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Conduent, Inc. (CNDT)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Conduent Inc. Second Quarter 2017 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 now will turn the call over to Alan Katz. Please go ahead.

Alan Katz
Investor Relations, Conduent, Inc.

Good morning, ladies and gentlemen, and welcome to Conduent's second 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 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 the transcript later this week.

I'd like to note that we've added some new disclosures throughout the deck, including adjusted EBITDA by segment, details on signings by segment, pipeline information, and various SG&A and operational spend metrics. We've also added a modeling consideration slide in the appendix. For those of you building financial models on the company, hopefully you will find this new information helpful.

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 9, 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, everyone, and thanks for joining our second quarter earnings call. Together with Brian, I will cover our performance results and progress to transform Conduent into a profitable, predictable, sustainable and market-leading enterprise. This was a solid quarter for us. As you will see, we are getting traction from an aggressive plan, creating change across every facet of our company. Some of these changes are having an immediate financial benefit. Others will require more time. But we are encouraged by the progress we are making and, as a result, are reaffirming our full year guidance.

When we separated from Xerox six months ago, Conduent was an assortment of entities with an unfocused portfolio, redundant systems, inconsistent processes, and unreliable management information. Evolving to become a singular, highly focused company is fundamental to our performance improvement. In phase one, we have aggressively attacked internal issues and problem businesses with the fastest return on effort. External market-facing and client-related issues take more time to correct. But as evidenced by healthy signings progress, we are well on our way to sharpening our in-market execution.

Before I cover our results, I will briefly outline the elements of our transformation program. It is organized around five areas, which collectively cover our company end-to-end. First, our brand. Over time, Conduent will be a premium brand in the marketplace. Next, we must grow our footprint in major clients, increasing service line penetration for higher signings and revenue. Our people are our greatest source of competitive advantage. We must invest in our workforce and create a one Conduent culture. We must unify the sprawling and costly IT and real estate footprint that we inherited. Consolidation here is one of our highest near-term priorities. Finally, we will manage Conduent with consistent information, actionable business intelligence, and contemporary management tools. As I go through our financial results, I will share examples of progress in several of these areas today.

On slide three, we provide an overview of our performance for the quarter. Revenue declined, as expected, as a result of several factors. We are exiting unprofitable contracts as well as very small or low opportunity relationships. Some of our businesses saw lower volumes and in other cases, recently won deals are just ramping up. On the other hand, our signings growth and pipeline quality indicate healthy market interest and client demand for our offerings, validating a vertical domain-based go-to-market strategy. I will cover this in some detail on subsequent slides.

Our margins improved substantially, we are integrating and streamlining Conduent across all fronts, including real estate consolidation, vendor rationalization, business intelligence, rightsizing the workforce, and streamlining corporate functions. Our Other segment made significant progress this quarter, minimizing what has been a longstanding drag on our financials. We had one of our best Q2 free cash flow positions over the past few years due to our focus on working capital management and collections. Overall, we are pleased with our position coming through the first half.

Now let me share certain highlights from across the businesses. On slide four, I will review our performance by our three key segments. Our Commercial segment represents approximately 60% of our revenue. Here we provide a range of business process services, supporting large enterprise organizations. These include customer experience, human resource services, finance and accounting, procurement, print and mail operations, learning services, and benefits administration.

During the second quarter, revenue declined in Commercial, as anticipated, as we focused our relationship on the greatest opportunity and continued to strategically exit contracts lacking the proper financial and risk criteria. Margins were flat but continued to be pressured by underperformance in our customer experience business, stemming from a small number of large client relationships. Addressing these client relationships is a major focus area for us. Both contract remediation and competing in higher value segments are key to improving profitability. And we are making meaningful progress on that front.

In Public Sector, we are one of the largest players in public transportation and a major partner to state and local governments across the U.S. In the second quarter, Public Sector revenue declined as expected. Key factors included prior-year contract losses and decisions made around strategic non-renewals in Government Healthcare and in the State & Local business. Margins declined as a result of revenue pressure, platform investments, including new bid investments, and dis-synergy costs.

My key focus is to build a strong Conduent for the future. In both Commercial and Public, we had a very strong quarter in signings and pipeline. Annual recurring revenue signings grew 12% and 31% respectively. Later, I will go into more detail on the changes we have made to our go-to-market strategy supporting these positive trends.

Our third business is our Other segment comprised of our health enterprise and education businesses. We have put an intense focus here, given its disproportionate impairment on our financial performance relative to its size. Our progress in this business led to its substantial profit recovery and was a key factor in our overall margin improvement. Our businesses are consistently recognized for industry leadership, and this past quarter was no exception.

Examples include NelsonHall, recognizing Conduent for our leadership in learning services, customer management and client experience. Everest recognized us for leadership in banking, pharma, life sciences, and automation. Gartner placed us in their Magic Quadrant for Customer Management Contact Center, and one of our largest clients has recognized us for achieving the highest net promoter score among all of their customer experience partners.

Moving to slide five, our strategic transformation activities underpin our game plan to align Conduent's cost structure with the rest of industry. We are on track to deliver on our cost savings initiative of $700 million by the end of 2018. We have identified opportunities for improved efficiency throughout the organization and have a large pipeline of savings initiatives on which we are executing.

Almost half of these savings stem from our infrastructure, including real estate and IT. Savings in our Commercial business is the other major facet of this program, where we will capture benefits for improvements we are making to the customer experience business. Overall, we are pleased with the progress we are making here and expect to see increasing benefits from this work in subsequent quarters.

On slide six, I will go into more detail on our strategic transformation progress. As I have described previously, Conduent inherited a strolling, fragmented, and costly operational structure that restrained our execution and competitiveness. Aligning our cost structure and operational footprint with industry benchmark is foundational to our turnaround plan. We are getting our arms around this opportunity, and the results are starting to show.

Our SG&A is down 9% in the first half of 2017, and annual SG&A expense per employee is down 2%. We closed over 80 locations around the world, exited almost 100 leases, and will exit many more throughout the rest of the year. We're also streamlining our accounting systems, reducing legal entities, consolidating payroll and billing systems.

Conduent is becoming a leaner, more focused organization enabling greater agility and sharper market execution. Strategic transformation is essential to this first phase of our turnaround plan. Our progress to date combined with the pipeline of future projects are key factors in our confidence to reaffirm our guidance for the full year.

Moving to slide seven, I will cover the positive progress we are making in our signings and renewals. Understanding our signings picture requires evaluating the composition and quality, as well as the overall growth trend. On an overall basis, our signings were down versus a year ago. This was expected, given the several large renewals signed last year making for a difficult compare. But compared to the first quarter, however, signings were up significantly, over 30%, with new business TCV up 24% and renewals up 46%.

Within the base of business that we are targeting, our renewal rate of 89% reflects ongoing value to our clients within the margin, risk and performance parameters that we are targeting. Collectively, these results portray a healthy demand picture for our service line and are encouraging signs for revenue down the road.

There are several contextual points to consider when evaluating these results. We achieved these signings while simultaneously conducting an extensive cleanup of our opportunity pipeline, providing more confidence and accuracy in our demand situation. Whereas we are making extensive reductions in SG&A through our strategic transformation, our benchmarks indicate we are under-invested in sales and marketing. Over time, we have the opportunity to remix our SG&A to bring more resources for account support, demand creation, and reputation building.

Finally, we are building a sales management and culture fit for a competitive business process service company versus a manufacturing organization. This includes verticalized industry orientation and clear account ownership in line with our inch-wide, mile-deep selling approach. Over time, we are confident these new approaches and investments will drive additional benefits to our pipeline and TCV results.

Now let's take a closer look at our go-to market results on slide eight. As I have mentioned, we completely reset our go-to market model in the first half, and these efforts are beginning to pay off. On a rolling 12-month basis, total pipeline has grown to over $16 billion, with over $9 billion added in the first half of this year.

We had notable wins and renewals across the business, including winning one of the largest automated tolling contracts in the country, becoming the HR outsourcing partner for a large multinational financial institution, and landing a health and human services contract for one of the largest states in the U.S. These accomplishments stem from a range of changes we've made to our sales engine, including realigning our sales coverage and account ownership to a vertical industry orientation, deploying a new sales and commission plan, naming new commercial sector leadership, and driving a higher emphasis on offer training and account planning.

While overall sales head count on a net basis was flat this quarter, we are re-mixing our talent to support our higher value cross-selling approach. As a technology-led business services firm, innovation is a key differentiator. We are advantaged with an impressive patent portfolio and have received 20 patents since our launch as a new company. A notable addition last second quarter was a patent for new technology that automatically recognizes faces from low-resolution cameras. This innovation brings practical benefits across a range of industries and builds on our expertise in computer vision technologies.

We are also continually investing and improving our existing technology platforms to close key gaps with competition and ensure higher levels of client satisfaction. Examples include, our Midas hospital case management platform in use in almost half of U.S. hospitals will soon be available via the cloud for greater accessibility and flexibility. Our Vector tolling platform is now supporting all-electronic or cashless tolling across many of our clients, featuring our proprietary and industry-leading license plate character recognition. BenefitWallet, our market-leading health savings account solution, released many new brand enhancements, including new chip-enabled debit cards, a new mobile application, and a range of security enhancements, making it what we believe is the most secure HSA platform in the industry.

Now let's turn to slide nine for an update on our progress relative to the portfolio strategy review currently underway. We are evaluating the assets in our company from several dimensions, namely desirability, feasibility and viability. Many of our businesses meet all three of these criteria. Others meet some, but not all. We have more work ahead to fully complete this analysis, but so far, there are few conclusions that we are drawing.

There are certain businesses in our company we are defining as core. In these cases, we are well positioned, have scalable technology assets, and visibility to achieving or maintaining market leadership. We will be taking decisions around organic and inorganic actions as opportunities surface that are in line with our portfolio strategy. These actions will strengthen our capabilities in core businesses and create a tight focus around segments where we can create competitive advantage.

At this point, we are evaluating $250 million to $500 million of revenue for potential strategic actions. We will be keeping our stakeholders informed of any final decisions and actions made as we complete our portfolio assessment.

Before I hand over to Brian, I will recap our results with several observations. During the second quarter, we are gaining traction on our turnaround plan. Some of the actions we are taking yielded identifiable results this quarter. Others will yield benefits in future quarters. But across the board, we are successfully transforming Conduent while simultaneously driving greater interest in our offerings across our client base through enhanced cross-selling.

Our financial position is improving. Stronger margins and better cash position are creating the capacity we need to take the next round of actions, including some that are more strategic and longer term. While we have more work to do, we are pleased with our position after our first six months as a company. Every element of our organization is aligned to our transformation plan. The next level of our management team has internalized the changes we must make and are driving them through their respective teams.

We are well on our way to driving the much needed transformation of the company. I expect us to build momentum in the coming quarters such that we will meet the expectations of the various stakeholders to whom we are in service; our clients, employees, investors, and the communities in which we operate.

With that, Brian 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 on slide 11 with an overview of the Q2 financial results and a walk through the P&L. As Ashok discussed, revenue of nearly $1.5 billion was down 7% on both the reported and constant currency basis compared with Q2 2016. This was in line with our expectations.

The year-over-year revenue decline was driven by a lost business, lower volumes with some existing clients, pricing and strategic decisions. These factors were partially offset by the ramp of new business. In the quarter, approximately 50% of the year-over-year revenue decline was the result of strategic actions, including the wind down in New York MMIS and prior-year Government Healthcare losses. I'll note that the price pressure eased this quarter, as we have maintained price discipline during the last several months.

Gross margin was 16.2%, an improvement of 40 basis points versus the prior-year period, reflecting transformation-driven savings as well as improvement in the Other segment, partially offset by dis-synergies, investments and the impact of the revenue decline.

SG&A expenses declined by $17 million, also driven by strategic transformation, partially offset by corporate dis-synergies and investments. Dis-synergies were approximately $18 million in the quarter and $35 million in the first half of the year. Our current full year estimate for dis-synergies is approximately $65 million, slightly higher than our previous expectations, driven by higher IT transition costs. As a reminder, these costs include spend in IT and technology as well as corporate expenses such as setting up new HR, marketing and finance functions and public company costs. We have been investing in our people, platforms and internal systems. We have hired the talent that we need to lead the organization from both the functional and operational perspective. We're also investing in HR and finance support systems that will give us the data that we need to manage the business. And we have started making investments in our platforms. We expect these investments to ramp in the second half to improve our revenue trends.

At the same time, as Ashok discussed, we are continuing to work aggressively on reducing our G&A and overhead expense by focusing on streamlining our real estate footprint and corporate functions. We took significant actions late in Q2, which we expect will yield results in the second half of the year.

Q2 adjusted operating margin of 5.9% improved 110 basis points compared with the prior year, driven by the improvements in gross margin and SG&A. Adjusted EBITDA in the quarter was $157 million, up 6% year-over-year, with an adjusted EBITDA margin of 10.5%, a 130 basis point improvement over Q2 2016. While most of the improvement in profitability this quarter was driven by the Other segment, we expect to see greater flow-through of our cost actions in Q3 and Q4.

Moving below the operating margin line, restructuring cost increased by $13 million in the quarter, as we closed facilities and continued the process of rightsizing our workforce. Interest expense of $34 million increased $23 million year-over-year due to increased debt levels. In the quarter, we've recognized a gain from the sale of the former ACS headquarters in Dallas, which resulted in $24 million of income during Q2.

Our pre-tax loss was $11 million, $23 million better year-over-year, driven by the increase in operating income, lower separation costs, gain on sale of assets, and other net income, partially offset by higher interest expense and restructuring costs. Our adjusted tax rate in the quarter was 33.3%. I would note that in Q2 2016, we benefited from the release of a tax reserve.

GAAP net loss in the quarter was $4 million or $0.03 per share. Adjusted net income was $36 million, a decline of $27 million compared with last year, as operating margin expansion was offset by higher interest expense and a higher tax rate. Adjusted EPS was $0.16.

An overview of Commercial segment results is provided on slide 12. Q2 revenue declined 7% compared with the prior-year period, impacted by lost business, lower volumes from existing clients, and strategic exits, mostly in high tech, retail, industrial and healthcare payer spaces. Approximately 40% of the year-over-year decline in this segment was strategic. Segment margins were flat compared with Q2 2016, but profit declined by $3 million. Adjusted EBITDA was lower by $1 million, and our adjusted EBITDA margin increased 50 basis points compared with Q2 2016.

Our strategic transformation savings were offset by profit pressure in our customer experience offering, the overall revenue decline from existing clients, investments and dis-synergies. Customer experience remains a challenge in the segment and is not performing as well as we would like. The continued pressure is being driven primarily by a handful of large client relationships, which we are in the process of addressing. While we have made many steps in the right direction in the Commercial segment, there is still much work to be done. We will continue to work as quickly as possible to turn this segment around and are confident our efforts will begin to show results in the back half of the year.

Now on to the Public Sector segment results on slide 13. The revenue decline we experienced in Q2 was as we expected, driven by prior year contract losses in our Government Healthcare, State & Local, and Payments offerings. Given the longer cycle nature of his business, some of the revenue headwinds we are seeing now are attributable to actions and decisions taken as far back as two years ago.

In particular, this quarter, we're beginning to see the impact of prior year's strategic decisions on our Government Healthcare business, which is resulting in a revenue decline. The legacy Government Healthcare contracts tend to be a higher profit margin business. So we'll continue to see the impact of this revenue decline in our segment profit as our mix changes.

Our Transportation business remained steady with flat revenues this quarter, as new business ramp in e-tolling was offset by price declines. Compared with Q2 2016, segment profit and adjusted EBITDA were down $19 million and $21 million respectively, driven by a lost business in our Government Healthcare, State & Local, and Payment Services offerings; dis-synergies; and investments in our core offerings, including bid investments to go after some large transit deals.

We see margins in our Public Sector business stabilizing at Q2 levels with the potential for modest improvement by year-end. We'll continue to use multiple levers to improve profitability, including a level of investments that we make and additional actions we can take around cost.

Let's move to slide 14, which provides an overview of the Other segment, including our Health Enterprise and Education businesses. Revenue within our Other segment was $80 million in the quarter, a decline of 16% versus the prior-year period. This was largely driven by the New York MMIS contract, which declined by $15 million, and the continued runoff of our Education business. The discussions are ongoing with our client for the New York MMIS contract. We are working to conclude these discussions as quickly as possible.

Our team has been extremely focused on improving profitability in this segment. During the quarter, the Other segment lost $3 million, a solid improvement year-over-year although slightly more than the Q1 loss. Much of this improvement year-over-year was driven by two factors; reduction in the amount of remediation work in our student loan portfolio and operational improvements in the Health Enterprise business. The Education business made a profit of approximately $1 million and Health Enterprise business lost approximately $4 million in the quarter. Consistent with what we indicated last quarter, while we would expect some variability and profitability quarter-to-quarter, we remain on track to achieve breakeven for this segment in 2018.

Moving on to slide 15, cash flow improved significantly year-over-year, as we made a meaningful push in the quarter to drive operational focus and improved collections and payables. Cash flow from operations was $67 million in Q2 2017 versus a use of $61 million in Q2 2016. This improvement was largely driven by working capital.

Free cash flow was $69 million, which includes $33 million in proceeds from the sale of our Dallas site. Even excluding this item, free cash flow improved versus the use of $97 million in the prior-year period. We still expect the back half of the year to be stronger than the first half of the year in terms of cash generation, and we remain on track to achieve our unchanged full year target.

CapEx in the quarter was $27 million, down year-over-year, as our balance sheet investments have come down. Given the slower pace of CapEx in the first half, we would expect CapEx to be closer to 2% of revenue for the year. Cash flow from financing was a use of $19 million, which included the fees associated with the re-pricing of our Term Loan B in April.

Turning to slide 16, I'll provide an update on our capital structure. We saw about a $50 million pick-up in cash in Q2. At quarter end, we had $309 million of cash on the balance sheet and over $663 million available on our revolver. During the quarter, we did not make any additional drawdowns on our revolver and had $70 million outstanding at the end of the quarter. I'll note that we are fine-tuning our outlook on interest expense, given trends to-date, and now expect interest expense for the full year to be about $140 million versus $145 million previously.

As a reminder, in April, we re-priced our Term Loan B, which resulted in a 150 basis point reduction in the interest spread and elimination of the LIBOR floor. Our adjusted leverage ratio for the quarter was 2.8 turns. Our target ratio remains less than 2.5 turns, which we expect to achieve over time through mandatory debt payments and improved profitability.

Now let's move to slide 17. Before I close, I want to reiterate our 2017 guidance we offered on our last earnings call. We still expect 2017 revenue to decline between 4.5% and 6.5% for the year. We expect to deliver adjusted EBITDA growth of between 5% and 6%, and we expect that 20% to 30% of adjusted EBITDA will flow through to free cash flow.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] And the first question comes from Shannon Cross with Cross Research.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you very much for taking my question. I'm curious, when we think about what's going on in terms of your Other segment and the recurring nature of some of the cost savings that you have there, can you talk about as you think most of what you've done there is recurring and we should see it in future quarters or if there were some one-timers during the quarter we should take into account? Thank you.

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

A

So, Shannon, this is Brian. The Other segment is improving, in line with what we're driving in both the Education space and the Health Enterprise space. There were no one-time improvements in the quarter. Having said that, there could be some lumpiness as we run off the Education business, and as we stabilize the Health Enterprise business, there could be lumpiness, but there were no one-time items and we expect to see continued progress in the second half.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Okay. Great. And then, when you think about the revenue that you're looking at for divestiture, the $250 million to $500 million, can you give us some idea of sort of what the parameters were that led you to think you move away from those businesses? Are they predominantly loss-making? Are they no-growth? I'm just kind of curious as to how – as you've gone through your pruning, what specific things you focused on?

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

A

Yes. Shannon, this is Ashok. So we basically used the lens of desirability, feasibility and viability. And by that, I mean, does the business have a growth potential? Is it addressing any whitespaces or what the size of the market is? Is there a differentiation or disruption that we bring to the table? Do we have the appropriate IT and talent and technology? That's the desirability lens. The feasibility lens is, what are the investments that are required to make it current or to make it competitive? Should we build more of this or should we buy what the technology product landscape and operating model are? And from a viability perspective, is that business a profitable, is it a predictable, sustainable business with healthy cash flows?

So we've looked at the – all our businesses, and you'll recall that we're made up of multiple companies that have been acquired over a period of time. So we have looked at each of these businesses to determine also apart from these three lenses, if there is a common golden thread that runs through them. And if it does not, then we obviously put that into a bucket where we believe that it should probably not be part of our go-forward business model. The financials of these -

Shannon S. Cross
Analyst, Cross Research LLC

Q

Sorry, go ahead. Sorry.

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

A

The financials of these business range, some are not profitable, some have a profitability characteristic similar to that of the company overall.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thanks. I was just going to ask, can you talk about whether or not you've sort of identified potential acquirer to these businesses or if you're still sort of in the, I guess, determining stage?

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

A

So we are in the determining stage. We've taken one action on one of our business, which is the global mobility or relocation business, which was a very negative margin business. But as we are identifying the businesses and identifying the nature of the transaction we need to do, we are obviously getting a lot more active on that front.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you.

Operator: Thank you. And the next question comes from Puneet Jain with JPMorgan.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Hey. Thanks for taking my question, and thanks for disclosures in the presentation. Let me ask about Public Sector business, which came in a little bit below in margins and revenue growth compared to what we were expecting. So understand margin impact from weakness in GHS, but can this business's margins improve in second half and pick up the slack if Other segment mean reverses?

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

A

Yes. So our view is that the pressure on the Public Sector margin will remain in Q3 and Q4, and we expect it to stabilize at the Q2 level. I'll note that the margin is still 15.4%, which is at the company's long-term overall adjusted EBITDA margin target. However, we do want to make progress in all segments over time. But given the revenue dynamics in government healthcare, given the investments we're making which are important for the transportation business as we go after large deals, we want to make sure we continue to be positioned well there. We expect the margins to stabilize at the current levels right now.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. And your revenue growth for first half is running somewhat below the guided range. Going forward, do you expect trends to improve from easier comps or strong bookings over last two quarters could begin to contribute in some way?

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

A

Yes. So, in Q3, we expect to see the decline moderate as we lap some of the strategic decisions we made, especially in the Commercial business in the prior year. And in Q4, we have an easier comp with the New York MMIS write-off. So between those two things, we have a line of sight through improvements Q3 to Q4.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

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

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

Q

Hi, good morning, and thank you for taking the questions. Brian, I was – well, I guess either Brian or Ashok, I was wondering if I could ask about the renewals. How are pricing and margins for those renewals? What kind of – maybe if you could give us some color on the businesses there? Were those – were there underperforming businesses in those segments where you anticipate you might get incremental margin improvement going forward because of better use of automation and so forth, or was this – maybe just a little bit of detail on the contracts there. And then I have a follow-up.

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

A

Yes. So I would say pricing has been stable. If I look at the past six months, and we've seen less of an impact on revenue from pricing than we have in previous years, some of our renewals are coming actually at higher prices as we go through contract remediation. And then others have the typical price balance. We typically deal with it renewal time. But I would say pricing is definitely better than in previous years given the remediation effort.

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

Q

Got it. And then maybe if you could highlight progress with the sales force, I know that no last time we spoke, the head count was relatively flat where you had some churn and mix shift more towards where you kind of trying to strategically align the sales force. Maybe an update there in terms of – since the beginning of the year how much churn have you had? And then do you still anticipate growing the sales force to kind of that 360 level at some point in near future?

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

A

Yes. So on the sales force, on a net basis, at the end of Q2, we are still relatively unchanged. We've added about 18 new salespeople in the last 90 days and lost about the same number actually, actually 20 salespeople, which we had to churn out. So, though the hiring is happening, so it's about two salespeople joined every week, it takes a little time for them to ramp up.

We're also driving – we're trying to get more people from the industry aligned with our industry vertical and domain-focused BPO. But that is not a situation that is necessarily where we want to be. So we still have our target of growing that by 20%. We're finding the right talent, but we're also having to very aggressively churn out the talent that will not necessarily align with our go-to-market model.

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

Q

Okay. Helpful. Thank you very much.

Operator: Thank you. And the next question comes from Keith Bachman of Bank of Montreal.

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

Q

Thanks very much. I have two questions if I could. The first is, the EBITDA – the adjusted EBITDA performance this year so far has been entirely driven by the Other segment, whereas the Commercial segment is still lower dollar profits. I know revenue hurts a little bit, and certainly the same for Public. You mentioned that cost actions will take hold in the second half of the year. Would you expect a more even contribution as you look at – or more evenly distributed contribution of EBITDA growth as you look at the back half of the year or the Other segment continue to be the driver?

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

A

I would say the Other segment will continue to do better year-over-year in Q3 and Q4. Public Sector will stabilize at the margin we saw in Q2. And then, Commercial, we expect to make progress on the Commercial margin, as we do restructuring, as we address the customer experience issues that haven't yielded yet. We saw the handful of large clients in the customer experience area that are actually dragging profits down year-over-year and quarter-over-quarter more than they did last year. And so, as we address those, we expect to benefit from customer experience as well.

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

Q

Okay. Fair enough. Then my follow-up relates to that is, I think in the press release and also in the prepared remarks you mentioned the call center business was proving to be a bit more challenging than you had anticipated. Is it still your view that this is a business that you can fix, so to speak, or improve the profit margins? In other words, is this still an asset that investors should be thinking about being part of Conduent on a go-forward basis?

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

A

So, Keith, the way I'd address that is we have actually looked at our entire customer experience business, both in the Commercial sector as well as in the Public Sector. In the Public Sector, our customer experience business has comingled or it's integrated into our overall value proposition. And the financial performance and the use of technology is much better. So the productivity numbers are much better.

On the Commercial side, by and large the customer experience business is fairly profitable, where we have a few select accounts and contract therein, which are old contracts they have been – the contracts have been written in such a way that that gives us very little leverage, and its performance is very poor. We've isolated them, we've identified the action items around that, got our arms around it, are in front of the client in terms of discussions, have had a few successes, few successes, but by and large, we believe the remediation of that will take a longer period of time.

So, on a net basis, customer experience is going to continue to be an integral part of the value proposition that Conduent brings to the table from an end-to-end perspective, but there are a few select large accounts and businesses therein where the contract structure is extremely complex, which we are addressing and some we have addressed, but the results of that will take longer to fructify than some of the other actions that we have taken.

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

Q

Okay. Helpful. Many thanks and best of luck to you.

Operator: Thank you. And the next question comes from Jim Suva with Citigroup.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much, especially for the details thus far. When we think about your plans to do the strategic reviews of the business, how much so far have you already completed? Because in Q1, you talked about the New York contract. In Q2, you talked [indiscernible] (42:29). So can you give us a grasp on how much has been completed thus far?

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

A

Yes. So, obviously, we made the New York decision in Q1, and then in Q2, we talked about small accounts in runoff businesses that would have about a point to point-and-a-half impact on revenue this year. We now see the runoff businesses impacting revenue at about a point for this year. And then, right now, we're looking at the rest of the portfolio, determining what's core and non-core and looking to divest, in some cases, the non-core, and that's where we give the range of $200 million to $500 million of businesses that are under consideration for divestiture. So that's where we are.

We'll provide more color on the process as we get ready to do transactions. And at that point, we'll update any guidance impacts that we'll have. But as we come into the next quarter, there should be more clarity around core and non-core. And we continue to talk about some core businesses such as transportation, HR, outsourcing, our workers' comp business, our compliance and financial services businesses. We've talked about those as core, and we continue to believe that they're core.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Great. And then my follow-up question is, for the ones that you talk about as core and the ones that are working you continue to believe is core, is it fair to assume again those you've already vetted and assessed and have put those in the bucket of keeping or you're still more due diligent for the strategic review even with some of those?

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

A

I think for the time being, we are – in that we have our hands around the number of assets that we believe we need to evaluate to see if they are core or non-core. I think at this point in time, we'll take a pause before adding anything new to that bucket.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you so much for the details and clarifications. It's greatly appreciated. Thank you.

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

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

Q

Thanks for taking my question. First, I wanted to ask about new business signings. What are some of the areas you're seeing there? I guess you mentioned some large transit deals out there, but more generally, what are you doing to ensure kind of high-quality by client and higher levels of profitability going forward in your new work?

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

A

Yes. So in these sectors, we are actually finding a lot of traction in the banking, insurance and capital markets business. I think that's been an area that's not been very strong for us. So we're finding good traction on that, especially in the compliance area, in the workers' compensation area. We're finding good traction in the payer business. We're finding good traction in the high-tech space. We're seeing good traction in our transportation business.

Obviously, there are a few large deals that are out in the market. We are not an incumbent in any one of them. We believe we are well positioned to be able to compete aggressively on a few of them that we think that would be profitable. Of course, we are continuing to hold ourselves accountable to profitable deals. We are not necessarily interested in long tenure. Of course, from a transportation and public sector, that's an exception. And we are focused on the industries where we believe we have an advantage. The delivery of these services, we are going to use the global delivery model more and more in order to drive higher degrees of productivity and profitability.

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

Q

Okay. That's helpful. Just a quick numbers question. What is the average contract length? And do you have a view or a bias as to where that should go?

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

A

Yes. So it's 3.5 to 4 with Public Sector being longer and Commercial typically being shorter. And we would expect it to probably be stable in Public Sector and maybe come down a little bit in Commercial, but overall it'd be stable.

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

Q

Okay. Great. And can you update us where we stand in terms of kind of the percentage of contract remediation efforts, where you guys are in terms of time horizon?

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

A

So we are – in terms of remediation, if I look at this quarter number as a proxy that we are using is what we call self-inflicted in terms of our renewals. So, about, overall for the company, 50% of the losses were self-inflicted, about 40% in the Commercial space and about 25% in the Public Sector space. We think we are progressing well on the remediation overall.

I think we need to do a little more work on our customer experience, only because these contracts were written a long time ago and they are highly unfavorable to us and very large from a client perspective. So we have – as I said, we've isolated that to the sector and to the contract and to the client, and we are in active conversations with them. We cannot afford to necessarily be too aggressive about it because we have other businesses aligned to that client, but that is an area of intense focus to us and we will continue to work on that.

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

Q

Okay. Great. Thank you very much.

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

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi, good morning. Thank you. Just a follow-up there on the customer experience progress. [ph] Did you just quote (48:07) how many of the contracts you've actually renegotiated, really how many more you need to renegotiate there? I'm just trying to get a sense of what share of the Commercial and Public segment currently represent and where you expect that to trend over the year?

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

A

So we haven't disclosed the exact numbers, but we have successfully remediated and renegotiated some customer experience contracts. We've exited others. And then there is the handful of that we discussed that we're still actively working. So that's how to think about it. A lot of it's behind us, but there are a handful of large clients we're actively working.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. And then on the pipeline, any notable differences in the pipeline versus your existing business or versus your recent new business signings? Just any further color on quality and composition across segment mix?

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

A

Yes. So for one, we've cleaned up our pipeline right in January – December-January timeframe last year and early this year, we cleaned up the pipeline. Our focus is to reduce the tenure of the deals to the point that Brian made, we're fairly comfortable with 3.5 years to 4 years, but we had a lot of deals in our pipeline, which were 10 years, 20 years, which is not an area of comfort for us. [ph] Intellect (49:19) public sector deals will go there. Our pipeline – the pipeline looks fairly decent from where in terms of meeting our expectations for revenue, et cetera. It's the conversion that we have to focus on.

We're beginning to see – beginning to get invited to a lot more of, what I would say, non-traditional BPO. We're seeing a lot more of the analytics business. One of the reasons we believe that customer experience will continue to be a core part of our business is because that's an area where we collect a lot of data, which we can put an envelope of analytics capability.

We're seeing a lot more cloud. For example, our Midas platform is now being – the accessibility for that is now required on cloud. So we're moving that. We just came out with our facial recognition technology. We've not seen any traction with necessarily on revenue of a lot of conversations around it. We think we'll be able to monetize that. So the nature of some of these deals is changing, but the bulk of it continues to be a BPO, essentially highly scalable repeatable businesses more so than we have seen in the past because that's a sweet spot for us and that's our focus area.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. Last one for me. Just what were the net transformation savings to-date and then the business reinvestment level and really any changes in the mix toward your targets?

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

A

Yes. So the 4/30 target, cumulative target for this year, we're on-track too. The actions we took in Q2 get us to be on-track to that target. Business reinvestment is increasing and we're starting to ramp investments, and we'll be focused on platform investments in the second half around our core areas to better position us. So things are progressing in line with our expectations and with our guidance.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. Thank you.

Operator: Thank you. And as that was the last question, I would like to return the call to Ashok Vemuri, CEO, for any closing remarks.

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

Thank you. So – we attempted to provide additional disclosure, as we had promised. We continue to look for feedback from you in terms of what you would like to see or hear. But the attempt is to remove the estimated way of information between what we are seeing and what we are talking to you about. We believe that – maybe I strongly believe that we have a management team that has fully internalized the transformation agenda. And I think we are beginning to see the impact of their efforts in the results. We have to obviously continue to keep up the efforts that we have made, but I think we're off to a start. Thank you very much.

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