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Conduent, Inc. (CNDT)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

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Jared Levine
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Shannon S. Cross
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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the Conduent Q2 2019 Earnings Call and Webcast. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded. I would now like to turn the conference over to Alan Katz, Head of Investor Relations. Please go ahead.

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

Good afternoon, ladies and gentlemen, and welcome to Conduent's second quarter 2019 earnings call. With me today, I have Cliff Skelton, our Interim CEO; and Brian Walsh, our 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 afternoon. These slides, as well as the detailed financial metrics sheet, are available for download on the Investor Relations section of the Conduent website. We will also post the 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, August 8, 2019, and are subject to a matter 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 afternoon and was furnished to the SEC on Form 8-K.

I will now turn the call over to Cliff, who will begin his remarks on slide 3. Cliff?

Cliff Skelton

Chief Executive Officer, Conduent, Inc.

Good afternoon, everyone. It's great to have this opportunity to introduce myself to the investment community. I joined Conduent as President and Chief Operating Officer in June and earlier this week was named Interim CEO and a member of our board of directors. Along with my colleagues I spent the last seven weeks meeting with Conduent's clients, our vendors and our partners, as well as employees throughout the organization, and what I learned on those visits was that our primary focus here at Conduent really needs to be on operational excellence. We need to establish a best-in-class service and sales delivery capability, while furthering our technology enablement, all of which are critical to our pivot to growth in our long-term success. That said, we have the capability, we have the assets to successfully execute this next phase of our journey.

Now by way of background, the last 20 years of my career included leading large-scale transformation efforts while serving as Chief Information Officer or Global Head of Technology and Operations at two Fortune 500 companies, in addition to having had the privilege of holding key operational and technology roles on the client side and some of the largest financial services companies in the world. This experience provides a unique viewpoint for understanding client needs and the direction for our overall corporate strategy. There's an opportunity here at Conduent to empower our employees around the mission and unlock tremendous value through transformation. Along with a loyal and diverse client base, we have strong platforms and significant talent within this organization.

Well, of course, there is room for improvement in how we manage our processes and our people. But if we modify our practices and motivate our employees and put the right people in the right jobs, we can unleash the value that sits within the organization and get us back on track and our pivot to growth. Now why don't we turn to slide 4 to discuss how we're going to get there? In the next phase of our transformation, we're considering all three decision-making outcomes of cost, risk and quality. Improvements in all three categories represent a tremendous opportunity moving forward, because increased quality, measured risk mitigation and process excellence enable and improve brand, enhance reputation and with it client retention. Along the way, we need to balance expense reduction efforts, with proper investment in our people, our processes and our technology, which are key levers in any transformation.

Regarding our people, we need to invest in the right talent to transform the foundation. We need to improve retention, better training, better hiring practices, and we need to drive leaders to motivate their teams. Attrition is something that has to be improved as it's costly and disruptive to clients and their end users, and teamwork is critical. With respect to process, we need to improve our change management, people management, risk management, incident and problem management processes, through better decision-making efforts and fewer handoffs. And finally, as it relates to technology, we need to continue to upgrade critical platforms, improve our development efforts and continue to focus on the value and security of client delivery.

Now with excellent execution, the outcome will be stronger growth, improved efficiency and a more stable environment, utilizing enhanced sales capability and state-of-the-art product offerings. I'm motivated by the prospect of enhancing our approach and look forward to serving our investors and positioning Conduent to capture the value it deserves. Meanwhile, as we continue to transform our company and make progress in our previously stated pivot to growth, our investments will also need to pivot; and as mentioned, extend toward client quality endeavors and people improvement. Efficiency improvements along with our platform modernization will have to continue but at a more measured pace, in view of these transformational needs. You will see that our go-forward EBITDA outlook will reflect such efforts.

Now, before I turn it over to Brian, to review our financial performance, I wanted to also mention that we'll be doing a strategic and operating review of the company in all business lines, and we will update you as that work progresses.

Brian, over to you for your comments, please.

Brian Webb-Walsh

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

Thank you, Cliff. Before I begin my prepared remarks, I'll note that throughout this presentation and in the exhibits in the appendix, we'll provide both GAAP and adjusted numbers, which provide a clean compare by removing the impact of the divestitures that we completed in 2018 and 2019.

Now let's start on slide 5, with an overview of the second quarter financial results. I will go through a few of the key line items on the P&L. Revenue was approximately $1.1 billion, down 3.2% compared with our Q2 2018 results adjusted for divestitures. This was driven primarily by the run-off of business we lost in prior quarters and strategic decisions, partially offset by the ramp of new business. On a constant currency basis, adjusted revenue was down 2.6%. When excluding the impact of divestures, adjusted EBITDA in the quarter decreased 7% year-over-year to $114 million, with an adjusted EBITDA margin of 10.3%, a 40 basis point reduction. While we continue to make progress on our cost transformation program, these savings were more than offset in the current quarter by both investments in the business and revenue pressure. Restructuring spend was $26 million driven both by continued head count related cost reductions and the ongoing facilities and data center consolidation program.

Our pre-tax loss in the second quarter was $1.12 billion compared with the profit of $54 million in Q2 2018. The loss was primarily driven by the goodwill impairment. The goodwill impairment which is non-cash and is adjusted out of our guidance metrics was driven by the change in our outlook this quarter. We impaired the goodwill of all of our reporting units as the fair values are found to be below the associated carrying values. As a result, we recorded a pre-tax charge of approximately $1.1 billion. We continue to see the potential for revenue growth over the long-term in our business and have that forecast embedded in our goodwill model. However, as I will discuss shortly, our near-term outlook is under pressure as a result of lower revenue driven by lower new business signings, losses and volume pressure, as well as lower cost takeout from a more balanced approach to cost savings. Adjusted net income was $30 million and adjusted EPS was $0.13, down from $64 million and $0.29 in Q2 2018.

Let's now go through the details of our segments on slide 6. As we did last quarter we have included a summary slide detailing the financial performance of all the segments and have included the shared IT and corporate cost line. As reported, our Commercial business revenue declined 5.4% driven primarily by loss business, price pressure and strategic actions. Adjusted EBITDA was down 11% as a result of lower revenue, while adjusted EBITDA margin was down 140 basis points year-over-year from Q2 2018. Our Government business declined 4.4% on the top line driven by pricing changes associated with a large renewal, lost business, and volume pressure. Government adjusted EBITDA increased by 0.9% as reduced IT spend offset the revenue pressure.

Our Transportation segment grew 8% for the quarter on the top line compared with Q2 2018 driven by new business ramp and higher international volumes. Adjusted EBITDA was up 22.9% as compared with Q2 2018 impacted by increased revenue and IT spend declines. Adjusted EBITDA also recovered 640 basis points compared to Q1 2019 as we had lower SLA penalties. As expected, other has gone to zero revenue. This is where the results associated with the student loan business and divested revenue was moved previously. We'll continue reporting other for historical comparative purposes.

In the second quarter, our Shared IT & Corporate Costs were $167 million, 3% higher than the prior year, driven by increased shared IT spend and go-to-market investments. We would expect to show year-over-year progress throughout the year as stranded costs come out of the business.

Before I get into the details on cash flow, let's go through our sales results on slide 7. Quarterly new business TCV signings were $328 million, down 5.2% compared with Q2 2018. While the performance improved compared with last quarter, we still have work to do on the new business front. In terms of renewals, we mentioned last quarter that we are no longer protesting the California Medicaid contract. This contract was booked as a loss this quarter and was a large driver of the lower renewal rate that we had this quarter. In addition to the California Medicaid loss, we had two other losses in the quarter that are negatively impacting the renewal rate. Without the California Medicaid loss, the renewal rate would have been 79%. We had fewer renewal opportunities this quarter, so select losses had an outsized impact.

From a year-over-year perspective, we had a multi-year renewal with our largest client last year, which made for a difficult compare. We have strong client relationships and a continued focus on improving delivery. We are investing to ensure that we have the right team and processes in place to leverage our technology and platforms. Sales head count declined this past quarter. We continue to look for the right talent in the sales organization and are focused on bringing in high performing sales professionals. Given new business losses and slower backfill in the quarter of new opportunities, we also saw our pipeline decline to $10 billion. We're focused on improving the sales governance process and strengthening our foundational capabilities to drive client confidence and increased sales.

Let's move on to our cash flow for the quarter on slide 8. The operating cash outflow of $185 million in Q2 2019 was primarily driven by the payment associated with the Texas settlement and other working capital. This quarter we paid $98 million towards the Texas settlement, and posted $118 million in letters of credit for the remaining balance due January 2020. CapEx was $43 million for the quarter, a decrease of $8 million compared with last year, driven largely by timing of investments. Adjusted free cash flow was an outflow of $160 million in the quarter, partially as a result of a large payment to one of our IT providers. Given the timing of CapEx and the typical seasonality of our business, we continue to expect to see free cash flow to be weighted towards the back half of this year and Q4 in particular.

Turning to slide 9, let's go through the updates on our capital structure. Our balance sheet continues to be healthy, and at the end of Q2 2019 our cash balance was $285 million. Our current net leverage ratio is 2.3 turns.

In terms of M&A, while we continue to look at inorganic opportunities, we will balance organic investments with M&A. We are continuing to see a higher valuation for technology enabled assets relative to our multiple, so we will be disciplined and opportunistic in terms of deals. Turning to slide 10, let's go through our 2019 guidance. As we have done in the past, the walk that we have provided is from our 2018 reported results to our adjusted 2018 baseline, normalizing for the impact of divestitures. We have updated our outlook for the year to take into account our performance in the first half of the year as well as two factors that have changed since the outlook on our last call.

First, we expect to see incremental pressure on revenue, as a result the continued volume pressure, some additional select contract losses and lower new business signings. As we have previously stated consistent double-digit quarterly new business signings growth is going to be the leading indicator that we are positioned for top line growth, while we reduce the new business rate to decline from Q1, we have yet to see this metric turn the corner towards growth. Second, as Cliff mentioned, we now see a need to better balance quality improvements and investments with our expense reduction efforts. We'll look at opportunities to address costs, but we'll do so at a more measured pace. Given those factors our updated guidance ranges are as follows. Our revenue outlook is now a constant currency decline of between 4% and 5%, implying a range of approximately $4.39 billion to $4.44 billion with adjust for the 2019 impact from divestitures.

Our updated adjusted EBITDA margin, given our expectation for lower revenue and slower cost takeout is now between 10.8% and 11.6%, which would imply a range of $480 million to $510 million of adjusted EBITDA. Lastly, our outlook for adjusted free cash flow is now a conversion rate of between 20% and 25%. This change is driven by the reduction in EBITDA. As a reminder adjusted free cash flow excludes the payments associated with the Texas litigation settlement. The factors that I mentioned earlier will also impact our results in 2020. We will have approximately a 3-point impact on revenue from the loss of our California Medicaid contract. In addition, we expect the rest of the business to face additional topline pressures next year from lower new business signings, lower volumes and incremental losses.

In terms of 2020 adjusted EBITDA margins, we expect them to be relatively flat as certain employee cost return and as revenue pressure persists. We anticipate these headwinds will be offset by stranded cost reductions and other efficiencies. As we have stated before we'll take a more balanced approach to addressing expense reduction as well. Well, we're not pleased to have to lower our outlook, the focus remains on turning around the business and balancing cost takeout with client delivery positioning us for long-term growth. As Cliff mentioned, along with the board we are also now conducting a strategic and operational review of the company and our business lines.

We'll look at potential opportunities to maximize shareholder value and we'll provide additional information as that review progresses, but do not have any additional details to share at this time. Regardless of the outcome of this review we remain focused on delivering improved performance. We have an attractive set of assets and a dedicated team behind us, and we will continue to work diligently to realize the full potential of our organization.

We will now open up the lines for some questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Bryan Bergin with Cowen. Please go ahead.

Jared Levine
Analyst, Cowen and Company

Q

Hi. This is actually Jared Levine on for Brian today. So in terms of a potential strategic review, would it be more likely to expect another round of kind of non-core business divestitures, or would it more likely be a broad based kind of selling the business off in pieces? And then I just have one follow-up after. Thank you.

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

A

So Jared, this is Cliff, thanks for your question. We've just started the examination with our board. So we don't have an exact plan, but all opportunities are under review, both selling pieces as well as the whole company. But there's lots of work to be done before we can give any updates in that category.

Jared Levine
Analyst, Cowen and Company

Q

Great. Thank you. And then in terms of the sales force decline, can you quantify what that was year-over-year and sequentially, and what are the investments being made in terms of the sales force?

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

A

So we're down to about 240 sales folks, we were at 290 previously. Some of the investment has paid off, some of the churn has caused this reduction. Our view is continued investment in our sales force not just from a numbers perspective but from a quality and sales leadership perspective is what's needed next. So as I said, we're down about 50, but we see that ramping back up pretty quickly.

Jared Levine
Analyst, Cowen and Company

Q

Great. Thank you.

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

A

You bet.

Operator: Our next question comes from Puneet Jain with JPMorgan. Please go ahead.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Hey, thanks for taking my question, and nice to see focus on balanced cost reduction. Is there a way to think about magnitude of incremental investments versus impact from lower revenue on EBITDA margin expectations?

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

A

Yeah. So hi, Puneet. If we look at the guidance change, it was about $65 million at the midpoint, and it's split pretty evenly between three things; one would be Q2 under-performance, the second would be revenue pressure expected for the year, and then the third would be overall spend not decreasing as much because of the balanced approach we talked about.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. And is there any timeline for the strategic review? And, Cliff, it's been around two, three months since you joined the company, could you share your initial thoughts on Conduent's positioning and which areas need the most attention?

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

A

Yeah, Puneet, great question. I've been here around seven weeks now. I can't give you an exact timeline on the strategic review. As I said, we're just getting started with that with our board, and we can give you an update at the next earnings call as to how that's coming and how much longer it will take. I would say, from a viewpoint from the balcony, if you will, of our company, and where we are and what we need to do different, I think that's the gist of your question, I think we've done a really good job with cost reduction efforts. We've done a good job with trying to drive sales improvement. I think what we need to do now is slightly tweak the approach around process and people so that we're not just driving cost out without a view toward the quality and the client impacts of those cost reductions. So we're going to spend a lot of time and a lot of effort in making sure we've got the right people, specifically in our infrastructure environment, and making sure you got the right sales executers and the sales leaders in our sales execution efforts. So it's a little bit of a different approach, it's the same strategy, but it's a little twist on the approach to make sure we've got the right process controls in place and client impact viewpoint as we make these investments and as we make these efficiency improvement efforts.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: Our next question comes from Shannon Cross with Cross Research. Please go ahead.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you very much. I was curious, you went through a litany of issues with the company, and I just, plays into the last question a bit, but can you talk a bit about what you see are the most – again, not trying to see the glass as half full, but just where are you seeing the most opportunity? And I know it's going to take a while so you're going to be able to give us timing on turnaround, but how we should sort of think about how you plan to spend the next year in terms of repositioning? Again, I understand you've only been there seven weeks.

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

A

Yeah. Shannon, so my view is, we've got a lot of great foundational attributes here. We've got great people, we've got a great client base. From my point of view, we've got what I would call good bones in our company. But we've missed a couple of steps on process and the right people on the right jobs. And so that's going to be a high priority effort right away. We expect to look at the organizational model and how we're going to market both from a sales perspective as well as how we run our operations, and you'll see over time slight tweaks to that as we try and get to better execution. So I think at the end of the day, when we look at growth, we've got to look at new logo growth, and we've got to look at new business in our current client base, and we've got to build a better reputation across our client base so our sales folks can be more confident in their abilities. With respect to new logos, it's really sales skills, market reputation and platform capability that we've got to focus on. And with respect to the ability to grow and penetrate our current client base, we've got to improve our relationship management skill and the quality and confidence and the quality of our platforms. And we just haven't done quite as good a job in that particular area over the course of last year. And my belief is these process steps and the people improvement steps are going to help make that happen.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Okay. Thank you. That was really helpful. Brian, can you talk a bit about cash flow? It was lower than we had anticipated, and I understand there were one-timers in it, which we had, but it was still lower. So I guess, what gives you the confidence in second half? I feel, as if every company I'm listening to this quarter is talking about a big second half cash flow. So I guess, from your standpoint, with the recurring revenue base that you have and what you see coming through, just maybe you can talk about where the specific puts and takes will be as we look to the second half of the year? Thank you.

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

A

Sure Shannon. So if you look at cash flow through the first half, free cash flow was down about $200 million, and it's driven by a lower EBITDA and the pressure on EBITDA, higher CapEx year-over-year of about $33 million in the first half, and then negative working capital somewhat related to an IT vendor that we had on payment hold, but we went through an audit that freed up in Q2. When we look to the second half, EBITDA ramps in the second half for us even though we reduced guidance, we typically based on our seasonality will have higher EBITDA in the second half. From a CapEx perspective we will actually decline in CapEx in terms of last year in the second half, and then we expect working capital to be neutral in the second half. So those are the things that give us the confidence to deliver the revised guidance.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Great. Thank you.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Cliff Skelton for any closing remarks.

Cliff Skelton
Chief Executive Officer, Conduent, Inc.

Well, thank you all for joining us today. We really appreciate your time and we look forward to a great next quarter announcement and lots of progress. So I appreciate your time.

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