03-May-2023

Conduent, Inc. (CNDT)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Conduent First Quarter 2023 Earnings Announcement. At this time, all participants are in a listen only mode. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Giles Goodburn, Vice President of Investor Relations.

Giles Goodburn
Vice President-Corporate FP&A and Investor Relations, Conduent, Inc.

Thank you, operator, and thanks, everyone, for joining us today to discuss Conduent's first quarter 2023 earnings. We hope you had a chance to review our press release issued earlier this morning. Joining me today is Cliff Skelton, our President and CEO; and Steve Wood, our CFO.

Today's agenda is as follows. Cliff will provide an overview of our results and a business update; Steve will then walk you through the financials for the quarter, as well as providing a financial outlook; Cliff will then offer his closing comments.

This call is being webcast and a copy of the slides used during this call, and as well as the press release were filed with the SEC this morning on Form 8-K. This information, as well as the detailed financial metrics package, are available on the Investor Relations section of the Conduent website.

During this call, we may make statements that are forward looking. These forward looking statements reflect management's current beliefs, assumptions and expectations, and are subject to a number of factors that may cause the 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 US GAAP, they should be viewed in addition to and not as a substitute for the company's reported results. For more information regarding definitions of our non-GAAP measures and how we use them, as well as the limitations to their usefulness for comparative purposes, please see our press release.

And now, I would like to turn the call over to Cliff.

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Clifford A. Skelton

President, Chief Executive Officer & Director, Conduent, Inc.

Thank you, Giles, and good morning, everyone, and thanks for joining Conduent's Q1 earnings call. We appreciate you being here today. As is our custom, I'll provide some high level comments about the quarter and characterize some of the nuance and timing of the revenue, EBITDA and sales, etcetera, and Steve, of course, will go into a bit more depth.

As you can tell, we've shifted our perspective here as we migrate to a new set of sell side analysis and, thus, we'll forego immediate questions following the earnings. But, as always, folks should feel free to reach out to our Investor Relations team with any kind of follow-up questions.

First, let's start with a quick view of the numbers. Despite some one-time events, and Steve will talk about those, in Q1, core run rate revenue beat our internal expectations due to the increased volume, specifically in our Government and Commercial businesses, partially offset by client-driven revenue milestone changes in our transportation business and a prior period adjustment in our government business, both of which somewhat muted that positive growth in volume.

These volume trends have continued and we do believe they will, should help bolster the remainder of 2023. Again, Steve will get into the details, but this is all part of the top line growth expectation that we previewed in our Investor Briefing in late March.

As we've discussed in the past, that net ARR number, which was higher year-over-year again at $108 million, is a leading indicator regarding our growth trajectory. We're certainly and especially pleased with improvements in client retention. However, outrunning that government stimulus volume from 2021 and 2022 takes some time. Slowly but surely, we're outrunning the past and landing in that sweet spot growth range we've previously laid out for you.

Regarding EBITDA, we exceeded our internal expectations, bolstered by expense favorability and a one-time legal settlement. Again, Steve will talk about the puts and takes regarding the segments, but of note are the changes in the transportation business. I look at those as essentially discrete, primarily client-driven milestone adjustments and a little bit of pain before the gain exercise. Our new leadership team in transportation installed more operational discipline as we level-set that project portfolio.

New business sales were predictably lower year-over-year as we referenced in Q4 earnings and our Investor Briefing. And, as you know and we discussed, Q4 was quite strong and we expect to bracket Q1 with enhanced sales performance as some opportunities push to Q2 and beyond.

We do see some late large opportunities that give us promise in Q2 and Q3, however. As you know, the timing of contracts, especially in the public sector, can have some back and forth to it based on the contracting regulations. But, meanwhile, our overall pipeline is strong and building across the entire segment base.

Now, I'm often asked whether the economic slowdown is affecting our sales. The answer is, we don't see a reduction in appetite, certainly not appetite to outsource in the commercial sector or fewer RFPs in the public sector, but we do see a slower timeline to contract.

It's simply taking a little more time to put ink on paper and the decision makers are more cautious. Steve will discuss, as always, the detail of our balance sheet, which is strong, the liquidity and leverage ratios remain strong with a consistent capital allocation appetite in very modest ranges.

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Regarding the future, we're on course, as we described in late March. Our base business is within the rails that Steve described, and we continue to see significant opportunities, especially in Government Healthcare and Real-Time Payments. In fact, we're rolling out some new real-time payment and disbursement solutions as we speak. We continue to also believe in the portfolio rationalization opportunities we discussed and, while it's a multi-year journey, we're definitely underway.

Finally, each quarter, we become increasingly proud of our progress related to culture, diversity and being a great place to work. As you know, employees flock to and stay with not a business or brand, but with a culture and its people and its leadership. We work hard every day to take care of our 60,000 hardworking associates across the globe, and I'm most appreciative of their efforts. I'm also thankful for our strong client base, and I look forward to a great remainder of 2023.

I'll now turn it over to Steve for a more detailed view of the financials. Steve?

Stephen Wood

Chief Financial Officer, Conduent, Inc.

Thanks, Cliff. As we have done in the past, we're reporting both GAAP and non-GAAP numbers and the reconciliations are in our filings and in the appendix of the presentation. Let's turn to slide 5 and discuss our key sales metrics.

Our Q1 sales results were as expected and fit into the pattern that we're anticipating playing out in 2023 and in line with how we messaged our expectations for sales growth in our recent Investor Briefing.

In our Q4 earnings presentation and, again, in our Investor Briefing in Q1, I referenced the expectation that Q1 2023 sales would be lighter than the prior year compare as we saw and called out a slower build in some of our next quarter or near-term pipeline, and, additionally, we were managing a tough compare from a very strong Q1 2022.

This lower pipeline build was specific to our Commercial segment, which we partially attributed to macro factors as we saw some commercial clients adjusting their budgets and slowing, but importantly not stopping their procurement activities. Similarly, in Government and transportation, where we typically know the timing of RFP-driven deals, we expected the first quarter to be light.

Before I talk about the quarter, let me give you a flavor as to where we're expecting Q2 to land and how that plays into the first half because, as we've said before, individual quarters can be lumpy.

We expect our Q2 ACV sales to grow over Q2 2022 somewhere in the range of 8% to 10%. This would put us just behind our first half performance from 2022, but with a strong pipeline of late-stage deals which we would expect to close in the second half of 2023, keeping us on target to achieve the sales growth expectations we laid out in the Investor Briefing.

In the first quarter standalone, new business ACV was $125 million, down 25% as compared to Q1 2022. There were some additional impacts from a handful of deals that slipped into Q2. TCV signings at $244 million were also down 47% against the very strong compare in Q1 2022. Most of this impact was in the Commercial segment where in the prior year, we signed some large and long-term expansion business in our European and APAC CX businesses.

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Annual Recurring Revenue, or ARR, was similarly down 43% as compared to Q1 2022. The same drivers were at play in terms of this being anticipated. The net ARR activity metric, our combined measure of wins, losses, pricing effects and other contractual changes, was again positive for the quarter at $108 million. As a reminder, this trailing 12-month measure does not predict the timing of revenue, but is based on the timing of notification and, as such, will fluctuate from quarter-to-quarter.

We also experienced lower levels of notified losses, consistent with some of the themes that we laid out in our Investor Briefing recently.

Turning to slide 6, we've covered many of the metrics on the previous slide, but just a couple of extra pointers here to comment on. Non-recurring revenue, or NRR, was up slightly as compared to Q1 2022. NRR is driven by both add-on sales into existing accounts, and as well as non-recurring revenues such as implementations on certain categories of new deals.

Our add-on business into existing accounts was strong in the quarter, despite the lower levels of new logo sales. Our average contract length in the quarter was 2.9 years, reflecting the lack of large deal signings in the quarter.

Let's now turn to slide 7 and discuss our Q1 2023 financial results. Adjusted revenue for Q1 2023 was $922 million as compared to $960 million in Q1 2022, down 4% year-over-year or 3.7% in constant currency. And given a couple of discrete items that I'll cover when we double click into the segments, this was slightly ahead of our internal expectations.

There's still a little bit of a year-over-year headwind in the quarter from the tail of government stimulus and some one-timers affecting the compare to Q1 2022, in aggregate, approximately $40 million. But that was offset with about $20 million of positive impact from interest rates on our BenefitWallet business and a couple of smaller items.

So, net-net, if you peel those back, the underlying business is within $20 million of being flat, which is consistent with what we said, but we're in the period now where we're transitioning from a long downward trajectory through a transition that will take most of this year, and then sequentially moving towards the growth ranges we outlined for you in our Investor Briefing.

Adjusted EBITDA was $90 million for the quarter as compared to $107 million in Q1 2022 and the adjusted EBITDA margin of 9.8% was down 1.3 points year-over-year as compared to Q1 2022.

There were some unusual items in the quarter, as you'll see in a minute, when we deep dive the segments. But, in aggregate, it's in line with what we expected for the quarter and how we laid out the margin progression for you when we gave a guidance on the quarterly progression in our full year 2022 earnings call.

Let's now turn to slide 8 and go over the segment results. For Q1 2023, Commercial segment adjusted revenues were $508 million, down [ph] 0.8 of a percent (00:13:07) as compared to Q1 2022 and approximately flat in constant currency.

As I said earlier, BenefitWallet drove an $18 million increase year-over-year and our new business ramp was healthy, but offset with a tougher compare on losses that included the final quarter of some business that went away in the second quarter of 2022 due to a bank merger.

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That was a $17 million effect, and this drops out of the compare next quarter, when we expect to show modest year-over-year top line growth in the Commercial segment.

Adjusted EBITDA for the Commercial segment in Q1 2023 was $65 million, up 20% as compared to Q1 2022, and the adjusted EBITDA margin of 12.8% was up 230 basis points year-over-year. Clearly, the fall-through from BenefitWallet was a significant contribution, along with the continued work on operational efficiency.

For the Government segment, Q1 2023 revenues were $264 million, down 7.7% as compared to Q1 2022. The year-over-year impact of the runoff of government stimulus was $14 million in the quarter. Revenue in the quarter also contains an out-of-period adjustment to correct an error that originated in 2020 and impacted all quarterly periods through December 31, 2022.

This adjustment, which the company considered immaterial, was a reduction to revenue of $7 million in the quarter. The balance of the result for the quarter was the effect of prior-year losses, offset with strong volumes in our government payments business, and sales ramp from implementations in our Government Healthcare business.

Adjusted EBITDA for the Government segment in Q1 of 2023 was $83 million flat year-over-year. This, however, included the benefit from a portion of a legal settlement recognized in the cost of services of $17 million. Normalized for the removal of this item and the out-of-period adjustment, the decline in adjusted EBITDA reflected reduced fall-through from the high margin government stimulus volumes and the impact of lost business.

Transportation segment revenues in Q1 of 2023 were $150 million, down 7.4% year-over-year, with the majority of the impact relating to certain discrete items which, we believe, are largely behind us now.

During the quarter, we revised certain timelines for some in-flight projects due to changes in client requirements, leading to a downward adjustment to the revenue of approximately $10 million, which largely explains the variance year-over-year. This revenue will be recognized over subsequent quarters as projects are delivered along the revised timelines.

Additionally, we expect at the conclusion of the projects to be able to recoup certain revenues associated with the changes in scope, but the timing on this is uncertain.

For the transportation segment, adjusted EBITDA for the quarter was $3 million as compared to $17 million in Q1 2022, and the adjusted EBITDA margin was 2%, driven by these discrete items noted above, which were revenue adjustments with 100% fall through to EBITDA.

We expect the transportation segment margin to recover next quarter and to normalize in the second half of the year as we transition a number of these projects through go live.

Let's turn to slide 9 and discuss the balance sheet and cash flow. Our total liquidity position remains strong with a combined $1.1 billion in cash and available revolving credit facility. We ended the quarter with approximately $547 million of total cash on the balance sheet, and our $550 million revolving credit facility is almost completely unused at this point.

Our net leverage ratio increased sequentially to 2.1 turns, but is comfortably inside our target range of 2 turns to 2.5 turns. Our debt maturities are long-dated and we have no significant debt repayments until 2026. The capital

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expenditure in the first quarter was 2.7% of revenue. As I noted in the Investor Briefing, we've updated this metric now to include the capital spent on product software, which hits operating cash flow.

On slide 10, you'll see that we have updated this in our modeling considerations, updating the 2022 full-year compare, as well as our outlook related to this measure. We are still awaiting a $29 million federal tax refund related to 2018, which we continue to expect to receive in 2023.

Let's turn now to slide 10, our full year 2023 guidance ranges are unchanged, at this point. We have no material changes to our view of the annual segment level growth trajectories we called out in our full year 2022 earnings update. Our view at this point in the year is that all three businesses have multiple paths to their full year revenue targets.

Except for the update to include the investments in product software to our CapEx metric, our outlook on all of the other modeling considerations is also unchanged at this point. You'll note from our reconciliations in the appendix of the presentation that we took a disproportionate amount of the full year outlook on restructuring charges during the first quarter. This was planned.

In terms of the second quarter, we're expecting adjusted revenue to be in the range of $900 million to $910 million and adjusted EBITDA margin, probably slightly below our full year guided range.

Q2 is the low quarter for revenue and margin in 2023, and this pace of first half revenue has us remaining on course for the full year. Last year we earned around 49% of our full year revenue in the first half and 51% in the second half, and we expect this to be similar this year. We also expect the impact of several cost initiatives to be mildly accretive to margin through the second half of the year.

In conclusion, Q1 had some discrete items, but when peeled away, we exceeded our overall expectations and were in line with how we've planned our full year outcomes for 2023.

That concludes our financial review for Q1 2023 and I'll hand it back to Cliff for any closing comments. Cliff?

Clifford A. Skelton

President, Chief Executive Officer & Director, Conduent, Inc.

Thanks, Steve. That concludes our view of Q1 2023. Thank you to everyone for joining. As I've consistently said, this is a journey. We've come a long way in the past few years. We continue to see a bright horizon ahead. Thank you for being with us.

Operator: This concludes today's conference. You may now disconnect your lines at this time. Thank you for your participation and have a great day.

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