09-May-2018

Conduent, Inc. (CNDT)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Alan Katz
Vice President, Investor Relations, Conduent, Inc.

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

OTHER PARTICIPANTS

Puneet Jain
Analyst, JPMorgan Securities LLC

Bryan C. Bergin
Analyst, Cowen & Co. LLC

James Eric Friedman
Analyst, Susquehanna Financial Group LLLP

Shannon S. Cross
Analyst, Cross Research LLC

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Mayank Tandon
Analyst, Needham & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Conduent Q1 2018 Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I'd now like to turn the conference over to Alan Katz. Mr. Katz, please go ahead.

Alan Katz
Vice President, Investor Relations, Conduent, Inc.

Good morning, ladies and gentlemen, and welcome to Conduent's first quarter 2018 earnings call. Joining me on today's call is Ashok Vemuri, Conduent's CEO, and Brian Walsh, Conduent's CFO. Following our prepared remarks, we will take your questions.

This call is also being webcast. A copy of the slides used during this call was filed with the SEC this morning, and is available for download on the Investor Relations section of the Conduent website. We will also post a transcript later this week.

During this call, Conduent executives may make comments that contain certain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995 that by their nature address matters that are in the future and are uncertain. These statements reflect management's current beliefs, assumptions and expectations as of today, May 9, 2018, 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 prepared in accordance with U.S. GAAP.

For more information regarding definitions of our non-GAAP measures and how we use them, as well as limitations as to their usefulness for comparative purposes, please see our press release, which was issued this morning and was furnished to the SEC on Form 8-K.

With that, I will turn the call over to Ashok for his prepared remarks. Ashok?

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Good morning, everyone, and thank you for joining our first quarter 2018 earnings call. Brian and I will cover our financial and operational performance and provide an update on our progress to transform Conduent into a profitable, sustainable and predictable enterprise. Brian and I will also take your questions following our presentations.

Let's begin on slide 3 with an overview of our performance for the first quarter. Note that I will be comparing our results adjusting for the impact of the new accounting standards and our 2017 divestitures. We're off to a solid start to the year. We're making strides across every facet of the company and are starting to see the return on the work we began last year. There are a range of highlights to share, but I will zero in on several that are noteworthy.

Revenue, we reached an important milestone this quarter. Adjusted for the strategic actions we have taken, total company revenue was flat compared to last year. Commercial segment revenue grew 3% when adjusted for strategic actions. This is an encouraging sign of stabilization in the top line of our core business allowing us to pivot to revenue growth in the next few quarters.

Profitability was also a standout metric this quarter. Our adjusted operating margins improved 180 basis points versus year ago. Adjusted EBITDA grew by 10% this quarter, and our adjusted EBITDA margin was up 140 basis points to 11.3% despite the fact that Q1 is typically a seasonally weak quarter.

Cash, improved profitability combined with an acute focus on cash management resulted in another strong cash performance this quarter. Adjusted free cash flow improved meaningfully and our use of cash in the quarter was half of what it was in the prior year. Our balance sheet continues to get stronger and we're well-positioned in terms of liquidity.

Finally, we are right on track with our divestiture plan. We announced two divestitures in the past several weeks, our off-street parking business and our HR consulting and actuarial business. Collectively, these represent $321 million in 2017 revenue. Additional divestitures of approximately $175 million in revenue from public sector are also in progress. And on top of this, I'd like to announce today that we are targeting divesting an additional $500 million of revenue from select standalone Customer Care contracts. These contracts represent transactional customer support work where we are not positioned to differentiate and are not achieving the adjusted EBITDA margins targeted as part of our long-term core business model.

Having said that, we will continue to provide customer support when it is required as part of an end-to-end bundled solution in support of a higher value services provided, of course, it meets our profitability goals. As a result of this work, we are approaching the final stages of our efforts to rightsize the company and focus on our core business. I will describe the characteristics of our core business in more detail in my comments later. Overall, I am very pleased with our progress in the first quarter. When adjusted for the divestitures that we have signed, we are well positioned relative to our original guidance. Now, let me share some additional highlights from the quarter.

I'm on slide 4. As I have done on prior calls, I will provide an update on our strategic transformation initiative. We remain on track to deliver on our cumulative cost savings target of $700 million by the end of this year. Here are some updates on several aspects of this work. The remediation of six large underperforming customer care contracts has been a focus for us. You might remember from the last call that we had addressed five of the six large contracts with one major contract to address.

During Q1, we successfully remediated this last contract resulting in a price increase for the remainder of 2018. We also now have the option to include this contract as part of the aforementioned Customer Care divestiture. We have also negotiated the option to exit this historically negative profitability account with high overhead costs by early next year. Either scenario results in profit and margin improvement.

Real estate and IT consolidation remain large contributors to our transformation work and are progressing well. Consolidations across our locations, data centers and networks will continue as we come through 2018. We also continue to make progress on our overall spend and expense management. SG&A as a percentage of revenue was down to 10.2% compared to last year, an improvement of 120 basis points.

As I have commented on previous calls, we are highly focused on our mix of SG&A with a steady shift towards greater investments in sales and marketing. During Q1, sales related spending increased 3% compared to the same period last year. Greater investments in our go-to-market engine will help drive signings growth, which in turn will support our return to revenue growth.

Moving to slide 5, I will go through a quick update on our segment performance. Our Commercial business had its best Q1 in many years. While revenue was down 2% on a reported basis, Commercial segment revenue grew 3% when adjusted for our strategic actions. Profitability also improved as we exited underperforming contracts, remediated others, drove expansion through cross-selling and service line penetration, as well as leveraged better technology deployment, price increases, and operational efficiencies. Adjusted EBITDA margins improved by 210 basis points in the quarter to 9.1%.

Our European business is also starting to gain traction in the market, and we've seen a new interest from clients in our four priority countries as we have reintroduced Conduent into those markets with tailored services and capabilities. Our Public Sector business performed as expected from a top line perspective. Revenue was down about 6%, with 2 percentage points of the 6% being the result of strategic actions. More importantly, despite the end of several high margin contracts last year, our adjusted EBITDA margins improved by 120 basis points year-on-year as a result of operational efficiencies, price increases, and technology deployment. Revenue productivity per person of approximately $217,000 per year continues to be industry-leading.

Moving to slide 6, I will cover our sales performance in terms of signings and pipeline. We continue to make very good progress in our go-to-market initiatives. As you know, this has been an area of focus for us. We have reoriented our sales model around industry verticals. We have invested in new sales leadership and client partners as well as onboarded five new industry and capability business heads this quarter. It'll take more than one quarter for us to achieve full productivity from these investments, but we see encouraging signs based on the improvements in pipeline quality, business mix, and improved deal throughput.

Total TCV signings were $1.4 billion, a 53% increase compared with the same period a year ago. Renewal signings up 150% year-over-year were very strong in absolute dollars. Our renewal rate at 94% continues to be strong and is an industry-leading number. My client management team has been able to achieve this while we continue to strengthen our standards for deal terms, risk profile and requirement for accu-shoring.

New business signings of $406 million are 23% lower than last year. Signings were impacted by a more selective approach to new business that discourages contracting standalone customer care deals versus signing bundled deals, underpinned by technology platforms with a potential for accu-shoring. These opportunities deliver greater client value, drive higher margins and align to our vision for the company. Importantly though, across our new business wins, 60% were new clients or new capabilities, demonstrating the traction we're getting with our new sales and engagement model. Again early, yet strong signs that changes in our go-to-market model are having an impact.

We had a range of notable wins and renewals during the first quarter. In the consumer and industrial segment, we extended a 20-year partnership with a major aerospace client to provide defined benefits, retiree medical eligibility and defined contribution services for current and former plan participants. In the healthcare insurance segment space, we won a new logo with multiyear contract for one of the nation's most experienced workers' compensation providers for large companies. In the public sector, we secured a major contract renewal for a multi-phase modernization project with a longstanding client in the transit industry that continues to rely on Conduent for innovative technology in design, installation, operation and key updates.

In Conduent Europe, we secured a new standalone arrangement with a longstanding client in the automotive industry to deliver a new capability, comprehensive finance and accounting services along with a renewal of our existing services. Our go-to-market strategy both from the perspective of new sales and existing client engagement is an important focus area for me. We're making the right investments and putting the focus back on our sales function to ensure that we win more than our fair share of business.

We have received very positive feedback from our clients and our new engagement methodology and our go-to-market strategy for new business. This will help us build a more accurate and reliable pipeline of profitable deals, while maximizing the opportunity to deploy a robust platform and software solutions. We have a game plan in place and we are executing on it.

In terms of the current pipeline, we continue to see healthy demand across the industries we serve. Our pipeline of approximately $12 billion is finally clean and realistic and reflects increased deal discipline and a focus on profitable bundled and platform-based deals. Overall, public transportation, government, banking and financial services, and high tech segments are well represented in the pipeline today. And these deals fit within the criteria that I just discussed. We have built out the right team to support these clients and opportunities to win this business. Before I hand over to Brian, I will recap our results with several observations.

During the first quarter, results from our turnaround efforts and redesigned go-to-market strategy are starting to show, in particular in our Commercial segment. This progress is encouraging. And I look forward to seeing continual margin improvement in the Commercial business. We grew adjusted operating income and adjusted EBITDA in line with our expectations. We began our 2018 divestiture program making good progress and signing two deals since the last earnings call.

We are announcing the divestiture of our select non-core standalone Customer Care business which will allow us to focus on the business that is core, platform based, high margin, scalable, standardized, and with a potential for accu-shoring. And finally, we have the team, resources, and offerings to strengthen our position as a best-in-class provider of technology enabled business service solutions.

With that Brian will take us through the financials in more detail. I'll then make some brief remarks prior to opening it up for Q&A. Brian?

Brian Webb-Walsh

Chief Financial Officer & Corporate Vice President, Conduent, Inc.

Thank you, Ashok. Before I begin, I want to discuss some modeling items. First, I want to remind everyone that as we discussed in our year-end earnings call, 2018 financials will have several factors that will impact year-over-year comparables. As such throughout this presentation and in the exhibits in the appendix, we will provide both GAAP numbers as well as our year-over-year results, after adjusting for the divestitures that we completed in Q3 2017 and the adoption of the 606 revenue recognition accounting standard. This accounting standard change primarily impacts how we recognize pass-through revenue for postage and deferred revenue. We have also provided a more detailed walk on a quarterly basis for our 2017 results by segment in the appendix.

Second, we have made several changes to the Other segment. As discussed on the last earnings call, we moved the health enterprise business out of Other and into the Public Sector. We also moved the Q3 2017 divestitures into the Other segment for easier segment level compares for our Commercial and Public Sector businesses.

Now, let's begin on slide 8, with an overview of the first quarter financial results and a walk through the P&L. Revenue of a little over $1.4 billion for the quarter was down about 9% year-over-year as reported and 10% on a constant currency basis. Adjusting Q1 2017 for the impact of divestitures and the 606 accounting standard adoption, revenue would have been down about 4% year-over-year.

As Ashok mentioned in his remarks, further adjusting for the impact of strategic decisions, year-over-year revenue would have been flat. Gross margin was 17.7%, an improvement of 100 basis points. The improving gross margin reflects continued progress in our transformation initiative and increased pricing from remediated contracts.

SG&A declined year-over-year and adjusted operating margin improved. Adjusted EBITDA in the quarter was $161 million, an increase of 5% year-over-year as reported and 10% excluding the impact of 606 and divestitures, in line with the midpoint of our prior guidance range.

Adjusted EBITDA margin grew to 11.3% improving 140 basis points both as reported and excluding 606 and divesture impacts. This improvement was driven primarily by the transformation initiative and contract remediation and was despite our increased investments.

Moving below the operating margin line, loss on divestitures and transaction costs increased by $15 million, primarily due to expenses associated with the Q2 2018 transactions. The other expense line increased by $40 million as we had some favorable legal settlements in Q1 2017 and in accrual this past quarter for a contract termination related to litigation with one of our technology partners. Our pre-tax loss in the first quarter was $54 million, worse by $32 million, driven by increased transaction costs and litigation accruals.

GAAP net loss in the quarter was $50 million or $0.26 per share. Our adjusted tax rate in the quarter was 34.7% compared to 34% in the prior year period. As a result of our geographic mix of earnings and the impact of the BEAT and GILTI tax provisions offset by the lower federal corporate tax rate. Adjusted net income was $47 million, up $12 million compared with the prior year period, and adjusted EPS was $0.22, an increase of $0.06 compared with Q1 2017.

As I go through the segments, I'll compare our Commercial and Public Sector results with Q1 2017 results adjusting for the impact of the 606 accounting standard. As a reminder, 2017 results for the Q3 2017 divested businesses were moved to the Other segment.

Turning to slide 9, we'll provide an overview of our Commercial segment results. Year-over-year, Q1 Commercial revenue declined 2%. This decline was driven solely by strategic decisions to exit long tail accounts and unprofitable contracts. Excluding strategic decisions, we would have grown 3% year-over-year. In addition, Commercial segment revenue was relatively flat sequentially despite Q4 typically being a higher revenue quarter.

Segment profit increased by 76% year-over-year driven primarily by our transformation initiative, including cost savings and price increases through contract remediation efforts. Adjusted EBITDA in this segment grew 28% and our adjusted EBITDA margin of 9.1% increased by 210 basis points year-over-year. While Q1 tends to be a lower margin quarter for our Commercial business given seasonality, we're obviously making progress and profitability year-over-year. This is encouraging to see and I'm glad we're starting the year on a strong note.

Now onto the Public Sector segment results on Slide 10. Revenue declined 6% year-on-year as we continue to have the impact of contract losses and strategic decisions. Strategic actions accounted for 2 percentage points of the year-over-year decline. Revenue was down 5% sequentially as a result of lower volumes from some transportation clients and some lost state and local business. As we stated in last quarter's earnings call, our Health Enterprise business was moved from the other segment and placed within the Public Sector beginning this quarter. We now see this business as core and are investing to support our Health Enterprise clients.

We have modules that we're bringing to market. Our aim is to grow this business over time. Our transportation business was down year-over-year and sequentially. However, we still expect to show growth in this area of the business in 2018 as a large tolling contract is expected to ramp by the end of Q2. Our Public Sector segment profit was up 18% driven by our cost savings initiative while adjusted EBITDA was up 2%. The margin profile of the Public Sector business improved this quarter with segment margins up 234 basis points and adjusted EBITDA margins up 120 basis points.

Moving on to slide 11, let's review our Other segment. The Other segment now only holds our education business, which is in runoff. However, 2017 as reported results include the divested businesses. The chart on this slide show the segment results both with and without the impact from 606 and the divestitures. Segment revenue was $8 million in the quarter, a decrease of $16 million year-over-year, excluding the impact from 606 and the divestitures, while segment loss was $4 million in the quarter. We're aiming to get the segment to zero revenue and breakeven by the time we exit 2018.

Slide 12 provides an overview of our cash flow in Q1 2018. Cash flow from operations was an outflow of $38 million in Q1 2018 compared with an outflow of $107 million in Q1 2017 driven by working capital. This is a strong improvement, and I'm very pleased with our cash flow performance in the quarter.

CapEx in the quarter was $39 million or 2.7% of revenue, an increase of $14 million compared with last year. Despite the increased CapEx and the acceleration of 2017 bonus payment from Q2 to Q1 for tax purposes, our adjusted free cash flow was a use of only $69 million in the quarter compared with the use of $143 million in Q1 2017.

We dispersed $6 million to employees as a result of the termination of our deferred compensation plan, and we'll continue to do so throughout 2018. The largest portion of the cash held for plan participants will be distributed in Q4. As I've discussed in the past, this flows to our operating cash flow and will be adjusted out of reported free cash flow accordingly. In addition, given the number of divestitures that we are working on, tax payments and other divestiture related expenses will be adjusted out of free cash flow as well.

Turning to slide 13, I'll provide an update on our capital structure. During Q1 adjusted cash, which excludes the cash balance associated with the deferred compensation plan I just discussed was $461 million compared with $559 million of adjusted cash at the end of 2017.

We continue to expect to use approximately $300 million of cash for potential acquisitions. In terms of liquidity, we also have over $730 million of capacity in our revolver. Our adjusted net leverage ratio is at 2.4 turns compared with 2.2 turns at the end of 2017. Given that we typically are a user of cash in the first quarter, this increase in our leverage ratio was expected.

Moving on to slide 14, I will cover the divestitures that we announced over the past several weeks as well as where we are for the remaining potential divestitures. In the second quarter, we signed agreements to divest our off-street parking and HR consulting and actuarial service businesses which generated approximately $321 million of annual revenues in 2017. These businesses generated $70 million in adjusted EBITDA in 2017.

We'll provide an update on the proceeds once these deals close. As we have said in the past, our expectation is that we would use proceeds for either potential debt repayment or acquisitions. We would also expect these deals to close in the next few months and we should have about six months of contribution from these businesses this year. I'll discuss the impact to our guidance ranges in a moment.

I'll also note that we have identified approximately $20 million of stranded overhead costs associated with these businesses that we'd expect to take out for 2019. After adjusting for the overhead takeout, the adjusted EBITDA lost from the sale of these businesses would be $50 million at a margin of 16%. We have to support these businesses through the transactions and we'd expect that we'll have approximately six months before we can action these stranded overhead costs. Of the original $500 million of revenue that we targeted for divesture, we are still working on transactions to sell $175 million of Public Sector revenue. As Ashok mentioned earlier, we're in the process of looking at options to divest select Customer Care contracts that we view as non-core, representing approximately $500 million of annual revenues.

In terms of financials, as we make progress in this initiative and sign a deal, we'll provide additional details, but I can confirm that this revenue base will have adjusted EBITDA margins well below the corporate average.

Before I close, I want to note that in the press release issued this morning, we updated our 2018 guidance based on the signed divestitures that we announced over the past several weeks. The table on slide 15 details the expected impact from the signed Q2 2018 divestitures using an anticipated close date of June 30. If the close date changes, that would impact these amounts.

It is important to note that excluding the impact from these divestitures, the guidance ranges that we provided during the last earnings call would not have changed. We now expect 2018 revenue to be between $5.4 billion and $5.6 billion compared with a $5.8 billion of 2017 adjusted revenue, approximately $160 million of the year-over-year impact is the result of the signed 2018 divestitures. We expect adjusted EBITDA to be between $672 million and $698 million compared with 2017 adjusted EBITDA of $655 million, approximately $35 million of the year-over-year impact is the result of the signed 2018 divestitures.

Finally, our free cash flow is still expected to be between 25% and 35% of adjusted EBITDA. We are well positioned in terms of our outlook for the year, and I'm very pleased with the Q1 performance and the progress we've made to date on our divestitures.

I will now turn it over to Ashok for some additional comments before we take your questions.

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Thank you, Brian. Before we wrap up, I'll spend a few minutes to elaborate on the kind of company Conduent is becoming and the way we are creating value for all our stakeholders, our employees, our clients, our shareholders, and society at large.

Over the last year, we have been refining our portfolio to put greater focus on those businesses which are scalable, profitable, and platform-based, have market-leading positions and market growth opportunities. These capabilities and services have a common strategic thread, which allows us to achieve differentiation and price advantages. There are two slides I will use to convey this.

Moving to slide 17, this is a one page depiction of how we think about the work we perform for our clients. I shared this on our last earnings call and whereas I will not go into as much detail, felt it was important to reinforce it with you. We are an essential participant in the value chain for how our clients deliver services to the end users. We work on behalf of our clients to manage data-intensive, repeatable, individualized transactions happening at massive scale. Our service offerings are delivered through a combination of technology platforms bundled with complementary business services, covering all stages of end user interaction from enrollment to transaction processing from account management to customer experience.

Here are some reference points for the scope and scale of our business. We manage approximately 50% of the automated tolling systems in the U.S. We manage the funding for a range of government payments across the country, ensuring approximately $100 billion is provided to citizens for their benefit every year. And we provide full HR outsourcing and benefit administration to some of the largest companies in the Fortune 500 list. Together our deep client base, broad offering portfolio and decades-long operating history provides the basis for our bold ambition to become an industry leader. We are a partner with some of the largest and most valuable companies in the world and manage essential aspects of their operations while interfacing directly with the people they serve.

Looking at the bottom layer of this diagram is our technology and platform solutions that supports over two-thirds of our revenue. These are proprietary offerings and services that underpin the essential services we provide for our clients, while also helping them progress on their own journey to become modern digital enterprises.

Moving to slide 18, I will share more details around how we are defining our core business and illustrate this with some examples. This should provide more context around the way we are creating value for clients as well as the lens we are using to identify both acquisitions and divestitures. An acute focus on our core business is a key strategic driver for successfully transitioning into the next phase of our turnaround plan, revenue growth. We're defining our core along the following five dimensions.

First, and building off the previous slide, the nature of the work we do uniquely positions us at the center of our client service delivery chain. We are experts at delivering individualized, secure and compliant interactions at massive scale on behalf of our clients to their end users. As examples, consider the work we do on behalf of companies supporting their employees or states in the country to manage the distribution of benefits or in supporting the communications between large insurance companies and their members.

Next, we rely on technology as the basis for service delivery and differentiation, specifically our major service deployments are supported with digital business platforms that integrate multiple aspects of a complex business process into a standardized and scalable software and services interaction engine. This allows us to bundle diverse services onto proprietary or third-party platforms for accelerated, efficient and agile deployment. As I have mentioned previously, we are aggressively modernizing our technology platforms with almost $200 million of new investment that will incorporate new technologies like blockchain, cognitive learning, and robotic process automation. An easily relatable example is our proprietary automated tolling platform, which connects every aspect of the value chain involved in the collection, payment, and service of tolling in our highway system.

Our core business must be conducive to a level of standardization as a way to yield efficiency and scale. As a first step, we are deploying client solutions from common platforms that can be customized on the margin. This is one reason why our HR consulting and actuarial business was deemed non-core in addition to having no technology-related assets, each engagement is custom, and one of a kind.

As a next step, we will create common methodologies for addressing client issues by domain or industry. And by identifying opportunities to reapply innovations across our portfolio, we will scale the return on our technology investments.

Fourth, core model must allow us to source and utilize talent anywhere in the world, we call this accu-shoring and it gives us the flexibility to leverage human capital from locations with the best balance of skill, availability, and costs.

Finally, our core businesses represent a portfolio with potential to expand our relationships within our client base. We gain efficiency in our client conversations by presenting an array of assets that meets the needs across a range of industries and ecosystems from transportation to healthcare, from HR to legal and compliance.

Increasing service line penetration is fundamental to our organic revenue growth and our core businesses provide a palette from which we can explore new ways of growing existing relationships. Collectively, these characteristics represent how we are defining our core. These help forge commonalities that create more unification among our assets, providing scale and flexibility for agile developed deployment of modern platform solutions for profitable growth.

In closing, I want to reiterate my optimism for the trajectory we're on. We are transforming Conduent to become a market leading growth-oriented business services company, delivering a differentiated value proposition for our clients, employees and investors. I am confident this next chapter will be just as productive as the ones that we have just completed.

Thank you. And I look forward to going into even more detail about our company at our Investor Day on June 8. Now, let's open the call for Q&A.

QUESTION AND ANSWER SECTION

Operator: Yes. Thank you. We will now begin the question-and-answer session. [Operator Instructions] And this morning's first question comes from Puneet Jain with JPMorgan.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Yes, hi. Thanks for taking my question. It seems like second quarter divestitures will hurt margins, but should be low growth businesses, and new Customer Care divestitures should be accretive to both revenue growth and margins. So my question there is; one, is that right? And second, as you deploy divested proceeds in M&A and debt pay down, how should we think about overall impact on your free cash flow from those actions?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yes. So, Puneet, this is Ashok. So I will address this question. I think it's important to first and foremost characterize the fact that the actions that we are taking on the divestitures very emphatically will be cash flow and EPS accretive. And I think it's important to sort of position what we are doing to better explain and understand.

If I look at the portfolio of divestitures that we're looking at, at the portfolio level, these businesses have margins and revenue opportunity growth well below the corporate average. In between these portfolio there are assets which have a margin or a financial profile which is better than the company average and in certain situations it's way, way worse.

If I look at the reasons why I'm doing it, it's not just about the financials at a point in time. It is also about the fact that what is the prospective future for it in terms of how much investments I need to make? What is the margin profile as I take that forward? Whether they fit the various facets that I described earlier on in terms of whether they can be platform-based technology underpinning, whether they can be scalable, whether they can be standardized, whether they have the potential for accu-shoring and whether they drive the opportunity for cross-selling and are in a growing market with growing opportunities.

If I look at all of that, not just the financial profile of a few assets within that portfolio, we come to the conclusion that we'll be better off in divesting these business and using the proceeds to continue to drive down our debt level so that there is cash improvement and EPS accretive, as well as, make acquisitions that will plug the delta between where our capability is today and where it could be. We are maniacally focused on optimizing our business and right sizing that business in order to drive shareholder value as well as provide a better service to our customers.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. And how much of fiscal 2018 revenue guidance is already in the backlog or in other words, how much of it depends on NRR or transaction volume?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yes, Puneet, it's Brian. Most of our revenue would be in the backlog. There is some that we expect from new business signings both ARR in the year and NRR, but a lot of it would be in the backlog. And we'll continue to progress as we lap some of the strategic actions we took last year as we lap some of the cancels inside of Public Sector. As we ramp the one tolling deal that I mentioned, we'll start to see progress. We see it on the Commercial side and we expect to see it quarter-by-quarter improve.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: Thank you. And the next question comes from Bryan Bergin with Cowen.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi, thanks. Follow up on the asset sale question. So, can you comment how the margin profile of the new $175 million of Public Sector sales compares to company average? And then just as we think about the net impact here in the aggregate for the planned sales that you've made that are above margin here and the additional $175 million, do you need to offset that with the Customer Care business to get to that lower than average trajectory?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

So what I would say is that the margin once we remove the stranded overhead costs is 16% on the two deals that we signed. If we look at the full $1 billion including Customer Care that we're looking to divest, that has a margin profile that is lower than the company average driven by the Customer Care margins. But as we divest that $1 billion, the margins of the company improve as we take out the stranded overhead costs. As Ashok said, it will be accretive to cash flow and to EPS once we deploy the proceeds. And then it positions us to better grow revenue as we have businesses that we believe are competitive in the markets that they compete in and that the markets are strong. So we view these divestitures as key to top line performance, profit improvement, cash flow improvement over time.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. And then, just on the cost takeout, looks to me on track and you affirmed the $700 million target, the run rate. You were ahead of that run rate last quarter. Can you give us an update on where you stand now relative to that?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yes. So the $700 million was an incremental $225 million of savings this year to drive profit improvement and to drive investments and other offsets that we need to cover. That is well on track and we're working to potentially overachieve. But, right now, we're sticking with the $700 million, but we are trying to drive overachievement.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay, thanks.

Operator: Thank you. And the next question comes from Jamie Friedman with Susquehanna.

James Eric Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Hi. Thank you. Ashok, I was wondering which segments you anticipate benefiting from M&A meaning like Transportation or Health Enterprise, Public versus Commercial?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

So we're looking at tuck-in acquisitions in order to enhance our technology capability. As I've mentioned before, we're not going to do acquisitions which are sort of contract or revenue aggregating acquisitions. I clearly see opportunities in the Public Sector space, in the federal government space, our footprint there is fairly small. I think there are good opportunities for technology deployment in the government business, in the state business especially and with emphasis on the Health Enterprise business, which is something that we now consider core, given the remediation we have done there.

In the Commercial space, I clearly think there are opportunities in our very fast growing compliance business. There are opportunities for tuck-in acquisitions around technology in our payer business segment that's growing very fast. So, I think we have a few places where I think M&A both in the public sector as well as in the Commercial sector would make sense.

James Eric Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Okay. Thank you. And then Brian, and I think in your prepared remarks you called out the performance in tolling, can we anticipate that tolling as the contract ramps will improve sequentially in terms of the top line growth?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yes. That's correct, year-over-year and sequentially.

James Eric Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Got it. Okay. Thank you.

Operator: Thank you. And the next question comes from Shannon Cross with Cross Research.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you for taking my question. I'm just trying to understand a little bit, again, there are so many moving parts here, right? So, when we get through, say, the end of 2019, you're down $125 million a quarter in terms of revenue, that's not really making any money. But then you also talked about sort of EPS accretion driving. Is that – are you talking about more debt payment on that or is that really dependent on where you make acquisitions? And then within that sort of can you give us an idea, I know you can't tell us exactly when you're going to make acquisitions, but do you have a plan for sort of how that might ramp, just so we can – when we get to 2020 or us getting closer to a more normalized level?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Sure, Shannon, it's Brian. So we have $300 million of cash available today for acquisitions, and we would also potentially use some of the cash from the divestitures for acquisitions, but we're also looking at paying down debt. We've been through all our options around paying down debt, and we have a plan and as we start to execute that plan, we'll communicate more about it.

But it's going to both be paying down debt lowering interest plus potential additional acquisitions. We've been prioritizing the divestitures, we have a pipeline of acquisitions that we're looking at and reviewing and working, but that will be more weighted towards the second half as we prioritize the divestitures right now.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Okay. And then as we think about this and all the changes you're making, how are you thinking about your EBITDA margin progression, has the thought changed because of some of the timing and the magnitude of the divestitures that you are doing or...

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

So...

Shannon S. Cross
Analyst, Cross Research LLC

Q

...yeah.

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

So, I think this year we'll work through these divestitures, but as we think about the out years, once we get the stranded overhead costs out, the $1 billion is at a lower margin than the corporate average. And this will help us get for our long-term margin targets faster.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Okay and then...

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

And we'll talk more about this at the Investor Day. But these divestitures position us both top-line and bottom-line to improve faster than we otherwise would have.

Shannon S. Cross
Analyst, Cross Research LLC

Q

And then just one – just in that line of thought, in terms of the overhead stranded costs and then obviously the loss of leverage I would assume in the business, do you anticipate needing to do further restructuring in 2000 –

maybe 2019 I guess to try to get the cost down? Or is that sort of already incorporated in how you were thinking about cash flow and that going forward?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yes. So as we think about next year we'll have a cost program that incorporates taking out the stranded overhead and everything else we need to do to continue to drive margins. We have money aside for restructuring and kind of the views we've provided before. As we get into the Analyst Day, we will reconfirm those amounts, but I think we have it modeled, that's kind of the next phase of our cost takeout journey, we'll be going over – going after the stranded overhead. And it shouldn't cause us to have to go beyond what we've said in the past for restructuring in 2019 and 2020.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you.

Operator: Thank you. And the next question comes from Brian Essex with Morgan Stanley.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Hi, good afternoon or good morning and thank you for taking the question. Maybe Brian, could you talk about what the current buying environment is like for the assets that you are selling, how you're maintaining the discipline, who the potential acquirers are, whether you see more activity on the strategic side, whether it's more financial, and how you maintain discipline around getting pricing for those assets?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Sure. So we have a professional process that is competitive that we run for each of these. We use advisors, and I would say that the market is good. We have both strategic and financial interest, and these have all been competitive.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And then just noting on the sale or proposed sale of the Customer Care businesses, I guess maybe a little bit of rationale behind those, I mean it sounded as though you as a management team were tending a little bit more towards given those businesses a go, and maybe just a little bit of thought behind the rationale for selling those. I know you fixed them, probably get a better price for the ones that are already fixed. But just as you work your way through that process what the rationale was, now those are on the block?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, this is Ashok. So obviously we wanted to get our hands around the size, scope and the opportunity to remediate this business. Clearly, the parts that we have sort of identified we needed to remediate them to make them more attractive from a divestiture perspective. We've done that.

These businesses are heavily focused, heavily concentrated if you will in the U.S. at a time when most of this is not done in the U.S. They are – they occupy a very large real estate footprint. They gave us no opportunity to cross and upsell. They're not technology oriented and are not scalable. So given that all these elements of that, we have identified these standalone transactional call center work as something that we intend to divest.

Now, what remains is part of the business that's actually bundled, because customer experience and support continues to be part of the value chain of what we bring, albeit maybe at the lower end of it, but it's bundled – in a bundled transaction, it allows us the opportunity to cross, upsell and drive much more of this service over a technology platform. So, that's the rationale which we have used for the divestiture of the business that we intend to do in Customer Care.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

That makes sense. Thank you very much.

Operator: Thank you. And the next question comes from Frank Atkins with SunTrust.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Thank you for taking my questions. I wanted to see if I could get an update on the global head count mix as well as some commentary around talent acquisition and retention?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah, so this past quarter, in Q1, our overall head count was down by about 4,800 people. We continue to very aggressively drive for accu-shoring both from the way we deliver our services to our clients, as well as how we run our company, and in terms of where the epicenter of these operations are. We've identified four core hubs Philippines, India, Jamaica, and Guatemala, where we are ramping up quite aggressively both in terms of talent, technology talent for example in India, operations talent in Jamaica and Philippines and Guatemala.

So, we are progressing well. I think in terms of the management talent, I mentioned five new capability in business heads, I think we're beginning to find the market or executives in the market are more amenable to come on board. We've seen a dramatic change in the way our customers are reacting to that very positively. We've seen that indeed despite the new business signings being down, the quality of that has actually very dramatically improved.

And I think we've been able to also hire a lot of talent into our client engagement teams. They are co-located with our clients. I think the renewal rate speaks to that. The fact that we've had very strong renewal growth also speaks to that fact. So, I'm actually feel in a very good place in terms of being able to drive that business with the talent that I am getting.

We also hired a lot of talent for a very important activity that we have talked about, which is our divestitures as well as M&A. This is not a cottage industry for us, we've hired very good talent from the marketplace, who are helping drive this and achieve the goals that we want.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay, great. And then I also wanted to see if I could get an update on the analytics business, is often a driver of growth in some of your peers. Where do you stand there? How are you incorporating analytics in your offerings and where can that go?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, you may recall that I have said in the past as well that about close to two-thirds of our business is driven off platforms, productized applications, or a technology stack. And most of our business, whether it's transactions, whether it is providing a service, is heavily data oriented. So we are sort of the conduit, if you will, for a ton of data flowing between the end consumer of our clients, so what we sort of sit in the middle of that ecosystem. And we are increasingly being asked to provide not just be a data throughput engine, but also provide the intelligence or the insight, if you will, on that data, which requires us to obviously ramp up our analytics capability.

So we are adding vast technology very aggressively both in terms of our people and management capabilities, as well as a lot more technology than we have deployed before. Because if I see most of the transactions in my pipeline, they are about not just being a good steward of the data from one end to the other, but providing a higher level of analytics insight and intelligence on that data both to the end user as well as to our enterprise plan. So we are sort of sitting in the middle of that digital interaction, if you will.

So a big business for us. If I look at what is generally described as a digital business, I would say that's close to about 40% to 50% in terms of where my revenue comes from today. Hence, we want to expand that, because that's more margin accretive, again, because we spend a significant amount of time on the divestiture conversation, I want to refer back to that, the businesses we've divested did not give us the opportunity or they had the potential to do this kind of work.

Frank C. Atkins
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Okay. Great. Thank you very much.

Operator: Thank you. [Operator Instructions] And the next question comes from Jim Suva with Citi.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. When you talk about identified divestitures, I believe you then said that a couple were identified by June, which makes sense, and then you said you had said more additionally, that was in Ashok's prepared remarks. Are those in addition to your original plan? Are those like incremental? And then following that, does that right-size the company perfectly to what you want or do you think that there is more divestitures yet to come?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So, Jim, we had earlier announced a range of $250 million to $500 million, of which we have achieved 340-odd. We have another $175 million as a part of that previous $250 million to $500 million. On top of that, we have announced today an additional $500 million of divestitures, which is our standalone customer care.

With this, the phase of the divestitures for the time is complete. I think what we are left with is our core business. We want to pivot away to amplifying and growing our core business. Obviously, as we look at the business over the years, things may change, like technology obsolescence or market positioning, then we'll come back. But for now, this is the end. Our job now is to sort of get this work that is in process to a point where it can be concluded and we can invest the proceeds from that, whether, as Brian said, into debt reduction, whether it is in terms of making the appropriate acquisitions to amplify the core business.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Great. And then my last clarification and follow-up is, those additional layer of divestitures sounds like are below corporate margins. So am I correct that now your go-forward company margin looks to be even more profitable than, say, when you did your Investor Day a year and a half ago?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

Yeah. So if you look at the $1 billion we're now looking to divest on average, once we take out stranded overhead, that will have a lower margin and company average and it will help us get through our long-term margin targets faster. And that's driven largely by the customer care standalone business, which has a very low EBITDA margin.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the clarifications and details.

Operator: Thank you. And next question comes from Mayank Tandon with Needham & Company.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Well, thank you. Good morning. Ashok, you've talked about investing in the sales force. Maybe you could give us an update in terms of where you're at in terms of these investments. And then when do we expect to see some maybe progress from that in terms of both growth in the core business and also in terms of maybe more consistency in terms of new business signings?

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

A

Yeah. So over the last few quarters, I'm actually very happy with where our client engagement team and our sales team in terms of numbers are. Obviously, this is a process that we start at day one, but it took us a while to get to the optimum number. I think we are there. We have the right talent. We have the right skill sets and the resonance that we're hearing and the feedback that we're hearing from the clients is actually pretty good.

Well, obviously, this takes us some amount of time for the business to ramp up, it's easier to do it in existing and install base of clients, and you can see that is happening from a renewal perspective. It takes a certain amount of time to do that in new business and we're seeing that as well, but obviously, we don't have the liberty of not having a consistent predictable new business signings trajectory. The good news is that the people that we have hired are all from the industry. We have a new leadership that specializes in these business whether it's in finance and accounting, whether it's in legal and compliance, whether it is in our total benefit outsourcing HRS business.

So we have strong leaders with great experience, great plan connect who will be able to drive the performance against that because we are definitely focused on not having to wait for a long period of time for these investments to yield. I actually think that with the sales team coming in with a much more vertical focus with an investment that we are making in our technology and most importantly or as importantly, we do not have to focus on businesses that are non-core gives us the opportunity to ramp up and provide the yield much faster.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

That's helpful. And just one follow-up question in terms of the global sourcing, I think you mentioned you call it accu-shoring. Is that additive to the margin over time? In other words, can you get to the mid-teens EBITDA target based on just the mix of business and the cost-cutting program that you have in place and then the global sourcing, once that takes off could actually be even more additive to margins longer term?

Brian Webb-Walsh
Chief Financial Officer & Corporate Vice President, Conduent, Inc.

A

That's part of the transformation program and going into 2019, accu-shoring and automation is a big part of how we'll look at the cost base that will help get us to the margin targets over time, but accu-shoring is definitely part of it.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Got it. Great. Thank you.

Operator: Thank you. And at this time, I would like to return the call to Ashok Vemuri for any closing comments.

Ashok Vemuri
Chief Executive Officer & Director, Conduent, Inc.

Thank you. And thank you everybody for being on the call. There is a lot of information to digest here. We've had a fairly busy quarter. We continue to have a fairly busy quarter. We are in the middle of a work-in-progress on our divestitures. You've seen the first steps of that. I think the full impact and the benefit of this will flow in as we finish the round of divestitures and more importantly use the proceeds in a manner that is accretive to the balance sheet, that is accretive to the shareholder and definitely is accretive, we think, both from a cash and EPS perspective and will drive a much more focused easily understandable and value-additive business to our clients.

With that, look forward to catching up with all of you on June 8, where I think we will be talking a lot more about our core business as we pivot off the revenue growth. Thank you so much.

Operator: Thank you. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect your lines.