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Conduent, Inc. (CNDT)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Conduent Fourth Quarter and Full-Year 2016 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, Head of Investor Relations. Please go ahead, sir.

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

Good morning, ladies and gentlemen, and welcome to Conduent's 2016 fourth quarter and full year earnings call. Joining me on today's call is Ashok Vemuri, Conduent's CEO; and Brian Walsh, Conduent's CFO. Following Ashok and Brian's prepared remarks, we will take your questions.

This call is also being webcast. A copy of the slide used during this call was filed with the SEC this morning and is available for download on the Investor Relations section of the Conduent website. We will also post the transcript later this week.

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 22, 2017 and are subject to a number of factors that may cause actual results to differ materially from those statements. Information concerning these factors is included in Conduent's Form 10 Registration Statement and its quarterly report on Form 10-Q filed with the SEC.

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

For more information regarding definitions of our non-GAAP measures and how we use them, as well as limitations as to their usefulness for comparative purposes, please see our press release which was issued last night and was furnished to the SEC on Form 8-K.

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

Ashok Vemuri

Chief Executive Officer & Director, Conduent, Inc.

Good morning, and welcome to Conduent's fourth quarter and full year 2016 earnings call. Today our primary focus will be on last year's results since this was our final performance period as a part of Xerox. On our first quarter earnings call, we will go into more detail about our go-forward strategy and plan.

That being said, it is important to note that we are reaffirming the goals we shared at our December Investor Conference and remain confident in the focus and underlying priorities supporting our company's transformation.

After providing an overview of our performance from last year, I'll hand it over to Brian, where he will go into more details on the financials. From there, we will open it up to Q&A.

Let's begin on slide 3. I'd like to open by describing our vision and highlight some of our near-term focus areas. While we have been characterizing ourselves as a $6.5 billion startup, our long-term ambition is to become a sustainable leader of this industry. This will require outperforming on many dimensions, including but not limited to profitable revenue growth, deploying leading technology leverage process capabilities and best-in-class people delivering best-in-class solutions.

As we begin this next chapter as Conduent, we are positioned well against this bold vision. We are a partner to some of the most admired companies in the world and every state in the U.S. We are currently a market leader in our industry, and by investing in our people, technology and processes we expect to retain this position. We have an aggressive change agenda and we'll make continual, productive change a facet of our culture and leadership approach.

Later, I'll describe the progress we are making in our strategic transformation program, but I remain satisfied with the plans we are making and the anticipated near-term benefits we expect to see from this work.

And again, our financial goals as shared previously remain unchanged. As we conclude this important separation milestone, I have an even stronger conviction that we are focused on the right actions and changes to enhance Conduent's leadership position in the marketplace.

I am now on slide 4, with highlights from 2016. First and foremost, in 2016, we were focused on the extensive work to separate from Xerox Corporation and starting up as a new company. We listed on the New York Stock Exchange on January 3, successfully completing that exercise and are now operating as a stand-alone publicly traded company. We have a lot of work ahead to fully realize our new operating model and vision for success, which my management team and I are committed to.

Initial focus areas including building our IP infrastructure, hiring management teams, setting up business plans with a new vertical structure and refocusing our go-to-market strategy. Today, Conduent has $6.5 billion in adjusted revenue, over 90,000 employees and one of the most attractive client list in our space. Our new name and branding has been well received and we've built a strong leadership team.

I now have most of my team in place, and we are successfully advancing within the next level of management to identify those employees that will be the next generation of Conduent leaders. We are taking important steps to streamline our businesses by strategically focusing on operational efficiencies, client relationships and contract remediations. The start of our transformation initiative is a cornerstone and our drive towards growth, and I will cover that in more detail shortly.

While we have been working hard to redesign a company for improved performance, we remain focused on continuing to serve our clients, as well as win new business, scoring major wins in transportation, within the public sector business, and the telecom and automotive industries within our Commercial business sector.

While I plan to have Brian address our 2016 results in a few minutes, I do want to note there are several one-time items impacting Q4 and 2016 results. I'd like to touch on one of these. We are currently in discussions with the State of New York regarding the status and scope of the Health Enterprise platform project, and believe we will not fully complete the implementation of the platform as originally designed.

The State of New York has been and will continue to be an important client for us and a location where we do significant business. We will continue working closely with the state to reach a mutually satisfactory outcome.

Moving to slide 5, let's discuss our strategic transformation in a bit more detail. Our strategic transformation efforts are well underway. In 2016, we launched our companywide program focusing on both cost savings, as well as operational optimization. We are making steady progress on identifying and prioritizing on the aggressive goals in the program. At the conclusion of this effort, we expect to deliver a cumulative $700 million in savings with approximately $430 million in cumulative savings targeted through this coming year.

These savings are being derived across every aspect of our company, most notably through IT and GA optimization and efficiencies. Contract remediation in certain client situations is another important aspect of this program. This work is having immediate impact and we are balancing reinvestment of the associated savings and margin expansion to meet both 2017 and long-term financial targets.

While cost initiatives are an important part of our transformation, we're also making improvements in a range of operational areas to improve our growth posture. These include deepening our industry and domain expertise, more effectively monetizing our solutions and platforms, redesigning our management process of faster decision-making, as well as the delegation of business decisions to the businesses for greater frontline authority and accountability.

We are also narrowing the geographical and industry focus to drive higher service line penetration to better service our core clients. As we aggressively progress our strategic transformation work, Conduent will steadily look like a very different company than the one just recently separated from Xerox.

And now moving on to slide 6, I will summarize drivers of our future performance. As we outlined during a investor event in December, our strategic plan is expected to drive top and bottom-line growth over the next several years, with cash flow reinvested in high-return opportunities. We will focus on three key areas; revenue growth, margin improvement, and free cash flow generation.

In support of revenue growth, we will drive new business signings while sustaining our strong track record on renewal rates in our core as defined by large, growing and profitable segments through a judicious mix of organic and inorganic investments. To achieve our margin goals, we will focus on building a portfolio of businesses with attractive return profiles. This requires simplifying, standardizing and streamlining our operations, as well as turning around areas of underperformance.

We will win business that is highly repeatable and supported by platform-based offerings. We will then leverage our experience in these offerings to add multiple clients to these platforms. This approach has been working very well in our Public Sector and Healthcare businesses. For example, our VECTOR Transportation platform is used across the country to support automated tolling and our Midas+ platform is used in over 2,000 hospitals for improving patient case management by capturing and analyzing patient data securely and confidentially.

These are but just two illustrations, and we have many more within our company. Expanding these approaches will be core to accelerating our performance. By progressing these first two drivers, we expect to deliver revenue growth, cost transformation and stable margin expansion. These will support our third performance driver, improved free cash flow and a more predictable cash flow over time creating expended capacity for reinvestment.

Before I hand off to Brian, let me reiterate that I'm confident in our ability to transform Conduent into a market-leading, growth-oriented business process services company, delivering a differentiated value proposition for our clients and investors. This will take time to achieve, but the priorities and work ahead are clear. And we are mobilized to drive all of the necessary changes required to make Conduent a great company.

With that, Brian will take us through the financials in more detail.

Brian Webb-Walsh

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

Thank you, Ashok. In an 8-K issued last week, we announced that we would be taking an impairment on goodwill and writing down our New York MMIS contract. The goodwill impairment is a non-cash impact of $935 million. Along with this impairment, we also realized the deferred tax benefit of $107 million, so a net impact of approximately $828 million. This was the result of the regular annual goodwill review of the Commercial segment.

Our focus continues to be to turn this segment around including our customer care offering. I want to be clear that there is no change to the long-term outlook for the profitability of the company offered in December. We remain confident in our turnaround efforts and plans for the future as we reposition for growth.

The New York MMIS write-down is the result of discussions that we are currently in with our client, which lead us to believe it is not probable that we will complete this implementation in its current form. Based on these discussions, we have recorded a charge of $161 million, a $115 million of which is non-cash. We remain committed to servicing our existing Health Enterprise clients in New Hampshire where we have achieved certification, as well as Alaska and North Dakota where we are working on certification.

On New York, we are working closely with the client on a mutually agreeable solution. We are committed to maintaining a good relationship with New York State and value the business we have across the number of other agencies within the state. While we are disappointed that we weren't able to deliver on the MMIS contract as originally planned, this move positions us with a more solid base of revenue and allows us to focus on other opportunities.

As noted in our prior disclosures regarding the Health Enterprise platform, these system implementations prove to be more difficult and more costly to complete than our initial expectations. So, we're not selling this offering any longer.

Now, let's move to the financial results. I'm on slide 8 with an overview of the full year 2016 performance. Our GAAP metrics were impacted by the one-time items which I just discussed. So I'll focus my commentary on our non-GAAP metrics, which reflect our ongoing operations. Reconciliations are available in the Appendix of the presentation. 2016 adjusted revenue was $6.5 billion, a decline of 4% compared with 2015, primarily driven by lower volumes, slower ramp of new business and the continued run-off of our other segment.

2016 adjusted operating income was $354 million, up 10% compared with the prior year. Adjusted EBITDA was roughly flat year-over-year with adjusted EBITDA margins of 9.8%, a 40 basis point improvement over 2015. As Ashok highlighted, we continue to make progress in our transformation initiative this quarter, and both sequential quarterly and year-over-year margin improvement reflect this.

I will now walk through some of our drivers of the quarterly financial results compared with Q4 2015, please turn to slide 9. Fourth quarter revenue declined 7.7% or 6.5% in constant currency as a result of lower volumes, slower ramp of new business, contract run-offs and the run-off of our Student Loan business. Adjusted gross margin was 17.8%, an improvement of 120 basis points versus the prior year period.

Selling, administrative and general costs improved by $8 million for the quarter and Q4 adjusted operating margin improved 120 basis points compared with the prior year. You can see the impact from our strategic transformation initiatives in all of these lines. We had a pre-tax loss for the quarter of $1.1 billion as a result of the goodwill impairment charge and New York MMIS write-off.

Let's now discuss the segment level performance in a bit more detail. Before I do, I'll note two housekeeping items. First, I'll note that as you can see, we have a number of non-GAAP metrics that we are utilizing for comparative purposes. We have kept these metrics consistent with the adjustments that Xerox utilized in prior reporting periods for this year. We are currently reviewing which of these metrics make the most sense from a shareholder analysis perspective so we may not use all of these metrics moving forward.

The second item to note is that starting in Q1 2017; we plan to report with three segments, Commercial, Public and Other. We plan to divide the current Healthcare segment between Commercial and Public with the work we do for payers, providers and pharmaceutical companies falling into the Commercial segment, and the government healthcare services work excluding Health Enterprise clients falling under the Public segment.

We plan for the Other segment to be unchanged still containing our Health Enterprise platform clients and our Education business, which includes our Student Loan offering. Given the results we are providing today are from prior to separation, I'll present the legacy four segments in today's commentary.

Please turn to slide 10 for the Commercial and Healthcare segment breakdown. Revenues in our Commercial business declined 10% in Q4 2016 versus the same quarter last year, as we saw slower new business ramps and lower volumes from existing clients. Their turnaround within the Commercial business is more challenging than we initially anticipated; however, we remain confident that we're addressing the issues.

Our focus remains on cost transformation, remediating challenging contracts and ensuring the appropriate guardrails are in place to improve profitability while still providing best-in-class service to clients. Operating margins were 2.3% in Q4 2016 versus 2.4% in Q4 of the prior year. As I discussed earlier, the goodwill write-off was taken as a result of profitability trends in Commercial, including the Q4 performance. We still have a meaningful amount to accomplish in this business, but we continue to see opportunity in the Commercial space.

Turning to the Healthcare business, fourth quarter revenues were $409 million, a decline of 11% year-over-year, driven largely by contract run-off and lower volumes. In terms of profitability, Q4 2016 operating margins in the Healthcare segment were 11.5%, up 190 basis points versus the prior year. We're seeing the impact of the cost transformation and productivity initiatives here. As you can see, this is the third quarter in a row of margin improvement.

Moving on to slide 11, let's discuss the Public and Other segments. Revenues in our Public Sector business were down slightly in the quarter compared with Q4 2015. The revenue trend was stable in 2016, although Q4 declined as the ramp-up of new business was more than offset by contract losses. Our Public Sector quarterly profit margins in the fourth quarter were up by 120 basis points versus last year, this is the result of both new business wins and the cost transformation initiatives flowing through the bottom line.

Adjusted revenue within our Other segment, which includes our Education business and all of our Health Enterprise clients, declined by 7.4% in Q4 versus last year. This was largely driven by the continued run-off of our Student Loan business. The business continued to run at negative margins in 2016 with the Education business, which includes our student lending business losing approximately $11 million and the Health Enterprise business losing approximately $75 million.

These results do not include the impact of the 2015 Health Enterprise charges related to the exits of the California and Montana implementations or the 2016 charges related to the write-down associated with the New York MMIS contract. Our goal remains to get the Other segment to breakeven over time.

Let's move on to an overview of our Q4 and full year 2016 cash flow on slide 12, my commentary will focus on the full year. Cash flow from operations and free cash flow were both down significantly from 2015, with cash flow from operations of $108 million and free cash flow of negative $81 million for the year.

The 2016 free cash flow was impacted by a number of factors, including restructuring payments of $46 million, separation payments of $44 million, $155 million of payments related to exiting California and Montana Health Enterprise contracts, the discontinuation of our factoring program which was about $130 million negative impact, and $47 million related to the cash outflows that were necessary as a result of the spin-off primarily related to lease buyouts.

Let's now turn to slide 13 to discuss our capital structure. Our balance sheet remains strong with ample liquidity, including $750 million of availability under our revolver and $390 million cash balance at year-end. Please note that this balance does not reflect a payment that we made to Xerox of $161 million in January related to separation.

Adjusted for this payment to Xerox and the issuance of an additional $100 million within our Term Loan B facility, which also happened in January, our cash balance net of those items would have been $329 million. Given the follow on offering to the Term Loan B, we now expect our annual cash interest expense to be in the range of $155 million to $165 million.

Our adjusted leverage ratio was 2.7 times net debt to adjusted EBITDA based on the $329 million cash balance I just discussed. This is compared to our target ratio of less than 2.5 turns; we aim to achieve this target by growing our adjusted EBITDA and making mandatory debt payments over time. One reminder for those of you building quarterly models on the company, we tend to be a user of cash in the first half of the year given our working capital trends.

Before I close, I want to reiterate what we highlighted in our financial goals in December. We expect 2017 revenue to decline at roughly the same rate as 2016. For clarity, this would be roughly a 4% decline from our GAAP 2016 revenue of $6.4 billion.

We expect to see revenue stabilize in 2018 with growth potential later in the year. By 2019, we expect to see revenue growth accelerating. Our goal is to grow adjusted EBITDA in both 2017 and 2018 by greater than 5% and 10%, respectively. Beyond 2019, we expect to see continued improvement in adjusted EBITDA as we grow the business.

Reinvestment into the business will be focused on capturing market growth opportunities by increasing the size of our sales force, continuing to invest in platforms and technology and looking at potential M&A, which will be limited in 2017, but should increase in 2018 and beyond. As you can see, we still expect our conversion from adjusted EBITDA to free cash flow to be approximately 20% to 30% in 2017 and 25% to 35% in 2018 and beyond.

In closing, I'm excited about the prospects for the business and the growth opportunities that are ahead of us. Now, let's open up the call for Q&A.

QUESTION AND ANSWER SECTION

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

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Yeah, hi. Thanks for taking my question and nice to see reiteration of fiscal year guidance. Can you comment on $170 million in business as usual savings you talked about in December; do you expect similar level of such savings that offsets investments in 2017 and in 2018?

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

A

Yeah, good morning. We do have a business as usual savings that we have to actually deliver this year and next year. When we put together the $700 million of the transformation target, it included $170 million of business as usual savings that we had to drive in 2016 related to contract losses and renewal price-downs.

The rest of the $530 million is all of the transformation initiatives we've put together to drive efficiency for the company, to reduce overhead, to simplify, those are truly transformational savings in changing the way we work that are not there to offset the business as usual pressures in the business.

When it comes to the business as usual pressures in the business, we'll continue to have contract losses, we will continue to have price-downs as a result of renewals and contract-by-contract, we will have to come up with those offsets, but that's outside of the transformation program going forward.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it. And can you also help us understand various puts and takes in the cash flow guidance? You'll obviously have incremental charge related to the New York contract, but the guidance remains the same. So can you comment on what offsets the charge and how much of $83 million revenue reversal will flow through in 2017?

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

A

Sure. So let me first start by talking about New York and then I'll move to cash flow overall. So for New York, in 2016, before the write-down, we had about $60 million of revenue on the contract and we lost about $30 million, and we used about $75 million of cash.

As we think about going into 2017, the fact is probably we will complete the project as originally contemplated, we most likely won't have the $60 million of revenue and we will try to manage to a breakeven outcome from a profit perspective, which would be a good year-over-year improvement.

And then we have the $46 million of the write-down that is a cash charge, but that is lower than the cash usage in the prior year. And keep in mind if the project had continued in its original form, the milestones were pushed out beyond 2017 so we would have been using cash this year. So from that perspective, it will actually be a little bit of good news.

Moving to cash flow overall, our free cash flow was down to negative in 2016, we had a number of one-time items, we had our Health Enterprise payments related to California and Montana of $155 million, we had separation-related payments including the lease buyouts of about $90 million. We stopped our factoring in program at year end and that hurt free cash flow by about $130 million.

So those are behind us. We will now have cash interest expense of $155 million to $165 million, but those other one-time items go away with a profit improvement that we're driving, we're confident we can meet our cash flow guidance that we gave back in December.

Puneet Jain
Analyst, JPMorgan Securities LLC

Q

Got it, thank you.

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

Ivan P. Holman
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Good morning. This is Ivan sitting in for Brian. Could you help us understand exactly in a little bit more detail as in the Other segment, any additional color on how many contracts still live in there, how are they structured, what's the duration? And you did mention that at some point you will try to manage that segment towards breakeven, can you update us on a timeline for flipping into profitability?

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

A

Yeah, so I think at this point, we probably won't back off the timeline of three to four years that we gave, although we will try to accelerate that as much as possible and make faster progress as we can. If we look at the Health Enterprise part of it, we have our Montana, California, Alaska and North Dakota, and New York Health Enterprise contracts that makeup the Health Enterprise component.

And then our Education business includes our Student Loan business and some other smaller businesses related to education, but there'll be multiple clients inside of that part of the business. But again, if you look at the loss, $75 million was Health Enterprise, $11 million was student lending in the overall Education business. In that, Health Enterprise was made up of about five contracts and they all have different expiration dates. And obviously, we are trying to manage all of them to profitability or at least to breakeven.

Ivan P. Holman
Analyst, Morgan Stanley & Co. LLC

Q

Great, thank you. And a quick follow-up, this question is for Ashok. How are clients receiving these contract renegotiations? I mean, obviously you're getting credit and you guys are definitely rolling up your sleeves and doing exactly what you had set out to do, but how should we think about how clients are receiving that? And I did notice that gross margins held in pretty well this quarter. I expect that's due in part to more disciplined contract guidelines. Any color on how clients are feeling about those renegotiations would be helpful.

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

A

Yeah, Ivan. So anytime you open up a contract negotiation, you have to be extremely careful and you have to ensure that a conversation with a client around that clearly amplifies the benefit to the client as well. But the remediation of these contracts is a multitude of things. Number one, it's also incumbent upon us to ensure that we are delivering to the contract that we have signed.

We are driving a higher degree of automation and better processes delivering them with appropriate optimal solutions, delivering them from the right locations, and ensuring that the delivery – the quality of the service delivered does not invite penalties. So there is a whole host of these things that go into the remediation.

Also from a client perspective, there are situations where the change management whether we have been chartering for the change management, whether those change management that the clients are requesting for are appropriate and can be delivered. So we're factoring those things as well. But clearly, our conversations with the client do indicate to us that there are certain situations where we may not be bringing in the kind of value that our clients perceived when they sign.

And so there is a mutually agreed to point where we decide that may not be worth continuing. There are situations where the service level agreements have changed considerably from the time they were signed. And there are situations where we are reemphasizing the fact that the – our performance will only improve if we get a return that is investable to provide them a better service.

So overall, I think the reception that we've had with our clients has been, I would say, positive. I wouldn't say it is overly positive. And the other factor to consider is, if you look at the decline in our business between Healthcare and Commercial, 25% of that is what I label as self-inflicted. We continue to hold the business with our clients, we're driving a higher degree of service line penetration not seeing it yet, but that is a conversation that we're having. So there is a whole host of these things that are going on with more active conversations with our clients.

Ivan P. Holman
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. I'll jump back in the queue.

Operator: And next we have a question from Frank Atkins of SunTrust.

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

Q

Thank you for taking my questions. Wanted to follow on that question, was there an impact in 4Q revenue of paring back some of lower margin business? What do you see going forward in terms of revenue visibility?

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

A

Yeah. So if you look at the Commercial and Healthcare segments, the revenue decline there, we would say about 25% of that revenue decline was because of decisions we made to exit contracts. And then the other 75% would be slower new business ramps, some lost contracts that we didn't want to lose and some volume issues with some large clients. But about 25% would be decisions that we made.

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

Q

Okay, great. And wanted to ask what was head count as of year-end, and is it your intention to provide some operating metric in terms of utilization or head count by geo or attrition going forward?

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

Yeah. So the head count at the end of December 31, 2016 was 96,000. As of February 15, it is 91,000. And to your second part of the question, we intend to provide a greater degree of metric that is more amenable to the industry that we belong to.

So it's not just about utilization and head count, we're also going to disclose recruitment numbers, attrition numbers, things like service line penetration, productivity, geographic mix, client concentration, a whole host – TCV signings, et cetera, a whole host of things that we think would provide a better color to our business, to all of you. We're also seeking inputs from the market in terms of what more they would like to see, and we factor those in as well.

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

Okay, great. And last one from me, if we look at free cash flow as a percent of adjusted EBITDA, what are the things that are going to push that towards that 35% range in 2018? And then, as you look at industry peers, do you think there is a reason that that could go north of 35% going forward?

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

So I think if you looked back historically, we've been in the 35% range. We've just had a lot of one-time items in the prior year that brought it down. So, I think we have line of sight to getting there, getting to the 20% to 30% this year and getting to 35% and beyond. And really beyond 2018, 2019, it's hard to tell, but if we could potentially improve more, but right now we see it the way we've called it.

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

Okay, great. Thank you very much.

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

Jim Suva
Analyst, Citigroup Global Markets, Inc. (Broker) **Q**

Thanks. Just a quick clarification before I ask my main question, during your prepaid remarks there was a mention about not selling and offering anymore, I think it was in the CFO commentary, if I heard correctly or something. Can you explain what that offering -was that in reference just to the State of New York or is it referring to all healthcare exchange or what was that comment about not an offering being out anymore?

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

It's our Health Enterprise platform. And when we exited Montana and California back in 2015, we actually – Xerox actually also communicated they wouldn't be selling it and would be focused on existing states only. And we just reiterated that. And with the exit of New York or the likely write-down of New York and it's not going to finish the way it was initially contemplated, based on that, we just wanted to reiterate the fact that we wouldn't be selling this platform again.

Jim Suva
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay, that's what I thought. And so then my follow-up questions is, with you not focused on it any more for future state, that almost sounds like you're deemphasizing it. So will – those states then you will eventually transition them off of your platform or are you continued to really keep investing in those? I'm just trying to figure out about, hey, what's the real strategy here with the state you have going on, are these platforms in the next few quarters or years we are going to see you take more scaling and running off write-downs?

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

A

No, so the other states that are on the platform, so Alaska and North Dakota, they are going through the certification process with CMS, the Centers for Medicaid & Medicare. And then we have New Hampshire which is already certified. We'll continue to service those contracts that are in – they are largely passed the development phase, two are still pending certification, but they are operating and we will continue to support those.

Jim Suva
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Okay. And then if you can – and then my last question is, can you just really help us understand bridging the gap of – in December you gave financial goals and today you reiterated them and that's very clear. However, you had a big write-off of your New York contract which was supposed to be starting to eventually turn positive, how do you bridge the gap of keeping those goals? Or when you gave those goals, did you know that New York was going to go away or did you win something big to plug the gap?

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

A

So, we did not know when New York was going to go away when we gave those goals, although we've pointed out the risk at our December 5th event. But you look at New York and it lost $30 million in the prior year, it used cash, it did generate $60 million of revenue, but from a profitability perspective, it will begin to use – if we can manage this to breakeven in 2017.

Obviously, we do lose the $60 million of revenue that we had in the prior year and we've said that from a – the guidance we gave in December was that revenue will decline at a similar rate to 2016 decline in 2017. And so we are now looking at $6.4 billion of GAAP revenue and there is going to be a decline of roughly 4% off of that. So there is a revenue issue related to New York. But from a profitability perspective, it should allow us to drive some good news.

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

A

Yeah. And let me just also add that even though we were not aware of this and it has happened now on the New York deal, clearly we – given our – the TCV signings for the year which are about $6.9 billion, all the strategic transformation that we are doing, just not only on the cost side, but on the operating model as well, we feel that sticking to that guidance is the right thing to do.

Jim Suva
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

And then the longer-term outlook of 2018, I believe you gave revenue growth of flat to positive momentum, but with the State of New York going away, is that still valid and intact? And if so, help me bridge that gap.

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

A

It is. So, again, New York generate $60 million of revenue, it would have generated something similar, but it's now out of our base. And so we've reset the base and again we think will decline about 4% this year off that lower base and then will flatten out as we get into next year and then grow beyond that, that's still valid. Although, we've reset the base by taking the $60 million out of for New York.

Jim Suva
Analyst, Citigroup Global Markets, Inc. (Broker)

Q

Great, thank you so much for the clarifications, greatly appreciate it.

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

A

Thank you.

Operator: The next question will come from Shannon Cross of Cross Research.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you very much and good morning. My question to start with is, basically, could you talk a bit more about what you're doing on the sales force side in terms of go-to-market? And you talked about 75% of the revenue in Commercial that went away, and the declines was not really what you wanted. Some of that sounded like contracts you wanted to keep. So I'm just curious – I know it's early, you're only seven weeks in as your own company, but how are you thinking about go-to-market, how are you incentivizing your sales force and what does the competitive landscape look like right now?

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

A

Yeah, so let me take that one-by-one. So number one, we have reoriented our go-to-market by verticalizing the company. So our go-to-market pivot, if you will, is the vertical industry focus, so we're driving a lot more of our solutions, our capabilities and customizing them to particular industries and issues within those industries, whether it's on the Commercial side, whether it's in Healthcare or whether it's in Public Sector.

We intend to ramp up our sales force. We have about 300-odd people for a company our size, so obviously that's way short in terms of boots on the ground. We intend to ramp that up to about 24%. We're also repurposing our service delivery leads. Clearly there is a lot more credibility if service delivery leads are in the market and facing off against clients. 80% of our revenue comes from transaction-based pricing revenue model. So we intend to increase that that requires us to monetize and deploy more platform-based solutions. We're driving a higher degree of automation, especially in certain parts of our business like customer care, where there is a desperate need for that.

So the go-to-market is going to get more verticalized. We're going to have – we will have more feet on the ground. We're also narrowing the geographical focus where we do business, so clearly we've identified North America and parts of Western Europe as our core markets where we will drive a higher degree of service line penetration. Even in the service line penetration, we're looking to see where the commonalities of our various services, we have a wide spread of services, we're trying to drive the commonalities of that and sell them in a much more bundled fashion.

And some of the confidence we get in that is because we have done a few of those now, and we feel confident that we seem to be getting the right sales model. Pricing remains stable as far as we can see. As we are moving to value-based pricing more from fee based, we're finding that we're able to bundle our capabilities better and provide an end-to-end solution, which is actually taking the conversation away from unit-based pricing to a much more outcome-based pricing, which is exactly where we want to be.

I think the last part of your question on in terms of – what was the last part?

Shannon S. Cross
Analyst, Cross Research LLC

Q

Competition. Hello?

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

A

Oh, on the competition, I mean, we have a very wide spread of competitors both in our Commercial space and Public Sector. Given our size, scale, given the client base that we have, we feel actually fairly confident that we're able to stand on our own against these competitors. There clearly are some situations where unlike in the past we will not necessarily continue to try and win every deal, there – we have a much more sophisticated qualification criteria. We have devolved some of the pricing mechanism and the pricing decisions into the field and that is allowing us to take – while we have set guardrails, allowing us to take faster decisions on a go-or-no-go basis.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you. That was very helpful. Just one last question. Actually, one of the challenges I think prior management had when they got in there and most of the – was that there were a lot of contracts that sort of surprised them and I think New York, California, again that was the Healthcare side of things. I'm just curious, as you've looked through your portfolio, do you feel pretty confident now that – you may lose the deal here or there, but generally speaking, the contracts you have right now once renegotiated or ones that you want to keep or do you think there's other large ones alongside – again, New York's still big, I'm not sure there would be – but other large contracts that perhaps you'll want to get rid of over time? I'm trying to figure out how far along you are in terms of contract pruning effectively rather than just renegotiating contracts you have.

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

A

Yeah. So it's a work in progress, and thank you for recognizing that we're only 35 days into the new company. So it is something that we will continue to work on, but the core philosophy now is to drive more repeatable, scalable and predictable business. We are not in the business of trying to capture a headline by doing a big deal that we do not even understand how to start working on it.

So it is going to be about redeploying our asset, it's about continuing to invest in the assets that we have a market presence in, a size in and a credibility and capability in. I don't think we are in the business also of signing long-tenure contracts necessarily, because process and technology changes happen so rapidly that really does that make sense to – and it's difficult for us to take a view on where this will go in, let's say, five years or beyond.

Shannon S. Cross
Analyst, Cross Research LLC

Q

Thank you for your time.

Operator: And our 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. I have two questions. The first one, Ashok, is for you – more philosophical. When you say you want to grow the company eventually, growing and where? And what I mean by that is, Conduent or Xerox or CSE typically had been at the very low end of the BPO market. IBM was in the call center business and sold to SYNNEX. You are in the transportation business, which most of the other traditional IT service providers aren't in.

And so as you think about it philosophically, are you trying to move up into higher-end portion of the BPO market to compete more directly with the Genpacts of the world? And if that isn't your intent, how do you move into the higher end of the BPO world and still enjoy the benefits of margin expansion?

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

A

Yeah. So, Keith, we have a mix of – very, very wide mix of businesses that we do. So we do business process outsourcing, which is transaction processing; we do customer care. If I look at my care business that ranges from very low end technical support, all the way to supporting, for example, pharmaceutical companies and nursing and pharmaceutical specialists, et cetera, who detail drugs and their side effects to doctors. So in that itself, we have a fairly wide range, in that we have to move up the value chain.

Secondly, we do software business. We actually build software. For example, we talked about Midas+ or VECTOR, these are software that we deploy in our clients. So we have that software business, which is – financially the way you sell it, the way you metric it, is all very different from a traditional unit-based pricing care business.

And thirdly, we do a significant amount of custom development, we deploy that. But the thing that we have to really work on is to take all these various service capabilities, find the common thread between them and sell them not as stand-alone or individual services or capability, but as a bundled solution, end-to-end bundle solution that – and driven by a significant amount of outcome-based pricing.

So we want to be cautious about what areas we want to get into. We are in many, many areas, so we have to narrow our focus. We want to drive growth in – for example, in the Commercial business, which is sort of been underperforming, we see tremendous opportunities. If we take the care business, we see automation, we see robotics, we see analytics, we are probably one of the largest collectors of data in the Public Sector and the Commercial space. So we have got to now start deploying our analytics capability, mining capability, warehousing capability on to that.

Some of our businesses – and you named one of the competitors; we may not be advantageously positioned with regards to their core competency. The only way we can compete therefore is to bundle that service or capability into a much more wider and more holistic solution out to them. So our focus is going to drive profitable growth, drive a business that is scalable, take advantage of our scale benefit, a business that's repeatable and a business that we do not venture into things that probably don't have a grasp of it, enough capabilities, enough clients and more, if you will, that we have where we can drive a higher degree of service line penetration and go deeper into these clients rather than expanding in a much more wider fashion.

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

Q

Okay, great. I look forward to having follow-up conversations on that. The second question I wanted to ask is on the source of savings. In this $700 million of target cumulative savings, it appears that 50% is procurement, G&A and IT, that's a fairly large number; call it, more than almost 6% of revenue savings from procurement, G&A and IT. Just if you could flush that out a little bit on what you're anticipating, how you drive those savings from those buckets?

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

A

Yeah, I'll ask Brian to detail that out. But I think the broad statement on that is, clearly as we move from a construct, which was more hardware-oriented, which was sort of manufacturing company-oriented, the cost structure supporting the business is very different in a services business. So intuitively walking in one can make out that the G&A expenses et cetera probably skewed against what a services business that I have seen before, I've worked in before. So that's one part of it, but I'll ask Brian to detail out in greater detail.

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

A

Yeah, I would just add that, if you look, when the business was under Xerox, actually like R&D and marketing was pushed to the BPO business because it had the greater growth opportunity. And if you look back at the overhead, when you see us was a stand-alone company, it was lower than what it is at the point of separation.

And we're – in the G&A front, we're focused on finance, marketing, legal, human resources and we have benchmarks reaching these functions and we're managing the functions to the benchmarks. We're trying to simplify everything we do, again focusing on what a services company would do versus a technology company.

When it comes to procurement, part of procurement is facilities, we have a very large facility footprint we're trying shrink, and then we're trying to work stand-up procurement organization and drive savings with our vendors. And then IT, IT again, it's about consolidating data centers, it's about limiting the number of servers we have, it's about bringing some things in-house that we currently outsource. So there is a lot that goes into the IT part of it too. So there is a lot of detail that goes behind all of these, but essentially, it's taking back some of our IT infrastructure and getting an overhead that supports the business and it's affordable.

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

Q

Okay. Fair enough. I'm going to sneak one more if I can, then I'll cede the floor. But your expected annual interest expense, call it a $160 million a year just for round numbers, how are you going do M&A and still work your debt down? I mean, I think you said this year probably limited M&A, but even if you look at 2017, as you're trying to grow your skill-sets to get into perhaps new areas or augment your existing areas, how do you complete the M&A and still manage your debt and interest expense?

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

A

So, we're going to fund the M&A through free cash flow generation. And so that's why it's very modest this year. And as we generate free cash flow, we'll use it to fund the M&A. And then from a debt pay-down perspective, we'll make our mandatory payments, which are pretty small this year. They get a little bit larger in 2018, and we'll do other things opportunistically to manage down the interest expense if and when we can. But really it's generating the free cash flow to fund the M&A.

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

Q

Okay, thank you.

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

A

And then we'll pace it when it's affordable.

Operator: And our next question comes from Bryan Bergin of Cowen.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi, thank you. Just a question on policy, have you noticed any change in clients' behavior just due to the uncertainty in the current political environment, and really anything surrounding their willingness or their pace to engage with their perception of outsourcing?

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

A

Well, not in great detail, I think it's still wait-and-watch for a lot of people. But clearly indicators are with potential regulatory overhang getting reduced, conversations in certain specific industries, financial services, for example, pharmaceutical industry that seems to have picked up momentum, but yet only conversations, nothing sort of converting. But the pace of conversations has gone up. I'd probably say that some of the recent developments on our side, have also been triggered I guess as a reaction to potential changes in the healthcare space.

We do expect Public Sector spending to pick-up in areas that would play to our benefit, whether it's infrastructure, transportation, tolling, et cetera. And we think that those conversations that are beginning to happen will gain momentum as things become more clearer.

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Okay, that was helpful. And then just on 2017 guidance, anything further you can provide on cadence of revenue and profitability measures, I heard you mentioned cash flow seasonality, anything else to call out otherwise?

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

A

So a couple of points on guidance. One, we're going to – when we do our Q1 earnings call, we plan to give more detail around 2017. Then we plan to do annual guidance, not quarterly guidance. With that said, Q1 from a seasonality perspective is a lower profitable quarter compared to Q4, so keep that in mind from a seasonality perspective, you can see that if you look back at the historical numbers. So those would be my comments.

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

And I think as I mentioned earlier, we intent to provide a higher degree of operational metric disclosure as we go ahead. Given that what we've provided in the past is probably the expectation should be to see a lot more of that from our side, whether it's segment information, client concentration, whether it's TCV, the mix from a horizontal vertical perspective, service line penetration for sure, revenue productivity and so on and so forth.

Bryan C. Bergin
Analyst, Cowen & Co. LLC
Q

Okay, thank you very much.

Operator: And this concludes our question-and-answer session. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.