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CNDT.OQ - Q4 2023 Conduent Inc Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the Conduent Q4 2023 Earnings Announcement. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Giles Goodburn, Vice President, Investor Relations. Thank you. You may begin.

Giles Goodburn - *Conduent Incorporated - VP of Corporate FP&A and IR*

Thank you, operator. And thanks, everyone, for joining us today to discuss Conduent's Fourth quarter and full year 2023 earnings. We hope you had a chance to review our press release issued earlier this morning.

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 year as well as providing a financial outlook. Cliff will then provide his closing comments.

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 morning 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 U.S. 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 - *Conduent Incorporated - President, CEO & Director*

Thanks, Giles, and thank you all for joining Conduent's Q4 and year-end 2023 earnings call. Hopefully, this will be the last call, earnings call where we don't have Q&A at the end. We've been working to establish a sell-side group to help provide services so that we have Q&A on the next call.

But let me start by saying, like everyone else, a lot's happened in our company since the last Q3 earnings call, both from within our own portfolio and our clients. As you know, Conduent retains a very diverse platform of products and services, spanning the myriad of industries in both commercial and the government space across federal, state and local levels.

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At times, we take advantage in the times we suffer through the changing financial pressures, our commercial clients' experience and oftentimes, the changing landscape, political and otherwise, that our government partners experience. But regardless of all that, the diversity of our offerings can be both a blessing and oftentimes, a headwind.

On one hand, we're positioned to capture more opportunities than most because of our diversity. On the other hand, that diversity requires horizontal bandwidth and with that, sometimes, comes opportunity cost. This is all to say, we continue to be very focused on narrowing the company's scope.

We want to be more nimble. We want to be more growth oriented. And you'll see in today's presentation a description of how we're progressing against this rationalization efforts you've heard us talk about in the past, and Steve Wood, our CFO, will take you through the resulting financial expectations, particularly indexed on a 2025 exit rate.

We see this as described previously in our Q1 2023 investor briefing as a 3-year journey. And we just finished year 1 of that journey in a year where we announced 2 divestitures with expected net proceeds just shy of $500 million. Both of those expected to close in increments in the first half of 2024. You might have noticed, we also announced a $75 million share repurchase program in 2023.

Meanwhile, let's begin with the results in 2023. Steve will, of course, take you through all the details. But Q4 and 2023 with large finished pretty strong for us. When compared to the outlook we presented in Q3 earnings, we exceeded expectations across adjusted revenue, EBITDA and EBITDA margins.

Adjusted revenue for Q4 was $953 million and $3.7 billion for the full year. Adjusted EBITDA was $103 million and $378 million for Q4 and full year, respectively, and our adjusted EBITDA margin was 10.8% and 10.2%, respectively. Again, all these measurements exceeded our expectations for Q4 and the full year.

However, regarding sales for the year, our performance was a bit of a tale of 2 cities. On 1 hand, our new business ACV was down slightly year-over-year and quarter-over-quarter, but roughly flat sequentially. On the other hand, TCV, total contract value, an indication of future long-term growth, exhibited the best achievement since we became Conduent, up 20% to $2,257 billion.

Meanwhile, revenue retention in 2023 was slightly better year-over-year. However, sales really, especially in the commercial space, created a sequential reduction in our net ARR number. As you might recall, our main focus is to keep that net ARR number positive and increasing to the new normal,and it doesn't take into account volume changes associated with market conditions or small shifts in the portfolio. But much like many of our commercial competitors experienced, market buying trends were slower in 2023. Steve will talk about that here in a minute. But it did add headwind to our sales performance.

Net-net, 2023 from a financial perspective was stronger than most of our recent predictions but certainly had room to improve in both sales and cash generation. Speaking of cash, Steve will take you through the details, but the timing of our expected tax return, implementation milestone achievements in our Transportation business, both made for a year, we expect to improve upon in 2024.

Regarding 2024, it's going to be a difficult or at least a different kind of compare. Again, Steve will provide an analysis of 2024 absent divestiture activity. But the fact is there will be a lot of divestiture activity and the revenue, expense changes, proceed increments and other predictions will have to include some level of predictability in 2024 expectations or flexibility anyway.

For the last 3 earnings, we referred you back to the investor event we had in March. I'm not going to disappoint as I'll mention that yet again, as it does remain the linchpin for our go-forward strategy and execution plan. We've always stated that a rationalized portfolio will tee up several levers for the future.

Let me talk about a couple of those levers. First and importantly, we expect to generate roughly $1 billion in capital to be used for highest and best future benefit. Some of that capital allocation will have timing components to it with increasing flexibility and optionality over time.

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That would include the obvious return to shareholder options and debt reduction as well as acquisition or internal investment options. Of course, there'll be more to come on that as the proceeds begin to flow in here later in March.

Second, a more nimble, more global portfolio platform. Third, a narrower scope of products and capabilities that allow for better management bandwidth allocation while retaining that defensive nature we enjoy with a diverse portfolio. Fourth, better cash flow conversion rates and an enhanced valuation.

Now as I mentioned, we announced the first 2 of our anticipated divestitures, which are expected to close and monetize as I also said in the first half of 2024. There are others in process as well. Again, the mission is to land on a $3 billion-ish, 3% to 5% growing company with reduced debt and an enhanced valuation at that 2025 exit. Steve will detail some components of that plan, but it's all of our job to make it happen.

Lastly, we compete every day out in the market like everyone else, whether it's for new business or new talent in our workforce. Our team of 59,000 associates worked very hard in 2023 to improve every aspect of our performance against that competitive landscape, and I'm proud of what we accomplished.

Whether it's in the financials or the culture improvements or the industry recognition or the strong improvement in our client relationships, we made significant progress. And that progress takes time to bear fruit, but the foundation is built, and the next level of achievement is clearly on the horizon.

So with that, I'll thank you in advance. And now I'll turn it over to Steve for the details. Steve?

Stephen Henry Wood - *Conduent Incorporated - Executive VP, CFO & Principal Accounting Officer*

Thanks, Cliff. As we have done in the past, we are reporting both GAAP and non-GAAP numbers. 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.

In the fourth quarter, our primary sales metric, new business ACV, was down $42 million versus the prior year at $152 million, roughly flat sequentially against the third quarter and in line with what we expected, absenting the volume of larger deals in the Government segment, which were a feature of our Q4 2022 ACV results when we signed 3 large deals. This quarter did include the signing of another double-digit ACV new logo in our Government Healthcare space, comprising a module of our cloud-native Conduent Medicaid suite.

Our Commercial segment is still experiencing longer decision-making cycles and cautious buying behavior, but finished the year stronger than it started, up 35% versus Q4 2022.

For the full year, ACV was down 13% as compared to 2022, with most of this impact in the Commercial segment, where ACV was down 29%. And this was partially offset in the Government and Transportation segments, which in aggregate, grew their ACV year-over-year by approximately 8%.

New business TCV was strong in 2023, growing 20% as compared to full year 2022. This was primarily due to the $1 billion contract we signed in Q2 with the State of Victoria, Australia, in our Transportation segment, where we began implementing the new account-based ticketing platform in Q3, and took over operations of the legacy system from the incumbent in December. As a reminder, this is a 15-year contract, generating implementation revenues over the next 3 to 4 years.

Our net ARR activity metric, our combined measure of wins, losses, pricing effects and other contractual changes has continued to remain positive. This trailing 12-month measure does not predict the timing of revenue, but is based on the timing of notification. A full definition of this metric is covered in the appendix of our presentation.

The Q4 2023 net ARR activity metric was down sequentially, primarily due to the roll-off of a strong ARR performance in Q4 2022 and lighter signings in certain areas of the Commercial segment during 2023. Losses were broadly in line with where we expected. Very briefly on Slide 6, you can see the large renewal quarter that we had in Q4 2023.

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Let's now turn to Slide 7, and discuss our full year 2023 P&L metrics. We finished the year with results coming in slightly stronger than how I messaged in our last earnings update, topping both our Q4 and modified full year guide.

Revenue for 2023 was $3.72 billion as compared to $3.85 billion in 2022, down 3.3% or 3.6% in constant currency. We experienced stronger-than-anticipated performance in our Government segment, offsetting some softness in both our Commercial and Transportation segments, which I'll cover as I discuss the individual segment results later.

Adjusted EBITDA was $378 million for the full year in 2023 as compared to $394 million in 2022. And our adjusted EBITDA margin at 10.2% was substantially unchanged compared to 2022. This was within our original full year guided range and slightly higher than how I laid it out in our last earnings update due to a couple of discrete items that affected the fourth quarter.

Let's now turn to Slide 8 and go over the segment results. For the full year, Commercial segment revenues were $1.93 billion, down 3% as compared to 2022. The incremental BenefitWallet revenue in the year was an approximate $54 million tailwind and non-repeating items in the prior year were an approximate $30 million headwind.

New business ramp and add-on sales fell slightly short of outpacing loss business for the year, primarily due to the soft new business environment in 2023 in certain areas of the Commercial segment. The balance of the impact on revenue was lower volumes from some large clients, predominantly in the CX space in certain industries, including travel, logistics and telecom. We believe much of this is macro related and therefore, likely temporary.

Commercial segment adjusted EBITDA improved 21% year-over-year, and the adjusted EBITDA margin of 14.2% was up 290 basis points year-over-year. Increased BenefitWallet revenue contributed to this margin improvement, along with operational efficiencies, and this was partially offset by lower volumes and non-repeating items from the prior year.

For the Government segment, full year 2023 revenue performed better than expected, declining 4.9% as compared to 2022. The year-over-year impact of the one-time government stimulus volumes in 2022, was a headwind of $42 million. New business ramp, including the 3 large deals we signed in Q4 2022, combined with stronger Government Payments volumes, drove the better performance, but not quite enough to outrun the known loss business from prior years.

Government segment adjusted EBITDA declined by 1.8% year-over-year, driven by the impact of the one-time government stimulus volumes in 2022 and lost business, partially offset with the benefit from a portion of a legal settlement of $17 million as well as stronger Government Payments volumes. The adjusted EBITDA margin of 29.7% was up 90 basis points year-over-year.

Transportation segment revenues declined 1.8% in 2023 as compared to 2022. Transportation segment results were negatively impacted from transitioning certain clients on large, long-running implementations through go-live. Some of these programs experienced extended completion timelines largely driven by increased or changing client scope and requirements as we near the end of these multi-year implementations. This caused more of a drag on revenue and margins during the year than we originally anticipated.

Transportation segment adjusted EBITDA was $41 million as compared to $84 million in 2022. And the adjusted EBITDA margin of 5.9% was down 590 basis points year-over-year. These extended completion timelines on a handful of our larger implementations caused most of this decline.

We continue to focus on implementation and operational discipline and returning the business to more predictable revenue and margin trajectories. Our Q4 Transportation results posted year-over-year revenue growth and a stronger adjusted EBITDA versus Q4 2022.

Let's now turn to Slide 9 and discuss the balance sheet and cash flow. Our total liquidity position remains strong with a combined $1.1 billion in cash and available revolving credit facility. We ended the year with $519 million of total cash on the balance sheet, and our $550 million revolving credit facility is almost completely unused. Our net leverage ratio was 2.1x, which is within our range of 2 to 2.5x.

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Our debt maturities are long dated, and we have no significant debt repayments until the end of 2026. Capital expenditure for the year was 3.1% of revenue, lower than our revised guide on capital spend, and we continue to find opportunities to drive efficiencies in our capital investment programs.

We only received $6 million of the $29 million federal tax refund related to 2018 in the fourth quarter of 2023. We have now received the remainder in the first quarter of 2024. Our modified guide for the full year contemplated full receipt of that tax refund. Our $93 million of adjusted free cash flow in Q4 was broadly in line with that modified guide for the full year due to some offsets from some other favorable timing items.

We repurchased approximately 6.6 million shares during the quarter at an average price of about $3. And as of the end of the year, we have purchased approximately 8.8 million shares. There is approximately $48 million remaining under our existing $75 million share repurchase authority.

Before we move to Slide 10 and talk specifically about 2024 guidance, let me spend a few minutes outlining our approach to how we talk about the year and interlock it for you into our previously discussed outlines that we gave around the divestiture work and what that means for deployable capital and an exit rate for the business in 2025.

As we move into 2024 and continue to execute on the financial framework that I laid out last March in our investor briefing, the key message I want to convey is that we believe we are on track to deliver the $1 billion of deployable capital by the end of 2025. I'll provide a slightly updated view of the walk to that $1 billion of deployable capital later in the presentation.

In 2024, we will have impacts of the 2 currently signed divestitures and potentially others. The sale of our BenefitWallet business that we announced in the third quarter will generate approximately $425 million of pretax proceeds and the sales of our Curbside and Public Safety businesses announced in the fourth quarter will generate approximately $230 million of pretax proceeds, as well as removing $30 million to $35 million of liabilities for the leased portfolio of assets associated with that business.

Note that related to the sale of the Curbside and Public Safety businesses, $50 million of the proceeds will be received during the first half of 2025. While timing is not certain, we do expect both to close during the first half of 2024. As mentioned earlier, we continue to work on other opportunities, which could also impact the latter part of 2024.

Our approach to guiding our expected results is therefore going to be as follows: I'll start by laying out a 2024 outlook for Conduent without removing the impact of these divestitures, thereby giving a like-for-like compared to the year we've just closed. I'll explain some of the larger puts and takes within the 3 segments and our expectations for those businesses in 2024.

I'll then provide a walk to our exit rate in 2025 and show you proforma effects of the divestitures we've signed as well as those we are currently expecting to sign and close in 2024. You'll see from that walk that we're broadly within the same range as we outlined last March at our investor briefing and the objective remains as stated to narrow Conduent into a more focused portfolio of assets, still generating revenue in excess of $3 billion, and freeing up approximately $1 billion of capital to deploy against our allocation priorities.

First, let's get into the content on Slide 10. Overall, we expect adjusted revenues in 2024 to be in the range of $3.6 billion to $3.7 billion. At the midpoint of this range, this would represent a year-over-year decline of around 2%.

We expect the Transportation segment to grow approximately 5% in 2023, driven by the State of Victoria contract, offset partially by a long-anticipated scope and pricing change from one of our large U.S. Transit clients.

We expect the Commercial segment to be down between 2% and 3% due to a couple of client decisions in the CX space related to their geographic mix of business as well as some uncertainty in volumes in certain industries, including travel, logistics and telecom. Here, we're anticipating a level of continuation of the macro pressures we saw last year, similar to some of our peers.

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Our Commercial segment backlog heading into 2024 is not quite as strong because of the lighter sales year in the first half of 2023, but the pipeline is improving, and revenue typically ramps quicker here than in the other 2 segments. Finally, we have not assumed any Fed interest rate changes within this guide in so far as the impact the BenefitWallet business.

Lastly, we expect the Government segment to be down between 3% and 4%. There are a couple of drivers here. We are anticipating the loss or minimally, a significant delay or reduction in scope unrelated to performance in a Government Healthcare contract. This represents 115 basis points of decline.

Additionally, we're anticipating some incremental volume headwinds in our Government Services business as the funding mechanism for summer EBT programs has changed in 2024, with funding now split between state and federal sources. This is causing certain states to reevaluate these programs against other priorities.

In terms of the pacing of revenue in 2024, we see it being very similar to 2023 in terms of weighting between the front half and back half of the year. As a reminder, Q1 is usually slightly higher than Q2 because of the impact of the open enrollment period within our healthcare client base.

In 2024, we expect adjusted EBITDA margin to be in the range of 8% to 9%. The larger puts and takes in this outlook year-over-year are the impact on EBITDA of the revenue drivers mentioned previously as well as the impact of our prior year non-recurring benefit of a $17 million reversal of reserves relating to a favorable legal settlement as well as another $6 million of non-recurring IT expense related to transitioning away from a legacy IT vendor.

We expect to convert adjusted EBITDA to adjusted free cash flow in the range of 5% to 10%, which is inclusive of the remainder of the 2018 tax refund and also a portion of incremental collections related to implementation activity within the Transportation segment, but offset with other timing items that we pulled into the fourth quarter of 2023. We expect CapEx to be approximately $110 million, and restructuring charges to be approximately $30 million. The latter being a substantial reduction as compared to 2023.

In terms of our expectations for Q1, which will only have a small fragment of divestiture impact in it, we expect revenue to be down between 2% and 3%. Based on some discrete items we are anticipating in the first quarter, we expect the adjusted EBITDA margin to be below our full year guided range. That concludes our outlook for 2024. Let's now talk about how that fits into a proforma walk to our 2025 exit rate.

Turning to Slide 12. The key message I want to leave you with is that we are still on track and expect to generate $1 billion of deployable capital through the end of 2025. This is roughly 130% of our current market capitalization.

With 2 divestitures announced and planned to close in the first half of 2024, generating approximately $495 million of after-tax proceeds, we have increased the range of total net proceeds from our divestiture program from $500 million to $700 million to a range of $600 million to $800 million. We have a handful of other transactions being marketed that we anticipate will close in the second half of 2024 and position us within this new range.

This increase in net proceeds comes with a slight change in revenue mix for the remaining businesses. Segment 2025 exit growth rates remain intact as previously stated, and this will still be an organization generating in excess of $3 billion of revenue. To date, we have only deployed $27 million of capital through our share repurchase program launched in Q2 2023, and this represents less than 3% of the total capital we expect to generate and deploy.

Finally, in my section, let's walk the 2024 outlook we saw on Slide 10 to an exit rate view of the business in 2025 and show you the hydraulics of how these divestitures roll off and the result into impacts on revenue, margin, capital expenditure and other metrics.

Let's turn now to Slide 13. Before we get into the details, I'll just orient you on this slide. The first column is the 2024 outlook that we discussed on Slide 10. The next column depicts the impacts of the divestiture program, both announced and other anticipated transactions that we would expect to sign and close during 2024.

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Following that, our assumptions and actions that we are planning for 2025 and the last column is the 2025 financial exit rate of the business to compare against what we previously outlined last March in our investor briefing.

Starting with the divestitures column, achieving the stated range of net proceeds will remove approximately $500 million of revenue from 2024. On proforma, that would be a similar number for 2023. This includes approximately $300 million of revenue from the 2 transactions signed and announced, which comes off at an adjusted EBITDA margin of around 37%, again, similar for both years. The adjusted EBITDA margin of all of the planned divestitures, both signed and contemplated here is approximately 27%.

This results in the divestiture program transacting at an aggregate multiple of approximately 7x adjusted EBITDA. This adjusted EBITDA margin includes the currently outsized impact from the BenefitWallet transaction. Against a more normalized long-run interest rate environment of, say, 2.5%, the aggregate divestitures are transacting at a multiple of closer to 10x adjusted EBITDA.

Looking at some of the other numbers on this page, our assumptions include approximately $50 million of annualized stranded costs that will be addressed after we close the transactions and that is included in the EBITDA margins of the divested businesses noted earlier. Timing of realization will depend on the nature and length of the transition service agreements we enter into with the respective buyers to support the successful transition of the assets.

We expect the announced transactions to close in the first half of 2024, with the BenefitWallet assets transitioning in 3 tranches, beginning at the very end of the first quarter and concluding in the second quarter. As noted in the second column of this slide, the after-tax proceeds for these announced transactions are approximately $495 million, and we have multiple parts to get into the range of net proceeds that I outlined on Slide 12.

Our expectation for 2025 is that the remaining organization will begin to achieve revenue growth of between 2% and 4% as we progress towards the 2025 exit growth rate of 3% to 5%. Our current sales pipeline sits at close to $25 billion of total contract value, our highest ever. With continued focus on client retention, further enhanced in a more focused portfolio of assets, we are confident we can achieve this growth.

We expect an adjusted EBITDA margin expansion of between 200 and 300 basis points will be achieved through a series of margin expansion levers, again, for which we have multiple parts. Additionally, we are targeting a further $50 million of annualized cost savings from a combination of efficiencies across the organization as we continue to streamline and right-size our central costs, facilities and technology footprints.

Consistent with the themes we laid out in the investor briefing last March, we expect that the impact of our portfolio rationalization, combined with the planned 2025 actions will result in a more agile, focused and higher-growth company with less capital intensity. We believe we remain on a path to achieve this, and we'll continue to provide updates along the journey as transactions get closer to closing and more transaction signed.

That concludes my financial review of the Q4 and full year 2023 results and our update to the portfolio rationalization. And I'll hand it back to you, Cliff, for closing comments.

Clifford A. Skelton - *Conduent Incorporated - President, CEO & Director*

Thank you, Steve. That concludes our Q4 and full year 2023 earnings call. Thank you very much, everyone, for listening to our review of 2023 and our outlook and plan for the future. We believe in the plan as I hope you do. Thanks, again, for being here, and here's to a great 2024.

Operator

Ladies and gentlemen, thank you for your participation. This concludes today's event. You may disconnect your lines or block off the webcast at this time, and enjoy the rest of your day.

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