02-Aug-2022

Conduent, Inc. (CNDT)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to Conduent's Second Quarter 2022 Earnings Announcement. At this time, all participants are on a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Giles Goodburn, Vice President, Investor Relations. Thank you. You may begin.

Giles Goodburn

Vice President-Corporate FP&A and Investor Relations, Conduent, Inc.

Thank you, operator, and thanks, everyone, for joining us today to discuss Conduent's second quarter 2022 earnings. We hope you had a chance to review our press release issued earlier this afternoon. Joining me today is Cliff Skelton, our President and CEO; and Steve Wood, our CFO. Today's agenda is as follows. Cliff will provide an overview of our results and a business update. Steve will then walk you through the financials for the quarter, as well as providing a financial outlook. We will then take your questions.

This call is being webcast and a copy of the slides used during this call, as well as the press release, were filed with the SEC this afternoon on Form 8-K. This information, as well as the detailed financial metrics package, are available on the Investor Relations section of the Conduent website.

During this call, we may make statements that are forward-looking. These forward-looking statements reflect management's current beliefs, assumptions and expectations, and are subject to a number of factors that may cause actual results to differ materially from those statements. Information concerning these factors is included in Conduent's Annual Report on Form 10-K filed with the SEC. We do not intend to update these forward-looking statements as a result of new information or future events or developments, except as required by law.

The information presented today includes non-GAAP financial measures. Because these measures are not calculated in accordance with the US GAAP, they should be viewed in addition to and not as a substitute for the company's reported results. For more information regarding definitions of our non-GAAP measures and how we use them as well as the limitations to their usefulness for comparative purposes, please see our press release.

And now, I would like to turn the call over to Cliff.

Clifford A. Skelton

President, Chief Executive Officer & Director, Conduent, Inc.

Good afternoon, everyone, and welcome to Conduent's Q2 earnings call. As you know, quite a lot has changed, especially in the markets since we last met. And while you will see that our financials are quite consistent with what we've been forecasting, we do have some interesting announcements and expectations we'd like to describe to you today.

I'll start with some high-level narrative on the financials before Steve takes you through the details. I'll then describe some recent changes and direct you to some future sessions we intend to hold in order to go deeper on our future three to five-year financial and strategic expectations.

Let me start by saying that our Q2 results were exactly in line with what we thought they would be and what we had previously described to you as an expectation. In Steve's remarks, you will see renewed conviction regarding our guidance and the expected strong Q3 and Q4 of this year. I look at Q2 as the bottom of the springboard, to use a metaphor, for the runoff of the government stimulus volume from 2021 and the manifestation of our stronger sales and retention efforts coming to bear, among other positive and negative nuances like interest rates and foreign exchange. Another point to remember is that our numbers do not yet include the full benefit from interest rate increases that will manifest in later quarters.

Regarding the financials, our adjusted revenue was $928 million and a little more than that on a constant currency basis. That's in sync with what we've previously guided to. For adjusted EBITDA, we finished the quarter at $87 million and a 9.4% EBITDA margin. Again, the thing to remember there is that's without a lot of that high-margin stimulus volume that we became accustomed to last year, but it's also right in line with what we guided to. New business signings were strong in Q2.

As it relates to annual contract value, our primary metric, it was one of our strongest quarters, driven in large part by strong penetration within our current client base and some partnership activity. Now, in order to provide an apples-to-apples compare, we look at ACV without the onetime government stimulus from either year.

Q2 new business ACV was $177 million as compared to $172 million in Q2 of 2021. Net annual recurring revenue activity impact was positive for the seventh consecutive quarter. As I've talked about in the past, what's important to see is a consistently positive number indicating future growth. And if the quarter-over-quarter trend line has a positive slope to it, it indicates an acceleration in growth. Meanwhile, Steve will dissect those numbers for you here in just a minute.

There are a few other important investor comments I'd like to make, as you might expect. First is an update on our Transportation business. We've previously told you that we intended to separate the Transportation business with a focus on spin. We've spent a lot of time with many of our largest public and private shareholders since our last earnings in order for us to better understand the outside-in perspective related to the market, our diverse suite of businesses and how we are perceived strategically.

I think it's obvious that the markets have changed in a reasonably profound way, especially valuations and sentiment in a public marketplace. We paid attention to that, as have most of our large shareholders. We looked at previous assumptions regarding public company valuations, interest rates and cash flow analyses and we applied the new market perspective to those assumptions. Because the potential for spin was now public, we could also closely examine, with the right experts, spin costs and management distraction with increased alacrity. All of this led management and our board to a changed point of view.

Our board and management carefully reviewed the changed outlook and now believes that the timing for a separation, certainly for a spin, is not now. We believe that same sentiment is likely held by a majority of our shareholders. Of course, there was a time in which shareholder value could have been maximized by a transaction such as a spin, but at this point, it's clear that the window of such opportunity is behind us.

So, you should expect us to keep our heads down and continue to grow this business as part of the Conduent family of products and solutions. And importantly, our outlook on the opportunities for this business and the rest of our portfolio increases every day. We have settled into a model without a need for large scale transactions.

Now with that discussion behind us, we owe you some investor communications we believe you now deserve to hear, without the backdrop of a potential transaction. In future communication efforts, we will describe Conduent assets that are either superior to the competition or assets that, frankly, no one else has. We intend to go deep on a description of those assets and strategies with our analysts, our investors and our future investors, as follows. We expect to have an Investor Day in late Q1 of 2023. We think it's going to be really important for you to understand our strategy and where we want to take this company and what you can expect from us over the next three to five years, both financially and strategically. And we want to kind of lean into that before Investor Day with some early reads as a primer to that Investor Day in late Q4 of this year to tell you basically what you can expect at a level of detail on Investor Day, to include an early read on our long-term plan by line of business.

In those two meetings, you're going to see a three to five-year growth plan, which will be the outcome of a couple of things. First, the view of our three individual business lines. Given the last three years of stabilization, talent upgrades, portfolio improvement and client retention, we will show growth expectations and margin expansion expectations over the next three to five years, absent any profound capital investments or inorganic solutions.

Second, we're going to talk to you about what we're going to do with discretionary investment capital and our strategy around a core suite of technology-enabled products. We think we have some solutions that are very, very shiny and impressive in the marketplace, providing growth opportunities that will create positive sentiment in the market. We will demonstrate these in a dialogue vis-à-vis five or six key technologies that are really unique to Conduent. We will contextualize these into opportunities with an investor perspective that transcends normal course and speed. Not only can these assets, when operationalized adequately, allow for accelerated revenue growth. Our belief is they will help our brand be perceived in ways that only technology companies can enjoy.

And then, lastly, we're going to come back to the capital allocation plan. What is it we're going to return to shareholders in terms of potential stock buybacks, debt paydown or other possible inorganic opportunities.

So with those expectations laid out, let us get into what you came to hear about in the near term, which are the details of Q2. I'll now turn it over to Steve for that. Steve?

Stephen Wood

Chief Financial Officer, Conduent, Inc.

Thanks, Cliff. As we've done in the past, we are reporting both GAAP and non-GAAP numbers. I would like to point out that certain non-GAAP measures adjust for the Midas divestiture. This is similar to past practice. The reconciliations are in our filings and in the appendix of the presentation.

Let's turn to slide 5 and discuss our key sales metrics. Our primary sales metric, ACV, grew 3% for the quarter as compared to Q2 2021, when normalizing for onetime volumes in 2021, which included government stimulus. This was also up approximately 7% sequentially, and we now have posted sequential growth in this key sales metric for the past four quarters, evidencing our continued strong underlying sales performance. This sales performance was particularly strong in the Commercial segment, with one of the highest levels of ACV signings since spin, at $124 million.

New business ARR was slightly down and the new business TCV for the quarter was impacted by an unfavorable compare from Q2 2021 when we signed large long-term deals with Highways England in the Transportation segment and New Hampshire Department of Health and Human Services in the Government segment.

The net ARR activity metric, our combined measure of wins, losses, pricing effects and other contractual changes, was positive for the seventh quarter. As a reminder, this trailing 12-month measure does not predict the timing of revenue, but is based on the timing of notification and such will fluctuate from quarter to quarter. Finally, the quality of our sales pipeline remains very healthy and we have the highest value of late stage pipeline since the third quarter of 2017, with strong coverage across all three segments.

Let's now turn to slide 6 and discuss some of the key sales metric trends. As I mentioned earlier, our trend on new business ACV, our primary sales metric, is encouraging with ACV increasing sequentially for the past four quarters. Our TCV will fluctuate significantly quarter-to-quarter as we have said in the past, given the change in mix of deals between segments. Commercial segment deals average between three and four years, whereas Government and Transportation segment deals are typically much longer in duration. This drives a lot of the variability in TCV as well as average contract length. Q2 was a quieter quarter for renewals after significant renewal activity in the two prior quarters. Our renewal rate remains extremely strong.

Now, let's turn to slide 7 and discuss our Q2 2022 financial results. Overall, as Cliff mentioned earlier, Q2 finished right in line with where we expected it and where we guided to when we laid out our expectations for you during our Q1 earnings call, especially considering the unfavorable exchange rates impacting our international transit and European commercial businesses. This was a $3 million revenue headwind against that guidance during the quarter and an overall $11 million revenue headwind when compared with Q2 2021.

In terms of the numbers themselves, adjusted revenue for Q2 2022 was $928 million as compared to $1 billion in Q2 2021, down 8% year-over-year or 6.9% in constant currency. The year-over-year headwind from the roll-off of onetime government stimulus volumes from 2021 in the quarter was $59 million. And as we told you in Q1 earnings, the year-over-year as well as the sequential trend was impacted as expected by a financial institution client merger that rolled off revenue in the quarter within our Commercial segment.

Adjusted EBITDA was $87 million for the quarter, down 26.9% as compared to Q2 2021 and the adjusted EBITDA margin of 9.4% was down 240 basis points year-over-year. Again, this was in line with our internal expectations and how we laid out guidance for margin progression for the year in our Q4 2021 earnings call in February.

As I'll discuss later in the presentation, when we look at the full-year guidance, Q2 is the low point of our year in terms of both revenue and margin, with one more quarter remaining where we are lapping the significant headwind from the onetime government stimulus volumes. But as we go later into the year, our revenue ramp reduces this effect.

Let's now turn to slide 8 and go over the segment results. For Q2 2022, Commercial segment adjusted revenues were down 3.7% year-over-year at $470 million, due largely to the previously-mentioned financial institution merger impact. There were also negative impacts from foreign exchange in our European business and these were partially offset with strong new business ramp.

Adjusted EBITDA for the quarter was $46 million, up 9.5% as compared to Q2 2021. Adjusted EBITDA margin was 9.8%, up 120 basis points. Both reflected the impact of mix from higher interest rates, which positively impacted our Benefit Wallet business as well as cost efficiency programs that we used to offset other expense headwinds.

Within the Government segment, adjusted revenues for the quarter were $279 million, down 17% year-over-year as compared to Q2 2021. The year-over-year impact of the runoff of government stimulus revenue was $59 million in the quarter. Removing that impact, the underlying base business would have been slightly higher year-over-year. Adjusted EBITDA for the Government segment in Q2, 2022 was $78 million, down approximately 34% year-over-year, reflecting that run off of government stimulus volumes, partially offset by operational efficiency initiatives. The adjusted EBITDA margin of 28% was down 710 basis points year-over-year.

Transportation segment revenues in Q2 2022 were $179 million, down approximately 3% year-over-year. Our international transit business within the Transportation segment had approximately $5 million of headwind from foreign exchange as compared to the prior year, and adjusting for that, we were essentially flat year-over-year, which was in line with our expectations, and again, consistent with how we laid it out for you in the Q1 earnings call. For the Transportation segment, adjusted EBITDA for the quarter was $24 million, down 4% as compared to Q1 2021, and the adjusted EBITDA margin was 13.4%, down 10 basis points year-over-year.

Let's now turn to slide 9 and discuss the balance sheet and cash flow. Our cash position remains healthy. We ended the quarter with $530 million in cash on the balance sheet and a net leverage ratio of 1.8 turns, which is below what we believe is our normalized range of 2 to 2.5 turns. Capital expenditure as a percentage of revenue decreased during the quarter to 3.6%, and we expect that sequential decline to continue through Q3 and Q4, as we have somewhat frontloaded our investment plans to drive revenue into the back half of 2022 and beyond.

Working capital increases during the quarter address the need to ensure supply chain timeliness and support our strong implementation ramp in the second half of the year. We expect many of these items to reverse during the second half of the year. Additionally, higher collections in the latter half of the year keeps us on course to achieve our full-year outlook for adjusted free cash flow.

Let's turn to slide 10 and review our 2022 guidance. We are updating our guidance for adjusted revenues in 2022 to be in the range of $3.85 billion to $3.95 billion. As we move into the second half of the year, we see increased confidence in narrowing this range with the following assumptions. We have baked in last week's 75-basis point hike in Fed rates, and against our original guide, this benefits in-year revenue by approximately $12 million. As a reminder, we will see much more benefit from this in 2023 as these increases in rates fully annualize within our 2023 numbers. We are also including in this guide the impacts of foreign exchange on our international transit and European commercial businesses, which we currently expect to be an approximate $20 million headwind for the full year against our original revenue guidance.

The overall midpoint of our revenue guidance remains unchanged, and we continue to expect the Commercial and Transportation segments to achieve full-year growth on a constant currency basis. When adjusting for foreign exchange headwinds, the Commercial and Transportation segments will grow approximately 1% and 3% year-over-year, respectively, which is in line with the segment level trajectories we laid out at the beginning of the year.

One of the key planks of our turnaround strategy has been to return the Commercial segment, our largest business, to a trajectory of sustained, constant currency growth. During the second half of the year, the Commercial segment will grow approximately 1.5% year-over-year as compared to the second half of 2021, and as noted above, we expect approximately 1% of growth for the full-year 2022 as compared to 2021 in constant currency.

Underpinning this turnaround has been an intense focus on all aspects of quality for our clients, which has brought increasing stability to our revenue base. Additionally, we saw in the second quarter of 2022 one of the highest ever quarters of ACV sales attainment in the Commercial segment, which is driving our ramp in the second half of the year and into 2023.

Baked into the above outlook for the Commercial segment is an expectation that a couple of our larger commercial clients are experiencing a level of normalization in their post-pandemic call volumes. We have this included in our 2022 guidance as an approximate $25 million to $30 million headwind this year and likely a $35 million to $40 million headwind in 2023 as far as we see it at this point.

I'll talk more about how these effects fit into our 2023 outlook when we get together later in the year, but to reiterate for now, this 2022 effect is contemplated in how we're thinking about the guidance we've just laid out.

Finally, as we think about our segments for 2022, we are now expecting the Government segment to perform better than our original guidance. We now expect the year-over-year decline to be around 13%, which, ignoring the onetime benefit from government stimulus programs in 2021, would have the underlying business growing slightly in 2022, where previously, we expected it to be flat. The drivers behind this are an expected elevated level of post-pandemic volumes in our SNAP programs and slightly better retention. We also have a very strong pipeline of late-stage deals in our government healthcare business.

We are updating our adjusted EBITDA guidance for 2022 to be in the range of 10% to 10.5%. The drivers are the mix of business, stronger contribution from higher interest rate expectations noted earlier, along with ongoing cost initiatives across businesses and functions. We still expect to convert approximately 15% of adjusted EBITDA to adjusted free cash flow, inclusive of paying off the remaining portion of deferred payroll taxes under the CARES Act. Similarly, we are not changing our outlook on CapEx or restructuring charges.

As we did last quarter, I'll lay out the revenue and margin expectations for the coming quarter. We see adjusted revenue in the range of $970 million to $985 million for the third quarter and adjusted EBITDA margin towards the midpoint of our full-year guided range.

That concludes our financial review for Q2 2022 and I'll hand it back to Cliff now for closing comments. Cliff?

Clifford A. Skelton

President, Chief Executive Officer & Director, Conduent, Inc.

Thanks, Steve. I think what you heard here from both Steve and me is that we're exactly where we expected to be at this juncture in the year. You'll recall a comment I made back in February when I called this a settling year. The year is playing out the way we expected it to. And equally important, we're now beginning to lay the groundwork via our sales efforts and improved retention to continue those sequential improvements as we move toward 2023, especially important now that the Transportation decision is behind us.

Yes, there are uncertainties and some headwinds still. Steve laid out some of those for you in his remarks. But more importantly, we now have a Commercial segment that is returning to a base level of growth, we have Government and Transportation segments that are proven to be good businesses during uncertain times and that, combined with the likes of our Benefit Wallet business, means we believe we have a solid set of assets to continue to drive benefits to our shareholders.

We look forward to being able to share those with you later this year and early in 2023 as I laid out earlier. As always, I'd like to thank our clients, our associates and our shareholders for their continued support. Stay safe, everyone.

Now, we'll open up the lines for some questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question comes from Bryan Bergin with Cowen. Please proceed with your question.

Zack Ajzenman
Analyst, Cowen Inc.

Q

Hi. Thanks. This is Zack Ajzenman on for Bryan. Maybe starting on the Transportation news, with the pivot away from the spin, how are you thinking about the balance of the portfolio from an asset divestment and simplification standpoint?

Clifford A. Skelton
President, Chief Executive Officer & Director, Conduent, Inc.

A

Appreciate the question, Zack. There's a lot of – as you know, many attributes of the Transportation business that make us very optimistic for the future, things like smart cities, infrastructure, payment opportunities, data analytics, we see this is a bright future. Now, I think what you're really asking is do we still have an appetite. And the answer is we are uniquely focused on growing the business as part of our portfolio and I can tell you there's not an ounce of energy being spent on anything other than that right now. So, that's where we see the Transportation business going.

Zack Ajzenman
Analyst, Cowen Inc.

Q

That's helpful. And maybe touching on Government, can you give a little more color about the growing volume of late-stage deals here? It sounds like it's really driving some of the incremental confidence and potential upside in that business.

Clifford A. Skelton
President, Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. Let me start and then Steve can fill in any gaps that he sees. Look, I mean, if you look at our overall pipeline in aggregate, it's pretty similar to where it's been in the last few quarters. But what's changed is things have moved further to the right in the sales cycle. So, late-stage deals are a much more – a much higher percentage of the pipeline. Specific to Government, we see a lot of opportunities specifically in government healthcare. And with this – with the modularity mandates out of the CMS, we also have a lot of opening opportunities that we just didn't see earlier in the year, and I mean, very, very strong pipeline.

Stephen Wood
Chief Financial Officer, Conduent, Inc.

A

Yeah. Zack, the only other thing I'd add to that is these – in many cases, these are deals that we've known have been around for quite a long period of time. But obviously, some of that contracting got sort of elongated because of COVID. And so, we're seeing some of that backlog now sort of work its way through into the late stages of our pipeline, and that's really the driver of the comment. We're quite excited about the size of that pipeline and the opportunities that may present themselves in that segment as we move forward.

Zack Ajzenman
Analyst, Cowen Inc.

Q

Got it. Thank you.

Operator: We've reached the end of the question-and-answer session. I'd like to turn the call back over to Cliff Skelton for closing comments.

Clifford A. Skelton
President, Chief Executive Officer & Director, Conduent, Inc.

Listen, I'd like to thank everybody for joining. And I'm sure we'll have ongoing conversations with our analysts in other settings going forward. So, there's lots more we can peel back. But we feel pretty confident that the quarter delivered what we said it was going to deliver and that we intend to keep doing that over and over again and tell you what we're going to do and then we're going to do it. And so, we're proud of that. And as I said earlier, and Steve reinforced, not only is it settling here but the springboard is at the bottom and we see a very strong Q3 and Q4, both from a sales, a revenue and an EBITDA of perspective.

So we look forward to talking to you, not only in Q3 results but as we get into the end of Q4, on the game plan for Investor Day, which we alluded to. In that plan, we plan to go much deeper on the base growth opportunities for the three lines of business. We're going to elaborate on some of those technology plays that I talked about and how that can double down on our growth in the next three to five years. And then, we're going to provide the framework and the details around what you can expect on capital allocation.

So we're looking forward to those conversations, as well as the next set of earnings, and we appreciate everybody's time today and thank you for joining.

Operator: This concludes today's conference. You may disconnect your lines at this time and we thank you for your participation.