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Conduent, Inc. (CNDT)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

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

Clifford A. Skelton
President, Chief Executive Officer & Director, Conduent, Inc.

Stephen Wood
Chief Financial Officer, Conduent, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the Conduent Fourth Quarter 2022 Earnings Announcement. At this time, all participants are in 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 fourth quarter and full-year 2022 earnings. We hope you had a chance to review our press release issued earlier this afternoon. 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 and full year, as well as providing a financial outlook. Cliff will then provide his closing comments.

This call is being webcast, and a copy of the slides used during this call as well as the press release were filed with the SEC this afternoon 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 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, how we use them as well as the limitations to their usefulness for comparative purposes, please see our press release.

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

Clifford A. Skelton

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

Thanks, Giles. And good afternoon, everyone. Thanks for joining Conduent's Q4 and full year 2022 earnings call. I'll make some high-level comments about the quarter, the year in 2023. In addition, I'll call out some exciting future opportunities as we like others slog through these somewhat uncertain times.

First, let me say that Q4 and full year revenue ended within the range of previous guidance, albeit on the low end, driven primarily by lower volume in our Commercial business and some revenue implementation timing in our Transportation business. EBITDA finished directly in line with our previous guidance, and margins also met expectations. Of particular interest is new business sales. The year finished strong, especially our Government Healthcare business where we won two large state Medicaid contracts in Q4. Commercial customer experience also progressed nicely through the year. Generally speaking, sales continue to improve each year, and we just need to keep that rolling.

Now, as I step back and debrief the year, I would say it's a tale of many cities, with headwinds and tailwinds, perhaps more headwinds than tailwinds. Inflationary events tended to bring interest rate tailwinds in the P&L. However, some of those same inflation-fighting trends create recession-like slowness to volumes, which impacted our Commercial business. Meanwhile, foreign exchange rates, primarily in Europe, created some headwind for our Transportation and Commercial businesses. On the upside, we received a modest tailwind from the remnants of government stimulus through pandemic SNAP volumes. The blending of all that in a company with strong businesses and a large and strong client base brought us to the low end of our full year guidance.

Our operational performance continued to improve in 2022 as well. Technology uptime is now a hallmark of success for us. However, having been a Chief Information Officer for two Fortune 500 companies, one never says we have arrived when it comes to technology or information security. But we can say that we've had a strong and concentrated effort around technology discipline and standards.

In addition, operational process improvements has helped with readiness, especially in our call center space and staffing. We worked hard in 2022 to ensure we operated with a culture of inclusion and fairness. Any company with 50,000-plus production folks knows how important culture, values and leadership are for client retention. This all helps our associates to act as strong ambassadors for our clients in the treatment of their end customers.

In that regard, we received recognition from General Motors, Toyota, H&R Block and several other top 50 companies for supplier excellence. Regarding culture, we're proud to have been recognized by Newsweek as a Top 100 Most Loved Workplace, as well as receiving several awards from others in recognition for diversity, disability inclusion, gender, and thriving in a remote culture. Finally, we received industry leadership recognition especially in customer service by NelsonHall, Everest Group, Gartner and others.

That all said, more should always be expected when it comes to financial progress. 2023 brings with it a year where past or legacy performance-related losses finally run off and we return to more normalized loss rates as a percentage of revenue. At some level, it's just math. When onboarded sales ramp outpaces losses, all else being equal, you have growth. All else is equalizing for us in 2023 and it will be a transition into growth year.

Every year since 2019, we've made progress and decreased the year-over-year decline, while fixing the foundation. That foundation phase is over. In 2023, two of our three businesses will grow and our government sector will be poised for growth in 2024 after the runoff of two or three large state contracts lost due to legacy performance.

Now, Steve will discuss our net ARR numbers in his remarks. But as we've discussed in the past, assuming the baseline business remains steady, now of course the economy can sway that assumption and did so in 2022, but with a steady baseline, if that net ARR number remains positive, over time, growth must manifest. And that number was positive, again, at $114 million, up quarter-over-quarter. As Steve will mention, all three of our sales metrics, net ARR or annual recurring revenue, annual contract value and total contract value were up in Q4, which again is a positive sign once we finish outrunning stimulus and legacy losses.

Regarding that Government business, we are still quite optimistic. We won significant contracts in our state-of-the-art Medicaid claims platform, from what we can tell, the only platform in the industry built from the ground up as cloud-native. The Government Healthcare pipeline has never been stronger. Now we must implement with precision. Steve will go into more detail regarding Government's performance and why, as we've now outrun the stimulus grow-over, we see blue skies ahead in the back half of the year.

There are many reasons to be quite bullish on Conduent. It wasn't that long ago that we were worried about our Commercial business. It declined modestly in 2022 and will grow in 2023. Transportation declined in 2022 and will grow in 2023. Government is the business requiring a little more explanation. Revenue declined 12% in 2022, driven by continued stimulus PSNAP grow-over and prior losses manifesting as I previously mentioned. However, the strong upside from new sales ramp will reverse that trend by the end of 2023.

We also have geographies and entrées into new client opportunities generated by a business development effort new to Conduent. We rolled out a new one-of-a-kind digital payments hub in partnership with BNY Mellon that will enable real-time bill payments to governments and businesses, real-time disbursements for disaster relief and reimbursements and client to vendor payments providing cost reduction benefits to clients. We're beginning to integrate these capabilities into our current offering sets, and we are seeing traction in sales. For payments, we definitely see real opportunity in our current client base as well.

Finally, we're in the middle of planning our investor event for the last part of March. We intend to show the three-year growth trajectory for the company. We think there are acceleration opportunities as well, centered on portfolio rationalization, unique investments and go-to-market opportunities that could enhance our posture even further with investors.

Steve will now take you through more details around the quarter, 2022 and 2023, but the bottom-line message is we did what we said we'd do in 2022. We'll do the same in 2023. Once our Government business gets through the last bit of 2023 headwind and reaps the rewards of the strong market and sales efforts, we'll experience the overall growth rates we've been waiting for. As always, we appreciate the patience from our investors, the confidence from our clients and the perseverance and hard work from our team.

I'll now hand it over to our CFO. Steve?

Stephen Wood

Chief Financial Officer, Conduent, Inc.

Thanks, Cliff. As we have done in the past, we are reporting both GAAP and non-GAAP numbers. 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 primary sales metric, ACV, grew 22% in the quarter versus the prior year to $194 million. It has also been up sequentially for the past five quarters. For the full year 2022, ACV also grew approximately 17%, ignoring the impact of the prior year government stimulus revenues, which as we have said before are nonrecurring and we saw the tail end of them in 2022. New business TCV was very strong in the quarter, growing 132% as compared to Q4 2021. More importantly, again, ignoring the impacts of government stimulus, it was up approximately 18% on a full year basis.

Double-clicking on some of the detail here, the main driver of these year-over-year increases, as Cliff mentioned, was a very strong finish to the year in our Government segment, including two significant wins for our modular cloud-native Conduent Medicaid Suite and another for our state disbursement programs, which benefit low-income families. The combination of these three deals contributed in excess of $400 million in TCV and will drive strong implementation revenues in 2023 and 2024 with follow-on operations and maintenance revenues at the conclusion of the implementations.

We said in prior quarters that we have a strong pipeline of late-stage Government Healthcare deals, and the business had a very strong sales finish to 2022. Our pipeline remains strong in this area. This year-end performance in Government drove the ACV up 36% as compared to 2021. In addition to this, the Commercial segment ACV was up 14% as compared to 2021, but had a slower finish to the year. Transportation ACV was up 5% year-over-year as compared to 2021.

New business ARR, the recurring component of our sales, was essentially flat both quarter-over-quarter and year-over-year. The net ARR activity metric, our combined measure of wins, losses, pricing effects and other contractual changes has, continued to remain positive. As a reminder, this trailing 12-month measure does not predict the timing of revenue, but is based on the timing of notification. A full definition of this metric is covered in the appendix of our presentation.

Turning to slide 6 to review some of our key sales metric trends. I've previously commented on our improving sequential trend in ACV. And you can see, in Q4 2022, the impact of the Government segment deals mentioned earlier driving upticks in TCV, new business NRR and average contract length. To differentiate project implementations from the recurring run component of a contract, we define the project implementation phases as NRR because they are onetime in nature. All three of these Government deals mentioned earlier have strong components of NRR, but will also have recurring revenue components from operations and maintenance.

Now, let's turn to slide 7 and discuss our full-year 2022 P&L metrics. We finished the year with results coming in at the low end of our full year guided range, but consistent with how I messaged it in the fourth quarter during our last earnings update.

Revenue for 2022 was $3.85 billion as compared to $4.07 billion in 2021, down 5.4% or 4.4% in constant currency. As we have said previously, 2022 was the year we were growing over the onetime government stimulus volumes from 2021. This represented a net headwind of $185 million in 2022. There were a lot of other puts and takes, which I'll cover as I talk about the individual segment results. Tailwinds from BenefitWallet interest rates, headwinds from foreign exchange, volume reductions from a couple of our larger commercial clients, ramp from new business and offsets from lost clients, all of which we'll discuss later.

Adjusted EBITDA was $394 million for the full year 2022 as compared to $448 million in 2021. And our adjusted EBITDA margin at 10.2% was 80 basis points down year-over-year as compared to 2021. This was within our full year guided range, but slightly below how I laid out Q4 in our last earnings update due to a couple of discrete items that affected the fourth quarter that I'll cover when we go through the segment results individually.

The puts and takes on the adjusted EBITDA for the full year were headwinds from the runoff of the onetime government stimulus volumes, headwinds from mix in foreign exchange, offset with the positive impact of increased fall-through from BenefitWallet revenue and our ongoing cost efficiency programs.

Our GAAP net income in 2022 was impacted by two significant events. In the first half of 2022, we recorded a pre-tax gain on sale of $166 million on the divestiture of our Midas suite of solutions. In the fourth quarter, we recorded a pre-tax impairment charge of $358 million on the carrying value of goodwill for our Commercial reporting unit.

After completing the annual goodwill impairment test, the Commercial reporting unit experienced lower than expected new customer contract signings in the fourth quarter and an unexpected softening of the near-term business pipeline for certain solutions, which we believe are being driven by macroeconomic conditions present in the fourth quarter.

The combination of these factors led us to review the Commercial reporting unit and further evaluate the portfolio. This triggered a goodwill impairment assessment for this reporting unit as of December 31, 2022, which resulted in this pre-tax impairment charge. The effect of this can be found in our filings and in the appendix of the presentation.

Let's now turn to slide 8 and go over the segment results. For the full year, Commercial segment revenues declined 1.2% year-over-year, which was a significant improvement to 2021 when it declined 4.1% from 2020. The net effect in the year of incremental BenefitWallet revenue offset with foreign exchange headwinds was an approximate $18 million benefit. For the first time, ramped revenue from new clients exceeded runoff from lost revenue, a function of both increased sales and better retention.

The offset to this was the previously messaged decline in volumes from a couple of our largest clients where they were normalizing their post-pandemic volumes. The full year effect of that was approximately $50 million in the year, and we expect that to continue into 2023. Net-net, the Commercial segment declined slightly, but performed well. Underlying revenues have stabilized, and we are projecting modest growth in 2023. More to come on that later.

For the Government segment, full year 2022 revenue declined 12% as compared to 2021. The runoff from the onetime government stimulus volumes in 2022 was a net $185 million. This decline was less than we had messaged at the beginning of the year, and the underlying business also performed well with higher volumes in our SNAP summer programs and other solutions within both our Government Services and Government Healthcare businesses.

Transportation segment revenues declined 5% year-over-year in 2022 as compared to 2021, with approximately half of this decline being driven by foreign exchange headwinds affecting the international transit business. The remainder of the decline was some onetime revenues that benefited our Q4 2021 results and the effects of slower than expected implementations in certain projects where we expect the revenue to catch up in 2023.

In terms of adjusted EBITDA and margin, the Commercial segment improved 17% year-over-year and the adjusted EBITDA margin of 11.3% was up 170 basis points year-over-year. Increased BenefitWallet revenue contributed to this margin improvement along with operational efficiencies and increased work-from-home, allowing continued real estate rationalization. This was offset with some headwinds from mix.

In the Government segment, adjusted EBITDA declined 24% and the adjusted EBITDA margin of 28.8% was down 460 basis points year-over-year. The roll-off of the onetime government stimulus volumes was the significant driver of this change in 2022.

For the Transportation segment, adjusted EBITDA declined 21% year-over-year as compared to 2021 and the adjusted EBITDA margin of 11.8% was down 240 basis points year-over-year. In addition to the onetime revenue item that benefited the fourth quarter of 2021, the quarter and the year were impacted by some higher than expected expenses related to certain projects. Overall, this was an approximate 3.5 point decline in the adjusted EBITDA margin for the quarter as compared to Q4 2021 and approximately 120 basis points on a full year. Some of these headwinds will persist in Q1 2023 before we see a more normalized margin rate returning.

Let's turn to slide 9 and discuss the balance sheet and cash flow. Our total liquidity position is strong with a combined $1.15 billion in cash and available revolving credit facility. We ended the quarter with approximately $600 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 is 1.8 turns, which we believe is below our normalized range of 2 turns to 2.5 turns. Our debt maturities are long-dated, and we have no significant debt repayments until 2026.

Our capital expenditure in the fourth quarter included a cash purchase of client equipment, which later in the quarter we financed. This grossed up our US GAAP cash flow statement by recognizing both investing CapEx and proceeds from the issuance of debt for $13 million, but had no impact to adjusted free cash flow. Without the effect of this item, our capital expenditure as a percentage of revenue in the fourth quarter would have been 3.2% and 3.7% for the full year, which was more in line with how we laid it out for you earlier in the year.

During the fourth quarter, a combination of factors drove a lower than anticipated adjusted free cash flow outcome. Firstly, an expected federal tax refund was pushed to 2023. As discussed earlier, some of the slower implementations in the Transportation segment and other timing impacts in the Government segment caused certain billing milestones to shift, which we'll now collect in 2023. It is the nature of our businesses that serve the Transportation and Government segments that the cash flows can be lumpy. Finally, we repaid the second and final installment of our deferred payroll taxes under the CARES Act in the fourth quarter.

Let's turn to slide 10 and we'll walk through our 2023 guidance. Overall, we expect adjusted revenues in 2023 to be in the range of $3.7 billion to $3.8 billion. The midpoint of this range would represent a year-over-year decline of $100 million or 2.6%. Within this number is the previously communicated year-over-year impact of two of our largest clients reducing their post-pandemic volume assumptions representing 130 basis points of decline and the runoff of the onetime government stimulus volumes representing 110 basis points of decline.

Additionally, we're anticipating some incremental volume headwinds that but we believe are mostly recessionary that contribute an additional 75 basis points of decline and the unanticipated loss of a Government segment call center client representing 70 basis points of decline. This is offset with an approximate 100 basis points of improvement from previously communicated interest rate decisions that positively impact our BenefitWallet business. These discrete items represent approximately a net negative 285 basis points of our year-over-year revenue decline. As you can see from this, our underlying base business has stabilized.

Double-clicking on each of the three segments at the midpoint of our range, we expect the Commercial segment to grow approximately 1.3% in 2023 and we expect the Transportation segment to grow approximately 1.8% in 2023. This is offset by a decline of approximately 12.5% in the Government segment, driven by client losses and the $42 million of government stimulus volumes in 2022, most of which was anticipated and communicated on our previous outlook that we gave in our Q4 2021 earnings update. There, we said we expected the Government segment to decline in 2023 mid- to high-single-digits.

The revised outlook given here reflects the loss of the additional call center client I referenced earlier that was notified in Q4 and is included in our net ARR metric in the fourth quarter in addition to the stronger than expected contribution in 2022 from the tail of the government stimulus volumes.

In terms of the pacing of revenue in 2023, we see it being very similar to 2022 in terms of weighting between the front half and back half of the year. As a reminder, Q1 is usually slightly higher than Q2 because of the impact of open enrollment period within our healthcare client base.

In 2023, we expect adjusted EBITDA margin to be in the range of 10% to 10.8%. The larger puts and takes in this outlook are the impact of previously announced interest rate increases that benefit our revenues and EBITDA in the BenefitWallet business and our continued work on cost efficiency across our business segments and corporate functions.

Offsetting these are the margin impacts on the nonrecurring government stimulus volumes and the previously noted volume reductions, some of which are recessionary in the Commercial segment. Like last year, we expect adjusted EBITDA margins to start the year slightly below the guided range and finish the year slightly above the guided range, driven by factors that include a sales ramp that is more weighted towards the second half of the year, as well as continued work on cost efficiency.

We expect to convert adjusted EBITDA to adjusted free cash flow in the range of 15% to 20%. As I mentioned previously, our cash flow in the short term is sensitive to some of these larger Government and Transportation segment projects as we work towards milestones that can move due to client requirements or other factors.

We expect CapEx to be approximately $130 million and restructuring charges to be approximately $40 million. The increase in our outlook on restructuring charges, at least for 2023, is largely driven by opportunities to further rationalize certain infrastructure expense as well as our real estate footprint as we continue to evolve our hybrid work-from-work, work-from-home model.

That concludes our financial review of the 2022 Q4 and full year results. And I'll hand it back to Cliff for closing comments. Cliff?

Clifford A. Skelton

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

Thanks, Steve. Look, in closing, I think it's important to restate that 2022 brought with it a lot of exogenous components, from interest rates being positive to EBITDA, to base volume changes that were unexpected from some of our largest clients, to foreign exchange rates that were certainly not planned for. All of which, when coupled with the normal puts and takes of a very diverse portfolio, made for a year when finishing within our guidance range on top line and EBITDA was somewhat impressive. The onetime events on cash are somewhat anomalous and normalize out in 2023, we believe.

Regarding 2023, we were hopeful that our pivot to growth would happen earlier in the year, but government buying timing patterns can sometimes be unpredictable. The good news is that selling and retaining revenue remains paramount, and two of our three businesses are growing and the third has very strong legs to it as we see real growth opportunity in that Government Healthcare business. Our very diverse portfolio can and has been a strength in the past, particularly during the pandemic.

But today, we need to keep looking closely at where within that portfolio we can generate the most future accretion and value by way of where there is; first, scarcity value externally; and second, where we can focus the combination of our bandwidth, new products and payments, new geographies, especially in Transportation, and disciplined investment protocols into something that not only grows, but generates the kind of market appreciation we think we should enjoy. Now, more to come on all of that in our investor event, but please be on the lookout for the next week or two for a firm date, the last part of March for that event.

In closing, we're proud of what we accomplished in our foundational work over the past three years. We're proud of our ability to hit the numbers we predicted in the 2022 year that brought with it some of its own unpredictability. And we look forward to again doing what we say we will do in 2023. The bottom line here is that we're quite sanguine about the future of Conduent.

Thank you again to our listeners, and as always, thanks to our clients and to our associates. Good day, everyone. Back to you, operator.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.