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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation's Fourth Quarter and 2022 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions] At this time, I would like to turn the meeting over to Mr. David Beckel, Vice President 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 fourth 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 expressed 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 Q4 2022 earnings call.
One year ago, it would have been difficult to predict the number and severity of obstacles we and many other companies would face in 2022. Supply chain conditions were challenged entering this year. In February, Russia invaded Ukraine and the humanitarian tragedy that disrupted supply chains further and led to the effective shutdown of our operations in those markets. These and the after effects of the pandemic fueled an unprecedented level of inflation and currency dislocation, and Central Bank efforts to control inflation drove historic increases in interest rates.

Finally, for Xerox, last year, we unexpectedly lost our dear friend and leader, John Visentin. I am proud to report that we managed through these challenges, taking significant corrective actions to match supply with demand and lower costs to offset inflationary headwinds.

For the year, revenue of $7.1 billion increased 1% in actual currency and 4.8% in constant currency, our first year of constant currency revenue growth since our separation from Conduent. However, growth in revenues and cost savings were more than offset by broad-based inflationary pressure, resulting in a decline in operating profits and free cash flow. Still, we delivered revenue and free cash flow above the revised guidance levels given last quarter.

Throughout the year, our company and our people remain resilient and never lost focus on what is most important, providing value to our clients. I couldn't be more proud of the effort our team expended in the fourth quarter to deliver the highest level of quarterly equipment revenue since 2019, an accomplishment that was instrumental in driving full year revenue and free cash flow above our revised guidance.

We ended the year with momentum in our values and business performance. Sustainability has long been a top priority for Xerox, and our sustainability efforts are being recognized in the marketplace. Xerox was recently named one of the global 100 most sustainable corporations in the world by Corporate Knights and received an A rating from the Climate Disclosure Project for climate transparencies, one of the leading evaluators of corporate environmental reporting efforts. Importantly, the progress we have made to improve the sustainability of our offerings is driving improvement in our clients' own sustainability goals, and our ability to help clients manage their sustainability goals is increasingly a competitive differentiator in the marketplace.

Turning to our performance in Print & Managed Print Services, equipment revenue grew at the highest rate since before the pandemic due to improved product supply. Consumables, such as supplies and paper, grew again this quarter and Contractual Print Services, our largest most stable source of revenue, grew low single digits in constant currency, including contributions from recently acquired Go Inspire. In Q1, we plan to launch a series of customer experience applications to improve the setup, security and productivity of equipment geared towards small and home office users. Included in these plans is the launch of CareAR Instruct, which provides augmented reality support for our A4 devices using digital twin technology.

IT Services grew revenue double digits for the quarter and the year, including contributions from Powerland in Canada. Enabling that growth is the breadth of enterprise class services we bring to mid-market clients. Xerox Automation, our Robotic Process Automation solutions, once again grew signings meaningfully on a quarter-over-quarter basis. The automation group wins business by understanding at a deep level our client's business, industry and needs, and then uses that knowledge to drive customer success through customized solutions.

Increasingly, our team is integrating automation with other leading technologies such as object content recognition and machine learning to drive productivity enhancements. As an example, this quarter, our automation group won new business from an existing UK client by developing an end-to-end document workflow
solution that combines multiple advanced technologies to extract, classify and process digitized information from scanned documents, saving the client significant time and money.

Digital Services signings also grew double digits in the quarter and for the full year. And our offerings are resonating in the marketplace. In December, Xerox was named a Top Accounts Payable Solutions Provider by CFO Tech Outlook in recognition of our ability to assist clients with digital transformation of their payables process. Our AP workflow optimization solution delivers a reduction in processing costs and improvement in working capital for our clients and is just one of many digital services we offer. In 2023, we will begin offering our suite of Digital Services to the mid-market, further augmenting the types of enterprise class services and solution sets we can bring to mid-market clients.

FITTLE grew originations this quarter more than 40% for both captive and non-captive leases, capping off a year where total originations grew high-single digits, including double-digit growth in non-captive leases. We recently announced an innovative funding solution for FITTLE, enabling a strategic shift in its business model to focus on being an asset-light, best-in-class provider of leasing services and solutions. This funding agreement also allows for growth in FITTLE's portfolio without the use of Xerox balance sheet. Xavier will explain this funding solution in more detail.

I will now touch on our priorities for 2023. Amid all the volatility and uncertainty in the marketplace, we at Xerox are focused on what we can control to drive growth in profits and shareholder value. Our three main priorities this year are customer success, profitability and shareholder returns.

Starting with customer success, we can deliver more value to our clients by making it easier to do business with Xerox. I have spent a lot of time since becoming Xerox CEO, meeting with our clients and partners to discuss the ways we can extend our relationships through additional value-added digital services. And all too often I have heard I didn't know Xerox could do that.

To leverage this opportunity and drive revenue growth, we are taking a more holistic, client-centric approach to improving customer outcomes by delivering essential products and services that are closely aligned with our clients' needs. The current macro backdrop plays to our advantage in this regard, as our IT and Digital Services are designed to increase productivity by reducing the cost and complexity associated with clients' technology and document workflows. Further, it is apparent from our market research that Xerox has a clear path to win more business within the IT and digital service markets because of the trust we have built over time providing value to our clients.

We are confident our brand and client relationships can be leveraged to expand our penetration of wallet share and we are confident in our ability to expand client TAM over time as we invest in and develop new types of digital services for a hybrid workplace and distributed workforce.

An example of our ability to increase wallet share is the recent renewal and addition of services at a large telecom operator in Canada. This client, like many, is adapting to the complexities associated with a hybrid workplace. Leveraging our deep relationships across the company, we took a holistic approach to tailoring a set of print and digital services that will help them in the hybrid transition and improve overall productivity. We also included advanced analytics for print management, digital mail to bring speed, security, and cost savings to their mail and carrier operations, and advanced software solutions to streamline and enhance their production print operations. By leveraging our relationships and portfolio of offerings, we are able to drive customer success while growing our annual contract value by double-digit rate.
Another priority for 2023 is the continued focus on profitability. Since 2018, Project Own It has been a cornerstone of our transformation efforts and a focal point for the optimization of our cost base. We reached our 2022 targeted gross cost savings of $450 million, bringing total savings since 2018 to more than $2 billion.

Just as important as these savings, however, is the management operating system, the set of disciplines around measuring and monitoring business processes that was instilled in our organizational culture by Project Own It. We do not plan to provide annual savings targets going forward, but the behaviors engendered by the program will aid in our continuous effort to implement a more flexible cost base and operating model.

Just as we will make it easier to do business with Xerox, we will make it easier to do business within Xerox by investing in processes that drive incremental organizational efficiencies and enable the types of collaboration required to offer holistic solutions to our clients. The current macroeconomic environment necessitates a greater focus and scrutiny on the profitability about offerings and operating units.

Accordingly, we have become more disciplined about where and how we do business, placing emphasis on metrics such as return on investment and the generation of profit, not just revenue dollars. This discipline has already been applied to our investments in R&D. In the past few months, we have taken actions to lower and in some cases, redirect investments in R&D towards projects with more certain and near-term returns.

We exited our joint venture, Eloque and had growth investments in 3D printing. Novity and Mojave, two successful businesses incubated at PARC, was spun out, allowing these businesses the freedom and flexibility to attract external growth capital at their own pace. To be clear, investments in innovation remain a priority at Xerox, but we'll be more focused on projects and partnerships that augment our existing strengths and opportunities within Print, IT and Digital Services.

Finally, we will continue to prioritize shareholder returns. A greater focus on customer success and profitability will naturally result in higher profits, but we also remain laser-focused on cash flow generation. Despite a strong finish to the year, free cash flow in 2022 fell below our initial expectations. 2022 was an anomaly, not a trend. Beyond expected improvements in profitability for 2023, we have already taken steps to improve our capacity to generate more free cash flow per profit dollars, such as FITTLE’s receivable funding agreement.

We also remain focused on improving working capital and expect improvements in inventory efficiency in 2023 as supply chain conditions normalize. Each of these priorities, customer success, profitability, and shareholder returns will remain cornerstones of our long-terms strategic plan. And each of these priorities are reflected in our full-year guidance, which calls for stable revenues amid a challenging and volatile economic environment and growth in adjusted operating income margin and free cash flow, the details of which Xavier will provide.

To recap, 2022 was a challenging year, one that tested the resolve of our employees and the strength of our business model. The lessons learned from overcoming these challenges will serve us well as we execute on our strategic priorities for the year, and these priorities will ultimately form the foundation of a long-term plan for delivering sustainable growth and profits.

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 mentioned, 2022 was a challenging year on a number of fronts. Revenue and profitability were impacted by surging inflation, supply chain challenges, currency disruption, the war in Ukraine, higher interest rate, and as a consequence, an uncertain and unpredictable macroeconomic environment.

Encouragingly, we ended the year stronger with full-year revenue exceeding our initial guidance of at least $7.1 billion despite more than $250 million of currency headwinds and more than $90 million headwinds from halting sales to Russia. Adjusted operating margin improved sequentially each quarter this year and grew 440 basis points year-over-year in Q4 due in large part to improved product availability. Full-year free cash flow exceeded our revised guidance and we put in place a funding solution at FITTLE that will improve future free cash flow generation while supporting FITTLE growth.

Q4 revenue grew in actual and constant currency for the first time since quarter two of 2021, due to resilient demand for our products and services and improvements in product supplies and mix. Revenue growth of 9.2% at actual currency was negatively impacted by 470-basis point of currency headwind, notably the euro and British pound.

Equipment revenue grew significantly, reaching its highest level since Q4 of 2019 due to an improvement in supply chain conditions. As a result, our backlog, including equipment and IT hardware declined 43% sequentially to $246 million. Our backlog remain elevated but is healthy. We expect backlog to decline through the first half of the year as supply chain condition further normalized.

Post sale revenue grew mid-single digit in constant currency for the fourth consecutive quarter. Growth this quarter was driven by IT Services, which includes the acquisition of Powerland and consumable. The resiliency of Contractual Print Services revenue was observed again this quarter, aided by recent pricing action and the acquisition of Go Inspire.

Turning to profitability, profit were higher year-over-year, driven mainly by better equipment sales, improved product and geography mix, and lower logistic costs partially offset by higher bad debt expense. We expect profitability to improve further in 2023 as we realize the benefit of price and cost action taken in 2022, further improvement in product availability, lower logistic cost, and additional operating efficiency. Gross margin improved 190 basis points over the prior year quarter, mainly driven by a favorable shift in product and geography mix, lower supply chain related costs and benefit associated with price and cost action taken throughout the year, partially offset by ongoing product cost increases and the effect of recent acquisitions.

OpEx, excluding bad debt expense, was lower year-over-year due to our focus on improved return on R&D investment and Project Own It action. Adjusted operating margin of 9.2% increased 440 basis points year-over-year, driven by 300 basis point of supply chain related cost improvement, 130 basis point from cost reductions action, and 100 basis point from price increase and currency. Partially offsetting this benefit where higher bad debt expense associated with the release of reserve in the prior year. Other expense net were $7 million lower year-over-year due to a $39 million benefit from sales of non-core business assets, partially offset by an increase in non-service retirement related costs and higher currency losses due to currency volatility in certain geographies.

Fourth quarter adjusted tax rate was 21.8%, compared to minus 8.8% last year. The increase was largely due to prior tax benefit for changes in remeasurement of uncertain tax position. Adjusted EPS of $0.89 in the first quarter was $0.55 higher than the prior year, driven by higher adjusted operating income, sales of non-core asset and a lower share count, partially offset by a higher tax rate. GAAP earnings per share of $0.74 was $4.71 higher, mainly due to a noncash goodwill impairment charge of $750 million or $4.38 per share in the prior year.
Let me know revenue cash flow on profitability in more details.

Turning to revenue, equipment sales of $554 million in Q4 grew 49% year-over-year in constant currency or 44% in actual currency. Growth was driven by better availability of product across all categories and regions, particularly for higher margin A3 devices in the Americas region. So, sequential growth in equipment revenue mirror the decline in equipment backlog, revealing a resilient order activity amid an uncertain macroeconomic backdrop.

We continue to see particular strength in demand for our A3 office machines. Equipment revenue growth outpaced installation this quarter due to favorable product mix and the benefit of recent pricing actions. Installation growth was strongest for higher margin, midrange product and color A4 multifunction equipment. Color A4 outperformed black and white due to a stop in shipment of A4 mono product to Russia and supply shortage.

Post sale revenue of $1.39 billion grew 4.2% in constant currency year-over-year and declined 0.4% in actual currency. Post sales growth in constant currency was driven by IT Services including benefit associated with the recent acquisition of Powerland in Canada and growth in consumable. Contractual Print Services revenue was resilient and grew low-single digit year-over-year in constant currency, reflecting benefit of recent pricing action and the acquisition of Go Inspire.

Notably, this important component of our annuity revenue grew modestly in 2022 despite a slower-than-expected return of employees to offices and ongoing macroeconomic concern. We believe we have now reached a normalized level for this revenue stream.

Growth in post sales revenue at constant currency was partially offset by lower financing revenue, reflecting a lower FITTLE receivable balance. Geographically, both regions grew in constant currency. The Americas region grew faster than EMEA due mainly to better product availability and mix, as well as stronger growth in consumable sales.

Let's now review cash flow. Free cash flow was $168 million in Q4, lower year-over-year by $14 million. Operating cash flow was $186 million in Q4 compared to $198 million in the prior year. Working capital was a source of cash of $73 million this quarter, $120 million lower than the prior year, driven by higher account receivable and the use of cash to position inventories ahead of Q1, partially offset by a higher account payable.

Additionally, cash used to fund finance receivable and operating lease was $169 million in the quarter compared to a use of cash of $50 million in the prior year, reflecting improved equipment sales activity and FITTLE growth strategy. Positively offsetting this effect were higher operating income in the current quarter and favorable timing of other liability payment. Going forward, we expect FITTLE receivable funding agreement to result in finance receivable being a source of cash as new originations are increasingly funded by third party financing partner, while collection runoff of existing receivables continues.

Investing activities were a source of cash of $17 million compared to a use of cash of $31 million in the prior year, due in large part to an asset sale in the current quarter, partially offset by slightly higher CapEx, which mainly support our investments in IT infrastructure.

Financing activities consumed $67 million of cash this quarter, which is comprised of dividend payment and the early payment of a portion of our 2023 notes netted by proceeds from finance receivable securitizations. During the quarter, we paid dividend totaling $43 million and did not repurchase any share.
Turning to profitability, quarter four adjusted operating profit margin grew substantially on a sequential year-over-year basis for the reason previously discussed. Importantly, margin expanded sequentially each quarter this year as we took corrective measure to offset an unprecedented level of inflationary pressure and ongoing supply chain challenges. We successfully implemented price increases across our portfolio of products and services and took action to rein in cost most notably across areas of investment where the expected payback period extend across multiple years or was less certain. Many of these actions were reflecting in the achievement of our targeted Project Own It savings of $450 million.

As Steve noted, we'll not be providing our targeted savings amount for 2023, but the principle of continuous improvement and operating efficiency instilled by Project Own It will play an important role in driving expected margin improvement in 2023 and beyond.

Turning to segment. In Q4, FITTLE finance assets were $3.3 billion, up 7% sequentially in actual currency. FITTLE origination volume grew more than 40% year-over-year. Both non-captive channel origination, which includes third-party dealers and non-Xerox vendor; and captive product origination grew more than 40%, a function of growth in new dealer relationship and third-party equipment origination, as well as higher Xerox equipment revenue.

FITTLE revenue declined 9.6% in Q4, mainly due to a reduction in operating lease revenue, which reflect lower equipment install in prior periods. Segment profit was minus $5 million, down $30 million year-over-year due to a reserve release of $12 million in the prior year quarter, lower net financing profit, higher intersegment commission associated with higher Xerox origination, higher bad debt expenses, and strategic start-up cost and investment. Segment margin was negative 3.4% compared to positive 15.2% a year ago.

Over time, we expect current and future receivable funding solution to result in lower financing revenue and profit for FITTLE, which will be partially offset by growth in fee-based commission and servicing revenue. However, in 2023, we do not expect a material change in FITTLE revenue or profit, as lower finance revenue will be offset by higher upfront commission and lower bad debt expense.

Print and Other revenue grew 10.2% in Q4. Print and Other segment profit tripled over the prior year quarter, resulting in the 640-basis-point expansion in segment profit margin year-over-year driven by improved product supplies and mix and the benefit of price and cost action taken throughout the year.

I'd like to spend some time now to discuss how FITTLE recent lease receivable funding arrangement is expecting to affect free cash flow for the year. The agreement Xerox and FITTLE signed with an affiliate of HPS Investment Partners contemplates sales of FITTLE lease receivable of around $600 million in 2023. This amount will have otherwise been funded by Xerox. So, this reduction in our funding obligation will result in a direct benefit to operating cash flow. However, this benefit is expected to be partially offset by growth in our lease receivable portfolio.

When considering the year-over-year change in free cash flow, the net receivable funding benefit will be additive to free cash flow. Additional agreement covering US non-direct and foreign receivable are not included in guidance but would further increase expected free cash flow for the year. Receivable funding agreement are expected to contribute to free cash flow for multiple years, but at a decreasing level due to the timing of prior lease receivable runoff.
Turning to capital structure, we ended Q4 with $1.1 billion of cash, cash equivalents and restricted cash. $2.9 billion of the $3.7 billion of our outstanding debt is allocated to and support FITTLE lease portfolio. The remaining debt of around $800 million is attributable to the core business. Debt consists of senior unsecured bond and financed asset securitization. We have a balanced bond maturity ladder over the next few years, and expect to repay the remaining $300 million of debt maturing this year in March 2023.

Finally, I will address guidance. We expect revenue to be flat to down low-single digit in constant currency in 2023. As noted earlier, demand for our portfolio of products and service remain resilient, particularly for our most material and profitable A3 office devices.

Contractual Print Services revenue, our largest contributor to post sale revenue, is expected to remain steady. While we have not yet experienced a meaningful put back in demand for our products or services due to macroeconomic pressure, our revenue outlook does account for potential deterioration in macroeconomic conditions. If economic conditions were to degrade further, we believe the most likely effect will be delays in equipment purchases or service implementations, not cancellation or order reduction and difficulty implementing future price increases.

Offsetting this risk are the annuity-like nature of our post sale business and the counter cyclicality of many of our IT and Digital Services for which demand is expected to increase even if IT budget are rationalized. This year, we are reinstituting guidance for adjusted operating income margin. For the year, we expect adjusted operating income margin to be at least 4.7%, an 80-basis-point increase over 2022 level driven by recent enacted and expected price and cost action as well as lower logistic costs.

We expect to generate at least $500 million of free cash flow, including the benefit of FITTLE receivable funding solution. Excluding the net benefit of the receivable funding solution, we expect free cash flow to be in the range of 90% to 100% of adjusted operating income. Finally, our policy of returning at least 50% of free cash flow to shareholders remained unchanged.

While we do not provide quarterly guidance, I want to provide some color on the expected quarterly cadence of our result. First on revenue, equipment sales growth is expected to be higher in the first half due to easier product supply compare. And at this time, we do not expect a significant deviation in the quarterly growth rate of post sale revenue.

For adjusted operating margin, we expect sequential improvement in margin after quarter one and year-over-year increase in margin in quarter one to quarter three. The sequential improvement reflect normal seasonality, the clearing of the remaining backlog, and the cumulative effect of lower R&D spend, which is expected to benefit margin in second half related to the first half.

Finally, free cash flow. The cash flow benefit of the receivable funding arrangement are expected to be realized throughout the year at roughly the same cadence as equipment sales revenue.

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

Operator: Certainly. [Operator Instructions] One moment for our first question. And our first question comes from the line of Ananda Baruah from Loop Capital. Your question, please.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Hey good morning, guys. Thanks for taking the questions and happy New Year and for all the context. I guess just starting right there, Xavier, with your comments about being kind of risk to the guidance then and what you’re seeing from customers.

Can you give us any context about sort of what you're hearing and seeing from enterprise customers sort of folks have started to see some slowing in enterprise? It doesn't seem like you guys are meaningfully seeing it yet. And so, you did – I think the point is equipment sales out just now with kind of like the primary risk to the forecast that you see; so just some context there? And then I have a quick follow-up after that. Thanks.

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

Yeah. Hi, Ananda. So, good morning, happy new year to you as well. So, yes, so what we are seeing here from a general point of view from our customer, enterprise-owned SMB customer, so demand is still strong on the Q4, as we have noticed it, has been a very good quarter for us. It was driven by the ability to reduce backlog, equipment backlog, mainly with this free equipment. But at the same time, the order pattern remains strong. So, we still see a demand on our offering and I should also flag services.

So, as I commented in the earlier comment there, we have seen equipment demand being strong, but if you look at the post sale revenue, post-charges made of contracted activity, so some of this is print related, some of it is not print related. And when we look at our forecast, we want to be, I call that realistic and balanced in the way we'll project, realistic because the macro environment is an environment which is bringing uncertainty. At the same time, we are confident on balance when we look at the demand, not only for the equipment side but also for the solution side. I'm sure Steve will be able to comment what offerings are currently driving these demand there.

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

Yeah, Ananda, Steve. So, one of the things that we're seeing, if you think about the macro environment with inflation, with the ability to be able to higher cost increases, all of our customers are dealing with those macro trends. And so, as we think about customer success and really driving solutions specific to driving productivity for our customers, we think we have a great opportunity to expand inside of the existing customer base that we're in today. Simple example, if you think about school districts and their challenge with administrators, teachers having more, doing more with less, how do we drive more productivity in workflow? Things like how equipment can do language translation, how equipment can grade papers, how equipment can do and look at things like plagiarism on documents.

So, driving productivity, driving workflow inside a very specific vertical, we can actually help drive and penetrate and help our customers with their macro trends. And we believe we've got a great opportunity to play, certainly in the small- and mid-market space.
Ananda Baruah  
*Analyst, Loop Capital Markets LLC*


Operator: Thank you. [Operator Instructions] And our next question comes from the line of Erik Woodring from Morgan Stanley. Your question, please.

Erik W. Woodring  
*Analyst, Morgan Stanley & Co. LLC*

Hey, guys. Good morning. Congrats on the really strong results in the December quarter. Steve, I guess I want to ask you a bigger picture question and that is just as we enter 2023, it feels like based upon our conversations that most enterprises and small businesses have kind of settled down into their hybrid work setup, whatever that may be. I'm just curious kind of what you've learned now as we've seen kind of hybrid work and work from home normalized. What have you seen in terms of how enterprises and SMBs are consuming Xerox in this new world? What's maybe surprising to you? What maybe came a bit unexpected to you? Would love to just get your feedback on that. And then, I have a follow-up. Thanks.

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

Yeah. I think there's a couple of things there. First of all, you're right, companies are getting settled into this new hybrid environment, but it's driving significant challenges in and around security of documents and data, security around how workflows happen in the company. How do you drive productivity?

And so what we're seeing is a great opportunity for a couple of things. One, to actually play in that space, right, we have been incredibly innovative, innovative through the years around how we drive workplace productivity. This is just a new area for us in terms of workplaces, wherever an individual is. And so we see an opportunity to do a couple of things. One, with our products and solutions workflow, with our cloud solutions, AI solutions, what we think we can do with augmented reality, we can actually help customers drive productivity, but more importantly, drive insights to the data that they have inside of those workflows.

So, we believe there's a great opportunity for us to play in that space and really be the provider of choice to help customers in this new world wherever their employees are and drive productivity and drive insights to the data. So, that's the first thing.

Second. I should think about the macro headwinds that customers are facing. As I talked a little bit earlier to Ananda, we have an opportunity to drive some very specific workflow solutions. You know, you heard me talk about what we're doing in accounts payable. We can do things like drive productivity and help out end customers in their workflow, but very specific around verticals and very specifically around customer success. And so we think we can play in this area and we have a great opportunity to expand our wallet share inside of customer accounts, Erik.

Erik W. Woodring  
*Analyst, Morgan Stanley & Co. LLC*

Okay. Super. That's super helpful, Steve. Thank you. And then, Xavier, maybe a question for you is really nice to see some margin expansion into 2023. Can you help us -- two-part question. can you help us so we better understand the tradeoff between gross margins and OpEx in 2023, how do you think about each of those? And
then, what would be some of the more influential factors that you would have to see in 2023 to help you, you know, maybe get operating margins closer to, for example, 2020 or 2021 levels? And that's it for me. Thanks.

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

Yeah. Thanks, Erik. So, as you have noticed it and as we commented it in quarter three, Q4 was an important quarter for us. And you have noticed that we have been able to drive margin up and Q4 was a strong quarter, driving the overall margin for the company and for the year up there.

So, the ingredients that make it work or the ingredient that will be required to achieve the plans that we have in 2023 are quite simple. Number one is things that we have already put in place. We have put in place price increase, price increases in order to face some of the cost inflation, but also to rebuild the margin here. These price increases have been enacted in 2022 throughout the year and we'll have a flow through of price increases that will still be valid, be measured during year 2023. These price increase, as you know it, are contractual. Two-thirds of our revenue is annuity based, is contractual, which means that when we enact the price increase then it lasts for the year, and for the year after and the year after as well.

The second point is the improvement on supply chain. You know that 2021 and 2022 have been, I would say, literally crazy from a supply chain point of view, and I say mainly the cost of supply chain on the uncertainty around this year. We are expecting and we're already seeing it the supply chain conditions to normalize. However, even if the cost of container is not yet at risk, what is was pre-supply chain crisis or pre-Ukraine and the COVID situation, I mean, we have seen a great improvement in the cost of container shipment, which will help to improve the gross margin impact.

Finally is the way we will invest; and the last point is quite important. We commented in our earnings that we are putting in place a flexible cost base. But being flexible, it just means that we'll be very selective in the way we make the investment. And in an uncertain macro environment, our responsibility is to ensure that we prioritize full-term, high-yield return investment versus longer-term investment. So that's a key component.

Obviously, we will have to offset some of the headwinds that could exist. Technically, you know that there was a benefit of Fuji Xerox royalty. We still have some inflation costs there. But that's the reason why back to the three main components that I mentioned to you, price, supply chain and investment, we are confident in our ability in 2023 to expand our operating margin.

Erik W. Woodring  
Analyst, Morgan Stanley & Co. LLC

Awesome. Thank you, guys.

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

Thank you, Erik.

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.

Angela Jin  
Analyst, JPMorgan Securities LLC
Hi. Good morning. This is Angela Jin on for Samik Chatterjee. Congrats on a strong quarter. So, a question about backlog. So, I saw that backlog came down about $183 million quarter-on-quarter and equipment sales are up about $164 million quarter-on-quarter. So, can you just walk us through the gap there? Like is the implication here that you're seeing an uptick in cancellations or equipment order rates are dropping. And if you continue at this rate, will you reach pre-pandemic levels back within a quarter? So, how should we think about sort of the cadence of backlog into the first quarter of 2023?

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

Yes. So, good morning, Angela. So, the backlog here, I would say it's a good story because this backlog was building up. We started to see a decrease of the backlog in quarter three and we were pleased to be able to get some of these backlogs reducing and to have just 43% of a decline in quarter four.

This mainly related to the high profit equipment that we have, what we call A3 equipment. And this is related to supply chain condition improving and also the logistic agility and logistic speed coming back to a normal level there. So, that was a good story. That was a good story because it helped the mix of products that we are selling, bringing it back to, I would say, more normalized mix. Second point, it helped the overall gross margin improvement, both on the equipment side, but also some of this product are driving good post sales revenue and profit here. So, that's regarding Q4.

When we look at the order pattern that we are seeing here, we still see quite a very strong demand still for the same mix of products. So, our A3 product, Steve described some of the capability of this product. Don't look at them as printer only. They are essential for our customers to drive workflow and productivity that they need in this current hybrid new ways of working here.

So, when you look at what was the equipment growth versus the decline in backlog, you look at the inventory we have as well on the channels that we measure with. I mean, the math works, I mean, we balance it and those growth that we can see on the equipment versus the backlog decline was in line with what we were expecting and planning for.

Looking at next year now, what we're expecting is to flush this backlog during the first half of the year. And to give you a number, the normalized backlog – if you look at the backlog that we have today versus the normalized backlog, we are currently at 2.5 times what is the normal backlog. So, we're expecting this to be cleaned or flushed in quarter one with some really impacting quarter two. Assuming supply chain and manufacturing stay good for the rest of the year, we should be in a BAU mode for the second half of the year.

Angela Jin
Analyst, JPMorgan Securities LLC

Got it. That's really helpful. And then for my follow up, so just thinking about your free cash flow guide of at least $500 million, can you maybe dig in more to what portion of that is attributable to your core business versus FITTLE since – it seems to imply right now that core free cash flow is sort of in the low 100s range, unless there's a plan to sort of very meaningfully ramp originations in 2023.

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

Yeah. So, if I go back to – that stuff is 2022. In 2022, we said free cash flow is an anomaly. And it's an anomaly for two reasons. One anomaly is related specifically to the reduced profitability that we have in 2022. The second
point and I call it good cholesterol, bad cholesterol. So, good cholesterol was that FITTLE is growing. And when FITTLE is growing, it means that the FITTLE is using cash and it has an impact on free cash flow.

So, now if I normalize this and I project this in 2023, what will be our normal free cash flow? We gave you – I gave you an indication in my earlier comment there by saying we expect in 2023 free cash flow – without FITTLE movement here, normalized free cash flow to be around 90% to 100% of adjusted operating profit. So, that's an earlier indication of what it could be.

Then, on top of that, you will have the benefit of what we call the forward flow agreement. You should look at this agreement as being simply the fact that we managed to get a great agreement with a mixable party who will fund the forward flow. By forward flow, you should look at this by saying this is like the three-tier receivable from FITTLE or three-tier origination of FITTLE and we won’t have to do that from the Xerox balance sheet. What does that mean? It means that you will have the one-off of the book that was on Xerox balance sheet that will be completely offset by this forward flow agreement here.

You have to take into account and there's a chart in the deck that explain it as an illustration, you have to take into account that FITTLE is still growing at the same time. So, this effect, the $600 million were the ones that we have signed in quarter four is offset by the fact that FITTLE is growing. So when you look at our guidance of $500 million, this take into account this normalized free cash flow without FITTLE, let's say, between $300 million to $330 million. And then, you add on top of that roughly $200 million. And then you have this $500 million guidance that we have provided.

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**Angela Jin**
Analyst, JPMorgan Securities LLC

Got it. And if I could just squeeze in one last quick one. So, equipment margins are up to 33%, so it drove a lot of upside in this quarter. It seems like the mix is more favorable than usual with A3 units being shipped and a strong US sale. So what is the sustainable level of equipment margin going forward?

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

So, equipment margin, when I look at the pattern we have had during the year, I'm not stopping only to quarter four, I look at how equipment margin evolved across the year and you're right, mix, that is a key driver, but one of the key driver was as well our ability to pass price increases to customer and to keep this important margin for us, I would say, protected or intact in the way we were dealing on pricing with customer. This is what we have done, and we believe that with the prices that we have enacted and the impact it will have in 2023, we will be able to sustain and offset some of the price – or cost inflation that we're expecting here.

So, normalized margin is not far from what you have seen. I won't say quarter four is on target representative, but we can, if you want, also provide via our IR team, I'll give more guidance around how we look at the margin for the rest of the year.

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**Angela Jin**
Analyst, JPMorgan Securities LLC

Okay. Thank you.
Thank you, Angela.

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?

Shannon Cross

Thank you very much for taking my question. I'm wondering about the balance sheet cash requirements. As you're shifting, obviously, your model on the financing side but also as the business itself changes more to solutions and services, how should we think about what level of inventory over time? Because I would assume this will maybe become a little bit more of an inventory-light model as you move more away from just equipment. And then also just in terms of core cash needed to run the business, because I'm trying to figure out what your excess cash is as you think about where maybe you're going to be exiting, I guess, 2023 – already in 2023. Thanks.

Xavier Heiss

Hi, Shannon. Let's go back. So, I just provided some market relations, so I will maybe repeat or clarify some of the points here. So, you can look at our guidance of free cash flow for next year in two ways, I would say, business without FITTLE and the business with FITTLE.

So, business without FITTLE, as we mentioned it, 2022 was an anomaly in the way our free cash flow came specifically due to the margin pressure, the erosion of margin specifically during the first half of the year. Now, if you look at the normalized on what we have put and guided for normalized free cash flow without FITTLE for next, you can count on around 90% to 100% of adjusted operating profit. This is, in number, between $300 million to $330 million.

The second part...

Shannon Cross

Xavier, I wasn't asking about cash flow. I was asking about actual cash. So, just to be clear, I understand the cash flow. I'm just saying what kind of – what level of cash do you need to run the business, and then just off of your balance sheet, because obviously you have to pay down some debt right now. But I'm wondering like if I think about your company right now, if you generate the $500 million in free cash flow next year, where do you think you need to be in terms of total cash coming out of 2023? So, that will give us an idea of what excess cash you might use to deploy elsewhere.

Xavier Heiss

Yes. So, we have been – so if your question is related to, I would say, to capital allocation on what we do with cash. So, the priority is quite simple and we did not change it, by the way. 50% of free cash flow will be returned to shareholder. The first part will be via dividend. As you know this, we have maintained our dividend and even during COVID-19 period. So, we keep our $1 dividend and this will be one of the driver and the way to drive the cash – to bring the cash back to shareholder. So, if you get 50% out of $500, you are at $250, so dividend is in the range of $140 million, $150 million.
The waves of cash will come on and the free cash flow will come during the year will be related to this funding agreement with FITTLE or it will be progressive. So, we will provide comment on more information during the next quarter earnings on how we will potentially use on the return of this cash between the shareholders. And also, we will invest for the business in order to support what Steve just described before, the investment or the strategies that we have on the high yield loan, obviously, low time at return that we will have on the product like Digital Services, but also all the automation offerings and the workflow automation that we are pushing to customers.

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

Okay. And then, I guess, my question is basically, as you think about the debt maturities you've had coming due and obviously, the near term, one will be paid with cash on hand, is the idea to delever the balance sheet over time because you are shrinking the FITTLE business or do you anticipate utilizing the cash that you generate from FITTLE in other areas and keeping a higher level of leverage on your balance sheet going forward?

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

So, what we plan simply to do is to face our debt obligation. So we have a small, medium debt to pay in March on the line and we plan to pay it based on the cash generated by the business. We are not planning at that time to add like a highly overall leverage of the balance sheet. And if you look at the debt ladder that we have in 2024-2025, I would say quite clean and we think that we'll be about to face with that obligation. So, I'm not specifically concerned about our ability to pay the debt and how that will take the prevalence versus other type of investments we plan to do.

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

Okay. Thank you. And then I guess just my last question is as you talk to customers and you look at some of these management services contracts that you have out there, what is the discussion in terms of page volumes going forward, size of equipment? Are you seeing – I think last quarter, you talked about some customers sort of negotiating in lower page volumes. Is that continuing or as offices open up are things normalizing? Thank you.

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

Yeah. Good question, Shannon. So, what we see are currently on the – we commented by saying we believe we have reached like a normalized position here. We don't see a higher erosion around, I would say, sales volume. We see as well our ability to negotiate contracts with that contract minimums there from a price point as well. We have had some data points showing that that price increase that we are passing to customer are sticking.

So, the way we look at this line is what we call contracted point revenue line there, the way we look at this line from a revenue next year is like a flattish type of line, which is good because this is not like an accelerated decline. So, return to office has been, I would say, slow in some places, a little bit higher in certain geographies. But the way we look at it then for the last three, four quarter, this time had been – I will call that like flattish steady. So, that's the way we look at it for the next year.

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

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

Thank you. Thanks a lot.

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

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Thank you. In your prepared comments, you mentioned about the Federal Reserve changing of interest rates and all that. And then I'll have a follow-up. But can you just kind of give us some outlook about what we kind of should be modeling or thinking about for interest expense? Because now that you have your relationship with FITTLE and things like that, it gets a little more complicated, especially with interest rates swinging a lot. Is the Q4 number like a long-term number that we could use or kind of use the full year number and just divided by four? There's just a lot of moving parts in your interest expense item.

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

Hi, Jim. Good morning. So, the way to look at the interest rate and I'm speaking here about core debt. So, first of all, our core debt is mainly based on a fixed interest rate. So, all the rate that we have for our debt maturing is not indexed or directly related to the Fed increase – rates increase or inflation that we can see right there.

Number two, we are paying down our debt as you have notice it. We did it this year. We had a maturity of $1 billion coming in March 2023. We took the opportunity early in March and also in December to already pay down $300 million and $350 million. We have two times $350 million. We have 300 million left to do and we plan to do that there, so no concern on our ability to pay down cash.

From an interest point of view, if you take just the interest charge that we have assumed at quarter four, and you roll it forward, that means you will be closer and the FITTLE business is not reported dominantly in this interest here because you have this being reported in interest income on one side, interest expenses on the other side. So the forward flow agreement will obviously change the way in the future on how the interest flows of FITTLE business will be reported. Maybe it give me just the opportunity to reinforce one point on FITTLE. With the forward flow agreement that we have signed, the business model of FITTLE is changing, and FITTLE is becoming now an asset-light servicing model for lease business, specifically related to, I call that, office-related or industry-related type of equipment, Xerox and non-equipment there.

What it does mean, it means that the ability for FITTLE to grow outside of Europe is now enabled, and it is not done at the detriment of the free cash flow. And potentially, as you highlighted, at the detriment of late or our ability to leverage or to get the rate that could make FITTLE competitive. We find and we signed this agreement with a strong partner and a strong balance sheet that help us to support the growth of this business without having the impact of the FITTLE flow.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Okay. And then, my quick follow-up, on page 12 of your earnings presentation where you talked about the effect on free cash flow of your receivable funding arrangement, I know this year is kind of the inaugural year of this
agreement with your financing partners and impact is a net positive net funding benefit to your 2023 cash flow. Long term, should they kind of equal out, meaning the growth and the receivables, should they kind of equal out or should they kind of always be a net funding benefit like we’re seeing in the year 2023?

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

So, you're right, Jim. The way to look at it is over time. On time would be four to five years, while the one-off of the existing portfolio, which has been funded by the Xerox balance sheet on securitization programs that were in place. So, this one-off will decline over time and it will be replaced by this funding agreement. And this funding agreement is done outside of the Xerox balance sheet.

So, this benefits as we see, specifically 2023 and also in 2024, will erode over time, but it will be offset not from a free cash flow point of view, but in the P&L way of looking at it there. It will be offset by the fact that this agreement, as I mentioned, this is a shift in the way people would work. It will be offset by commission that we're receiving every time we sell some of this secured receivable to our partners. But also we are still highly, I would say, rewarded by the facts that we will have fees from this business and also some benefit of how we will service or manage this portfolio.

So, this is a change. This is a shift in the way the FITTLE business is being built. This is for the good, I would say, of Xerox, because the less use of Xerox balance sheet while preserving the growth of FITTLE and being able to preserve the revenue on the profit related to this business.

Jim Suva  
*Analyst, Citigroup Global Markets, Inc.*

Thank you so much for the details and clarifications.

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

Thank you, Jim.

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. We have turned the page on 2022. Macroeconomic conditions remain uncertain, but this past year has proven that at Xerox, we can react and drive profitable results. I am confident we have the right team and strategy in place to deliver growth and profitability, and shareholder returns in 2023 and beyond. Thank you for joining our call, and have a great day.

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