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Conduent, Inc. (CNDT)

Q1 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Conduent First Quarter 2017 Earnings Conference 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 would now like to turn the conference over to Alan Katz, Senior Vice President of Investor Relations. Please go ahead.

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

Good morning, ladies and gentlemen, and welcome to Conduent's first quarter 2017 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 the 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 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, May 10, 2017, 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, and welcome to Conduent's Q1 2017 earnings call, our first quarter of results as a public stand-alone company. Brian and I will cover our financial performance as well as detail the progress we are making to transform Conduent into a profitable, predictable, sustainable and market-leading enterprise.

In addition to sharing an overview of our first 90 days, I will provide a view of the work ahead and the operational improvements we are making to achieve best-in-class performance. I'll then hand it over to Brian to go into more details on the financials and our outlook for the year. From there, we'll open it up for Q&A.

I'm on slide 3. During the first quarter, we achieved financial results in line with our expectations while making major strides in standing up our new company, refreshing the business model, developing a client-centric go-to-market strategy, focusing on our operating model and creating a One Conduent culture. Additionally, our strategic transformation continues to be on track, and I remain confident of our journey forward. Brian will provide more detail on our progress in his presentation.

In terms of our financial performance, revenue declined within the range we expected, while our key profitability metrics improved across the board. And since our last call, our finance team took advantage of an opportunity in the credit markets to reduce our interest expense by re-pricing our Term Loan B. I'm very pleased with the results and appreciate the commitment to making this happen.

Strategically managing our balance sheet reflects just one of the many internal improvements we are making in the company. Additionally, we are addressing the way we are structured, the way we operate, and the way we go to market. Our legacy is as an organization comprised of many stand-alone acquisitions made over several decades that were never fully integrated, standardized or managed as a single operation to derive the synergies thereof. The opportunities to streamline and consolidate are key to the gains we expect to see in our go-forward operating model.

For example, we have realigned our go-to-market teams around industry verticals for deeper account coverage to focus on cross-Conduent opportunities and drive service line penetration. Corporate support functions like HR, finance, marketing and legal continue to be staffed with best-in-class people and practices to support our go-to-market teams. Importantly, the design and focus is to transition to a modern business services company versus a traditional hardware manufacturing model. Business intelligence has been a major focus for us, driving better insights for decision-making. We are now running the business with cleaner data, business analytics and one version of the truth.

Consolidation across our real estate and IT infrastructure is yielding tangible savings, but we have a long way to go. We are exiting countries, which are non-strategic and offer little long-term potential. We are strengthening our relationships with our core technology partners and revisiting our contract obligations to ensure balance and mutual benefit. We have completed our key business leadership hires and with our management roster now in place, we are turning to the important work of establishing our culture based on client centricity and operational excellence.

This is an extensive body of work that we are undertaking to recreate Conduent into a profitable, predictable and sustainable enterprise in the business services industry. We have an ambition to not just perform well financially, but to contend for leadership in our industry and over time become admired along with other well-known and great companies.

Let us now look at our three business segments and some key operational highlights on slide 4. As we addressed in our last earnings call, we have realigned our segments, enabling deeper account development and supporting greater cross-selling of our portfolio. Looking at our Commercial segment, this is a highly diversified and balanced book of business with no one client representing more than 4% of our total revenue.

Our offerings are based on our reputation for high-quality service and differentiated industry-recognized technology platforms, supporting a range of business activities, including digital processing, human resource services, customer experience, learning and compliance. These are commonly identifiable activities in any large organization, and therefore, provide the headroom for growth.

We are investing in our technology platforms to make them scalable across multiple client situations, and we are recognized leaders across a range of industry benchmarks. Last quarter alone, we were recognized by leading industry analysts for leadership in benefits administration, contact center and learning services. Brian will discuss the financial performance of each segment in more detail, but I'll provide some highlights for each of our segments.

During the first quarter, while Commercial revenues declined, profitability improved, reflecting the progress we are making in our go-to-market account and portfolio management effort in this segment. We now have much higher visibility into the offering penetration and margin profile of every Commercial account, allowing faster and more decisive actions for achieving industry-level margins and over time revenue growth. And with new leadership in place, we can bring the control and intentionality we need to further deliver the profit improvement we are targeting. We are building a targeted cross-selling approach to grow relationships with existing clients, further contributing to margin improvement down the road.

Our Public Sector revenue also declined in the first quarter, but as in the Commercial business, grew margins year-to-year, lead primarily by the Transportation business. Similar to the work we do in Commercial, Conduent operates and manages significant facets of government operations on the back of our differentiated technology platforms. From government payments and benefit administration to parking and automated tolling, our solutions are industry recognized and we operate in all 50 states.

We also announced several new platform solutions during the first quarter that we are proud of, including the launch of our new Mobility Companion Platform in Europe, which improves public transport access and usability by simplifying the passenger experience from ticket purchase to best routes available.

Our third segment, Other, is comprised of our Health Enterprise and Student Loan businesses, both of which we are managing as stand-alone transitional units. The team spent this quarter focused on addressing the key challenges and was able to make great strides in creating a more efficient and profitable path. I'm very pleased with our progress to date, and we are now on track to achieve break-even earlier than initially anticipated.

Now let's move to slide 5 and I'll discuss our signings and renewals for the quarter, which are illustrative of the progress we're making in our selling and go-to-market activities. Total TCV signings were $931 million, which consisted of large wins, including a five-year agreement with a Fortune 100 multinational company to provide benefit administration services; two state agencies leveraging our strong capabilities in customer experience and expertise in the Medicaid eligibility and benefit services; and finally, a significant expansion of business in one of the largest technology brands globally.

The decline in year-over-year TCV was primarily driven by two factors. First, 2016 was a year of high renewals, leading to fewer renewal opportunities in 2017. However, we remain focused on expanding our pipeline and increasing the penetration of our current clients. Second, our ARR, our annual recurring revenue, was up 11% in Q1. But the average contract length is declining, driving a lower TCV. Non-recurring signings also grew in the quarter, up 12% year-over-year. And our renewal rate at 92% was indeed very healthy for the quarter.

These figures are indicative of efforts to remake our sales engine for industry depth, service line expansion and account profitability. I've called this our inch-wide, mile-deep approach. And it emphasizes quality of opportunity and quality of the dollars over the pure dollar size or number of deals. As a result, we are cleaning up our pipeline significantly. It is becoming more accurate and includes a richer mix of cross-Conduent opportunities.

We are also taking an aggressive look at the mix of contracts in our portfolio with the intention of reducing the long tail, refocusing our investments in core business services and geographies, and arriving at a better sense of what businesses and services will be part of the future of Conduent. As part of that process, we are also remediating our contracts in line with our profitability and service line penetration ambitions. We are determined to continue this strategy to enable our inch-wide, mile-deep approach to sales. This strategy will be reflected in Brian's guidance presentation and will speak to the quality of the dollar earned than the mere size of the revenue.

Finally, on slide 6, I'd like to share the following table that summarizes many of the changes we're making to transform our company over the next several years. Each of these represent an area of work where we are reshaping the assets we've inherited in a way to build an industry leader. We continue to discover the many assets in this organization that had been isolated and underleveraged as a result of the fragmented and disaggregated approaches, which managed this business in the past. This framework helps convey the kind of work ahead across the entire company to achieve our long-term goal of becoming a profitable, predictable, sustainable and market-leading enterprise.

We recognize that we have a long way to go, but 90 days in, we believe we are off to a solid start. Margins are improving and we are on plan to achieve growth in our adjusted EBITDA goals as we come through the year. We're bringing more discipline, consistency and higher standards to every corner of the operation.

With that, let me turn it over to Brian, who will take us through the financials in more detail, and then we'll come back for Q&A. Thank you.

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

Thank you, Ashok. Let's start with an overview of the Q1 financial results with a walk through the P&L on slide 8.

As discussed, revenue of $1.55 billion was down 8% or 7% on a constant currency basis compared with Q1 2016. This is in line with our expectations. The first quarter is also typically our weakest quarter from a seasonal perspective, given that starting in Q3 and through Q4, we have higher volumes from open enrollment activity in the Healthcare sector and higher levels of customer service and industry-specific activity in the retail and travel industries through the holidays. We also have increased expenses in the first quarter with higher employee-related expenses.

In terms of year-over-year, the decline was primarily driven by lower volumes from existing clients, contract losses and contract remediation efforts. Including the impact of New York MMIS, approximately 40% of the total revenue decline was a result of contract remediation efforts.

Gross margin was 16.7%, an improvement of 100 basis points versus the prior year period, reflecting the transformation initiatives and improvement in the Other segment. Selling, administrative, and general costs improved $14 million for the quarter, driven by a strategic transformation, partially offset by corporate dissynergies. We continue to work aggressively to reduce G&A by focusing on streamlining our real estate footprint and our corporate functions. Q1 adjusted operating margins improved 150 basis points, compared with the prior year, driven by the improvements in gross margin in selling and administrative and general costs.

Adjusted EBITDA of $153 million was up 5% year-over-year with adjusted EBITDA margins of 9.9%, a 120-basis-point improvement over Q1 2016. We are pleased with the progress that we're making in growing both adjusted operating profit and adjusted EBITDA. Interest expense was up $25 million year-over-year in the quarter. As a result, adjusted net income declined by $12 million compared with Q1 2016, with the operational improvements more than offset by increased interest expense. Excluded from adjusted net income and adjusted EBITDA is other net, which was favorable this quarter from two litigation outcomes.

Let's now turn to slide 9 to go through our Commercial segment results in a bit more detail. As we have discussed in the past, we put our Commercial Healthcare business under the Commercial umbrella, which improved the reported margins in this segment. Q1 revenue declined 8% compared with the same quarter last year, due to contract runoff and lower volumes across healthcare, communications and media, and high-tech verticals. Approximately half of the revenue decline in this segment was strategic.

Segment margins improved by 40 (sic) [50] (16:51) basis points compared with Q1 2016, driven by our transformation initiatives. As you can see on the slide, we have a good mix of business from both a vertical and horizontal perspective. This diversification from both an industry and service-line perspective is a key advantage for us. We are focused on selling more of our offerings to existing clients. This segment is still under pressure and there is more work to be done. Segment-specific cost actions, and more generally, our focus on G&A, are directed at improving margins in this segment.

Moving on to slide 10, let's discuss our Public Sector segment, which now includes our Government Healthcare business. Revenue declined in this business as expected, driven by lower volumes and contract losses in our State & Local business and in the Government Healthcare space. This was partially offset by growth within our Transportation business. Segment margins were up 40 basis points year-over-year, driven by growth within our Transportation offering and improved profitability within the Government Healthcare business.

Moving on to the Other segment, which includes our Health Enterprise and Student Loan business, I'm now on slide 11. Revenue within our Other segment was $81 million in the quarter, a decline of 24% versus the same quarter last year. This was largely driven by New York MMIS and the continued runoff of our Education business. The discussions are ongoing with the client for the New York MMIS contract; however, we have not yet come to a conclusion with the client. We hope to do so within the next two quarters. We have made good progress in improving the profitability in this segment, and we have a segment loss of only $1 million in the quarter. The majority of this improvement year-over-year was driven by two factors: Reduction in the amount of remediation work in our Student Loan portfolio and the New York MMIS contract.

The Education business, which includes the Student Loan portfolio, made a profit of approximately $3 million. And the Health Enterprise business lost approximately $4 million in the quarter. It is important to note that some of this improvement in this segment is captured in the D&A line, which improves segment profit, but has no impact on adjusted EBITDA or free cash flow. I am pleased with the progress we've made in improving profitability within the segment. We expect some lumpiness quarter-to-quarter as we run off the revenue and address the cost base. However, we now see this business reaching break-even faster than initial expectations.

Our transformation initiatives remain on track, as indicated on slide 12. Our outlook for transformation savings in 2017 and 2018 is unchanged. We more than doubled our transformation savings year-over-year. And while we are slightly behind our full year target for 2017 on a run rate basis, we are confident that we'll hit our full-year goals. I'll note that there are some offsets to these savings, including dissynergies and investments, in our quarterly results.

We have made good progress both within the segments and on G&A spend, such as real estate and corporate spend. We're also working with vendors to ensure we are optimizing our relationships and using our resources in the most effective way possible. Contract remediation is progressing, and we have identified a number of contracts, where we are in discussion with clients to find win-win solutions before moving ahead with the relationship. We also have some clients, where we weren't able to find a resolution, which as I noted earlier, is a factor in the revenue decline. We are all committed to achieving success in this program and see it as critical to reaching our long-term goals.

As you can see on slide 13, cash flow from operations and free cash flow both improved from Q1 2016, with a use of cash flow from operations of $106 million and free cash flow use of $136 million for the quarter. As we have previously discussed, we are generally cash users in the first half of the year. Operating cash flow in the quarter was driven primarily by the reversal of fourth quarter working capital actions, including accelerating accounts receivable collections and holding payables. As a result, working capital was a $209 million use of cash this quarter.

A few additional points to note on cash flow. CapEx was a bit lower this quarter than our typical run rate, as balance sheet investments were lighter than what we expect to see moving forward. We still expect CapEx to be approximately 2.5% of revenues for the year. Cash flow from financing was a use of $6 million, and I will now discuss the dynamics. Please turn to slide 14.

Our balance sheet continues to have ample liquidity, including over $650 million of availability under our revolver and $255 million of cash at quarter-end. As we discussed in our Q4 call, in January, we made a payment to Xerox related to the separation of $161 million and issued an additional $100 million within our Term Loan B facility. We also drew on the revolver in the quarter with $70 million outstanding as of March 31st.

In Q1, our treasury team undertook a re-pricing of our Term Loan B, which was completed in the first week of April. This action significantly reduces cash interest expense going forward. The result was 150-basis-point reduction in the interest spread, elimination of the LIBOR floor and some favorable changes to other provisions.

This should result in annual cash interest savings of about $12 million. For 2017, this cash savings will be offset by the payment of the soft-call premium and the transaction expenses.

Given our updated outlook on interest expense and draws on the revolver, we now expect our annual interest expense for 2017 to be approximately $145 million. Our adjusted leverage ratio was 2.9 turns. Our target ratio remains less than 2.5 turns, which we expect to achieve by growing adjusted EBITDA and making mandatory debt payments over time.

Before I close, I want to provide some commentary on our 2017 guidance. Please turn to slide 15. We now expect 2017 revenue to decline between 4.5% and 6.5% for the year at constant currency. While this decline is greater than what we had discussed during our last call, we have completed a review of our portfolio, and as Ashok mentioned, we are making certain strategic decisions to address the long tail, remediate unfavorable contracts and to reduce our geographical footprint.

We are focused on making sure that every dollar of revenue that comes in is profitable. This means that certain service lines will be de-emphasized in our go-forward plan. We expect to deliver adjusted EBITDA growth of between 5% and 6% for the year. And we expect that 20% to 30% of adjusted EBITDA will flow through to free cash flow.

I'll also note that our long-term goals remain unchanged. Our progress in Q1 was encouraging, and I remain excited about the business and the opportunities that I see within the company. We have a great team and we are positioned to grow.

Now, let's open the call for Q&A.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Brian Essex of Morgan Stanley.

Brian L. Essex
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good morning, and thank you for taking the question. I guess I just wanted to point out one point of inquiry that I've gotten from investors, particularly over the past couple of weeks and then follow-up on it. But there's been a growing interest in BenefitWallet within your platform, particularly I think as one of your peers kind of called it out. Could you help us understand, maybe size of business, how profitable it is and who the competition is there?

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

A

Yeah. Sure, Brian. So BenefitWallet is an integral part of our overall HRS value proposition. We don't break that out to give the details in terms of its financials, but suffice it to say that it's profitable, actually very profitable, growing at a very healthy pace, very integral to our overall solutions in the benefits space, in the HRS space, and something that we will continue to invest in and extremely proud of the performance to-date.

Brian L. Essex
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Maybe just as a follow-up, I've been getting a number of calls from investors along this line of questioning, and I know that you've spent a lot of time with investors kind of managing expectations, talking about the underperforming businesses and the one's that need fixing or turning around, but any others inside your portfolio that you would highlight that you get the most excited from, maybe ones that are growing quickly with better margins that would offset some of the ones that are in decline?

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

A

Yeah. So, as I mentioned in my last quarter's call, we had asked all our business heads to sort of take us through their business plans and sort of substantiate why they should be part of the future of Conduent, so that exercise is now done. Through that exercise and through the verticalization of the company, we are very clearly in a position to identify the services, the platforms and the businesses we believe are core. We continue to provide some amount of time and flexibility to our other businesses that have not made the list of core in the first round.

Out of that, we expect some of them to sort of, with a little bit of investment and appropriate yield, in a short timeframe expect them to be part of core. We are taking a hard look at some of our businesses that clearly, both from a geographic perspective, both from a value proposition perspective, from the investment required or the technically obsoleteness of the technology, will not make the cut. At this point in time, the reviews are still going on, so we do not want to make a comment, specifically as to which businesses are core and which are not, but that's an aggressive work in progress for us.

Brian L. Essex
Analyst, Morgan Stanley & Co. LLC

Q

And any indication in terms of timing when you might expect to conclude that review?

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

A

We should be able to conclude that review by the end of summer and then make the appropriate decisions and have discussions with regard to how we continue to amplify those that will be part of the Conduent of future.

Brian L. Essex
Analyst, Morgan Stanley & Co. LLC

Q

Very helpful. Thank you.

Operator: Thank you. [Operator Instructions] Our next question will come from Puneet Jain of JPMorgan.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Yeah. Hey. Thanks for taking my question. So, can you talk about some of the drivers that were incremental relative to your prior revenue expectations? And do you still expect flattish growth profile by next year?

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

A

Sure. Good morning. So, if we look at revenue decline for this year, we've worsened our guidance to 4.5% to 6.5% of a decline. When we looked at Q1 revenue performance, it was in line with our expectations. About half of it or 40% was due to strategic decisions, including the Other segment, and the rest of it was lost contracts and volume issues, specifically in customer care.

And as we look at this year, the reason we're worsening the guidance is the portfolio review that Ashok mentioned. There are some businesses that we will be de-emphasizing and running off because of where they are located from a geographical perspective, because of the profitability of the business, because the business may have a long tail of a lot of small clients that create a lot of complexity. And so based on that decision, there's about 100- to 150-basis-point impact on revenue that we're expecting from those changes.

And again, this is just businesses we're running off. Any divesting would be outside of that, and we would need to talk about that at the point we are ready to start getting serious about a transaction. So this is just businesses we're running off. And then, as we think about next year, getting to flat is still the goal. And again, just as a reminder, it's going to be a combination of organic improvement and acquisitions. As we build up our cash for this year, we intend to use it for strategic acquisitions.

Puneet Jain
Analyst, JPMorgan Securities LLC
Q

Got it. And then quickly one follow-up. The Other business segment, thanks for all the updates on why it was break-even, but what do you expect for Other's margins for the entire year? The loss in Q1 was a little bit below what we had expected.

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

Yeah. So, we see Other as being lumpy quarter-by-quarter. So, we don't see it to getting to break-even this year. But we do think it'll get to break-even faster than what we initially said, based on all the work we're doing on the segment. So, sometime in 2018 we think it'll break-even. But we're still running off revenue. We still have a lot of cost actions to take on the segment, and we don't believe it'll get to break-even this year, but we'll make good progress. And just keep in mind, some of this progress is lower depreciation, amortization, so it doesn't flow through to adjusted EBITDA.

Puneet Jain
Analyst, JPMorgan Securities LLC
Q

Got it. Thank you.

Operator: And our next question comes from Jim Suva of Citigroup.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you very much. I have one question and a follow-up, which I will ask at the same time. The first question is on the lower revenue guidance, I understand it sounds like you've completed a review of your company. How is this review different than like upon the initial separation from Xerox when you took over as CEO, the Investor Day and the earnings call three months ago? And it sounds like it's kind of not completed, that there could even be some more defocusing the revenues or am I reading that incorrectly? It just seems like the full business review wasn't wrapped up, when you did the separation.

And then the follow-up question is on the signings. You mentioned that difficult comps year-over-year. And while I appreciate that, I just wonder, is this something where in two or three years or in future pipeline, do you have a lot of other challenged year-over-year total contract signings? Because the percent decline year-over-year of like minus 30% or something like that is quite concerning as far as when you look at this as a future pipeline in this for Conduent. Thank you.

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

A

Okay. So, Jim, let me address each of the questions that you've asked, starting with the revenue. So clearly, as we stood the company up and we looked at our portfolio of business, we looked at our contracts, we established a much more tighter discipline in terms of deal qualification and criteria of that kind of businesses that we want to get into. We began to see the picture of actually what the business really looks like in terms of its sustainability, in terms of its growth opportunities.

We have completed our exercise with regards to all our business segments. And I think as Brian mentioned, we've gone through, thanks to a much more tighter business intelligence and a much more transparent deal financials into each and every contract to see which are the ones that we want to continue to sustain and grow, and those which we will take active remediation exercise and negotiation with our clients. So, we believe that the picture that we have right now is the picture as we see it. There is no asymmetry of information with regards to a change in that based on any further review. Of course, this is a function also of how the market behaves.

With regard to signings, you know, we had a total contract value, which was $931 million, a TCV which was lower than last year. But in there, there're two elements to this. One is TCV for new business, which is $530 million, which is composed of ARR, which is about 11% higher than where we were this time last year, and non-recurring revenue, which is about 12% higher than where we were last year.

The number speaks to the fact that we are much more disciplined in terms of the deals we want to do, the geographies that we want to be in, the fact that we do not want to be in long-tenor complex transactions. We'd like to see more smaller term transactions because the changes in technology sort of make some of the solutions that we are building obsolete over the five, seven years. We've had contracts also – some of these contracts have become shorter tenor because of the way the clients also want to engage with us. So, it's worked out well for us on both.

So, if you look at the new business at $530 million, that reflects our more purposeful and much more disciplined sales approach. With regard to renewals and the renewal rate of 92%, and that speaks to the fact that we are – 92% of the deals that we wanted to renew, we've been able to renew. That again speaks to the fact that we're taking a much tighter, disciplined approach, again defocusing from some of the geographies. We do not want to do deals just because they are high TCV in parts of the world that we are not able to deliver our solutions or platforms that would require a significantly higher degree of investment, driving down the yield.

So from a signings' perspective, from a total contract value perspective, I'm extremely pleased with our ARR and NRR performance, and our renewal rates speaks to the fact that what we are invited to do, we seem to do a good job, and also the fact that we want to be more in control of what we renew and what we sign, rather than signing and renewing everything that we had contracted in the past.

I don't think I fully understood the last part of your question. If you could repeat that, maybe I can answer to that.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Is there some lumpiness in the contract signings looking ahead that we should be aware of as you kind of cited year-over-year the TCV that was impacted by a difficult comp year-over-year?

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

A

There – why don't you...

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

A

Yeah. I would just add to that if you look at renewals that are – contracts that are up for renewal in Q1 versus Q1 of last year, we had less contracts up for renewal, and we see that playing out this year as well. Last year was a very high renewal year for us. So that is the dynamic that's impacting the renewal TCV.

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

A

Jim, I would just note that we provided...

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details.

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

A

Jim, and I would just note that we provided some additional disclosure on the bookings and renewal rate on slide 18 of the deck. So, I'd encourage you to take a look at that.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thanks so much for the details. Greatly appreciated.

Operator: And the next question will come from Keith Bachman of Bank of Montreal.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)

Q

Hi. Many thanks for taking the question. I was hoping you could talk about the cash flow guidance. You're keeping the same percent of EBITDA and yet it looks like you're guiding to a negative free cash flow number. I think Street – we checked consensus estimates. The estimates were over $200 million, a positive number, and yet, it looks like you're guiding to a negative $80 million. Could you talk about what's in that? And it appears to be, I think, a bit worse or significantly worse, and what Street is missing. What's the composition of that number, please?

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

A

Yeah. Good morning, Keith. So the $81 million was the use of cash last year for free cash flow. The guidance for this year is 20% to 30% of adjusted EBITDA, which is roughly a $130 million to $200 million, and that's consistent with what we said on the fourth quarter call and at the December investor event. So, our cash flow...

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)

Q

Right. Yeah. Sorry. I was trying to understand it. I think the $81 million is the number where you had some puts and takes. Is that a normalized number on that negative $81 million? In other words, you had some one-time items and also some significant tax benefits that also helped the number.

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

A

That's right. So last year, the negative $81 million was impacted by a lot of separation costs, restructuring charges, the fact that we stopped our factoring program in the fourth quarter. So, there are a lot of one-time items and we also had some capital lease buy-outs we had to do and operating lease buy-outs related to the separation. So, the $81 million was impacted by one-time items. This year, we obviously have higher interest expense that we have to take into account, but there are one-time items that go away that were inside that $81 million and that's contemplated in our guidance.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)

Q

Okay. And then my follow-up question would be with the cost savings that look to be consistent or are consistent with what you previously announced, could you talk a little bit more about – you mentioned that there was going to need to be some investments against those potential cost savings and contract adjustments. And is there any kind of metrics that you can give us as we look out? You've already given guidance for this year, so implicit within that presumably is the variance between the cost savings and what the potential benefits are to the bottom line? But could you give us some help on how to think about that as we look out over the following year?

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

A

Sure. So one, I'll just make the point that we have dissynergies this year that we believe will be about $60 million for setting up the corporate functions that offset the savings. We do need to make investments in our sales force, in our platforms, in our IT infrastructure, in our employees to a certain extent, and those investments started in Q1 and they'll ramp as we go through this year. The portfolio decisions that we're also talking about create some near-term pressure on profitability, because we have to take additional cost actions to take overhead costs out as we run off some businesses.

So, those are the dynamics that we're seeing this year. As we get into next year, obviously, the dissynergies are part of our run rate, and we will continue to make investments in those same areas and we'll see flow through and again our long-term guidance hasn't changed. We believe adjusted EBITDA will be greater than 10% growth next year.

Keith Frances Bachman
Analyst, BMO Capital Markets (United States)

Q

All right. Fair enough. Many thanks.

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

Thank you.

Operator: And the next question comes from Shannon Cross of Cross Research.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Thank you very much for taking my question. The first one is, can we talk a little bit about what you're seeing in terms of your verticals and maybe specific customer bases within those – within the segments? I know you noted Transportation was strong but State & Local was weak, and I think Government Healthcare as well, which I think probably makes some sense. But I'm just kind of curious as to what you're hearing from your customer base in terms of how they're looking at signing deals? And also what they're thinking about in terms of deal length? You said customers are kind of shifting to shorter deals, which that's your strategy, but I'm curious, is that across the board or is that with the specific customers? And then I have a follow-up. Thank you.

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

Okay. Yeah. So, in terms of – let me break this down in terms of our performance in ARR and NRR, so that'll give you a better picture of how the segments themselves or the sub-segments themselves are performing. The banking, insurance and capital markets sub-segment is actually performing very strongly in ARR terms. Our high-tech industrial and retail businesses have performed very well, in that specifically high-tech business has performed very well. If I look at the NRR business, which is typically where the Public Sector has a better performance over the Commercial sector, we've seen good performance in Healthcare, we've seen good performance in State & Local along with our Transportation business, which quarter-on-quarter has performed fairly well.

The one stand out for us in the NRR part is our Healthcare Payer, which is part of the Commercial business, which has also turned in a fairly strong performance. So across the board, we've had good performance with a few exceptions, especially the Comms & Media business, which has not – which continues to sort of underperform quite significantly as compared to the rest of the businesses, but that is also because it's very, very strongly supported by customer experience, which we still have some ways to go before we turn that around.

With regards to tenure of deals, I think along with our strategy to sort of make the tenure of the deals smaller and drive maybe renewal rates higher as these turn. So, in the Commercial space, it was typically three to four years in the past. We are now driving more towards two to three years. That is being reciprocated by the clients as well. This is not just about customer experience. In fact, outside of customer experience, we are seeing tenures – deal tenures come down. The Public Sector continues to be where it always has been, five years and beyond. But clearly in the Commercial space, we are beginning to see, as the usage of platform increases, as the usage of more of the analytic work increases, or our share of that increases, the tenure of the deals is becoming shorter.

Shannon S. Cross
Analyst, Cross Research LLC
Q

Okay. Thank you. That was very helpful. And then in terms of EBITDA for this year, I'm just trying to understand, given you're ahead of plan and I understand some of the benefit from a segment margin perspective was D&A, but given that it seems like you're heading and things are progressing in certain segments and you held to the full year for transformation, do you think you're being conservative or was the sort of the EBITDA 5% to 6% growth, which I understand is sort of in line but maybe tightened a little bit? Is that more a reflection of maybe a little more revenue pressure? I'm just trying to understand, because if you're walking away from unprofitable contracts or low-profitability contracts, do you think maybe you'd see a little benefit so? Thank you.

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

A

Yeah. So the dynamics I would point out is the Other segment is improving but some of it, as you said, is D&A and again, that can be lumpy as we go throughout the year as we run off the Education business and as we work to improve the Health Enterprise business. The transformation savings are tracking and that's good, and we do have the dissynergies that are offsetting some of those savings. Also, the portfolio dynamics as we run off certain aspects of the portfolio, even though they're low margin in a lot of cases, it creates pressure on the overhead cost structure, which we have to address and which we will address, but that's a timing issue as we do that. And then we do need to ramp our investments. The 5% to 6% is how we see it based on the forecasts that are coming in, and if we need to change the range as we go throughout the year, we will do that appropriately.

Operator: And our next question comes from Frank Atkins of SunTrust.

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

Q

Thanks for taking my questions. I want to ask a little bit about public company costs and the impact to the P&L going forward and investments in kind of systems to give you visibility on operating metrics. When will you lap that? And what's the impact of that over this year?

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

A

So corporate dissynergies, we're expecting them to be $60 million this year compared to about $10 million last year, so it's $50 million incremental. We had about $17 million in Q1, as we had some IT costs that, where we had double costs as we were transitioning off TSAs and then transitioning onto our own systems. We expect those IT costs to come down as we go quarter by quarter. But that's how we see it. And then as we get into next year, it'll be normalized. And at the same time, we are attacking these corporate functions, finance, HR. You know the non-corporate parts of the function we're attacking them to become more efficient to automate processes. So, it's not just the fact that we have dissynergy that we have to deal with, but we're also looking to modernize the functions and reduce the cost of the functions.

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

Q

Okay. Great.

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

A

And then from a systems' perspective, business intelligence is very important. We've started ramping those investments, and we will see those ramp this year, but that's well underway and in progress. Some of the more infrastructure, data center transformation, IT infrastructure information, that's mostly ahead of us at this point.

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

Q

Okay. Great. And for my follow-up, I wanted to ask a little bit about some of those operating metrics as you're taking a look at them. Where do you see kind of utilization, attrition and the trajectory of some of those going throughout the year? And if you could comment briefly on the wage environment in the U.S. and what the tighter labor market they means for that?

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

A

Yeah. So in terms of attrition, we had about 6,000 people decline in Q1 over the previous year. So that is a combination of voluntary as well as involuntary attrition. We clearly are an organization that is structured from a people and an organizational design perspective, not as a services company. And as we approach that, we'll probably continue to see some more optimization and streamlining of the various resources that we have.

As a function of the reduction of the geographic footprint, we will continue to see some attrition, involuntary attrition happen. As we drive more of our business onto platforms, and given the investments that we are seeing in our automation business and the reception that it's getting in the marketplace and the uptick it's getting, we again expect to see some amount of attrition from a people perspective, as we drive more automation into the business.

From a wage perspective, we are continuing to see the standard wage increases we have seen last year. Nothing extraordinary out of that. But as we are hiring more and more people to drive more of our analytics, more of our mobility business, our wage structure is changing, only marginally at this point in time. We've hired – we continue to hire aggressively our sales people on a gross basis. That number is higher than last year. But on a net basis, it's lower, only because the churn in our sales team is quite extensive. We cannot continue to sell what we want to sell with the sales capability that we had in the past.

Altogether, I would say from a wage perspective, it's probably not changed very much. Our sales compensation structure has changed quite a bit in terms of the fact that we want to drive our sales people more towards revenue and the quality of the dollars. We have provided incentives for our management team in order to hit our strategic transformation goals. And all of that, though not directly in our financials at this point in time, will hit our financials of course based on the fact if we hit our target.

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

Q

Okay. Great. Thank you very much.

Operator: And this concludes our question-and-answer session. I would like to turn the conference back over to Ashok Vemuri, Conduent's CEO, for any closing remarks.

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

Yeah. Thank you, and thank you all for participating in our call. I think, in conclusion, I'd probably say that the first 90 days have been fairly exciting. We've stood up the corporation. Our management roster is now complete. We've hired our leadership team. We took the opportunity in the marketplace to re-price our Term Loan B. We're doing extensive portfolio analysis, whether it's contract remediation, whether it's changing the operating model to make it more services oriented, driving a higher degree of client centricity.

We are hiring sales people in the market that are focused towards delivering the appropriate yield for a services business. We're tightening the deal criteria. We're standing in front of our clients and proactively pushing our various solutions. We're focused with a dedicated team on our strategic transformation both on the go-to-market model as well as on the savings part of it. We have better visibility and business intelligence in terms of how our own company operates, how we take decisions, how we price deals, et cetera, and we're driving towards the culture of One Conduent.

So on the whole, I'd say the first 90 days have been extremely exciting. The team has really stood up to the test, and for us, now the job is to continue to sustain this performance in order to achieve the results that our constituents look forward from us. Thank you very much.

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