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Conduent, Inc. (CNDT)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Conduent Third Quarter 2018 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 third quarter 2018 earnings call. Joining me on today's call is Ashok Vemuri, Conduent's CEO; and Brian Walsh, Conduent's CFO. Following our prepared remarks, we will take your questions.

This call is also being webcast. A copy of the slides used during this call was filed with the SEC this morning. Those slides as well as the detailed financial metric sheet are 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, November 7, 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 with the SEC. We do not intend to update these forward-looking statements as a result of new information or future developments or events except as required by law.

The information presented today includes non-GAAP financial measures. Because these measures are not calculated in accordance with U.S. GAAP, they should be viewed in addition to and not as a substitute for the company's reported results prepared in accordance with U.S. GAAP. For more information regarding definitions of our non-GAAP measures and how we use them, as well as limitations as to their usefulness for comparative purposes, please see our press release, which was issued this morning and was furnished to the SEC on Form 8-K.

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

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Good morning everyone, and thank you for joining our third quarter 2018 earnings call. Brian and I will cover our financial and operational performance, and our progress towards becoming a market leading digital interactions company. We will then take your questions.

Before I turn to our performance, I'd like to provide a quick update on our Texas litigation. As you may have seen in our press release, we increased the reserve associated with this litigation. While we can't comment much on pending litigation, in October we had discussions with the state to determine if a mutually acceptable settlement might be reached. Those discussions were not productive.

In the wake of those discussions, we have recorded an additional $72 million reserve, increasing the total reserve to $110 million. We continue to vigorously defend ourselves in this matter.

Let's begin on slide three with an overview of our performance for the third quarter. As I have done throughout this year, I will be comparing our results adjusting for the impact of new accounting standards and our 2017 and 2018 divestitures.

For the third consecutive quarter, our adjusted revenue which excludes strategic actions and the impact of divestitures was flat year-over-year. New business ramp and price increases were offset by contract losses from prior years. In constant currency terms, excluding strategic actions, revenue grew 1% this quarter, a meaningful demonstration of the progress we are making in the core business.

Excluding the impact of divestitures, adjusted EPS increased 180% year-over-year while reported adjusted diluted EPS was up over 27% year-over-year. This was driven by both operational improvements and lower interest expense due to tendering of our high yield notes in July. We also continued to show margin expansion in the third quarter while continuing to make aggressive investments in our digital interactions and platform-based offerings.

Adjusted operating margins increased 210 basis points versus a year ago and adjusted EBITDA grew by 10% this quarter to $157 million. Our adjusted EBITDA margin was up 150 basis points to 12%. Our profit improvement trend was driven by our transformation program, our focus on higher margin clients, digital offerings, platform solutions and remediation of troubled accounts.

In terms of quarterly highlights we had a number of noteworthy achievements. We continue to execute on our transformation plan. We are well-positioned to achieve our goal of $700 million in cumulative cost savings by year end and I'm especially pleased with the progress that we have made on our accu-shoring initiative.

We held our 2nd annual client event, Conduent's Continuum which was attended by more than 130 of our top commercial clients, a three-fold increase from last year. At Continuum, we showcased Conduent's distinct value proposition as a technology lead digital interactions company. I'm pleased to share, that we received extremely positive feedback from our clients as we demonstrated how Conduent is leveraging new technologies to transform their current operating models, accelerate their digital journeys and help them stay ahead of their competitors.

In terms of divestitures, we closed three of our previously signed transactions resulting in $272 million in cash inflow. More than $40 million of unfunded pension obligations also went with the divestitures further strengthening our balance sheet. We continue to invest in our industry leading platforms such as Life@Work, Strataware and the Conduent's suite of automation platforms. These technologies enable faster, more efficient and more strategic interactions with our clients' end users.

We signed an agreement to divest the $500 million of standalone customer care contracts that do not fit within our long-term core business model. We expect to receive approximately $50 million of economic value from this transaction after working capital adjustments. More importantly, we avoided significant potential shutdown costs that we would have incurred had these businesses been run-off. Once this transaction closes, it will conclude our previously announced plan to divest $1 billion in non-core assets.

Lastly, we signed an agreement to acquire Health Solutions Plus or HSP, a leading core administration processing system provider in the healthcare space. This is a strategic technology based platform acquisition that will enable us to bring an industry leading end-to-end healthcare payer administration solution to our commercial and government payer clients, helping them achieve operational efficiencies, lower cost, and enhance digital experience for their members and providers.

This deal is immediately accretive to our adjusted EBITDA margin, and it's precisely the type of deal that we see adding value to our portfolio. We expect to close on this transaction in late Q4 or early January at the latest, so we would expect to get a full year of benefit from the deal in 2019.

We have lowered our outlook for the full year. Our lowered outlook can be attributed to five factors. First, lower sales activity. As we focus on technology led digital transactions which are replacing traditional BPS deals, the sales cycle and ramp up tends to be longer. Today, 65% of our services are delivered over technology platforms, a huge leap from a time when a majority of our services were labor intensive commoditized services at lower margins and value. This pivot to digital which is where our clients are headed is both timely and necessary. While it may seem disruptive to our performance in the short-term, our increased discipline around pricing, terms and conditions, improved risk profile, and shift from commodity to technology-based value-added services is essential to creating long-term value.

Second, we have had continued suboptimal performance from an inherited legacy technology vendor. The performance issue stem from the vendor's inability to deliver on service level agreements, lack of responsiveness to Conduent's needs, and poorly structured contracts which we inherited. We had our first planned data center migration in Q3 and during this migration we uncovered issues that caused significant disruption to our client delivery and operations and resulted in penalties to Conduent. We are aggressively renegotiating our contract similar to what we successfully undertook with our largest client-facing applications IT vendor last year to take back more control of our IT.

Third, our outdated and historically under-invested legacy IT infrastructure has caused major disruptions to our operations and impacted client and delivery performance. We are investing in our IT infrastructure to ensure our

IT performance is in line with our clients' expectation. This includes new investments in our data centers and networks, consolidation of our sprawling technology landscape, modernization, enhanced cybersecurity and move to cloud. This investment can be seen in the increased CapEx outlook for the year.

We have made changes to our internal IT organization, brought in new talent, and have a game plan to address these issues. Near-term, we expect to make meaningful progress on the back of increased investments and influx of both internal talent as well as new external support.

Fourth, we have seen a delay in yield from our European business. This has historically been luckily a call center oriented business. As we started the divestment process of that business this quarter, we are looking aggressively to drive our other service lines into the European market. While the overall softness in the market and time for sales team ramp has led to this delay, we are gaining traction.

We recently closed an opportunity to provide digital interaction experience services to our premier European automotive company. Our solution will deliver a more engaging technology led experience to the drivers of its new connected car models.

And lastly, we are seeing the impact from the timing and slippage of deal signings into later quarters due to rapidly changing investment cycles as our clients focus on increased technology based processors. Brian will discuss the guidance changes in more detail during his remarks.

We continue to see tremendous opportunity in the market and in our ability to expand our increasingly robust and modernized service capabilities to our loyal and long standing core client base. As we have completed our planned divestitures, we now have the management bandwidth and the funding capability to focus on our core portfolio with a clear strategic thread running through the business. Collectively, these factors coupled with a robust and actionable M&A program enable us to bridge our capability gap and bring our next generation of technology enabled digital service offerings to our client base.

Now let me share some additional highlights from the quarter. I'm on slide 4. We remain on track to deliver on our cumulative cost savings target of $700 million by the end of this year through our strategic transformation initiative. This past quarter we continued to make progress on consolidating our real estate footprint with total locations down 26% and total square footage down 21% compared with Q3 2017. We further optimized our geographic footprint reducing our operation centers by 30% year-over-year. We have also lowered our total labor cost through accu-shoring.

As a company, we hit an important milestone this past quarter. We have now achieved a 50/50 ratio of employees located in countries with labor markets that have relatively low cost as compared with countries that have high cost labor markets. We are taking advantage of our global workforce and serving our clients from our key delivery hubs which gives us the best balance of skills, availability and cost. We expect to show continued improvement on this metric over the next two years. We had guided to achieving 55% accu-shoring by the end of 2020, and based on our progress thus far are well placed to meet that goal.

Reported SG&A spend was down again this quarter as we streamlined costs within the G&A line while continuing to invest in our sales and marketing functions. As we look out to 2019, we have a robust pipeline of additional transformation opportunities related to accu-shoring, technology improvement and automation. We will take advantage of these efficiencies in 2019 while we also address the stranded costs associated with the 2018 divestitures.

Moving to slide 5, I will go through a quick update on our segment performance. Our Commercial business again showed meaningful improvement this quarter. Commercial adjusted revenue was up 1% in constant currency terms, excluding strategic actions. Adjusted EBITDA margins also improved again this quarter, up 110 basis points compared with Q3 2017. This increase was driven by our move to higher value offerings, the continued shift to digital interactions revenue, price increases and operational efficiencies. Revenue productivity also improved to approximately $47,000 per employee, up 5% year-over-year. Our European business accounted for 11% of Commercial revenue for this quarter.

Our Public Sector business also performed well this quarter with the revenue decline continuing to flatten out, and profit margin expanding. Adjusted revenue at constant currency was down 0.5% excluding the impact of strategic actions and FX. Adjusted EBITDA margins improved by 340 basis points year-over-year as a result of operational efficiencies and price increases. Revenue productivity of approximately $214,000 per year was up 2% year-over-year.

Moving to slide 6. Let's go through our sales performance in terms of signings and pipeline. I will note that we have removed the impact from divested business from our signings information as well as updated the historical detail that we provide in the appendix.

Our Q3 renewal rate of 91% continues to be strong, and is higher than our stated renewal rate of 85% to 90%. This is our fifth consecutive quarter achieving a renewal rate greater than 90%, reflecting the strength of our client relationships, quality of work, and strong client management teams. These renewals are aligned with our business model, have acceptable levels of risk, and are contracted for an improved margin profile.

New business signings of $264 million reflect our focus on larger and more strategic deals and the continued ramp of our sales team. You may recall that I discussed the impact of the ramp of our sales force and the required investment in the business on our last call. As we continue to move up the value chain and sell larger, higher priced technology focused deals, the close time tends to be longer. Third quarter signings were also impacted by certain deal signings slipping into Q4. Almost half of these deals have since closed.

Our book-to-bill ratio was 1.14 times this past quarter and has now stayed above one for the second consecutive quarter. We are focused on improving this ratio over time, as we sign new business and expand our work with existing clients.

I continue to remain confident that we will begin to show year-over-year new business growth in 2019 based on the pipeline, quality of potential deals, traction of our solutions with clients, and prospects, and our increasing ability to attract a higher performing sales and management team into the company. We continued to focus on expanding service lines with our existing clients and are investing in both our client-facing offerings and the people that run the business.

Our pipeline remains strong and the quality of deals reflect strong demand for our digital solutions and platform-based offerings, as well as front office transformation opportunities for clients in transportation, insurance, healthcare and payment verticals. The pipeline of $12 billion in Q3 was flat compared with last quarter when adjusting for businesses that we divested. It is a strong pipeline of real opportunities and we are aggressively working to improve the yield from these opportunities and I remain satisfied with the progress that we are making.

In terms of the deals that we have signed recently, they fit within our three core dimensions for service delivery, individualized, immediate and intelligent. This model for framing client needs and developing technology solutions has become the cornerstone of our value proposition with our clients. We're investing in platforms that enable faster, more efficient and more strategic interactions with end users, and we are scaling these offerings by selling to more clients and bringing the discussion around our capabilities to our clients C-suite. Clients are embracing this new ethos. We are seeing it in new business wins, our client conversations and in service line expansion with existing clients.

Let me share a few examples with you. In the total benefits outsourcing space, we won a three year contract on RightOpt, our single private health insurance exchange platform with a new logo client, a company with more than 15,000 U.S. employees that provides government services and information technology support. Through our platform enabled solution which utilizes analytics and artificial intelligence, we are elevating the digital experience to provide an individualized interaction for each participant, highly customized and personalized throughout the process. To enable immediacy, we are putting a suite of tools at the fingertips of every participant so they can find information and take other health related actions at the click of a button. The win is a prime example of how Conduent is helping its clients' users. In this case its employees take better action for their health.

We also continued to grow our footprint in the clinical care management space across healthcare and insurance with a win at a leading global provider of third-party administration and risk management services. Again, this win is a good example of how our technology and data driven solutions paired with industry expertise makes Conduent an exceptional choice for our clients.

Along with our Nurse First Response platform, we will deploy a fully customized claim intake process which assesses injuries' severity and helps identify the right course and level of treatment. Additionally, our advanced analytics provide intelligence about each case, information about the cause of injuries and severity to help employers improve their overall safety, while reducing the cost of their claims.

And in public transportation space, Conduent was awarded an eight year contract with a longstanding client, the Los Angeles County Metropolitan Transportation Authority. We are modernizing the tolling system on the express lanes for two of LA's busiest highways using the latest digital interaction technology. Our technology and tolling platform will help to increase accuracy and overall performance of the express lanes as well as deliver an intelligent and immediate experience to the commuter by leveraging machine learning and artificial intelligence. The work we are doing here is a prime example of how our platform enabled solutions are helping build smarter cities and addressing traffic congestion, as well as commuter safety in major cities across the globe.

We continue to make progress on leveraging our global footprint, embedding technology into everything that we do, and expanding our reputation as a leading digital interactions company.

Let me now close with a quick recap of our progress. In the short term, lowering guidance is disappointing. However, we are on track on our medium and long term plan. We are in transition, and transformation which sometimes results in bumps in the road in the short term. But we have a definitive plan, a deep and loyal client base, dedicated and motivated management team, a value proposition that is resonating in the market, an understanding of our inherited issues and a demonstrated track record are resolving them over the last two years.

A few quick highlights, this is our seventh consecutive quarter of year-over-year margin expansion, and adjusted EBITDA growth. We're clearly on the right track towards our long-term profitability goals. We executed or signed all of the targeted divestitures, especially the non-core call center assets. We remediated underperforming contracts and negotiated higher pricing, tendered the high yield notes, strengthening our balance sheet. Attracted best-in-class employees to the executive management team, continued to invest and build out our IT infrastructure and client facing technology, have identified and have cleaned up many of the inherited issues in the business and are progressing to complete the rest. We signed a definitive agreement for our first acquisition and completed the majority of our $700 million transformation initiative and identified actions to put us in a position to achieve the full amount by the end of the year. We have built a clean and actionable $12 billion pipeline and have established an outlook for top line growth in 2019.

We are making the right investments in our go-to-market team and solutions to drive revenue growth. Our executive management team is driving an across the board transformation of our operations, balance sheet and go-to-market strategy. We have streamlined our portfolio around a set of core businesses. Platform based, technology led digital solutions that have relevancy today and well into the future. With this strong foundation now in place and given our outlook for the business today, I feel confident that we are on the right track to deliver our 2019 commitments which remain unchanged from our last guidance.

With that, Brian will take us through the financials and our outlook for the business in more detail. We will then open up the call for Q&A. Brian?

Brian Webb-Walsh

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

Thank you Ashok. As a quick reminder, our 2018 financials have several factors that impact year-over-year comparables. As such throughout this presentation and in the exhibits in the appendix we will provide both GAAP and adjusted numbers which provide a clean compare removing the impact of the divestitures that we completed in 2017 and 2018, as well as the adoption of the 606 revenue recognition standard.

On a segment basis, we have moved the historical results for both the 2017 and 2018 divestitures which include the Commercial Vehicle Operations, Off-Street Parking, Actuarial and HR Consulting and Government Software Solutions businesses into our Other segment. Once we have closed the sale of our standalone customer care contracts, we'll move those historical financials to Other as well.

We will not be moving the $70 million of stranded costs related to the divestitures into the Other segment. So they will remain in the Commercial and Public segments and you should see a benefit to segment margin in 2019 as we address these costs.

Now let's start on slide 8 with an overview of the third quarter financial results and a walk through the P&L. Revenue of approximately $1.3 billion for the quarter was impacted by divestitures and the 606 accounting standard change. Adjusting Q3 2017 for the impact of these items, revenue would have been down about 4% year-over-year.

Looking at our year-over-year revenue on a GAAP basis, we are down $176 million of which $82 million was as a result of the divestitures, approximately $21 million from the exit of our Student Loan business and $34 million from the impact of 606. The remaining impact was from strategic decisions, most of which was due to the run-off of low profit or loss making customer care contracts. Adjusting for all these items as well as the impact of a 1% currency headwind, year-over-year revenue in the quarter would have been up 1%.

Gross margin was 19.2%, an improvement of 160 basis points. This improving gross margin reflects continued progress in our transformation initiative, increased pricing from remediated contracts, and ramp of higher value business. SG&A continued to decline year-over-year while adjusted operating margin expanded by 50 basis points, as reported, or 210 basis points excluding the impact of 606 and the divestitures.

Adjusted EBITDA in the quarter was $157 million, an increase of 10% and adjusted EBITDA margin grew to 12% improving 150 basis points, when excluding the impact of 606 and divestitures. This improvement was driven primarily by our transformation initiatives and contract remediation, and was despite both increased investments and the run-off of our student lending business.

Moving below the operating margin line, restructuring costs were $31 million, an increase of $9 million compared with Q3 of last year. Restructuring is running higher than our initial outlook, given our accelerated progress on accu-shoring and real estate reductions. We now expect full year restructuring costs to be closer to $85 million.

Interest expense decreased by $13 million in the quarter, primarily as a result of the term loan re-pricings and the tender of our senior unsecured notes which was completed in early July. Our transaction costs and losses on divestitures were $54 million, primarily due to a $47 million impairment charge associated with the pending sale of our standalone customer care contracts. This is a result of the expected proceeds from this deal being lower than the net assets that we are selling.

We also had a $78 million increase in our litigation related reserves in the quarter, as Ashok discussed, we increased the reserve for the pending Texas litigation by $72 million. The total reserve associated with Texas is now $110 million. We also had a charge of $108 million associated with the tender of our senior notes. Our pre-tax loss in the third quarter was $252 million driven primarily by the discrete items, I just discussed. GAAP net loss in the quarter was $237 million or a $1.16 per share driven by those same factors.

Our adjusted tax rate in the quarter was 25.6% compared to 36.8% in the prior period, as a result of the lower federal tax rate. We still expect our full year adjusted tax rate to be between 25% and 28%. Adjusted net income was $61 million, up $13 million compared with the prior period and adjusted EPS was $0.28, an increase of $0.06 or 27% compared with Q3 2017 driven by lower interest expense and tax rate. Excluding the impact from the divestitures, adjusted EPS increased 180% compared with Q3 2017. This was driven by operating profit expansion, the lower tax rate and lower interest expense.

As I did last quarter, I'll go through the segments and compare our Commercial and Public Sector results to Q3 2017 results adjusting for the impact of the 606 accounting standard. The businesses that we divested in 2017 and 2018 were moved into the Other segment and are out of the year-over-year compares. As I mentioned, the stranded costs associated with those businesses remain in the Commercial and Public Sector segment results. As we address those costs later this year and in 2019 it'll be a tailwind to segment margins and is expected to improve results.

Turning to slide 9, let's go through the Commercial segment results. Year-over-year Q3 adjusted Commercial revenue excluding strategic decisions in currency was up 1%. As reported, adjusted revenue declined by 4%. Segment adjusted profit increased by 28% year-over-year, driven primarily by our transformation initiative, including cost savings and price increases through contract remediation efforts Adjusted EBITDA in the segment grew 10% to $67 million and our adjusted EBITDA margin of 9.2% increased by 110 basis points year-over-year.

Now let's move on to the Public Sector segment results on slide 10. Adjusted revenue declined about 0.5% year-on-year excluding strategic actions and currency. As reported, adjusted revenue was down 1% compared with Q3 2017. Our transportation business, excluding the impact from divestitures, was down 1% year-over-year as a result of lower volumes and some operational challenges that resulted in penalties but was up 2% sequentially driven by the ramp of new business.

I'll note that we have made progress in the large tolling contract that we discussed on the last call. While the operational challenges will have a financial impact on our 2018 results, we continue to work closely with the client and are making progress and expect the issues to be largely behind us in the near future.

Our Public Sector adjusted segment profit was up 48% and adjusted EBITDA was up 25% driven by our cost savings initiatives. The margin profile of the Public Sector business improved this quarter, with segment margins up 420 basis points and adjusted EBITDA margins up 340 basis points, a meaningful improvement given that this is prior to addressing the stranded costs.

Moving on to slide 11, let's review our Other segment. As a reminder, student lending revenue was fully run-off this quarter. This was an important milestone in the continued shift to our focus on digital interactions and platform based offerings and our move away from our non-core business. We are pleased with this progress and this is in line with what we had committed to back in late 2016. We have moved the Student Loan wind down expenses to the other income and expense line for current and future reporting periods. Segment adjusted revenue was $57 million in the quarter primarily from divestitures while adjusted EBITDA was $5 million in the quarter.

Slide 12 provides an overview of our cash flow in Q3 2018. Cash flow from operations was an outflow of $30 million in Q3 2018 primarily driven by working capital and net cash tax payments. One of the larger drivers of the working capital move was an increase in accounts receivable. We're very focused on our DSO to bring this number down and are putting resources to work to realize an improvement on this line.

We expect our cash taxes to be approximately $120 million for the year which will include tax benefits associated with the payment of deferred compensation plan assets and the tender offer as well as a tax headwind from the net gains on the divestitures. When adjusting for these one-time items, our cash taxes would be approximately $80 million.

CapEx in the quarter was $60 million or around 4.6% of revenue. Year-to-date CapEx is $150 million, an increase of $66 million compared with this point last year. We now expect CapEx to be approximately 3.75% of revenue for the year. We are investing heavily in our IT infrastructure and in client facing technology and anticipate continuing to do so next year as well.

Adjusted free cash flow was a use of $32 million in the quarter compared with $80 million of adjusted free cash flow generated in Q3 2017. This was driven by lower operating cash flow and higher CapEx. As our guidance indicates, we expect to generate meaningful adjusted free cash flow in the fourth quarter and expect to end the year with a healthy cash balance.

We had a cash outflow on the financing line of $587 million in the quarter associated with the tender of our senior notes. We disbursed $13 million to employees in Q3 as a result of the termination of our deferred compensation plan and have already distributed the remaining $77 million of cash held for plan participants in October. As I discussed in the past this flows to our operating cash flow and will be adjusted out of reported free cash flow accordingly. In addition, given the number of one-time items we are working on, cash tax impacts from the divestures, the deferred compensation plan, the tender and other divestiture related expenses will be adjusted out of free cash flow.

We received $672 million in pre-tax proceeds from divestures so far this year. We still expect to receive approximately $700 million in total proceeds from the closed divestures. However, the balance of the cash we expect to receive will be in future periods.

Turning to slide 13, let's go through an update on our capital structure. During Q3, adjusted cash which excludes the cash balance associated with the deferred compensation plan I just discussed as well as restricted cash was

$509 million compared with $903 million of adjusted cash at the end of Q2, 2018. We completed the tender offer to pay down $476 million of our 10.5% senior notes in Q3.

As I discussed last quarter, we expect the impact of the tender and the term loan re-pricing to lower our interest expense by approximately $57 million annually moving forward. We now expect one more interest rate hike in 2018, and two additional rate hikes in 2019. So our 2019 interest expense is expected to be around $89 million.

Our current net leverage ratio is 1.6 turns compared with 1.7 turns at the end of Q3. In addition to the $98 million for our acquisition of HSP, we still expect to spend an additional $200 million of our current cash balance for acquisitions.

We expect to generate adjusted free cash flow of between $200 million and $235 million in Q4, and would look at using our cash balance for further investments in the business both organically and through acquisitions.

Moving now to slide 14, we closed three of our divestitures in the third quarter, including the Off-Street Parking, Actuarial and HR Consulting and Local Government Services businesses. We have now closed on divestitures that generated approximately $500 million of revenue and $120 million of adjusted EBITDA in 2017, before adjusting for stranded costs. We also removed approximately $40 million of unfunded pension obligation with these divestitures strengthening our balance sheet. In terms of 2018 results and the quarterly impact of the divestitures, we've provided details removing the divestitures from our 2017 and 2018 results in the metric sheets that have been posted on our website. This should help with Q4 2018 and 2019 modeling.

As Ashok mentioned, we also signed an agreement for the divesture of our standalone customer care business which generated approximately $500 million in revenue in 2017. We have not adjusted 2018 guidance for this, and don't anticipate the deal closing until the end of the year at the earliest.

This is another important milestone in our shift to more platform based and digital interactions offerings and we forego the potential for up to $100 million of wind down costs, if we retain these contracts in our portfolio. We expect to receive approximately $50 million of economic consideration after adjusting for working capital for this transaction.

All in, we expect $750 million of total pre-tax proceeds, including working capital adjustments for all of the divestitures. Given the timing of the divestitures, we expect to take action on the first tranche of stranded costs at the end of 2018 and to be able to address the rest in mid-2019. Overall, we expect to see $25 million of an impact from stranded costs in the first half of the year.

Turning to slide 15, we have updated our 2018 guidance to reflect lower sales growth than initial expectations, a slower ramp in our European business and the impact from some operational challenges, in particular stemming from the under-performance of one of our legacy technology vendors and our outdated IT infrastructure. We now expect 2018 revenue to be down approximately 4% on a constant currency basis year-over-year or $5.34 billion to $5.4 billion. Excluding strategic actions, at the midpoint, revenue in 2018 would be approximately flat. We expect adjusted EBITDA growth of between 7% and 9%, or between $640 million and $650 million.

Finally, our free cash flow conversion is expected to be between 25% and 30% of adjusted EBITDA or between $160 million and $195 million. While we anticipated revenue growth in the fourth quarter as of our last call, given lower new business signings, volume pressures and operational performance issues, we no longer expect to show growth in the quarter. While this is disappointing, we are addressing these issues head on by investing in sales and technology and working closely with clients to ensure that we improve our delivery.

Before we turn to Q&A, I'd like to discuss where our 2018 core now looks like and our 2019 outlook. We also included this commentary in our modeling considerations slide in the appendix. I'll remind everyone that our 2018 core business excludes all of our divestitures and also excludes the full $70 million of stranded costs. The core will be the baseline that you should all be using when considering growth moving forward starting in the back half of 2019.

In terms of revenue, we now see 2018 core revenue between $4.59 billion and $4.65 billion and see core adjusted EBITDA of between $605 million and $615 million. For 2019, we are maintaining our revenue growth outlook that we gave at our Analyst Day of 2% to 3% or 2.5% at the midpoint from our 2018 core. However, we now expect a higher contribution from acquisitions which we are funding with cash generated via divestitures and free cash flow generation. We are also maintaining the growth outlook for adjusted EBITDA and continue to see 8% to 12% growth from the 2018 core for 2019 excluding the $25 million of stranded costs impact in the first half of the year.

We believe that this business remains well positioned over the medium and long-term. We are leveraging the progress we've made so far around divestitures and M&A, we have a strong balance sheet and we'll continue to have a robust pipeline of transformation opportunities to address our cost structure. Now let's open up the lines for some questions. Operator?

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Puneet Jain of JPMorgan.

Puneet Jain
Analyst, JPMorgan Securities LLC

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Hey, thanks for taking my question. I guess, like the operational issues that you mentioned, it seems like a lot of them stem from the infrastructure subcontractor that you use. So my question there is how much of the charge or penalties that you expect to incur in 4Q can be passed on to that subcontractor? And as you reassess in sourcing of some of that work, how fast you can address those issues? It seems like the core for 2019 – core revenue for 2018 has been rebased lower. So do you expect these issues to continue into next year as well?

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

A

So Puneet, this is Ashok, so let me – there's multiple questions that you've asked. So let me actually address each one of them. Number one is that we did inherit a very challenged infrastructure both from a network perspective, the quality of the assets and unfortunately a contract that necessitated us to continue to work with the service provider that we had engaged with prior to the formation of Conduent. We have addressed just like we addressed the client-facing application issue with another large service provider that the work was outsourced to prior to the formation of Conduent last year, similarly we have addressed this issue for the last six to seven months.

As we have progressed from more labor intensive work to digital technology work, the impact or the nonperformance of this has become severely amplified resulting in penalties, as Brain mentioned, as well as deferment of revenue that's one of the reasons that we gave for the changing of the guidance.

Now we have our arms around the problem, we were constrained by the contract. We were constrained by the fact that we did not own a lot of these assets. We have brought in experts into that. We have completely retailored our organization, brought in new talent, and we think that at this point in time the yield on that is not becoming apparent, but let me assure you that we have our hands around the problem. We are working diligently to resolve it, including holding accountable the vendor, this service provider to provide us better services, and using each and every means that we have to ensure that happens.

With regard to the impacts that we've had with clients, my basic focus at this point in time is to ensure that these service providers or this specific service provider, we hold him accountable, we hold them accountable in order for them to service our clients and meet their needs. I will take all and necessary action that is permissible under the contract and under the law to ensure that I hold them accountable, but at this point in time my priority is to ensure that I provide smooth and seamless service to my clients.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. And how much of these issues, like could be isolated to like few clients or a few process, it seems that way. But could there be a risk that this could be like a symptom of like an underlying operational challenges from significant cost cuts over last few years?

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

A

Yeah. So this is isolated to a few set of clients in a particular segment of our business, especially in the Public Sector part of the business. We do not face these challenges in our Commercial business. As we are moving our data centers and consolidating them, modernizing them and moving to the cloud, as we can see with regard to the pipeline or the deals that we have signed, our clients feel confident with regard to the services that we are able to deliver. We feel confident that as we pivot with our technology platforms both the quality of the client facing applications and the infrastructure that supports it is robust.

So the isolation of this is important because that allows us to take quick and efficient remediation action which is what we are doing right now. I think, the subpart of your question with regards to the speed of cost cutting, let me actually phrase that and change the premise of that question, because we needed to do a clean-up of the company. We needed to ensure that our management bandwidth is supporting those businesses that are core and that have a future in the company. We needed to – we've got burdened with not only infrastructure issues and contractual issues, but also with a significant amount of unnecessary debt, et cetera which needed to be brought down in order for us to translate our operational performance into our financials.

So I actually think that we are continuing to make the investment as you see in the increased CapEx, we're spending $200 million, we have not swayed from that, we're continuing to spend the $200 million on our infrastructure as well as on our IT applications and we will continue to do that. So I think the efforts that we have done that I sort of highlighted at the end of my prepared remarks, lead to the creation of a solid foundation for the company to pivot. These incidents and issues that we have again are isolated. We will rectify them, we are on our path. It takes time for a data center migration and its impact to become apparent, but we are on it.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Operator: And the next question will come from Mayank Tandon of Needham & Company.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Thank you. Good morning. Ashok, you mentioned that you do expect new business signings to start to tick off sometime in 2019, and I believe you gave a timeframe around next year. Could you maybe just talk about like what will be the key catalyst to get that new business activity to pick up and then ultimately drive, hopefully, some positive organic core growth in the business?

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

A

Yeah. So Mayank, number one is that our sales teams are still ramping. I feel that they are in a better position with regard to the understanding of our various capabilities and [ph] a better (50:43) appreciation from the changing dynamics in the marketplace. If you see in the last few months in the Public Sector, we had certain deferments or lack of decision making as a result of the events leading to yesterday. Hopefully, that is behind us now and people will come back to work and take decisions. We've seen a significant shift in the way our Commercial clients are consuming technology and processes, the pivot to technology has been much faster quite honestly than I have seen any other shift happen in the past. Europe which has been a very soft market for us because there's been a significant amount of the business was customer care. So as the sales team and as the organization which has had a long history, if you will and/or a muffled memory of selling customer care, pivots away from that to more digital transactions that [ph] heal (51:35) will only get better.

There's no question about the fact that growth for us will be driven significantly by performance in the new business. We have sort of hinted towards inorganic, we now have the dry powder to exercise on that, we've done one. We will do transactions of that nature which are accretive quite immediately, to our balance sheet and to our financial performance. But the core business growth is absolutely important. We are not going to cut down on the discipline that we have, we are not going to slack down on the kind of deals that we do, the deals are out there, we are finding them, traction is building, it's a matter of time before it happens.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Okay, that's helpful. Then as a quick follow-up, any additional insights you can provide Ashok on the pending litigation with Texas that might help reassure investors that you can actually navigate through this and ultimately at least come out in a situation that is better than where you are today with it?

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

A

Yeah. So as I mentioned in my prepared remarks, we engaged in discussions with the State of Texas to try to establish a framework for settlement. However, these discussions did not lead to a formal settlement negotiation and in accordance with the accounting guidance we therefore determined that we're required to increase the reserve from $38 million to $110 million. That's an increase of about $72 million. Mayank, I will also emphasize the point that we take this matter extremely seriously. We have dedicated resources helping us resolve this matter in a reasonable fashion. But in the meantime we will continue to defend ourselves very vigorously.

Mayank Tandon
Analyst, Needham & Co. LLC

Q

Okay. Thank you.

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

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Ashok, you've been there now for quite a bit of time, and you successively did a lot of divestitures. But I guess, the surprising thing of laying out five different issues now, I think, is catching investors in the stock off guard today of their reaction. Things like outdated infrastructure and stuff shouldn't be a surprise today, and now they're really kind of coming out. So what did you uncover, or is this just a new look under the covers or new chapter, or how should we think about, why now as opposed to 12, 14, 15, 18 months ago?

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

A

Yeah, Jim, so we've been talking about the challenges of our business right from inception. We've talked about – I think, in fact I've characterized it as at one point in time, our infrastructure being fifth world with no necessary trying to characterize any fifth world situation, but it has been challenge, and we've been working on it. We have addressed and remediated our client facing applications very, very quickly because that impacted not only the performance of our business, but the services we provide to our clients, citizens, consumers, et cetera.

From an infrastructure and network perspective, the work started last year, it takes time for it to sort of unravel or for the results to – good or bad, to become – to be revealed. And since we were constrained by the service provider that we used, we were doubly challenged, and this sort of blew up in our face, if you will, or have got amplified as we moved more and more of our capabilities and our business from labor base to more technology base and the amplification became extremely apparent in our results as you have seen in this particular quarter.

This is not a new issue. We've been addressing this for a while. The impact of this has suddenly accelerated and got amplified. We've been working on it. This has spurred us to make the changes much more quickly. Those changes have already been made. We've hired talent within the company. We've hired external experts and vendors and professionals who can help us in this journey because, trust me, we understand the impact of this on not only our financials, but the impact it has on our clients' performance and our ability to deliver the services to them.

So again, not new but amplified suddenly. If you look at the other reasons we've talked about which is yield in Europe, our expectation of the yield in Europe was much higher but sales cycle is taking longer because we're changing what we sell, it's been customer care. We have not been selling customer care since the first quarter of this year there. The market itself has been sort of soft and we've had challenges with regard to the ramp of our sales team which we have all identified and are correcting as we speak.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details.

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

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Good morning. Thank you. I wanted to ask on bookings, do you have outsized renewals pending in the coming one or two quarters. And can you give us a sense of what level of increase you're talking about when you're citing a positive turn in 2019 new business bookings? I'm trying to connect the level of confidence in 2019 new business bookings growth [ph] while (56:47) also hearing longer sales cycles and other factors?

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

A

So, hi Bryan. This is Brian Walsh. Starting with the new business, we expect to pivot to new business growth for the full year in 2019. We haven't said exactly when that happens and exactly how much it is, but we would expect double-digit growth for the full year and hopefully it's sooner rather than later. We expect organic revenue growth to be back-end loaded. We now expect between flat and 1% for the full year. So that's obviously a delay from what we originally expected but we still are focused on organic growth in addition to getting growth through acquisitions.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. And I know you gave the 2019 outlook here, does your thought process on your prior fiscal 2020 margin goals changed here? And really how critical is top line growth to driving the projected margin expansion?

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

A

We're still comfortable in 2020 of getting about 15% EBITDA margins and we expect to make progress on margins next year at the midpoint 13.7%. So top line growth is important, it obviously takes pressure off the cost base. But we're focused on cost transformation, we're focused on driving top line organically and inorganically and we're confident in our margin improvement next year and in 2020.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay. Thank you.

Operator: And our next question will come from Brian Essex of Morgan Stanley.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good morning and thank you for taking the question. Brian, I just wonder if you could talk to your adjusted free cash flow guidance and cash flow conversion for the year and outlook going into next year, it looks like maybe given the year-to-date number of a $41 million drag that we've got on slide 12, [ph] what will the (58:36) guidance and it looks like you're looking for a meaningful ramp in 4Q. What are some of the elements we need to consider as we kind of reconcile a ramp in free cash flow conversion and what kind of bleeds into fiscal 2019 as we look at the cash flow generation of the company?

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

A

Just a couple of points, if you look at the year-to-date free cash flow were down roughly $50 million year-over-year, CapEx is up $67 million, so it's completely driven by our increased investment and that's going to IT infrastructure, that's going to our enterprise applications for internal systems and that's going to our client facing applications and that's important to fix the IT situation. So, that's driving the year-over-year decline on a year-to-date basis. In the fourth quarter, we have strong free cash flow projected, $200 million to $235 million and that's typically were our fourth quarter weighted in our free cash flow and that's going to come from strong collections performance which we're very focused on and have a path to.

We'll also have in Q4 another tax payment of roughly $45 million that we'll have to make and so that is inside of that as well. And we expect about $50 million of CapEx, but we're comfortable with our forecast and when we look at the full year it is at the lower end of our conversion, 25% to 30% and that's a reflection of EBITDA being lower and then the incremental CapEx we've had to invest in the business.

As we think about next year, we expect CapEx to stay elevated next year. We expect restructuring to get cut back. We're doing about $85 million of restructuring this year. We expect that to cut in half as we get into next year which will help. Cash taxes will remain about $80 million on a business as usual basis. But we're comfortable with the cash generation of the business. We still see using our free cash flow to invest organically and inorganically and we're comfortable with the model.

Brian Essex

Analyst, Morgan Stanley & Co. LLC

Q

Got it. That's helpful. Maybe just a follow-up, if I could circle back on the legacy vendor just for a minute and maybe try and connect a few dots. Ashok, is there anything you can incrementally can tell us about the relationship there. How locked into that relationship are you – have you kind of developed on that platform that it'd be too costly to move or what kind of leverage points that you have with that vendor either to move away from them or to really kind of hold their feet to the fire to execute to their SLAs?

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

A

We have to hold their feet to the fire, we have to execute on the same game plan that we did with the previous service provider who was providing services to us on the client application side. Clearly, this is a complicated and extremely sprawling infrastructure that's not been invested for over the last 10 years. And therefore there are challenges on both sides that we have to appreciate. But given that the bulk of the issue lie with the service provider, our job is to ensure that they provide appropriate services to us so that we can continue to service our clients. My immediate focus at this point, I've had multiple conversations with them. They have demonstrated commitment. They have accelerated and improved their performance over the last few weeks. We will continue to hold them accountable to that.

And as I said, I am not shy – as I have demonstrated in the last year, I am not shy to take any and every action that is available to me under the contract as well as under legal recourse to ensure that I get what I'm paying for. I also want to emphasize that this is again a situation which has gotten amplified. It is not that we don't keep an eye on it. We have an eye on it. We have the talent to take care of this, but it's gotten amplified as we've moved – as we have moved and pivoted very quickly to a digital – to become a digital interaction company. I think we will – I don't want to give a timeline but I think a quarter or two should have – we should have this completely resolved. I don't think we would need to bring in new contracts for this. But clearly as I said, if that is required that shall also be done.

Brian Essex
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's helpful. I appreciate the additional color.

Operator: The next question comes from Keith Bachman of Bank of Montreal.

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

Q

Hi. Thank you very much. Ashok, I want to go back to some comments on CY 2019. When you think about dispositions and then strategic actions which are two different things, as you look at 2019 will all those actions be concluded? In other words will you have cleaned everything up you think by the end of this calendar year such that there won't be any more even some of the strategic decisions, i.e., walking away from some of the contracts as well as further dispositions?

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

A

Yeah. So Keith two parts to your question. One is that we have completed all the dispositions, the divestitures are with the – when we close out the standalone call center business that will be the end of the divestiture program that adds up to a $1 billion. With regard to strategic actions which were things like long tail and remediation or not doing standalone call centers, I think the discipline is now very well entrenched in the company.

We are not going to shy away from continuing to be extremely disciplined about the kind of deals that we do whether it's with regard to tenor, whether its regard to the terms and conditions, whether it's regard to multiple service lines which is what we need, we will be maniacally focused on service level penetration. We will do deals in our core markets. So that discipline is not going to go away, but the actions with regard to dispositions and what we have so far called strategic actions will go away. We want to give our numbers with as little noise as possible in 2019. So we don't have to keep doing adjusted, adjusted, adjusted and that what numbers that you see will be based on our core 2018 numbers and I think we captured that in the appendix at the back of what our core is and that is the number that we are using to project the growth for 2019 and our guidance is based on that growth. We are maintaining the numbers that we had given in our prior guidance albeit on a smaller base.

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

Q

Okay. Let me follow up then on a question on new business TCV. As you mentioned in one of your comments, you're trying to get into the new areas or digital areas and yet that's a very competitive area and some of the activities are new for you. How are you finding when you're trying to get into those areas pricing as well as margin profile in the new categories. And then before I submit the floor, I just wanted to acknowledge, thanks very much to Alan Katz and team for a very helpful slide deck.

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

A

Thank you Keith for recognizing Alan and his team. We are not betting our shop on moving everything to digital. Clearly, there are parts of our business like omni-channel, et cetera which – remember when you move to digital, the ramp time, the sales cycle time take a certain – a longer period of time than if you were doing things like omni-channel, et cetera which are shorter ramp. Yes, the shortest ramp time, the shortest deal is that if you do customer care, but obvious reasons why we are not going to touch that business.

I am not moving the entire company totally to digital interactions because we're not yet ready for that. We have certain areas that we have really moved fast. We are fairly advanced. We are actually the market leaders in some areas like whether its workers' compensation on Strataware, whether it is on some of our HRS business, et cetera where we believe that we have the advantage and we are going to try and maximize that, we're going to try and expand that service line capability into our existing clients, as well as prospect. In that particular space, the pricing is actually very good. The margin yield is actually very good. As long as we keep moving to as-a-service business or more digital technology business, the pricing gets actually very good. The yield is, of course, a little delayed, but the margin profile is better.

But I am not at the point where I am betting the house on everything digital. It will be a judicious mix of things that are traditional, not customer care, not call center, but still traditional, a little bit of technology and as we pivot to about 15%, 20%, 25% of our business will be digital. We will actually be disclosing our percentage of digital business in subsequent quarters so that the market can actually better understand, you can better understand where that shift is happening and what the profile, the financial profile of these two different horizontal businesses, if you will, look like.

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

Q

All right. Many thanks.

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

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

Yeah. Thank you very much for attending this call. I'm sure we will continue to converse over the course of this year as well as next year. I just want to reiterate the fact that notwithstanding the change that we have demonstrated. We put the guidance the way we saw it. We saw the impact what is having and we disclosed it. I – for one, I'm completely convinced that I've never seen our company as strong as it has been whether in terms of the traction in the market, the client response, whether it's my balance sheet, whether it is the dry powder that I have to make investments both in my own business as well as acquire capabilities through M&A.

I feel confident about my team. I feel confident about the guidance that I've put out there. It is a transition. It is a transformation and it will have some bumps. But we are invested for the long-term – for the medium and long-term and we will not feel ourselves compelled to provide or meet any short-term requirements by compromising on either the quality of service we provide our clients, or the investments that we make in our business. I look forward to continuing the conversations. Thank you so much.

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