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Conduent, Inc. (CNDT)

Q4 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Conduent Fourth Quarter and Full Year 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, Vice President of Investor Relations. Please go ahead, sir.

Alan Katz

Vice President, Investor Relations, Conduent, Inc.

Good morning, ladies and gentlemen, and welcome to Conduent's fourth quarter and full year 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 a transcript later this week.

During this call, Conduent executives may make comments that contain certain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995 that by their nature address matters that are in the future and are uncertain. These statements reflect management's current beliefs, assumptions and expectations as of today, February 21, 2018, and are subject to a number of factors that may cause actual results to differ materially from those statements. Information concerning these factors is included in Conduent's annual report on Form 10-K filed with the SEC.

We do not intend to update these forward-looking statements as a result of new information or future events or developments except as required by law. The information presented today includes non-GAAP financial measures. Because these measures are not calculated in accordance with U.S. GAAP, they should be viewed in addition to and not as a substitute for the company's reported results prepared in accordance with U.S. GAAP.

For more information regarding the 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 Q4 and full year earnings call. During our prepared remarks, Brian and I will cover our financial and operational performance and highlight the progress we are making to transform Conduent into a profitable, predictable, sustainable and growth-oriented enterprise. We will also provide our outlook for 2018.

Last year, we launched Conduent to deliver significant value to our shareholders, clients, employees, and partners. We positioned our company to be more unified, focused, agile and better positioned to win in the markets where we compete. Our 2017 results are in line with our expectations following our first full year. In some areas, we exceeded our own expectations creating a sense of momentum and confidence for what lies ahead.

We would not have been able to complete our first year so successfully without the support of many stakeholders. I'd like to thank my management team and all Conduent employees for their hard work and resilience, our clients for their continued trust and confidence, and our business partners for their continued support during a year of tremendous change and accomplishment.

Slide 3 provides an overview of our results for the year. In terms of our operational performance, we met or exceeded our goals for the year, and early results from our strategic changes indicate we are on the right path. Here are some highlights. Our revenue declined 6% in line with what we projected for our first year. But when evaluating this result, it is important to view it from the perspective of our inherited history and the change we are making to our go-to-market strategy.

Prior to the spin-off, revenue had been on the decline for many years. We inherited an opportunity pipeline comprised of low margin, single service line deals with weak underlying technology. Deal structures were inconsistent and with limited opportunity for upsell or cross-sell. We knew reversing this revenue trajectory would not happen immediately. In fact, our first strategic actions to create more focus would actually constrain revenue opportunity in the short term. We sold businesses, exited countries, and ended over a 1,000 client relationships. We raised the standard for deal qualification both in the content of the transaction and the financial return.

Intentional actions like these contributed to 50% of our revenue declined last year. During the fourth quarter, these strategic decisions drove 100% of the revenue decline in our commercial sector. Given these extensive year one actions, we are pleased with our ability to deliver revenue within our guidance while laying the groundwork for our future, as well as our ability to sustain a $13 billion sales pipeline while improving its quality and composition.

Given this progress, we entered 2018 with the confidence that we are on the right path to generate profitable growth as we come through this year. Looking now at our operational performance last year, we made significant progress that has improved the financial capacity of the company. Operating margins improved 140 basis points and adjusted EBITDA grew 6%. This is above the high end of our initial guidance normalizing for divestitures. Our adjusted EBITDA margin exceeded 11.2%, an increase of 140 basis points. In addition, we generated $204 million of free cash flow, above the high end of our guidance range, and ended the year with around $300 million on our balance sheet available for investments including acquisitions.

Our Commercial business made significant improvement in profitability last year. Full year segment margin increased 110 basis points. Troubled contract remediation has been a key focus for improving results. We have successfully remediated five of six major customer experience contracts last year and expect to finalize the sixth within the next three months. As we streamlined our portfolio, we created a clearer definition of what we consider to be our core business and took decisions to action our non-core. We completed five divestitures in 2017 and have several more in process as we had outlined in previous earnings calls. We exited over 1,000 client relationships due to unfavorable terms and limited growth potential.

Underlying these financial results were extensive changes across every facet of our new company. These included our go-to-market model, our infrastructure, HR policies and performance management. We rightsized the workforce, while simultaneously attracting new talent. We consolidated over 50 independent units under one brand, while maintaining our client relationships and service levels. And with a high intensity focus on collections by our sales teams, we returned to a more healthy cash flow profile in 2017, ending the year at 30% of adjusted EBITDA, which was the high end of our guidance. This compares to having a negative free cash flow in 2016.

I'm now on slide 4. Consistent with what I have done on prior calls, I will share an update on our strategic transformation initiative, which targets delivering $700 million of cumulative cost savings through 2018. During 2017, we overachieved our transformation goals, exceeding our year-two target by $45 million. As a result, we have greater confidence in our ability to meet the three-year goal we had set for this initiative. We have a healthy pipeline of transformation initiatives and are executing through these very well.

Let me share a few areas contributing to our strong progress. First, our real estate. On previous calls, I have described the fragmented portfolio of businesses that we inherited. With these businesses came a sprawling, underutilized real estate portfolio, saddling our business with cost and unproductive assets. Since setting up Conduent, we have eliminated 123 locations or the equivalent of 25% of our total square footage. We are on our way to take out another 100.

In addition to real estate, we are driving a comprehensive initiative to consolidate our IT and network infrastructure. In 2017, we addressed our sub-optimized IT-related workforce and vendor relationships. Next, we expect to see benefits from the platform rationalization work completed last year.

We're also driving a multiyear program, driving data center and network consolidation. We opened for business with over 100 data centers and 13 separate networks. We are on track to reduce these to less than a handful of data centers in a single network backbone for the company. I look forward to sharing our progress here in more detail on future calls.

We have also aggressively attacked our SG&A, reducing it to 10% of revenue for the quarter and 10.2% for the year, an improvement of 60 and 40 basis points, respectively. A range of actions across the company combined to help us achieve these kind of efficiencies, including streamlining our workforce, organizational realignment and process standardization, and importantly, an aggressive adoption of new technologies like automation and analytics.

While we were reducing SGA in total, we were simultaneously remixing our expenses in support of revenue growth. Historically, this business had underinvested in go-to-market functions like sales and marketing. We began rebuilding our selling engine last year. As I have described on previous calls, we reset our coverage model to be vertically oriented and an inch-wide and mile-deep.

Our net sales and engagement management head count increased by 35 last year, and we added an additional 15 in the first six weeks of this year. This will be a growing focus area for us as we look to bring more of our portfolio to our client base and increase our potential for pipeline, signings and revenue growth.

I am now on slide 5. Consistent with our philosophy of being a predictable, sustainable and profitable business, our next set of changes will be intentional and deliberate. Before I cover more of our 2017 results, let me contrast this coming year with the one we just completed. This slide creates a simple comparison based upon a few facets of our business.

For our financial plan, we intend to continue our strong margin performance, while improving the revenue trajectory of our core business with a goal of turning positive by year-end. In 2017, margin improvements were led by our transformation work. Going forward, margin expansion will come from a combination of both transformation and delivery efficiency. We expect continued strong cash conversion through high focus on conversion and DSO improvement.

In terms of our portfolio, 2017 was focused on clarifying our sources of value creation and defining our core. In 2018, we will sharpen this distinction through additional divestitures of non-core businesses and by acting on potential acquisition targets and new technology investments to modernize our core assets. We will also amplify our core, infusing it with the latest technology and fueling it with a sales engine that can drive value creation with our clients.

We continue to build our capabilities as a technology company. During our first year, we needed to inventory and rationalize our technology portfolio. Starting 2018, we've begin our work to modernize our offerings with cutting-edge technology, supported with an almost $200 million multiyear investment program. As a services company, our people are the heart of our business, and over time, our goal is to make Conduent a preferred place to work. We hope to attract the best talent in the industry.

That being said, our work model must become more contemporary and innovative. We require a global smart sourcing model that delivers the right work from the right locations, a concept we're calling accu-shoring. This allows our clients to benefit from our capabilities globally, 24 hours a day, and provides access to attractive talent pools at competitive cost structures.

Finally, last year, we introduced our new name to the market, but we have more work ahead to create a reputation. We're investing more in our marketing in 2018 for greater outreach across the industries we compete. We will focus on creating greater awareness in select segments about who we are and the value we create.

Slide 6. I will now briefly review the performance of our three segments, with two of our segments namely Commercial and Other segment showing particularly impressive results as we close out the year. In Commercial, revenue was down 7% as expected, again, driven heavily by strategic actions we took to improve our revenue quality. That work in addition to improved efficiencies, contract remediation and cross-selling led to significantly improved profitability. Margins improved 110 basis points year-on-year, and we exited the year even stronger, improving 160 basis points in the fourth quarter.

Our Public Sector business revenue declined 6%, in line with our expectations. Margins declined by 140 basis points year-on-year as a result of revenue pressure, but our exit margin of 12.4% showed an improving trajectory. Public Sector in many ways best exemplifies those characteristics we define as core. Technology platform solutions supported with a range of corresponding business services. We are well-positioned in this market segment, and it contains many attractive opportunities. Going forward, we will be targeting growing segments like transportation, payments and government healthcare for future growth.

In 2017, we called out the European market as a new focus of the organization. Our European business is advantaged with several large global clients, and we see an immediate opportunity to expand these relationships. In addition to dedicated leadership, client coverage and improved delivery, we expect to develop industry-specific solutions for this region over time. As I mentioned in my previous calls, we spend a considerable amount of time and effort in our Other segment to drive overall profit improvement.

Today, we're glad to report that it's a breakeven business. Driven by improved pricing and other contract improvements, adjusted EBITDA in our Other segment improved by approximately $70 million. Our decision last year to isolate these businesses as standalone unit paid off, as it created the focus we needed to address what had been a systemic drag on our results.

Moving to slide 7, I will share the progress we have made on signings, renewals and our sales pipeline in the most recent quarter. We are advantaged with a stellar client portfolio, representing some of the world's top brands as well as every state in the country. As we reimagine Conduent and strengthen our client relationships, we are seeing improved penetration and better cross-sell of our various service offerings in our client base. We signed over $1.7 billion in total business last quarter, up overall on a year-over-year basis. While fourth quarter renewals were a big factor, this growth illustrates growing momentum in our sales engine, stemming from our new client coverage model and greater cross and upselling.

Let me elaborate on this a bit more by looking at our new business TCV. We signed $683 million in new business last quarter, which is down from 2016. However, we have raised the bar significantly for the new businesses we are targeting. New opportunities must contain the right technology content and provide acceptable margins, and they must be contracted with terms and conditions more consistent with our aspirations and, thus, creating the right balance of risk and return.

Identifying and capturing these opportunities has required more than a shift to our verticalized structure. It requires new skills, content and relationships within our accounts. As an example in our consumer and media vertical, the percentage of customer experience business we have in our pipeline has declined from 80% at the start of 2017 to around 40% today. Providing customer support will always remain a component of our business services portfolio, but we're now bundling it as a component of a platform-based engagement versus providing it purely as a standalone service.

Renewals were exceptionally strong for the year, hitting 96% with large renewals within healthcare insurance, communications and media and industrial clients. This reflects not only our deep client relationships but stronger account management, new focus on higher value services and improved quality of delivery.

Our rolling 12-month pipeline indicates demand for our service lines is healthy. Total pipeline stands at approximately $13 billion. This is flat both quarter-over-quarter and year-over-year, but it is important to view this in the context of the strategic shift we took in year one. Some of these I mentioned at the beginning of the call when discussing our revenue performance.

We exited markets, we ended unprofitable client relationships, we shifted our pipeline composition from opportunities with high labor content to one with greater technology and software content at higher margins. And we refocused our sales and engagement management in a narrower set of high value markets and clients. Client feedback on our new more focused go-to-market strategy has been positive, and its benefits are showing up in some of the notable wins we had last quarter. Here are some examples.

We had two impressive new logo wins in our Public Sector business. One was a four-year contract with two one-year options with a large Midwestern state to verify that providers are eligible to deliver services to Medicaid eligible patients. The other was a new three-year contract, also with two one-year options with an independent non-profit organization to provide program information and support as well as speedier third-party eligibility determination.

This was a very successful quarter for wins in the commercial healthcare space with notable wins with two top five U.S. healthcare carriers. These deals included a multi-year extension to support member services, benefit eligibility, claims status inquiries, and fulfillment as well as a new five-year engagement and contract renewal in our multichannel services offering.

This positions Conduent as a preeminent provider of these services in the healthcare insurance industry. Three of the top four healthcare payers now rely on Conduent for their insurance member outbound communications. Lastly, we expanded our relationship with one of the largest brands in the pharmaceutical industry by winning a deal to manage their philanthropy programs, providing access to lifesaving medicines to patients who struggle to afford them.

Before I hand it over to Brian, let me share a few closing thoughts on our first year as an independent standalone company. I'm extremely proud of what we deliver in 2017. Financially, our performance was within guidance or exceeded the targets that we had set. Margins improved, cash flow was healthy and our balance sheet is in much better shape. At the same time, we made impressive progress towards transforming our company in almost every dimension, with every function and unit contributing in some way. Let me recap some of these. Some of which I've mentioned on previous earnings calls.

We have made significant progress turning around our Commercial business, aggressively remediated difficult client contracts, re-priced our Term Loan B twice, reducing our interest expense and improving our profitability and cash flow. We consolidated over 50 standalone company brands under a single umbrella. Reset our go-to-market model in support of broader service line penetration, consolidated our infrastructure for greater commonality and asset leverage, and finally, stood up in one Conduent way of running our company across management processes and decision making.

We are well on our path to building a single unified company that delivers market leading performance and a company with a single, clear, strategic threat that runs all the way through our core portfolio. I will talk more about that at the end of my presentation.

With that, I will turn it over to Brian to take us through the financials in more detail. Following Brian's remarks, I will take some additional comments about the way we're positioning Conduent in the marketplace. Then we'll take some Q&A.

Brian Webb-Walsh

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

Thank you, Ashok. Let's start on slide 9 with an overview of the fourth quarter financial results and a walk through the P&L. Revenue of just under $1.5 billion was down 1% as reported and 2% on a constant currency basis compared with Q4 2016. The year-over-year revenue decline was driven by strategic decisions, lost business, lower volumes from existing clients, and the impact from the Q3 divestitures. These factors were partially offset by the Q4 2016 revenue adjustment taken as a result of our decision to exit the New York MMIS contract as well as the ramp of new business.

Gross margin of 18.9% was an increase of over 10 percentage points versus the prior year, reflecting the impact from the New York MMIS charge taken in Q4 2016. Adjusted gross margin which removes the impact from New York MMIS was up about 100 basis points compared with the prior year period driven by our transformation program. SG&A was $21 million, lower year-over-year driven by strategic transformation, partially offset by corporate dis-synergies and investments. Dis-synergies were approximately $18 million in the quarter.

Q4 adjusted operating margin of 8.7% improved 190 basis points compared with the prior year driven by the operational improvements in adjusted gross margin and SG&A. Adjusted EBITDA in the quarter was $188 million, an increase of 9% year-over-year, while adjusted EBITDA margin improved 180 basis points to 12.6%, driven primarily by the improvement in our Commercial segment as a result of our transformation program as well as modest improvement in our Other segment.

Moving below the operating margin line, restructuring charges were $25 million as we continue to close facilities and reduce head count. Our pre-tax income in the fourth quarter was $4 million. When looking at the year-over-year improvement, remember that we had the impact of the goodwill impairment and the New York MMIS charge in 2016. GAAP net income in the quarter was $208 million or $0.98 per share on a fully diluted basis, driven by the revaluation of our deferred tax liabilities as a result of recent tax reform. I'll note this is a non-cash item, so only impacts the GAAP profitability.

Our adjusted tax rate in the quarter was 31.6% compared to 40.2% in the prior year period, primarily as a result of favorable tax adjustments that were realized in Q4. Adjusted net income was $67 million up $6 million compared with the prior period, as operating margin expansion and lower tax rate was partially offset by higher interest expense. Adjusted EPS was $0.31 in Q4, an increase of $0.02 compared with Q4 2016. Ashok went through some of the full year results, so I won't go through every line item, but will touch on some highlights.

I'm now on slide 10. Revenue of approximately $6 billion was down 6% on both the reported and constant currency basis compared with 2016. Dis-synergies were $73 million in the year in line with our expectations of the last call. 2017 adjusted operating margin was 6.9%, a 140-basis-point increase compared with the prior year driven by a significant cost takeout and improvements in our Other segment. Adjusted EBITDA was $672 million, an increase of 6% compared with last year, while adjusted EBITDA margin improved to 140 basis points to 11.2%.

I'll take a minute to highlight that we also achieved an 18% improvement in adjusted operating income. This is higher than the improvement in adjusted EBITDA. While we believe that both metrics are important to focus on, the over-performance in operating income was driven by lower depreciation and amortization in 2017. CapEx came in lower in 2017 compared with our historical run rates. Moving forward as we ramp investments, we would expect to see CapEx closer to 2.5% to 3% of revenue.

Moving below the operating margin line, restructuring costs were $101 million in 2017 as a result of closing facilities and rightsizing our workforce. This was slightly higher than the $95 million we expected on the Q3 call driven by continued progress on the transformation effort. As Ashok mentioned, we overachieved on our target for the year and are doing well in terms of real estate, which tends to account for a large portion of restructuring expenses. Full year adjusted net income was $186 million, while adjusted EPS was $0.85 both down year-over-year reflecting higher operating margin expansion more than offset by higher interest expense.

Turning to slide 11, I'll provide an overview of the Commercial segment results. Q4 revenue declined 5% compared with Q4 last year, impacted by strategic actions and lost business partially offset by new business ramp. Normalizing for the impact of the Q3 divestitures, revenue would have declined by about 4% year-over-year. Sequentially revenue grew more than 2% due to both seasonality and new business ramp. Normalizing for the divestitures, this would have been closer to a 4% increase.

Segment profit increased 42% year-over-year driven by cost improvements from strategic transformation, including the impact from our customer experience contract remediation efforts. Segment margin improved 260 basis points compared with Q4 2016, primarily driven by the same factors. Adjusted EBITDA in the segment increased 31% versus the prior year period, and adjusted EBITDA margin increased by 330 basis points.

Q4 tends to be seasonally strong quarter for our Commercial business given both open enrollment season and higher volumes from our travel, retail, and healthcare clients. The progress and profitability year-over-year is very encouraging and we're ending the year on a strong note. I'm pleased with the improvement that we have achieved in the segment in 2017.

Now, on the Public Sector segment results on slide 12. Revenue was down 7% compared with Q4 2016 and 1% sequentially as we continue to realize the impact of the contract losses for decisions made prior to 2017 that we discussed earlier this year within our government healthcare, state and local, and payments offerings.

Transportation revenues declined compared with Q4 2016 and were flat compared with last quarter as new business ramp offset lost business. Segment profit and adjusted EBITDA were down $10 million and $18 million, respectively, compared with Q4 2016, driven by the revenue decline, dis-synergies and investments in our core offerings. However, both metrics improved sequentially driven by the continued impact from the strategic transformation initiative. The sequential improvement is better than our expectations as of the last earnings call and points to the progress the team has made.

Moving on to slide 13, I'll provide an overview of the Other segment. Revenue within our Other segment was $74 million in the quarter. This was an increase of $70 million on a GAAP basis, as we had the impact of the revenue adjustment related to our New York MMIS contract in Q4 2016. On an adjusted basis, revenue declined $13 million year-over-year.

The Education business, which includes the Student Loan portfolio, lost approximately $1 million in the quarter and the Health Enterprise business made just under $4 million in the quarter. We have focused on improving profitability in this segment in 2017, and we achieved a $78 million segment profit improvement year-over-year. Given the progress that we've made in improving our Health Enterprise contracts, we now see these contracts as part of our core Government Healthcare business.

As a result beginning in Q1 2018, we'll move to Health Enterprise contracts into our Public Sector segment. Other will continue to have our Education business in it, which is in runoff. While this will obviously change the reported profitability for both the Public Sector and Other segments, it will reflect how we plan to run the business moving forward.

Slide 14 provides an overview of our cash flow in Q4 and for the full year. Cash flow from operations was $237 million in Q4 and $302 million for the full year. Adjusted free cash flow was $205 million in the quarter and $204 million for the full year. This compares with a use of cash of $81 million in 2016. We ended the year just above the top end of our guidance range for free cash flow. This was partially driven by the sale of the former ACS headquarters in Dallas as well as lower CapEx for the year, which came in at $132 million or just over 2% of revenue.

As I mentioned, we would expect CapEx, as a percent of revenue, to be closer to 2.5% to 3% in 2018 as we ramp investments to drive revenue growth. As I noted last quarter, most of the proceeds generated from the termination of our deferred compensation plan are yet to be disbursed and will be done so throughout 2018. This will ultimately flow through our operating cash flow and will be adjusted out of our reported free cash flow accordingly, as we did this quarter with the $70 million of payments that we have already made.

Turning to slide 15, I'll provide an overview of our capital structure. During Q4, cash increased to $559 million, excluding the $99 million that we'd expect to pay out related to the deferred compensation plan. This compares with $352 million at the end of last quarter. We have approximately $300 million of cash that we see available for reinvestment in the business for acquisitions.

I'll also note that our revolver, which has over $730 million of availability under our credit agreement, remains undrawn. We expect to raise additional cash in 2018 from future divestitures and would expect to use this either to repay debt or for future acquisitions. Given our adjusted EBITDA and growth in our cash balance, our adjusted net leverage ratio is at 2.2 turns, down from 2.6 turns last quarter. We are now below our target leverage ratio.

Before I close, I want to discuss our 2018 guidance. Please turn to slide 16. We have included a table highlighting some adjustments to items impacting the year-over-year results. In order to have a clean year-over-year comparison, we are removing the revenue, adjusted EBITDA and free cash flow impact from the divestitures that we closed in Q3 2017. Until we have a signed deal, we will wait to incorporate the impact from any additional divestitures or any acquisitions into our guidance.

In addition, like all companies in 2018, we'll be adopting the most recent accounting standards for revenue recognition. And on this table, we have highlighted the impact the new standard would have had on our 2017 actual results had this been in place. This provides you with an apples-to-apples comparison when looking at our year-over-year guidance. The major impacts from the change for us are no longer recognizing certain pass-through revenues, primarily postage, and changes in deferring certain revenue items.

As you can see, the accounting change will be an approximate $165 million negative driver on the revenue line and a $15 million impact to adjusted EBITDA. It'll have no impact to free cash flow. Given these adjustments, our 2018 guidance ranges are as follows. Compared with the $5.8 billion of revenue, we expect 2018 revenue to be flat to down 3% on a constant currency basis. For adjusted EBITDA compared with the $652 million, we expect growth of between 8% and 12% in 2018.

Let me spend a few minutes on the hydraulics driving the adjusted EBITDA from 2017 to 2018. In 2017, the two largest positive drivers in adjusted EBITDA growth were our transformation program and the improvement in our Other segment. One of the negative drivers was the $73 million in dis-synergies.

Looking at 2018, our year-over-year growth will be driven by our transformation initiative, including improvements in our customer care offering, where we see contract remediation benefits flowing through. Our Other segment, as currently constructed, should be largely breakeven and will not have additional dis-synergies. Both of these items should be relatively neutral to adjusted EBITDA in 2018.

We'll continue to make meaningful investments into the business in 2018, which will position us for growth over the longer term, but will also be an offset to other adjusted EBITDA positive growth drivers. Moving to free cash flow, we expect free cash flow to be between 25% and 35% of our 2018 adjusted EBITDA.

Before I hand the call back to Ashok, I want to spend a minute on the recent tax reform and how it could impact our tax rate moving forward. The lower corporate tax rate will be a benefit for us. However, given our global footprint and delivery model, there will be other tax provisions that will offset some of the benefit of the lower corporate rate such as the BEAT and GILTI tax provisions. Overall, we expect our 2018 adjusted tax rate to be between 30% and 35%.

I will now turn the call back to Ashok for some additional remarks.

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Thank you, Brian. Before we wrap up, I'd like to pick up on a discussion that began last quarter around the way we're describing our company. Many of you have asked for additional clarification for how to think about Conduent.

Looking at slide 18, you might remember this chart from last quarter. It is a depiction of our value chain. At the highest level, we manage essential aspects of our client operations, while engaging directly with the people they serve. We manage millions of interactions every day, 24x7, with patients, physicians, employees, customers and citizens. Across the full spectrum of the work we do whether it's procurement, finance and accounting, customer experience, workers' compensation, compliance or HR outsourcing, we work on behalf of our clients to manage data-intensive, repeatable, individualized trends, interactions happening at massive scale.

We support these digital interactions with a range of industry-specific, technology-based workflow and business process solutions from our core offerings. In each case, we are managing large amounts of data and personal information, and with each interaction those we serve expect these interactions to be seamless, personalized, intuitive and secure.

While our portfolio spans many segments, we are not simply in the tolling business, or HR outsourcing business or the payments business. We are not simply a business services company. We are in the business of helping our clients manage digital interactions with the people they serve, seamlessly, securely, personally and at massive scale. We are a digital interactions company. And as part of our next stage of work, we will undertake the important work of showcasing our assets, expertise and capabilities to demonstrate this distinctive positioning.

In closing, we are off to a solid start for our new company. We're improving our performance. Our balance sheet is healthier. We're executing against our transformation. We're making the right investments in our technology platforms and elevating our position as an essential participant in our client's value chain. And as a next step, we are honing a unique and differentiated positioning that captures our value simply and provocatively, digital interactions. These are the essential components for supporting our ambition to become a leader in our industry and ultimately over time a great company.

I'll open the call now for Q&A.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] At this time, we will pause momentarily to assemble our roster. And our first question today comes from Frank Atkins of SunTrust.

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

Thanks for taking my questions. First one would be on signings, can you talk about how much of the new signings is industry specific or has some sort of technology component? And then was there any one-time-ish impact in that signings number?

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

Yeah. So let me take that question. In Q3, we had mentioned that we had about $200 million of signings that skipped or missed the timeline by which we could have qualified them to be in Q3. So that's $200 million that slipped into Q4. In terms of most of the signings and business are a combination of technology and domain-based capabilities that we have built for our industry solutions or for our verticals.

So all of the new business that we are signing has to necessarily be a technology platform based either or has to be a software based and is a vertical solutions, or whether it's compliance in the financial services, whether it is a better outreach in the PBM market, whether it is more a sophisticated way of doing claims management in the payer space, et cetera. So these are all – the direction that we're moving in is to a more verticalized solution, which is of course technology and domain based.

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

Okay, great. And could you give us a quick update on head count mix by geography and how that's diversifying? And then also what do you see out there in terms of the labor environment and talent acquisition?

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

So maybe I'll start with the head count mix. Headcount, we ended the year at 90,000 employees versus 96,000 in 2016, and we do have a shift to lower cost geographies. Inside of that, we also have some in-sourcing that we've done on the technology side that's increasing our head count as we in-sourced some of the things we had previously outsourced.

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

A

On the talent part, I would say I mean the – we will operate out of locations and geographies where the availability of talent is there and it makes economic sense for us to do business. Clearly, as we are moving into a more sophisticated technology zone, we will be looking for talent both in the U.S. as well as outside the U.S. I think we're continuing to be challenged by being able to find that at scale. But this war for talent has been going on for a while, and we have to attract people based on the kind of value proposition that we want to create.

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

Q

Okay, great. Thank you very much.

Operator: The next question comes from Brian Essex of Morgan Stanley.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good morning, and thank you for taking the question. Maybe for you, Ashok, as you shift your strategy towards technology- and analytics-driven platform business, what percentage of your business right now would you consider platform and maybe what do you anticipate that reaching in the future? And then what is the margin profile of this business relative to the rest of the business that you have?

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

A

Yeah. So, Brian, the percentage of work that we deliver on platforms at this point in time is about 60% to 65%. So it's a fairly healthy and that's one part of our business that's actually we've been maniacally focused on and that's the one that we are driving. And that also interestingly is the one that's finding the most reception in our client base.

With regards to – obviously as we do more of work on platforms and from a – and the more software we deploy, the margin profile dramatically improves. We've not seen the benefit of that dramatic improvement as yet, but our focus is on to continue to drive that because we're talking about bundled services, low labor concentration or low labor utilization allowing us to reuse the platforms because these are multi-used platforms. So the idea here is that even though we're beginning only now to see some of the impact of the better margin performance as we deploy our software and platform, the expectation based on the deals that we have already signed and the deals that we're working on that that margin profile will definitely improve.

But from a delivery perspective at this point in time, between 60% to 65% of what we deliver is on platforms, but the efficiency of that, the multiuse of that, the fact that we need to bundle that better to provide seamless transactions at scale needs to get better, therefore, the investments that we're talking about in our technology platforms and infrastructure.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's helpful. And maybe to follow up, on the contracts that you've remediated, it seems as though that's at least kind of helped the bleeding a little bit. But how profitable can those contracts be going forward? And maybe remind us are these commodity contracts, are these higher value contracts. And how do we think about how this plays in your customer relationships if they are commodity contracts in terms of why you'd need to invest in those businesses?

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

A

So I'll start. The six contracts that we're remediating are standalone customer care contracts and they've been losing money. Even in the fourth quarter, they lost money, but they improved year-over-year. Now that we've remediated through today five of the six, we're going to start to see every quarter – we're expecting to see year-on-year improvements in 2018, and we expect by the middle of the year to get to breakeven or better on these group of contracts. And we're still working aggressively to remediate the six contracts, which we expect to have done over the next couple of quarters.

This is not part of what we're looking to divest in the $250 million to $500 million. We do have a lot of important big relationships here, where we do other offerings and have other offerings. But we'll continue to look at the portfolio and we'll make the best decisions for the company. So we continue to look at it.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

I guess what I was getting at those, is there a good rationale? I mean I understand that they're important relationships, but it seemed as though, in previous quarters, some of the comments around those contracts were that they were relatively commodity in nature. So is it – I guess the question would be, is it really that critical to hold onto them.

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

A

So some of them are commodity. So we have to take and look at every option that's available to us. I think the first way to look at this is to try and see if we can remediate them, make them much more efficient, drive a lot more automation and technology into it, and see how they perform. We have to remember that a lot of the experience business is bundled with other services. The end of the value chain in the digital interaction space is still the experience part of it.

Now, do we need to be picking up phone calls for all of these things? Maybe not. Are we shifting to chat? Are we shifting to web-based? Yes. Are we moving the whole experience part from a low end commodity based to a higher end? Yes. So we'll see how they perform. And as I said, none of the options are off the table. And we're very clear that we're not signing or interested in signing any deal which is a standalone experience business.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's helpful. Thank you.

Operator: And next we have a question from Shannon Cross of Cross Research.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you very much for taking my question. I was wondering, can you talk a bit about what leads you to see the improvement in revenue through the year? I understand that first half has been tough comp, because you divested revenue. But specifically, what are you hearing from your customers, what are you seeing in terms of signings that lead you to believe that you should be at an organic revenue growth rate by the end of the year? And then I have a follow-up. Thank you.

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

A

So if we look at the strategic decisions we took in 2017, as we go through the first half of 2018, we started to lap those decisions. So the first couple of quarters will be harder compares and then the compares get easier in the second half, and we'll also have new business that starts to ramp in the second half. So if you look at both Commercial and Public Sector, we'll have tougher compares Q1, Q2 and then they get easier and we'll see more new business come in the second half of the year.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Yeah, I agree. I'm just wondering what leads you to have comfort about the new business that's coming in. How much of that is sort of signed and in the pipeline at this point or how much is that is just based upon conversations you're having with potential customers?

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

A

Yeah. So a lot of what we're ramping and talking about is already signed, and there's a transportation deal, for example, in Public Sector that's going to go live in Q2. We expect transportation inside of Public Sector to grow in 2018. We have the Government Healthcare and payments contracts that have been running off. We'll lap those as we get through Q2. So you take a look at Public Sector, and we can see based on the new business that we've already signed plus the lapping of those other contracts, the revenue trend improving. Commercial, the same thing.

We've signed a lot of new business in Commercial in the last two quarters that will ramp. And again, a lot of the strategic decisions will be behind us. We continue to have a strong pipeline at $13 billion. We're very focused on the sales investments and driving in-year signings that deliver revenue, but we have a line of sight to a large portion of it.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Okay, great. Thank you. And then, my second question is just on use of cash. You talked about, especially with the divestitures, that you'd utilize cash for debt paydown or more acquisitions. How do you sort of balance the two and how are you thinking about acquisitions? You haven't done any obviously, you're trying to divest right now. But how are you sort of thinking about that in timing? Thank you.

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

A

Yeah. So we've specifically called out acquisitions because we do realize that there are gaps in our capabilities. There are adjacencies that we could expand into. We're not talking about big bang acquisitions, more tuck-in in the nature. And we've said that the acquisitions will actually be funded by conversion of EBITDA to free cash flow. Obviously, as we generate more cash with regard to divestitures, we will balance the opportunity for reducing debt vis-à-vis acquisitions. And we'll do this in a way that is both fair to our shareholders, as value creating for our shareholders, as well as that for the company.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you.

Operator: And our next question comes from Puneet Jain of JPMorgan.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Yeah. Hi. Good quarter, guys. So you are in the final year of your cost takeout program and the Other segment is also going to be breakeven this year. So how should we think about drivers of margin expansion and level of investments beyond this year? And then, as you move past restructuring payment, should we expect any change in your use of cash priorities from next year?

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

A

Yeah. So, on the first one, when we take a look at – what was the first question?

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Margin expansion and...

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

A

Yeah. Puneet, sorry.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

...level of investments beyond this year.

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

A

Yeah. So, margin expansion, as we look at this year, we have $225 million of incremental cost savings coming from the transformation program, and into the midpoint, we're calling $65 million of adjusted EBITDA expansion and the rest will be used for investments and other offsets as we need them. We have investments that are going to ramp in our technology platform investment. Ashok mentioned a $200 million three-year program. Part of that's CapEx, part of that's OpEx, so that'll take a lot of our investment. And then, we have to continue to make the go-to-market investments we talked about.

When we think about the long-term margin profile of the company, if you look at the midpoint of our guidance for 2018, we get to 12.6% margin roughly from a 9.8% margin that we started with in 2016. So we're halfway towards our long-term model of 15%. We'll continue in the out years to get margin improvement by pulling back on some of the investments eventually, by revenue growth and by takeout. There'll always be cost takeout even though the formal program will be over at the end of this year. We will always have cost takeout programs in place to drive margin expansion. And everything...

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

And...

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

A

Go ahead.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Go ahead.

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

A

I was just going to say, everything we see today, we are confident in our long-term model that we've been talking about.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

And should we expect change in use of cash, maybe capital returns could be on the table as we move past restructuring payments?

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

A

Yes. So, right now, we're focused on acquisitions and paying down debt, restructuring the business. Obviously, we're calling for $50 million to $75 million of restructuring in 2018, which is down from $100 million in 2017. So restructuring will be less of the cash use and it'll help us generate more free cash flow. When we get – we're really focused on the divestitures and paying down debt and acquisitions in 2018. As we get out to 2019, we'll have to see what makes the most sense for the company.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

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

A

Thank you.

Operator: So next we have a question from Bryan Bergin of Cowen.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi, guys. Good morning. Thank you. On the cumulative gross savings, you're currently ahead by $75 million. What's the potential there for outperforming that total savings target? And if you can, what are the areas that are most likely to drive that?

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

A

So we're ahead by $475 million, so we're ahead by...

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

A

$45 million.

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

A

...$45 million. And we're focused on over-achieving the whole program, but right now, we're confident we're on track for the $700 million. We believe that $225 million of incremental savings gives us what we need to drive the investments and the profitability improvement this year. And the areas that would overachieve, if we overachieve, would most likely be real estate, which Ashok talked about, and G&A. Those are areas that we've been very focused on. They've been overachieving up to this point and we stay focused on them.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. And then on signings, can you comment on the new business bookings trajectory, particularly within the Public Sector? And then just overall mix within the pipeline, can you just comment how that has changed?

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

A

Yeah. So in terms of our signings, we're fairly comfortable with the way that's progressed, renewals have been high, new business signings. I would actually say it's been sort of middling, but you have to remember that we have introduced a lot more stringent conditions in order for people to sign new business. That level of discipline and rigor has allowed us to improve the quality of the pipeline for sure, but then, of course, it's much tougher to get a deal approved past us. I would say that Commercial has obviously done extremely well because of how much of a laggard it was and we paid specific attention to it.

In the case of Public Sector, you have to remember that decisions that are taken a few years past, so a few decisions that were taken prior to 2016 has sort of – or losses that we had prior to 2016, the impact is being felt. Now that's the way the Public Sector business is. Longer term deals, sales cycle is longer. Feel very confident about how we're progressing in the transportation and the payments space, especially in the Public Sector space where we'll continue to concentrate.

In the Commercial space, clearly, we're seeing a huge amount of traction in the high-tech, in the retail and industry space. We're seeing transaction in the banking and insurance space. And I think the one call-out for us would be the entire payer space in Commercial, which is doing extremely well. We're beginning to see traction in Europe, but I think it'll take some amount of time before we actually see that ramp up as aggressively as the Commercial business in the U.S. is.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. Thank you.

Operator: The next question comes from Jim Suva of Citigroup.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thanks very much. I have a clarification question and that might be more appropriate for Brian, and then a more strategy question probably for Ashok. So, Brian, the clarification question is on the revenue guidance, I think it was minus $3 million to flat. Does that include the divestitures that you've identified? You mentioned during this call that you identified several more. Or would those be incremental, we need to take out? And I think on the last earnings call, you mentioned you identified about $250 million to $500 million. Where do we sit in the realm of – is that still the target, have they kind of been whittled away?

The strategy question...

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

A

Yes.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

...for Ashok is, Ashok, you'd mentioned you're a lot more disciplined, a lot more stringent to get deals approved with multifaceted profitability, and you're just not doing deals to win deals, that's very commemorable, and I think why your profitability is improving. But I wanted to ask is your criteria now at the industry average or above the industry average or was this just a catch-up or how can we think about the move to be more stringent and disciplined versus the rest of the industry? Thank you.

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

A

Okay. So, I'll start. The all additional divestitures, future divestures are not in our guidance, and when we close a deal, we'll update guidance and provide the information. We are still working $250 million to $500 million revenue to divest, and that is in process and we're working it as quickly as we can, but we're balancing making sure we get the right buyers with the right price points. And the same goes for future acquisitions. We've included nothing in our guidance for acquisitions. And as we said in our commentary, we have $300 million available to do acquisitions with, and as we do those deals, we'll include them in our guidance.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Perfect.

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

A

Yeah. So in terms of the criteria, the way we are looking at it is we have a set of aspirational goals. We look at the industry leaders in this particular space and in the various segments that we compete in, and we see what their margin profile or the kind of transactions that they're doing. Of course, this is a function of – we have to be pragmatic in terms of how much the market can bear and where we are at this point in time. So it's a journey for us. But we definitely have aspirational targets. And as we set those targets and be pragmatic about being able to be a little flexible about it, we will cross our catch-up. So it's not just a catch up, it's more than a catch-up.

We're just not doing this from a one-year perspective. Some of these transactions are three and five years. So we intend to catch up and we intend to overtake. And we're using our competitors and we're using what we have done traditionally, how we can do that better. We're also seeing what the market can bear. There are transactions out there quite honestly, which we have done at lower margins than our aspirations and expectations are because of the belief that as we bundle more transactions into it, the profitability paradigm will improve.

Again as I tell everybody, you cannot make revenue out of profit. You can make profit only when you get revenue, but – so we have to balance the two and – but we have to be very disciplined about the kind of transactions, the terms and conditions, the contractual agreements, the tenor, and where we're delivering these services from and how we're delivering these services.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

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

Operator: And our next question comes from Mayank Tandon of Needham & Company.

Kyle Peterson
Analyst, Needham & Co. LLC

Q

Hey. Good morning. It's actually Kyle Peterson on for Mayank today. Just wanted to touch a little bit kind of on organic revenue growth, realized that there's a lot of moving pieces, some of the divestitures and kind of re-ramping the sales force and rightsizing contracts. But I guess once some of that dust has settled, kind of what are you guys looking at in terms of organic revenue growth opportunity for the business?

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

A

Yeah. So in 2018, at the midpoint of our guidance, organic is declining 1.5 points, which is in line with the commentary we previously gave, where we said flat with the help of M&A. As we look into the future years, we'd expect 2% to 3% growth organically and then to get to industry level growth rates with the help of acquisitions, that's been our model and we're still working towards that model. And again, we'll see revenue improve in 2018 quarter-by-quarter as we lap our strategic decisions. A lot of the revenue decline we'll see in 2018 will be driven by the strategic decisions, and then, we'll have the new business and other normal losses starting to get positive as we go throughout the year.

Kyle Peterson
Analyst, Needham & Co. LLC

Q

Okay, great. And then I guess just a little bit, if you guys could touch on – I know you guys mentioned potential divestiture proceeds could be easier for additional acquisitions or kind of debt paydown. On the debt side, have you guys kind of thought about which pieces of the debt pack you guys would maybe kind of prioritize, whether it'd be kind of one of the term loans, or any possibility for any action on the senior notes?

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

A

So, we are looking and spending a lot of time on this. And we will do what makes the most shareholder value – makes the most sense from a shareholder value perspective. And we'll talk about it more as we get there.

Kyle Peterson
Analyst, Needham & Co. LLC

Q

All right. Great. Thank you.

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

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

Okay. Thank you. Thank you, everybody. Quite pleased with the performance. I have to again thank everybody in Conduent, our clients and our partners for helping us through this fairly interesting first year. We continue to hope to expand the performance in 2018 and to turn ourselves into a profitable growth company not just meeting competitor standards, but exceeding them as well. Look forward to talking to you again. Thank you very much.

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