we call, the base business, the ESR type of business but also on MPS. So, we are a leader on our segment in our territory. And this is quite important because it’s clearly show the correlation between employers wanting to have employees being back, investing in their infrastructure, so they can operate when they are back in the office.

Regarding the specific element or specific impacts that we have on gross margin, so product mix is number one. The second one is we have faced, as a lot of industry, some increased freight on delivery costs specifically related to certain tension in containers and cost of shipment here, as you know it as well. Third element is Fujifilm. We have lower royalty from Fujifilm even if we have had some good news from a cash point of view in our FCF on Fuji. But from the profit point of view, we had lower royalty.

On last item, this is more y-over-y compare, government subsidies were at the highest point in quarter two last year at the peak of the pandemic. And those have been lowered, as I mentioned it in my initial comment here.

So, now back to the gross margin, your gross margin question, what is a normalized view. Clearly, there is a straight correlation between revenue, our ability to drive up revenue growth and gross margin, and specifically on
post sales revenue. So, it is possible to go back to the gross margin with all the activity – gross margin we had before with all the activities that we are driving both from an Own It point of view and also supporting post sales activity. Yes, the trend is going and will be favorable for H2.

Angela Chen
JPMorgan Chase & Co.

You reiterated that your full year guidance is $7.2B in revenue. Thank you for that guidance. So, what do you see are risks to the upside and downside of that target?

Xavier Heiss
Executive Vice President and Chief Financial Officer

So, we are quite confident in this – confident, Angela, in this guidance here. So, obviously, there are things that we can control and there are things that are more difficult to control. So, the things we can control is the way we will execute a presence to the office is something that we feel, I would say, quite strong. However, it is dependent on, I would call, that one element which is the pandemic is still present and the Delta variant could have an impact. But so far what we have seen is that the impact on our – existing impact on the geography we’re managing is quite manageable.

The second element will be supply demand. So far, we have a clear line of sight on how we can manage it here. But if the supply demand on some of the tension on certain component on raw material will stay specifically in Q4, then we will consider the action. But so far, we are managing – even in Q2, I mentioned it, we have had a little bit of supply chain tension here. We manage it. We find alternative ways on supplier to overcome the challenge. And we feel confident that we can deliver the $7.2B.

Angela Chen
JPMorgan Chase & Co.

All right. Great. Thank you. And just a quick follow-up question. So what is your view on print market consolidation broadly speaking?

Xavier Heiss
Executive Vice President and Chief Financial Officer

Okay. So it is a trend that we have seen. This is like a historical. I will always use this expression by saying in order or to dance, you have – you need to have two parties. You know that we have been active on this one. And we are clearly open to I call that dance here and finding the right parties. But the industry consolidation is a long item in this print industry. And it is something that will happen over time.

Katy L. Huberty
Morgan Stanley

With the return to the office in Q4 this year and the behavior of print in the office that you mentioned earlier, should we assume that post sales revenue in Q4 2021 can look more similar to Q4 2019 pre-COVID levels, obviously, assuming the Delta variant doesn't impact current return to office plans.

Giovanni John Visentin
Vice Chairman & Chief Executive Officer

Oh, we’re not...
Katy L. Huberty  
Morgan Stanley

Just want to understand how you’re thinking about that.

Giovanni John Visentin  
Vice Chairman & Chief Executive Officer

Yeah. Katy, in our model for our guidance, we’re not assuming 2019 – to go back to 2019 numbers in Q4. We’re assuming a more modest return, and then, after 2022.

Katy L. Huberty  
Morgan Stanley

Okay. And then in a normal environment, EPS is typically about flat in Q3 relative to Q2, how should we think about the EPS trajectory in the September quarter this year?

Xavier Heiss  
Executive Vice President and Chief Financial Officer

So, normal environment, usually, from – so, first, EPS is mainly driven by revenue. So when revenues come in, EPS is expanding. So and then we manage, via Project Own It, all the cost element of the company. Usually, quarter three is a softer quarter. I say usually prior to pandemic, a softer quarter than quarter two. The two highest quarter being quarter four first and then quarter two. So, this year is a little bit special, because we see this gradual recovery. And as an example, schools and several firms have not been open for quite a long time, open to presence in the office or presence in schools. It will be one of the trends that we will monitor into the quarter. So, if I look at how we look at the quarter, we said gradual recovery, and specifically, by gradual, we expect September to show clearly a pick up vs. last year, and then, quarter four to follow this trend here.

Katy L. Huberty  
Morgan Stanley

And just quickly, the tax rate was much lower in Q2, can that sustain in Q3 or should we assume that the tax rate comes up and that’s going to be a headwind to those sequential EPS?

Xavier Heiss  
Executive Vice President and Chief Financial Officer

Yeah. So, you know, Katy, that we manage our tax rate on a global basis. We’re present in a lot of different countries here. Here, we have an international, I would call, that exceptional items which is related to a law change in one of our European countries that give us the opportunity to get one-off credit of a deferred tax asset. After this, depending on how this law change are applied to country by country, we will obviously follow the tax guidance here on the adjusted tax rate. But I do not expect quarter three to be as positively impacted as what we have in quarter two.

Shannon Cross  
Cross Research

I wanted to see what’s going on with regard to channel inventory. Xavier, I think you said something about some of the sales in the reseller channel was – were those companies looking to replenish probably in anticipation of demand I would assume. But I’m just curious where you see inventory at right now. Thank you.
Xavier Heiss
Executive Vice President and Chief Financial Officer

Yeah. So, what we've seen on – this is maybe a compare vs. last year. If you remember, in quarter two, last year, channels depleted their inventory, mainly to protect their cash position. So we've seen it all across the industry. And step by step, this inventory have been rebuilt. What we are pleased with is that in quarter two, this inventory rebuilt a little bit stronger than what we saw in former quarter. However, it is not like – I call that a very high number. I mean our – we track what we call a week of inventory. And the week of inventory are still at this stage lower than some of the highest point we could have had pre-COVID.

So, channels are coming back, but step by step gradual as well. As I mentioned it and you saw that, on SMB, on the mid, mid and entry, which is mainly office type of activity, we gain share. And the channels are part of this share again on being able to drive our ESR revenue up q-over-q.

Shannon Cross
Cross Research

Okay. Thanks. And then both of you I think during your script mentioned investments in growth areas as use of cash and some impact to margin. Can you be a bit more specific on exactly where you're putting your investment dollars and how we should think about ways to track return on investment or how quickly you expect to see benefit from that? Thank you.

Xavier Heiss
Executive Vice President and Chief Financial Officer

So, as you know, if we invest in the three areas of the business – by the way, this is the area of business that we informed you in the past by saying we will stand-up these businesses. This is XFS, Software and Innovation. And I'm pleased to report that, in each of these areas of business, we achieved milestone and we continue despite the environment. We continue to invest in the business.

I will give you two examples here. On XFS and – I believe we mentioned that in our presentation. In XFS, we grew origination and the portfolio is great. When you do that, it means that you use FCF. And we have used this quarter $60mm of FCF in order to support this activity. What does that mean? It means that we are building for the future of the portfolio, because all these origination will drive future revenue and profit growth for XFS.

In Innovation, we carry on our investment on the – I'm sure you remember that we announced in quarter two, Eloque. And Eloque is this joint venture that we have with the Australian Victoria government here. And this joint venture is now running, has been enabled and we have a commitment from the government to invest AUD 50mm in the infrastructure, and to set up more of this bridge sensor that we are developing here. So, it is just an example sharing that in RDE, some of our costs, despite the current environment and FCF, we carry on investing in order to develop the future revenue growth of the company.

Giovanni John Visentin
Vice Chairman & Chief Executive Officer

On Analyst Day, we'll...

Xavier Heiss
Executive Vice President and Chief Financial Officer

Yes. On the...
We announced that – in November, we’ll have an Analyst Day, and we will provide you more detail on each of these towers.