

26-Oct-2021

Xerox Holdings Corp. (XRX)

Q3 2021 Earnings Call

CORPORATE PARTICIPANTS

John Visentin

Vice Chairman & Chief Executive Officer

Xavier Heiss

Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

Katy L. Huberty

Morgan Stanley

Ananda Baruah

Loop Capital Markets LLC

Angela Jin

JPMorgan Securities LLC

Shannon Cross

Cross Research

Jim Suva

Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

John Visentin

Vice Chairman & Chief Executive Officer

BUSINESS HIGHLIGHTS

Revenue, Adjusted EPS and FCF

- I hope everyone is safe and healthy
- Revenue this quarter of \$1.76B was essentially flat with the prior year's third quarter, despite a challenging operating environment
- Adjusted EPS of \$0.48 was flat y-over-y and we generated FCF of \$81mm, down slightly from \$88mm in the prior year
- Adjusted operating margin of 4.2% was lower y-over-y by 320BPS

Delta Variant

- This quarter's results were negatively affected by two significant secular challenges: a deterioration of global supply chain conditions and the Delta variant
- As Q3 progressed, the challenging supply chain conditions we highlighted on our Q2 earnings call deteriorated further
- Specifically, raw material and component shortages limited the availability of certain of our products and supplies, particularly our A3 devices

- Transportation constraints extended delivery times by weeks and drove unit shipping cost multiple higher than normal levels
- And when our products arrive, labor shortages further delayed delivery times
 - These challenges accounted for two-thirds of the y-over-y decline in this quarter's gross margin and caused equipment revenue to fall short of our expectations

Backlog

- Demand for our product remains strong, resulting in further growth of our backlog of equipment and third-party hardware to \$265mm, which is approximately 90% higher y-over-y and more than 20% higher than the prior quarter
- Our backlog also has a larger proportion of high-margin A3 devices relative to the previous periods

Post Sale Revenue

- Post sale revenue grew 1.7% y-over-y, but fell below our expectations, as the Delta variant disrupted many companies' plans to return workers to the office
- We expect vaccination rates will improve as governments encourage companies to implement vaccination mandates, and we continue to see a strong correlation between vaccination rates, a return of employees to the workplace, page volumes, and importantly, post sale revenue, which carries a higher margin than equipment revenue
- And we are seeing improvements across each of these metrics
- For example, September was the second highest month since the pandemic began in terms of page volumes and services and outsourcing revenue, which are two of the largest components of post sale revenue and the components that are most closely tied to page volumes

FCF

- Based on what we know today, we expect supply chain challenges to continue during Q4 and through H1 2022
- We continue to expect the return of workers to the workplace, but our expectations for a broader return have been pushed from Q4 into 2022
- For these reasons, we are reducing our revenue guidance for the year to \$7.1B in actual currency, or \$7B in constant currency
- Importantly, we are reaffirming our guidance for FCF of at least \$500mm
- Our focus on cash generation gives us the confidence to maintain cash flow guidance in spite of the top line headwinds we face, all while continuing to invest in our strategic growth initiatives

Strategic Initiatives

- Throughout these challenges, we have been guided by our four strategic initiatives:
 - Optimize operations
 - Drive revenue
 - Invest in and monetize innovation
 - And focus on cash flow
- In Q3, we made progress across each of these initiatives

Project Own

- Project Own It has made our organization more agile and efficient
- That agility was demonstrated this quarter, as our operational team responded to unprecedented levels of disruption and uncertainty across our global supply chain
- Our team responded quickly and is working diligently to mitigate the adverse effects of the supply chain disruptions on our business
- For example, we are working to accommodate a wider array of products and materials, pre-purchase components and freight, and selectively increase pricing to offset higher costs
- And we are doing everything we can to minimize disruptions to our clients' operations

Core Print Business

- We cannot control the pace of supply chain normalization or office reopenings, but we are driving revenue growth in areas we can control
- In our core print business, we gained share of total print devices again in Q2, per the most recent report from IDC, marking the fourth consecutive quarter of annualized market share gains

Market Share

- Growth in market share is a key pillar of our strategy in print and is being driven by the quality of our products and our ability to provide secure, connected workflow solutions that our clients need across their multifunction printer fleets
- Complementing our leading position in equipment, our suite of digital solutions is resonating with clients, who are increasingly digitizing document workflows and adapting to a hybrid work environment

Global Signings

- Global signings for our capture and content services, which help clients extract, categorize, and automate document routing, such as our Digital Mailroom offering, increased 67% y-over-y in Q3
- Our subscription-based Workflow Central Platform allows clients to manage document workflow from any device, including PCs, tablets, and smartphones, with the enhanced security and functionality clients expect from our leading multifunction printers

Products and Solutions

- Our products and solutions are evolving to enable productivity from whatever our clients' employees choose to work
- Our IT services business grew double-digits this quarter, despite a y-over-y increase in our backlog of third-party equipment
- Within IT services, RPA continues to gain traction
- We now have 500 internal bots performing 4mm transactions per quarter
 - These transactions create a platform and set of use cases for us to deploy externally
- And in Q3, we deployed bots to support our Lexmark Managed Services integration and enabled document classification and posting for our SMB clients

IT Services Footprint

- We continue to invest in the expansion of our IT services footprint to deliver a wider set of services to new and future SMB clients
- Earlier this month, we acquired Competitive Computing or C2, a leading IT services business based in Vermont
- C2 provides us with access to a broader set of clients and capabilities that we can leverage throughout our IT services business

Software Business

- A key strategic focus in 2021 has been the standing up of the three new businesses: software; innovation; and XFS
- This quarter, we made progress towards our goal of standing up these businesses and monetizing our investments in innovation
- In early September, we announced the formation of our software business, CareAR, a Xerox company
- CareAR is the industry's first service experience management platform and we believe it will transform service and customer experiences with live visual augmented reality and artificial intelligence-driven interactions, instructions and insights

CareAR

- CareAR solves a number of critical secular challenges facing field service management, including a systematic loss of institutionalized knowledge due to the accelerated workplace retirement and the need to be more eco-friendly
- CareAR solves both challenges by enabling field workers with access to live and eventually AI-driven expertise
- And it reduces field service visits by more frequently fixing problems the first time around
 - We estimate the total addressable market for CareAR will grow to \$80B by 2028

ServiceNow

- We also announced that ServiceNow, a leader in digital workflows, invested \$10mm in CareAR at a post-money valuation of \$700mm
- This investment serves as an endorsement of CareAR's technology and will support its growth as CareAR is the leading certified and integrated AR solution within ServiceNow's field service and customer service management platform

Go-to-Market

- In Q3, we expanded the go-to-market reach for CareAR by adding 15 resellers and forming a partnership with L&T Technology Services or LTTS, a leading industrial manufacturing and engineering services company
- With LTTS, we will develop joint solutions across a range of industries including discrete manufacturing, truck and off highway vehicle maintenance, and oil and gas

New Client Signings and Pipeline Growth

- Momentum in new client signings and pipeline growth gives us the confidence to reaffirm our expectation of CareAR generating at least \$40mm of revenue in 2021 and at least \$70mm of revenue in 2022
- At PARC, we made advancements across our three primary innovation pillars: Internet of Things; 3D print; and cleantech

IoT

- In IoT we continue to deploy Eloque's bridge sensor technology in Australia
- The data being gathered by these sensors allows asset owners and operators to monitor the health of critical infrastructure assets in real-time, which is particularly useful after the events such as the recent 5.9 magnitude earthquake that hit Melbourne, Australia in late September

Addressable Market

- Our technology deployed in Longwood, Victoria, allowed immediate assessment of the strain caused by the earthquake, resulting in a decision that the bridge was safe to operate without needing to wait for manual inspection
- Our technology helps bridge operators optimize maintenance schedules, limiting expensive field service visits and ultimately lowering the carbon footprint associated with infrastructure maintenance activities
- We estimate the total addressable market of Eloque's technology offering is \$9B, and we are currently in conversation with multiple transportation authorities around the world about deploying our technology

3D Print

- In 3D print, early feedback of our liquid metal printer, ElemX has been positive, resulting in a healthy pipeline in our target verticals of manufacturing and defense
- We are working to add additional materials which will expand our addressable use cases
- In cleantech, we are optimizing the performance of the alpha prototype for our energy-efficient air conditioning technology
 - This will inform the design of our beta prototype which we plan to complete by the end of 2022
- This technology can help reduce energy consumption in air conditioners by up to 80%
- We look forward to sharing more about this groundbreaking technology in the coming quarters
- Our work in cleantech is just one example of how we are working to reduce our impact on the environment
- In our recently published 2021 Global Corporate Social Responsibility Report, we announced a roadmap to reach net zero by 2040

XFS

- At XFS, originations grew approximately 10% y-over-y
- We further expanded XFS penetration within XBS and began offering leasing solutions for IT services
- The quality of our book of loans remains high with loss provisions below 1.5% despite the ongoing pandemic

FCF

- During the quarter, we generated \$81mm of FCF, only a slight decline from the prior year levels despite the effects of supply chain constraints on our operating profit
- Our focus on FCF has served us well and we have delivered positive FCF every quarter during the pandemic
- And that focus gives us the confidence to reaffirm our guidance of at least \$500mm of FCF this year, despite the reduction to our revenue outlook and while continuing to invest in our strategic growth initiatives

Balance Sheet

- That focus, along with our strong balance sheet, also gave us the confidence to request that our board authorize a new \$500mm share repurchase program
- We will opportunistically buy back shares and remain committed to returning at least 50% of FCF to investors while continuing to invest in innovation and pursue value accretive M&A

SUMMARY

- Before I hand it over to Xavier, I would like to emphasize a few points
- Q3 presented us with an unprecedented level of supply chain disruption and further delays in company's plans to reopen offices
- I would like to commend our team for its resiliency while facing these challenges
- Revenue and margins have fallen below our expectation for the year, but demand for our products and services remains strong, our backlog is growing, and our new business remains on track to deliver future growth and a strategic optionality for Xerox
- Through it all, our focus on delivering cash flow has not changed
- And the buyback authorization allows us to deploy that cash in a highly accretive manner
 - We also continue to look at M&A transactions, both small and large, that are accretive to our business

Xavier Heiss

Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Revenue and Volume

- As John noted, significant disruptions to global supply chains and delays in the returns of workers to the workplace negatively affected our financial results in quarter three
- Despite these challenges, our revenue were essentially flat y-over-y as gradual improvements in page volumes and IT services drove growth in post sale revenue and offset lower equipment sales, which were negatively affected by component shortages and logistics constraint that affected both cost and capacity
 - However, underlying demand for our equipment remained strong, as evidenced by our growing backlog which is almost two times higher than normal level
- Higher supply chain cost, a less profitable mix of equipment sales and lower margins and post sale revenue drove our profitability lower y-over-y

Gross Margin

- Gross margin declined 440 basis points
- Around 290 basis points of this decline is attributable to supply chain costs and capacity restrictions, including significantly higher freight and shipping costs and constrained availability of higher margin equipment. 60 basis points of the declines relate to investment to support future growth
- The remainder of the decline reflects lower government subsidies, net of Project Own It savings, and lower royalty from FUJIFILM Business Innovation
- We expect supply chain-related pressure on gross margin to dissipate over time as supply chains normalize, but this pressure will likely continue to weigh on gross margin in Q4 and into H1 2022

Adjusted Operating Margin

- Adjusted operating margin of 4.2% decreased 320BPS y-over-y, reflecting lower gross profit, lower government subsidies, and higher R&D investment to support our targeted growth area
- Indeed, we maintain this investment despite the unfavorable operating environment
 - These headwinds were partially offset by lower bad debt expense and savings from Project Own it

SAG Expenses

- SAG expense of \$413mm decreased \$31mm y-over-y, primarily driven by savings from Project Own It, lower bad debt expenses, which include \$14mm finance receivables reserve reduction, and lower sales and marketing expenses
- Savings were partially offset by lower government subsidies, investment in new businesses, and prior year 401(k) match reversal, and negative effect from translation currency
- RD&E was \$82mm in the quarter, or 4.7% of revenue, which was an increase of 40 basis points as a percentage of revenue y-over-y
 - This reflects increased investment in PARC innovation towers and 401(k) match reversal in Q3 last year

Other Expenses

- Other expenses, net was \$18mm lower y-over-y, primarily driven by higher gain on asset sales, a reduction in non-service retirement-related cost, and lower net interest expense
- Third quarter adjusted tax rate was negative 3.5%, compared to 21.1% last year
- The 24.6% y-over-y decrease reflects a non-recurring change to our tax positions and remeasurement of deferred tax assets
- Adjusted EPS of \$0.48 in Q3 was flat compared to the same quarter last year
- The y-over-y reduction in pre-tax income was offset by lower taxes on a reduced share count

GAAP EPS

- GAAP EPS of \$0.48 was \$0.07 higher y-over-y due to a decrease in adjusted items, including lower y-over-y non-service retirement-related costs and lower restructuring charges

Revenue

- Turning to revenue, supply chain disruption obscured underlying strengths in our business, as evidenced by our growing backlog and post sales revenue, both of which grew sequentially and y-over-y
- Demand for our equipment remains strong
- But in the time since our quarter two earnings call, a challenging supply chain environment deteriorated further, causing shortages in product and logistic delays and cost
- As a result, our backlog expanded in the quarter to \$265mm, almost two times normal levels

Equipment Sales

- Equipment sales of \$387mm in Q3 decreased 7.6% y-over-y, or 8.4% in constant currency, due primarily to supply chain disruption, specifically component shortages and logistic capacity constraints, which affected the Americas region more than EMEA.
- In EMEA, equipment sales grew y-over-y, led by our indirect channel and developing markets
- At the product level, supply chain constraint most negatively affected installation of our higher-priced color equipment in both the mid-range and high-end, causing a negative mix effect on equipment revenue and margin
- The negative mix effect was partially offset by lower installation of A4 black and white equipment, which faced difficult comparison against last year work-from-home demand

Post Sales Revenue

- Post sales revenue of \$1.4B increased 1.7% y-over-y or 0.5% in constant currency
- We continue to see strong correlations between vaccination rate, workplace attendance and page volume
- Page volume increased sequentially this quarter, but at a slower pace than we expected due to the Delta variant
- Nonetheless, we are seeing a pickup in page volume as workplaces gradually reopen and schools welcome back students

Page Volume

- As John mentioned, September was the second highest month for page volumes since the beginning of the pandemic
- Additionally, page volumes are correlated well to service and outsourcing revenue, both of which are key components of our post sales revenues
- We continue to expect gradual improvement in post sales revenue as employees return to the workplace

IT Services Sales

- Post sales revenue also included unbundled supplies, which grew significantly due to rising page volume and to a lesser extent channel rebuilds
- IT services sales which are included in other sales also grew this quarter
- Last, new business signings for our services business grew in the quarter, as did our renewal win rate and services revenue in the SMB space grew y-over-y

Cash Flow

- Next, turning to cash flow, we generated \$81mm of FCF in Q3, down from \$88mm in the prior year

- Our strong focus on cash flow resulted in only a mild decline y-over-y despite lower gross profit and an increase in investments in targeted revenue growth areas
- We generated \$100mm of operating cash flow in the quarter compared to \$106mm in the prior year, as working capital improvements offset lower profit
- Working capital was a source of cash this quarter of \$46mm, which was \$101mm better than the prior year
 - This reflect y-over-y improvement in inventory, accounts payables, and accounts receivable

CapEx

- Investing activities were a source of cash of \$18mm due to an asset sales of \$38mm, partially offset by CapEx of \$19mm
- CapEx primarily supports our strategic growth program and investment in IT infrastructure
- Financing activity consumed \$46mm of cash
- Net proceeds from additional debt contributed \$76mm of cash and reflected new securitization proceeds of \$175mm, partially offset by securitization runoff
 - We expect to complete additional securitization in support of XFS in Q4

Net Proceed

- Net proceeds from debt were offset by \$87mm of share repurchase and \$49mm in dividends, resulting in a total return of cash to shareholders this quarter of \$136mm, circa 170% of quarter three FCF
- The \$87mm of share repurchase in the quarter completed our remaining share repurchase authorization of \$500mm
- As a result, a new share repurchase authorization of \$500mm was requested and approved by our board and will be used to opportunistically repurchase shares

Profitability

- Next, looking at profitability, on our quarter two earnings call, we expected supply chain disruption to continue into Q3, but the magnitude of the impact on our business was greater than anticipated
- A further deterioration in supply chain conditions and delays in the return of workers to the workplace accounted for nearly the entirety of the y-over-y decline in adjusted operating income margin
- Lower royalty revenue and savings from government assistance programs were largely offset by lower bad debt expenses and savings from Project Own It
- We are actively working to mitigate the incremental cost associated with supply chain disruption, but we do expect this cost to weigh on profitability again in Q4 and into H1 2022

Project Own It

- The ultimate duration of supply chain costs and capacity constraints and the period of time for which it will affect our profitability remains uncertain
- However, cost efficiencies associated with Project Own It, improvements in page volume.
- The clearing of our backlog, and growth of our newer businesses are expected to positively contribute to operating profit going forward

XFS

- Turning to Xerox Financial Services, XFS grew originations almost 10% y-over-y, driven by growth in originations at XBS
- We are also actively offering lease solutions for our IT services businesses
 - However, global finance assets of \$3.3B in Q3 were down slightly compared to Q2 due to equipment availability constraints which reduced equipment sales and associated new lease originations and loan repayments

Capital Structure

- Next, I will comment on our capital structure
- We ended September with a net core cash position of around \$900mm, slightly below quarter two levels. \$2.9B of the \$4.3B of our outstanding debt is allocated to and supports the XFS lease portfolio
- The remaining debt of around \$1.4B is attributable to the core business
- Debt mainly consists of senior unsecured bonds on finance assets securitizations
- We have a balanced bond maturity ladder with no bonds maturing in 2021 and \$300mm maturing in 2022
- YTD, we have returned circa \$650mm of cash back to shareholders, around 170% of FCF, which contributed to the \$400mm decrease in net core cash since the end of 2020

GUIDANCE

Global Supply Chain

- Finally, I will address revised guidance
- Quarter three presented our business with a number of unexpected challenges, including a rapidly deteriorating global supply chain and the prolonged impact of the Delta variant
- Product shortage, shipment delays, and cost increases, and delay in the return of workers to the workplace resulted in a lower level of quarter three revenue than we expected just one quarter ago

FCF and Growth Initiatives

- Given the continued uncertainty associated with global supply chains and the delay in many companies plan to return to workplaces until 2022, we are lowering our revenue guidance to circa \$7.1B in actual currency or \$7B in constant currency
 - However, our focus on cash gives us confidence to reaffirm our FCF guidance of at least \$500mm while continuing to invest in our targeted growth initiative
- We've also decided to postpone our Investor Day to February of next year, at which point we'll be in a better position to provide 2022 guidance along with our long-term financial projection
- We also look forward to sharing additional financial detail about our new businesses at that time, which we believe will be more meaningful within the context of our 2022 guidance

QUESTION AND ANSWER SECTION

Katy L. Huberty

Morgan Stanley

Q

How much of the \$200mm lower revenue guide at constant currency is a function of the backlog build vs. the slower recovery in page volumes? And just connected to that, how much do you expect backlog to build in Q4? And I have a follow-up.

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

Hi, Katy. Good morning. This is Xavier here. So, the – regarding backlog, the \$200mm revised guidance there, the vast majority of this is related to equipment, to equipment backlog that we face here. As recorded here, we ended with \$265mm of backlog, which is close to 60%, 59% of the total revenue of quarter three. We expect this backlog to grow based on the supplies outlooks that we have for quarter four adjusted.

Katy L. Huberty

Morgan Stanley

Q

Okay. So, backlog grew about \$50mm sequentially in the September quarter. If most of that \$200mm guide down is related to backlog build, that would imply that you would expect even more backlog build in Q4, is that the way to think about it?

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

This is correct, Katy.

Katy L. Huberty

Morgan Stanley

Q

Okay. Okay. And then, I know it's really early, but do you have any initial thoughts as to how you – how you're contemplating FY2022 as it relates to the increased supply chain costs and revenue impact that carry into H1? Does that set up for potentially flattish or even pressure on EPS and FCF relative to 2021, or is it too early to tell?

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

Katy, as we indicated during the call here, we expect the supply chain impact to carry on and have some impact during H1. During quarter three, we have been surprised by the size of this supply chain as we commented here. It is mainly related to some material shortages, but also the fact that the chips on the processor are becoming – we are facing paucity this year. We've put in place a lot of action, including redesigning some of the way some of boards are currently implemented on our product, but it will take time to recover.

So second point as well is not only the scarcity of certain components here, it's also the overall supply chain. You have heard of it; it should not be new news here. The challenges that a lot of company are currently facing with container shipment, but also up to the last point, up to the delivery to the end customer. So we expect some of it to stay into H1 2022.

And clearly, our backlog is a strong evidence that our customers are still renewing the equipment. Also, as we mentioned it during our comment, we grew market share. So we are still growing market share. We did it in quarter one. We did it in quarter two as well. And clearly, the orders that we are receiving from our customers have the evidence that there is still a strong demand here. So, we will manage it. It's a little bit early to provide guidance on that. As we mentioned it, we will hold and manage, we hope, a face-to-face Investor Day in February, where we'll be able to provide you more information.

Ananda Baruah*Loop Capital Markets LLC*

Q

I apologize if this has been addressed. I have a couple calls and an event going on this morning. But just to what you guys are seeing sort of demand-wise, revenue-wise, and any sort of incremental feedback you've gotten from your enterprise customers as you move through the quarter that might be different from what you have been communicating to us over the last couple of quarters or so? Thanks.

John Visentin*Vice Chairman & Chief Executive Officer*

A

Yeah, Ananda, what we've been seeing is demand is strong. And the other thing that we've noticed is return to the office has slowed down from what we anticipated. So we're anticipating more early next year being full back to the office. Because of the Delta variant, a lot of the corporations we've spoken to have delayed their openings or slowed them down. But demand for our product is strong. And again, with the supply chain constraints, that's become an issue for us.

Ananda Baruah*Loop Capital Markets LLC*

Q

I appreciate the context, John. And then, let me just ask a follow-up in that regard. Because you guys are pretty deep in the weeds with your conversations with your enterprise customers, strategically from their perspective, have you seen anything change in terms of long-term's intention for sort of how they're thinking about kind of back to the office or the use of your products in the context of those strategies?

John Visentin*Vice Chairman & Chief Executive Officer*

A

No. We haven't seen a change from what we've expressed in the past. They're focused on bringing their employees back to the office in a safe manner, and they are using our products more for product – both for productivity and for security; and in some cases, with our software, to utilize a hybrid environment in which when their employees do work from home, but not really much of a change there. I think what slowed that down was the Delta variant. And everybody's being careful in getting their employees back safely to the office.

Ananda Baruah*Loop Capital Markets LLC*

Q

Very good.

[indiscernible] (00:36:23)

Ananda Baruah*Loop Capital Markets LLC*

Q

...I appreciate it. Absolutely.

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

Ananda, if I may add as well, we have seen as well on our Global Document Solution (sic) [Solutions] (00:36:31) businesses some good traction on offerings enabling to work from home and work in the office here. As an example, in Capture & Content Services here, we have seen significant double-digit growth of signings, which show that enterprise are supporting these type of offerings but also willing to enable this environment.

Angela Jin

JPMorgan Securities LLC

Q

The first question I have was, HP at their Investor Day said that they expect a low- to mid-single digit decline in supplies next year, which we thought was interesting. Are you seeing similar trends there given that you're also forecasting greater return to office in 2022? And then I have a follow-up.

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

Yeah. So, good morning. So, as you know it, our business model is slightly different from the one that HP had. We are less dependent on what we call a toner out or consumable out model. Our model is based on subscription and we do not see this trend. Our trend is mainly related to page volume and how customer are using our equipment, but not only to print but also to drive their workflows, that our equipment are much more than a device and support workflows that the customer are using here. So, we – if you want like a data point or proof point of what we have faced, we saw some increase in quarter three of what we call the sole supplies revenue. And we are positive of seeing a gradual recovery of page volume over the time.

Angela Jin

JPMorgan Securities LLC

Q

Great. Thank you. And then for my follow-up, just thinking about your product mix on A3 vs. A4 printers, it seems like for the industry view is that A4 will become more popular over time as offices migrate towards smaller printers spread out more evenly. Are you seeing a shift in strategy towards A4 printers? And if so, will that result in a structural margin decline?

John Visentin

Vice Chairman & Chief Executive Officer

A

Yeah. If we look at our third quarter, our backlog for A3 went up from Q2. We're gaining market share and we're seeing a strong demand in the A3 and we've also gained market share in the A4 market.

Shannon Cross

Cross Research

Q

I was wondering about the pricing environment both on the short- and long-term for hardware as well as pages. Obviously, and given all the supply chain challenges, certain other industries have been able to raise prices. I know inkjet printers, for instance, there's less promotion. So, I'm curious what you're doing there. And then, we talked to Canon and they're thinking long term they're going to see some price pressure on pages. So, I'm just kind of curious how you think this plays out both in the next few quarters and then maybe long-term. And then, I have a follow-up.

Xavier Heiss

Chief Financial Officer & Executive Vice President

A

Thank you, Shannon. Good morning, Shannon. Yes, it's a good question here. What we see on the pricing environment, mainly related to the supply-demand dynamic here is the ability of raising prices. And this is something that we started executing. We started executing already in quarter two and we have planned in order to reflect some of the costs that we are facing here, specifically on supply chain and some of the raw material costs that we have here.

Regarding page volume and those price per page here, this is, I would call, the usual business and usual negotiation. We have not seen an increased competitive environment on this. And, as you know it, we are quite stringent in managing the pricing and also predicting with minimums our annuity volumes.

Shannon Cross*Cross Research*

Q

Okay. And then, SG&A is at the lowest level that I have in my model even after incorporating the \$14mm. It's going back, split, and then I'm assuming pre-split, Xerox was a bigger company back then. How much further can you cut SG&A? What did you take down? How much of SG&A is one-time vs. recurring in nature? Just trying to understand given the gross margin pressure you're facing, how much flex you have in some of your other expense lines? Thank you.

Xavier Heiss*Chief Financial Officer & Executive Vice President*

A

Yes, Shannon. So, on SG&A reported, the only, I would say, one-off that I highlighted here is related to the bad debt release that we have which is, by the way, a good news, which shows that the business is recovering in light of last year or two years ago starting the impact of COVID-19 here.

For the rest, you know that we have Project Own It in place. And Project Own It is much more than a pure cost cutting type of activity. It's also ingrained in the DNA of the company on how we adjust our cost base based on, I would say, the environment here. So flexibility exists within the cost base and we will ensure that we can reflect some of the gross profit decline and gross margin declines that we have in our fixed cost base as well.

Shannon Cross*Cross Research*

Q

Do you think you can get down below \$300mm or – I'm sorry – \$400mm on a dollar rate?

Xavier Heiss*Chief Financial Officer & Executive Vice President*

A

It's a little bit early. Yeah, it's a little bit early here, Shannon, because we are going through the planning cycle here. But clearly, Own It, as I mentioned it, and Own It is not only SG&A. Own It is the entire cost base of the company. And we look at any opportunity we can have here. You know that we have had the benefit of last year and we call it the amount on this year as well. So we have the benefit of the government subsidies. These government subsidies are decreasing and you can see that in our cost base, basically in G&A, we're able to offset this via cost actions that we are taking to flexibilize the cost base.

Jim Suva*Citigroup Global Markets, Inc.*

Q

Thank you for being so open and transparent about the – taking the outlook down a little bit. And can you help us understand, do you fully believe or can you know, is this supply chain issue-driven or, I know, of course, going

back to the office has been delayed, or is it actually structurally people are printing less? And how should we think about that if it's the case or not the case or how do we actually know? Thank you.

John Visentin

Vice Chairman & Chief Executive Officer

A

Yeah, Jim, we've seen a strong demand for our product and, in fact, you saw in third quarter that our backlog increased again to record levels. So, we are seeing the demand. We're increasing market share. Even in September, there's a direct correlation with vaccination and going back to the office and volumes, and we saw an uptick in September. So, our belief is that going back to the office is a question of when, not if, and the delays have happened for, again, safety of employees. And – but that's how we're seeing it right now.

John Visentin

Vice Chairman & Chief Executive Officer

CLOSING REMARKS

- Look, we cannot predict with precision when supply chains will return to normal, but we expect they will normalize over time
- We also believe a broader return of the employees to the workplace is a matter of when, not if, and in-office work will be different
- But we are prepared to meet workers evolving print and document management needs.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2021 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.