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Xerox Holdings Corp. (XRX)
Q3 2022 Earnings Call
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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation Third Quarter 2022 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions]  

At this time, I’d like to turn the program over to Mr. David Beckel, Vice President and Head of Investor Relations. Please go ahead, sir.  

David Beckel  
Vice President & Head-Investor Relations, Xerox Holdings Corp.  

Good morning, everyone. I’m David Beckel, Vice President and Head of Investor Relations at Xerox Holdings Corporation. Welcome to the Xerox Holdings Corporation third quarter 2022 earnings release conference call hosted by Steve Bandrowczak, Chief Executive Officer. He’s joined by Xavier Heiss, Executive Vice President and Chief Financial Officer.  

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 express permission of Xerox. During this call, Xerox executives will refer to slides that are available on the Web at www.xerox.com/investors and 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’d like to turn the meeting over to Mr. Bandrowczak.
Steven John Bandrowczak  
Chief Executive Officer & Director, Xerox Holdings Corp.

Good morning and thank you for joining our Q3 2022 earnings call. I want to start by saying how honored I am to lead this great company and team of people as we embark on Xerox’s next phase of growth. Since being named Xerox’s permanent CEO in August, I have spent a large portion of my time with our stakeholders, employees, clients, partners and investors.

On a recent international road trip, I spoke with dozens of clients and thousands of employees in more than 20 different cities. The goal for my meetings with clients was to hear about their current needs, what they expected from Xerox, and what we can to improve our business. It was clear that Xerox brand and legacy are meaningful and we have earned our clients' trust over time. And from that position of trust, clients are asking us to do more to help them streamline, optimize and improve the overall productivity of their information workflows.

We have the solutions today to help them do just that, including solutions like Workflow Central and Digital Mailroom, to name a few. And by focusing more on client solutions rather than product offerings, I believe we can maximize our relevancy and share wallet with existing clients.

We also have the reputation and credibility, the right to win to build new solutions for our clients that leverage our institutional knowledge of client processes and integrate leading technologies such as AI, AR, RPA and machine learning. These new solutions can provide intelligence, value-added services and automation to workflows we already process for our clients, as well as new workflows we can and will process in the future.

You will hear more from me in coming quarters about how we plan to become a more customer-centric business, one that is capable of expanding and capturing more of the addressable market within our existing client base by further embedding our offerings into our clients’ end-to-end processes.

Summarizing results for the quarter, revenue of $1.75 billion grew 4.7% in constant currency and declined 0.4% in actual currency. Adjusted EPS was $0.19, $0.29 lower year-over-year. Free cash flow was a use of $18 million compared to a source of $81 million in the prior year, and adjusted operating margin of 3.7% was lower year-over-year by 50 basis points. Revenue growth this quarter accelerated in constant currency, reflecting strength in demand for our products and services amid an increasingly challenging macroeconomic environment.

Equipment revenue grew 6.7% in constant currency or 0.8% in actual currency, marking the first quarter of equipment revenue growth since supply chain constraints began last year. As expected, backlog declined slightly sequentially, reflecting sustained order flows offset by a gradual but lower than expected easing of supply chain constraints.

Post sale revenue increased 4.1% in constant currency and decreased 0.7% in actual currency. Post sale growth was driven by another strong quarter for consumables such as paper and supplies. Growth in consumables also reflects the early benefit of recent pricing actions, and for supplies, an ongoing gradual recovery in print-related activity. Page volume continued to closely correlate with return-to-work trends.

Post sale revenue also benefit from strong growth in IT and Digital Services, including contributions from recent acquisitions. Adjusted operating margin declined slightly year-over-year but improved sequentially, reflecting the benefits of price and cost actions taken year to date. Improvement was slower than expected, however, due to persistent high rates of inflation across our cost base, an unfavorable geographic mix in equipment sales, and a slower than expected easing of supply chain constraints. Xavier will discuss our outlook for profitability in more detail.
The global macroeconomic outlook has become increasingly somber over the past three months. The current outlook, notwithstanding, we believe our prospects for continued revenue growth are strong. We see resiliency in demand for our products, particularly our A3 devices. We have a sizable and healthy backlog, and we have visibility into the realization of benefits from recent pricing actions. However, the adverse effects of Western European currency on full-year revenue are now forecasted to be significantly larger than expected, therefore, we are lowering our revenue guidance for the year from at least $7.1 billion to a range of $7 billion to $7.1 billion in actual currency.

While our revenue outlook declined only slightly, we are lowering our 2022 free cash flow guidance from at least $400 million to at least $125 million, both of which excludes $41 million one-time product supply termination payment. The reduction to our outlook is in part due to persistently high rates of inflation across our cost base and slower than expected supply chain improvements, both of which are expected to inhibit margin improvements this year relative to our expectations.

Most of the reduction in free cash flow guidance, however, is a function of large and unexpected use of working capital which has no earnings impact, including our decision to utilize more capital to fund FITTLE’s origination and operating lease growth. We continue to expect operating margins to improve going forward as supply chain conditions ease and previously enacted pricing actions are realized. When combined with additional plans to streamline our operations, we believe our 2022 free cash flow performance will be an anomaly and not a trend.

I am often asked by investors if we are planning a significant strategic shift now that I have been made permanent CEO. I alluded to some of our longer-term strategic plans a few moments ago, but in the near term, we remain focused on the execution of our print and services strategy and improving operating efficiencies amid a challenging macro backdrop. As in the past, the successful execution of our strategy rests on four strategic priorities; optimize operations, drive revenue, monetize innovation, and focus on free cash flow.

Operational efficiencies and flexibilities have taken on a new level of importance in light of the current macroeconomic environment. We remain on track to achieve our targeted $450 million of gross cost savings from Project Own It in 2022. Our target was designed to completely offset the effects of inflation for the year, but in the past few months, inflationary pressure has outpaced our initial expectations.

With less than three months remaining in the fiscal year, we will not be amending our savings target for 2022. We will provide an update on 2023 savings target when a full-year guidance is provided next quarter. Along with this update, we will provide additional details about changes to our business structure that are expected to drive greater operating efficiency and enable further penetration of services at existing clients.

Our print and services products continue to resonate strongly in the marketplace as we deliver the most advanced services and solutions portfolio for our clients. I am pleased to announce that we grew our leading share in managed print services in 2021 per IDC’s recent MarketScape report. In further support of our leading position in managed print, Quocirca recently named Xerox as a Leader in Managed Print Services in its 2022 Landscape Report. According to Quocirca, Xerox maintained the highest position over all other vendors in the market in both strategic vision and depth of service offerings.

To ensure we continue gaining share in print and managed print services, we are focused on consistently improving the customer experience to meet clients’ most pressing needs. To that end, in Q4, we'll be launching the Xerox Customer Experience app which will help our clients streamline the installation of our products, better monitor supplies, and help clients self-troubleshoot our A4 products.
In IT services, we are seeing traction in newer markets like Canada as we realize synergistic benefits from the recent acquisition of Powerland and greater collaboration with our existing print and managed print services sales force. And then our robotics process automation offering once again grew signings double-digits quarter-over-quarter. In Q3, Xerox automation expanded its presence to retail, sports and entertainment, and manufacturing verticals.

In Digital Services, our recently acquired Go Inspire business won a Breakthrough with Data award from DataIQ for its partnership with the UK home goods company, Lakeland. Go Inspire uses Lakeland's customer data to deliver a hyper-personalized experience for each of its members, resulting in a strong uptick in revenue and triple-digit return on investments.

Xerox Digital Services recently launched an intelligent document processing platform which leverages AI, ML, object content recognition and natural language tools to automate document and data processing. Born from our legacy of innovation and service excellence in this domain, the platform will help our clients recognize a variety of languages, classified documents, and validate customer identities without human intervention, providing significant time and cost savings.

We see the evidence of value being delivered through our integrated solution offerings each quarter. For example, this quarter, we assisted a European commercial banking client with a digital transformation project in which our devices were used to digitize document workflows and improve the client's onboarding process. For a large Brazilian insurance client, we added services to help them automate invoicing and medical claims reimbursement, improving processing time from days to hours and reducing manual processing performed from 150 employees down to 40.

Moving forward, we'll enable more of these types of success stories as we place a greater focus on holistic client solutions rather than discrete product offerings. Regarding our newer businesses, we are adjusting our approach to capital allocation in response to changes in the macroeconomic environment. As a result, we have taken recent actions to streamline our innovation portfolio by closing Eloque, scaling back our 3D print operations, and reevaluating research priorities at PARC.

 Separately, we continue to see promise from Novity, an industrial predictive maintenance company created at PARC; and Mojave, an energy-efficient HVAC business leveraging PARC technology. We recently spun both companies out as a separate independent business, with Xerox continuing to hold minority share. These actions will help us preserve free cash flow while maintaining the opportunity to realize value from their future success.

Meantime, we continue to invest in commercialization of FITTLE and CareAR, both of which are executing on their strategic plans. FITTLE made significant progress this quarter in its effort to diversify its lending operations away from captive sources towards new customer and product lines. Non-captive originations grew 33%, including a more than 150% increase in originations for third-party equipment and services.

CareAR has completed a soft launch of Experience Builder, an intuitive, no-code toolkit which allows users to quickly self-publish instructional content at scale. We believe the Experience Builder toolkit will provide a unique point of differentiation for CareAR and further its leading position in rapidly growing service experience management market.

At Xerox, we are accelerating our own use of CareAR as a means of approving (sic) [improving] operating efficiencies and client service. Our remote resolution rate is better by 9% when CareAR is used, which greatly
improves equipment availability and avoid sending technicians on-site. CareAR helped Xerox reduce site visits by more than 21,000 in just one year, saving more than 269,000 metric tons of CO2 as a result. Among our technicians using the product, calls escalated to higher level reps are resolved on an average one business day sooner. We expect further efficiencies and progress towards our sustainability goals as we more fully introduce the platform to more of our clients.

Free cash flow was a use of cash of $18 million in the quarter. In the first nine months of the year, free cash flow has been of a use of $66 million or $25 million excluding a one-time contract termination payment of 41 million in Q2. To be clear, our cash flow generation year to date has fallen well below our expectations due to our strategic decision to invest in FITTLE’s growth, a slower than expected improvement in supply chain conditions, and persistent inflation.

I do want to emphasize that free cash flow remains a key tenet of our strategic priorities and an enabler of our future growth. We expect a significant improvement in free cash flow next year as supply chain conditions improve further and benefits of additional price and cost actions are realized.

To recap, the current macroeconomic environment presents risks to all businesses, but I see far more opportunity in the coming quarters and years for Xerox. I see opportunities to expand our penetration of existing products within clients, as we are doing with managed print, IT and Digital Services, and I see opportunities to expand our TAM with clients by leveraging our unique position as a trusted partner to deliver value-added digital solutions to our clients’ workflow processes. In the near term, we remain laser-focused on profitability and free cash flow generation.

I will now hand over to Xavier.

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

Thank you, Steve, and good morning, everyone. As Steve noted, quarter three result reflect continued strength in demand for our product and services. We saw an acceleration of revenue growth in constant currency and delivered the highest rate of constant currency growth in over a year. Currencies, notably euro and British pound, negatively impacted revenue by more than 500 basis points this quarter. Equipment revenue grew for the first time since Q2 2021 in both actual and constant currency, driven by healthy demand and modest improvements in product availability.

Equipment backlog of $429 million declined slightly quarter-over-quarter but remain well above historical level as improvement in supply chain conditions did not materialize to the extent expected. We continue to expect backlog to decline in Q4, and throughout 2023 as supply chain conditions ease. Post sales revenue grew again in constant currency due to strong growth in consumable such as paper and supplies, and IT and Digital Services, including benefit from recent acquisitions.

Consistent with prior quarter, we continue to see a strong correlation between return-to-office trends and page volumes. We are encouraged to see another quarter of page volume improvement relative to 2019 levels. However, page volumes are recovering slower than we expected as employers’ effort to bring employees back to offices have been slow to gain momentum.

Turning to profitability, profit were lower year-over-year due to a slight decline in revenue at actual currency, the effect of persistent high inflation on cost of goods sold and a slower-than-expected improvement in supply chain condition, which negatively impacted product geography mix. This factor, along with the release of bad debt
reserves in the prior year, drove adjusted operating income margin lower on a year-over-year basis. However, adjusted operating margin improved 170 basis points sequentially due to benefit associated with pricing and cost reduction action. We expect operating margin to improve sequentially in Q4 but at a slower pace than previously communicated as I will discuss later.

Gross margin declined 60 basis point in the third quarter. Constraint on the availability of equipment and product cost inflation, net of lower logistic costs, contributed to the majority of the decline.

Favorable currency, pricing, and restructuring benefit were offset by lower benefit of government subsidies in the prior year and other non-product-related operating cost. More specifically, supply chain constraint adversely affected the geographic mix of equipment installed in Q3. We expect gross margin to improve significantly in Q4 as geographic and product mix improve, a higher portion of contractual price increase are realized, and we see further benefit from improvements in supply chain costs.

Adjusted operating margin of 3.7% decreased 50 basis points year-over-year, reflecting lower gross profit, higher bad debt expense, and inflation-related operating cost increases partially offset by lower R&D spending and Project Own It savings. Specifically, supply chain disruption and higher product costs accounted for 60 basis points of the decline in operating margin. Higher bad debt expense and government subsidies benefits in the prior year accounted for another 110 basis point of the decline. Offsetting this impact were benefit from pricing, currency and the recent cost reduction action noted above.

SAG expenses of $418 million increased $5 million year-over-year. The year-over-year increase was largely driven by an increase in bad debt expense of $11 million, reflecting a release of bad debt expenses reserve in the prior year as well as labor inflation, the effect of acquisition and benefit from temporary government subsidies in the prior year. These increases were partially offset by currency benefit and savings from Project Own It. SAG expense declined sequentially by $20 million, excluding the one-time accelerated share-based compensation expense recognized in Q2, due to Project Own It savings, offset by the effect of acquisition and investment in new businesses.

RD&E was $73 million in the quarter or 4.2% of revenue, which was a decrease of 50 basis point as a percentage of revenue year-over-year. The reduction was driven by lower spending for print and the suspension or deferral of innovation project.

Other expenses, net, were $34 million higher year-over-year. The increase was mainly driven by lower sales of noncore business asset, an increase in non-service retirement related interest cost due to higher discount rate and higher litigation expenses.

Third quarter adjusted tax rate was 42.1% compared to minus 3.5% last year. The increase was largely due to changes in election made to certain tax position for recently filed return as well as prior year nonrecurring tax benefit from tax return filing position and the remeasurement of deferred tax asset.

Adjusted EPS of $0.19 in the third quarter was $0.29 lower than in the prior year. This decline was driven by a year-over-year reduction in adjusted operating income, lower sales from noncore business asset and a higher tax rate, offset by a lower share count. GAAP lost per share of $2.48 was $2.96 lower year-over-year due to an after tax noncash goodwill impairment charge of $395 million or $2.54 and an increase in adjusted item including higher non-service retirement related and restructuring costs. The goodwill impairment charge reflect the reevaluation associated with macroeconomic uncertainty as well as higher discount rate being applied to our forecast.
Turning to revenue, demand for our product and services was strong in Q3, but total revenue fell slightly below our expectation due to significant euro and British pound weakness. Despite adverse currency movement, equipment revenue was at its highest level since supply chain constraint began last year.

Post sales revenue grew mid-single digit on a constant currency basis for the second straight quarter inclusive of the benefit of acquisitions. While we are observing increased caution from some of our customer, the underlying driver of demand and revenue growth for our business remains healthy. Equipment orders continue to benefit from years of underinvestment in print hardware. Growth in supplies revenue reflect improvement in print activity, managed print, IT, and digital services revenue is growing. And we are realizing the early benefit of recent price increase.

Equipment sales of €390 million in Q3 grew 6.7% year-over-year in constant currency or 0.8% in actual currency. Constant currency growth was driven by strength in EMEA. The geographic disparity of revenue growth between region this quarter reflects the availability of unit more than demand trend, which remain resilient in both regions, particularly for A3 equipment. We receive more equipment specific to European market than expected, which negatively affected gross margin as the achieved selling prices are lower in EMEA.

Installations were down year-over-year across all category of black-and-white machine, but higher year-over-year for all categories of color machines. This reflect our prioritization of installation to higher value color equipment. Margin benefit associated with an improvement in the mix of color devices were offset by geographical mix and the installation of equipment from our backlog that does not yet reflect recent price increases. We expect a more favorable geographic channel and product mix in Q4.

Post sales revenue of $1.36 billion grew 4.1% in constant currency year-over-year and fell 0.7% in actual currency. Post sales growth in constant currency was driven by IT services, which includes revenue associated with the recent acquisition of Powerland in Canada, and growth in sold supplies and paper. Maintenance and outsourcing services revenue growth accelerated this quarter in constant currency due to recent pricing action and the acquisition of Go Inspire. These improvements were partially offset by lower financing revenue, which was impacted by Xerox product availability.

Let’s now review cash flow. Free cash flow was a use of $18 million in Q3 and was lower year-over-year by $99 million driven by a $60 million increase in the use of working capital and an incremental $46 million of capital used to finance origination and operating lease growth at FITTLE. Operating cash flow was a use of cash of $8 million in Q3 compared to a source of cash of $100 million in the prior year.

Working capital was a use of cash of $14 million this quarter, $60 million higher than the prior year, driven by the late receipt of product in the quarter and an increase in inventory in anticipation of higher Q4 revenues. Additionally, cash used to fund an increase in finance receivable and operating lease was $54 million in the quarter compared to a use of fund of $8 million in the prior year quarter, reflecting FITTLE portfolio growth strategy.

Investing activity were a use of cash of $33 million compared to a source of cash of $18 million in the prior year, due in large part to $41 million of cash used to acquire businesses and lower proceed from the sales of noncore business asset, partially offset by lower CapEx. CapEx of $10 million was $9 million lower year-over-year. CapEx mainly support our investment in IT infrastructure.
Financing activity consumed $168 million of cash this quarter driven by a net reduction in securitized debt. During the quarter, we paid dividend totaling $43 million and did not repurchase any shares. We remain committed to returning at least 50% of our free cash flow back to shareholder. We expect to exceed this amount based on the year-to-date share repurchase and our annualized dividend.

Turning back to profitability. Adjusted operating income margin improved sequentially this quarter but at a slower pace than expected due to the effect of supply constraint, geographic mix, and the impact of higher-than-expected inflation across our cost structure. We remain on target to deliver $450 million of gross cost savings this year through Project Own It, but high level of inflation have caused the rise in operating cost above the level expected when we increased our savings target to $450 million in Q1. Further, supply chain condition are improving but not at the pace we anticipated as recently as last quarter.

We expect adjusted operating margin to improve again in Q4 as product supplies constrain ease further and we realize the benefit of incremental pricing benefit, a more profitable geographic mix, and cost action. However, we no longer expect our full-year operating income margin to exceed prior-year level. We are not providing an update to our 2023 margin outlook today, but I will provide some perspective.

Profitability improvement is the most important midterm prerogative for our management team. We expect adjusted operating margin to improve in Q4 and continue into 2023. Specifically, price increases and cost action taken this year have trailing and compounding benefit for 2023 and, incrementally, if revenue continues to grow as we expect it will. Further aiding our profitability next year are the action we have taken to reduce our spend on innovation project with longer period of realized benefit. We will provide more detail on expected 2023 savings from adjusting spending on new businesses when we provide 2023 guidance next quarter.

Finally, we remain diligent in our approach to managing our overall cost structure. Project Own It will have delivered more than $2.2 billion of savings since 2018 by the end of this year. As we have noted in prior calls, Own It is as much about generating operating efficiencies as it is cost cutting. We have additional capacity to do both in the coming year. As Steve noted, we are currently undergoing a detailed strategic review of our business structure, the result of which is expected to yield significant savings and enable greater sales. We expect the combination of margin improvement from better supply chain condition and price and cost action already executed, along with future profit-enhancing actions will drive operating margin in 2023 closer to the level indicated at our February 2022 Investor Day.

Turning to segments, FITTLE revenue declined 12.3% in Q3, mainly due to a reduction in operating lease revenue, reflecting lower Xerox equipment install due to product constraints. Segment profit fell $16 million or 67% due to lower profit from operating lease and higher bad debt expense, including the reserve release of approximately $14 million in 2021, which were only partially offset by lower intersegment commissions due to lower originations.

Segment margin was 5.4% compared to 14.3% a year ago. Year-to-date, FITTLE margin of 9.3% remained above our full year estimate of 8% to 9%. We continue to expect FITTLE margin to fall in that range for the full year as Xerox lease volume picked up driving increase in intersegment commission.

In Q3, FITTLE's finance asset were stable at constant currency quarter over quarter. FITTLE origination volume grew 6% year-over-year. Non-captive channel originations, which includes third-party dealers and non-Xerox vendor, grew 33% year-over-year due to growth in new dealer relationship and third-party equipment origination volumes. This growth was partially offset by a decline in captive product origination of 11%, which were negatively affected by Xerox product availability.
Print and other revenue grew slightly in Q3 in actual currency. Print and other segment profit grew 14% year-over-year with a 50-basis-point expansion in segment profit margin despite being negatively impacted by the ongoing effect of supply chain constraint and inflation.

Turning to capital structure, we ended Q3 with a neutral net core cash position. $2.7 billion of the $3.7 billion of our outstanding debt is allocated to and support FITTLE lease portfolio. The remaining debt of around $1 billion is attributable to the core business. Debt consists of 10-year unsecured bond and finance asset securitization. We have a balanced bond maturity ladder and no unsecured maturity for the remainder of the year.

As a reminder, we plan to refinance the entirety of our 2023 obligation with additional securitized receivable financing. The vast majority of our debt carries a fixed rate. As a result, we do not expect material near-term profitability or free cash flow headwind associated with rising interest rate.

Finally, I will address guidance. We lower our revenue guidance from at least $7.1 billion to a range of $7 billion to $7.1 billion at actual currency, largely due to adverse currency movement and, to a lesser extent, slower-than-expected easing of supply chain constraint. Since we last gave guidance, currency fluctuation have caused a $70 million headwind to our revenue outlook in actual currency. Our constant currency outlook for full-year revenue growth is largely unchanged as we maintain a sizable backlog and good visibility to Q4 product shipment.

We lowered our free cash flow guidance for the year from at least $400 million to at least $125 million. As noted on previous call, our guidance was predicated on an easing of supply chain condition and an expected level of page volume improvement. While we have experienced improvement on both fronts and continue to expect further improvement going forward, the improvement realized to-date are lower than our initial expectations.

More than $150 million of the decrease in free cash flow guidance reflect a greater than expected use of working capital to fund origination growth of FITTLE and inventory, which was a larger than expected use of cash in Q3 due to late delivery of equipment. Neither of these have any impact on profitability and our investment in FITTLE portfolio are expected to produce double-digit margins on the return on investment over time. The remainder of the reduction in free cash flow guidance reflect a lower operating profit outlook for the second half of the year due to slower than expected improvement in supply constraint, page volume trends, and stronger than expected inflation across our cost base, the effect of which we expect will normalize in 2023.

Similar to my comment on margin, I want to be clear that we are in no way satisfied with this year expected free cash flow result. Our team is working tirelessly to improve margin and working capital efficiency, and we expect significantly stronger free cash flow result in the years ahead due in part to improvement in supply chain constraint and an easing of inflationary pressure on our cost base in combination with additional strategic action. Our expectation is that free cash flow will more than amply cover our dividend of $1 a share, which we have every intention of maintaining.

We now open the line for Q&A.
QUESTION AND ANSWER SECTION


Ananda Baruah  
Analyst, Loop Capital Markets LLC

Hey. Good morning, guys. Thanks for taking the question and a lot of really, really useful detail, so appreciate that. I guess the big one for me is really on demand [audio gap] (00:39:33-00:39:47) the revenue, which has held up really well. Any customer context that you can share that would be useful. And I guess even including any sense you guys have for how much of the revenue that you've been putting up is driven by backlog relative to fresh organic demand coming on as you've been moving forward. And I guess what's your – without giving a guide, sort of a 2023 guide, what would you convey as your expectation for us with regards to how you see macro kind of manifesting on your customer base and on demand? Appreciate that. Thanks.

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

Thanks, Ananda. So, as we noted, so our demand for product and services remain very, I would say, resilient. You understand the macro environment is challenging. At the same time, what we have seen is the demand for product remained strong. Our backlog moderately reduced. It was only 8%. And as we mentioned it in quarter two, we're expecting the backlog to tail and then to reduce around quarter three, quarter four.

We are still seeing a high demand of our product. I would say all product fronts and specifically on A3. And what we see from a macro environment is that we are not seeing a reduction in IT investment related to our product, and our product support the resolution of how our customer are currently looking at addressing some of the challenges that they had, specifically when you speak about workflow solution, everything which is around digital services where we have a set of solution that address some of the challenge here.

So, in a nutshell, we don't see demand decrease and the backlog is steady. We're expecting to absorb some of the backlog as well in Q4. And what we are facing currently is mainly related or the challenges we face during the quarter was mainly related to supply chain and inflation pressure.

[Indiscernible] (00:42:03)

Ananda Baruah  
Analyst, Loop Capital Markets LLC


Steven John Bandrowczak  
Chief Executive Officer & Director, Xerox Holdings Corp.

And the other thing I would say is on productivity, customers are facing the same headwinds that everybody else is dealing on the macro side. And our products and services are really helping to drive productivity inside of their infrastructure. So, we see strong demand where we've got clients that are trying to deal with inflationary costs as well as we are and our products help us significantly there.
Ananda Baruah  
*Analyst, Loop Capital Markets LLC*

And, Steve, thanks for that. And, Xavier, I believe you may have mentioned you expect to – you guys expect to grow in 2023. Is that accurate? And I guess, what underpins that, is it really just sort of the stuff you talked to just a moment ago or is there anything incremental to that? Thanks.

Xavier Heiss  
*Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.*

Yes. So, I would say, I will give you two data point. So, data point is on the equipment revenue. Equipment revenues, the backlog still remained strong. We have $429 million of backlog. It was down only 8% during quarter three. And if you compare this backlog compared to the total equipment revenue we are used to generate is close to one quarter of the full-year revenue. So, still a strong backlog here. I would call that as well a healthy backlog. I gave a data point by saying that less than 50% or more than 50% of this backlog is less than 90 days old. So, it does not mean that this backlog is aging. We do not see cancellation of orders from customer. So, it is healthy and our customer are clearly waiting the supply chain challenges to be fixed there.

Regarding post sales, and as you have noticed it in quarter two, by the way, both on equipment and post sales since quarter two 2021, so this was the first time where we started to face some of the supply chain challenges there. But equipment revenue and post sales, both revenue, both digital revenue grew in constant currency since more than a year, which is a very good indication that we saw the gradual recovery of page volume but also other revenue, other revenue stream in post sales taking shape and generating additional revenue here.

We mentioned into the call IT services. That was growing. The supply business was growing. So, it’s a post sales stream there. So, quite a good indication. I also called that 80%. When you compare to 2019, post sales revenue is now at 80% of where we were in 2019.

So, if you take all this component and you project this is for next year, we’re expecting revenue to grow. ESR will be a key driver, but IT services as well and all the revenue stream in post sales will drive the growth.

Ananda Baruah  
*Analyst, Loop Capital Markets LLC*

That’s a lot of good detail. I appreciate it, guys. Thanks a lot.

Xavier Heiss  
*Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.*

Thank you, Ananda.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Erik Woodring from Morgan Stanley. Your question, please.

Maya Neuman  
*Analyst, Morgan Stanley & Co. LLC*

Hi. Good morning, guys. This is Maya Neuman on for Erik Woodring. Thank you for taking my questions. Maybe just to start. You highlighted that project deployments are taking a little bit longer and that page volume commitments are slower. When did you see this behavior start to change and how should we think about what linearity looks like in the quarter?
Xavier Heiss  
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

Yes. So, these two indication is to address one question we often receive around how do you see the post sales revenue stream growing there. So, as I mentioned it, post sale was a growth in the quarter. It was at constant currency a growth of 4.1%. So, still I would say a healthy stream here. However, we have noticed in some occasion customer are taking longer to deploy certain project. This could be already due to return to the office. But also, I would say, budget decisions that they are making.

This delay in project does not mean it has a direct impact on [indiscernible] (00:46:12) losing revenue because often these customer are currently using our solutions. So, this is an expansion of the current contract up to the next contract.

Commenting on the page volume, we have seen in quarter three over quarter two a sequential growth increase also on page volume. We are not yet at 80%. Some of our geography at 80% of what we were in 2019 but it's a gradual recovery. To be, I would say, transparent here in our expectation, we were expecting a higher recovery during this quarter. But this just reflects some of the challenges a lot of firm are currently facing in bringing employees back to the office.

However, despite this, it was still a growth. So, this is not like page volume going down. This is still growth quarter-over-quarter and a sequential improvement here and still the correlation that we flagged in the past between presence in the office and page volume.

Maya Neuman  
Analyst, Morgan Stanley & Co. LLC

Great. Thank you. And so, just a follow-up question, can you provide a little more color on what exactly the goodwill impairment charge relates to?

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

Yes.

Maya Neuman  
Analyst, Morgan Stanley & Co. LLC

And then, yeah, I’ll let you go. Thank you.

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

Okay. It’s very, I would say, simple and technical. So, every year we conduct, at this time of the year, an assessment of our goodwill. The goodwill is mainly related to prior goodwill being booked on acquisition. You have mainly two components when you make this adjustment. One key component is what is the interest rate assumptions that you have when you build the case, so discount rate on how you calculate your WACC. And obviously, the vast majority or a big chunk of this goodwill impairment is driven by this due to the current macro environment.

So, second element is related to the way we look at our forecast and how we just adjust it. It’s one of the component that help us to assess how the goodwill should be sustained in the future. I want to reiterate this point...
Maya Neuman  
*Analyst, Morgan Stanley & Co. LLC*

Great. Thank you so much.

Xavier Heiss  
*Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.*

Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Samik Chatterjee from JPMorgan. Your question, please.

Samik Chatterjee  
*Analyst, JPMorgan Securities LLC*

Hi. Good morning and thanks for taking my question. I guess I wanted to go back to the comment about page volumes again. And I know I think I heard you say page volume recovery has been slower than expected and wanted to see if you can dig into that a bit. Is it your understand that that's driven by less return to the office or has printing behaviors sort of been different even as employees have come back? And as you're starting to sort of see some budget cancellations from your customers, why isn't that more of where you would expect sort of your customers to take certain budget decisions or priorities based on the page volumes that you're seeing? Why wouldn't there sort of priorities in their budget changed around print? Why shouldn't we think of that into 2023? And I have a follow-up, please.

Xavier Heiss  
*Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.*

Yes. Thank you, Samik. So, the main point that we observed here is that the return to the office has been slower [indiscernible] (00:49:56) where these are expected or incented employees, too. When employees are in the office, you remember we commented this during the prior quarter, we see employees using the devices and printing even if they are on a working pattern of [indiscernible] (00:50:12) giving this example of three days out of five. Three days out of five could mean 60% of page volume. We are getting our trajectory to go to 60%. We are getting closer to this number. And I mentioned some geography are already above 80%, but we are not yet there in every places there. So, getting closer, gradually improvement, but we do not observe like a significant shift or changes in the printing pattern of our employee.

Another point is we still have a strong demand around our MPS, managed print solution (sic) [services], around working from home or when employee wants – when company wants to support their working from home. Under the A4 business, so the demand that we have seen on A4 businesses on the solution that we are leveraging here was quite strong in the quarter here.

And finally, I would like to add a point, because page volume is one indicator, but another indicator is how the devices have been used by our customer. I would like to flag that if you remember we launched earlier this year, I would say, a suite of software that customer are using, which is called Workflow Central which can do, I would say, a lot of things much more than printing for customer like they can do translation, redaction, or conversion to audio.
On this quarter, we have seen the sales of this solution for workers that are either working from home or in the office, rising significantly and being very close to a sale that we are seeing on the apps that we are selling on the product to you. So, this is encouraging because what does that mean? It means that page volume is an indicator, but we see also other revenue stream around the multifunction devices being generated.

Samik Chatterjee  
Analyst, JPMorgan Securities LLC

Got it. And for my follow-up, if I can ask on the cash flow, the change in guidance here from $400 million to $125 million for the year, can you just outline how much of that is just the different sort of endpoint related to inventory given some of the supply challenges that's more of one-off versus more underlying sort of profitability? And then you mentioned you were looking to scale back on investments in PARC. I believe you had updated us that you're looking at a cash flow or cash investment, about $250 million or so annually. But maybe just update us in terms of what you're thinking there, as you go forward, what the run rate could be in terms of cash investment on an annual basis.

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

Yeah. So, the way to look at it and to simplify it, so the reduction between $400 million and $125 million, more than $150 million is related to working capital. One item of working capital, as you describe it, is more as a one-off, it is related to inventory and this is late arrival of product in Q3, which is good news because it will help us as well to deliver a strong quarter four from an ESR point of view.

The second part of this working capital is what I call the good collateral, is the use of cash in order to fund FITTLE growth. And you know FITTLE is a business where you borrow money, then you sell this money back to customer as part of our financing arrangement with customer here. And the fact that FITTLE is growing, it's a good things because what does that mean? You have heard it, the portfolio of FITTLE now at constant currency is flattish, on the start, has a trajectory to reverse the trend that was a trend down.

What does that mean? That FITTLE is able, outside of Xerox, to grow and to generate origination, new businesses with non-Xerox equipment, which is exactly the strategy that we built for FITTLE. So that's the working capital. It's more than $150 million of decline, free cash flow decline or difference versus guidance. The remainder which is around $125 million is mainly related to profitability, and the end profitability, this is supply chain challenges that we face. And the fact that the mix of products that we are receiving on the inflation within supply chain, we won't be able to correct the trajectory this year. However, I want to repeat this message because I think it's important, we expect sequential improvement in margin, and free cash flow in Q4 and in 2023. The reason why, it's mainly related to the fact that we have put in place price increases and cost action to address some of the inflation pressure.

We are also seeing improvement in supply chain, as I mentioned it, late delivery in Q3 means good delivery in quarter four or good install in quarter four, and we have also taken action and, we mentioned it during our call there, reducing some of the R&D and innovation project. Some of these project have a longer [ph] recession (00:55:18) period, so we are focusing on better return investment on some of these projects here. And as always, Project Own It is one of the driver of our cost-based adjustment here.

So, again, I want to repeat and reinforce this message here. Improvement in margin sequentially and free cash flow in Q4 and 2023.
Okay. Thank you. Thanks for taking my questions.

Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Shannon Cross from Credit Suisse. Your question, please.

Thank you very much. I was wondering, can we take a step back and just talk a bit, I mean, if we went back to the Analyst Day and there was all this focus on growth businesses, which obviously aren't working out or are costing too much, I guess, I don't know, if you can talk just a bit about what you think will be the drivers of growth going forward since there was so much of a focus on 3D print and the bridge business and the HVAC business and that. And how should we think about the value or how to track the minority ownership that you retained in those businesses? And then I have a follow-up. Thank you.

Hey, Shannon, it's Steve, thank you for the question. So when you think about macroeconomic conditions, the cost of capital and valuations of high growth businesses, now they've evolved since Investor Day, right? Current opportunity is in favor, investments of businesses over investments in long, deep [ph] tech (00:56:51) technology. So, if you really think about it, some of these early-stage technologies require a longer lead time, require a significant amount of capital, and what we've decided to do is to take a look at, given the macro conditions, to reevaluate how we deploy capital.

So, we've shut down Eloque as we think about the amount of investment that it would take and the long lead time for return, we scaled back 3D, but, importantly, we've made sure that two businesses, specifically, Novit and our HVAC business, Mojave, have been spun out and they will get cash investments and see that grow. We have a minority position in that. So, those are two good assets that we see have potential to grow but we didn't want to use our cash as you think about long-term return on those investments, and we reallocated our capital towards things like, if you think about Digital Services, you think about IT services, all the things that we have in front of us that we think can grow our revenue near term.

Good. Okay. So, the two spun out businesses, what percentage you retain of them?

So, it's a minority position and we don't disclose the specific details here.
Shannon Cross  
**Analyst, Credit Suisse Securities Research**

Okay. So, there’s no way to get a valuation on that just so we can watch how it goes. Okay. And then, I guess, thinking about Project Own It and you talked about some structural changes, I’m just curious if you could provide some more details on exactly what you’re going to do to change costs. Are you looking at massively shrinking your technicians or going more to inside sales, or how should we think about how you’re going to morph this given sort of the end market dynamics as well as the macro challenges?

Steven John Bandrowczak  
**Chief Executive Officer & Director, Xerox Holdings Corp.**

Yeah. I think there’s a couple of things there, Shannon. First of all, large opportunity in our supply chain in terms of looking at what we do with our inventory, location of inventory, supply chain, significant optimization there using technology, artificial intelligence, et cetera. As you look at our go-to-market opportunities, I’ve talked about a couple of times now where we can penetrate existing clients with expanding our products and services inside of our current client base, in other words, growing the TAM inside of our clients.

Looking at how we think about technology in and around our service delivery, [indiscernible] (00:59:24) artificial intelligence, the ability to do more remote solve, less truck rolls, meaning second calls to our customers and the ability to drive productivity in our service delivery, in our field service delivery using technology and significant technologies. We also will look at a variety of other things within our portfolio to think about how we optimize the costs in and around SG&A, how we go to market, et cetera. So, there’s lots of opportunities that we can drive, supply chain, field service, go-to-market as part of Project Own It. And, obviously, as we get to end of Q4, we’ll give you more colors on that.

Shannon Cross  
**Analyst, Credit Suisse Securities Research**

And then just my final question is on cash flow, I know you’re confident in driving higher cash flow numbers, but I’m just trying to figure out how you can maintain the dividend that you’re at and what your – the thought, what you’re doing given you’re going to have some payments in December, I think, on the debt side. And maybe if you can just let us know what the minimum level of cash is that you need to run the business? Thank you.

Xavier Heiss  
**Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.**

So, Shannon, we have no issue with paying the dividend and maintaining the dividend here. From a debt point of view, we have, as you know, it’s $650 million to pay in March 2023 as part of the revolver covenant that we have. $350 million will be paid on December, will be entirely funded by securitization, and this is in flight. So, we have no concern in term of this point here.

Regarding our free cash flow, again, in quarter four, what I mentioned here, the vast majority of the Q3 use of free cash flow was related to FITTLE growth, which is a good thing to have; on the other side, inventory. I clearly expect the inventory situation to reverse. As you know, it – Q4 is always the strongest quarter and we’re still sitting with a backlog of $420 million. So, we should have a strong quarter four from an ESR point of view that will deplete the ESR inventory and reduce this inventory down.

Shannon Cross  
**Analyst, Credit Suisse Securities Research**

Okay. Thank you very much.
Xerox Holdings Corp. (XRX)  
Q3 2022 Earnings Call  
Corrected Transcript  
25-Oct-2022

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

Thank you, Shannon.

Operator: Thank you. One moment for our final question. And our final question for today comes from the line of Jim Suva from Citi. Your question, please.

Jim Suva  
Analyst, Citigroup Global Markets, Inc.

Thank you so much for fitting me in. Can you help me better understand how to bridge with more investment in the FITTLE and we're just reducing your sales outlook? Is it your customers are asking you to finance more or is it the cost of capital more, or you are like building or expanding something within FITTLE? Because if sales are being challenged and you have a more cautionary outlook on macro concerns, building FITTLE just seems kind of interesting. If you can help me bridge that, that'd be great.

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

Yeah. So, Jim, I will step back a little bit and describe FITTLE's strategy. So, FITTLE has been for a long time a captive operation, and this, as a captive, was behaving as what you described, which was a completely linked, connected, correlated with the Xerox equipment revenue. When Xerox equipment revenue was up, the origination were up, and then the financing is – was up, and the opposite was true as well.

Since, I would say, two years now and since we reinitiated, reinvigorated FITTLE, due to the fact that FITTLE has a strong credit assessment capability, a good platform and the ability to expand beyond Xerox, the FITTLE team, management team has expanded well beyond the pure Xerox product. And what we have noticed in quarter three and what we are expecting from the team is growth outside of the Xerox, what I call, captive activity.

So, this is what did happen in quarter three. And as I describe it, I call that a good cholesterol because this is a use of cash that will have a strong return, double-digit return in the future, and this is as well an activity that help to strengthen and keep a good relationship with our partner and with our resellers and end customer here. So, back to your question, precise question, this was mainly related to non-Xerox equipment or solution growth, not correlated to the pure Xerox equipment.

Jim Suva  
Analyst, Citigroup Global Markets, Inc.

That makes sense. Thank you so much.

Operator: Thank you. This does conclude the question-and-answer session of today’s program. I’d like to hand the program back to Steve Bandrowczak for any further remarks.

Steven John Bandrowczak  
Chief Executive Officer & Director, Xerox Holdings Corp.

Thank you for listening to our earnings conference call this morning. The past few years have tested the resolve of our people. I'm honored to lead this company that is filled with great people who have proven time and again their ability to overcome incredible challenges. When I meet with our clients and our employees, I am filled with
optimism about Xerox’s ability to do more with our clients and about the team we have in place to deliver more value to our key stakeholders, including shareholders, clients, partners and employees. Thank you for listening to this call and have a great day.

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