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CNDT.OQ - Q2 2023 Conduent Inc Earnings Call

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Giles Goodburn *Conduent Incorporated - VP of Corporate FP&A and IR*

Stephen Henry Wood *Conduent Incorporated - Executive VP, CFO & Principal Accounting Officer*

PRESENTATION

Operator

Good morning, and welcome to the Conduent Second Quarter 2023 Earnings Announcement.

(Operator Instructions)

As a reminder, this conference is being recorded.

At this time, I would like to hand the call over to Giles Goodburn, Vice President of Investor Relations. Thank you. You may begin.

Giles Goodburn - *Conduent Incorporated - VP of Corporate FP&A and IR*

Thank you, operator, and thanks, everyone, for joining us today to discuss Conduent's Second 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 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 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 actual results to differ materially from those statements.

Information concerning these factors is included in Conduent's annual report on Form 10-K filed with the SEC. We do not intend to update these forward-looking statements as a result of new information or future events or developments, except as required by law.

The information presented today includes non-GAAP financial measures. Because these measures are not calculated in accordance with U.S. GAAP, they should be viewed in addition to and not as a substitute for the company's reported results.

For more information regarding definitions of our non-GAAP measures and how we use them as well as the limitation 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 - *Conduent Incorporated - President, CEO & Director*

Thank you, Giles. Welcome, everyone, to Conduent's Q2 Earnings Call.

I'm joined by our CFO, Steve Wood, who will follow me with the financial and sales details. Today, I'm going to focus on 4 key messages. First, and importantly, will be a Q2 "flyby", if you will. Q2 was a good quarter for us with puts and takes, but generally exceeding expectations.

Second, these days, no one can get through a discussion without touching on those 2 popular and sometimes hyped-up letters, AI. And more specifically, Generative AI. We'll discuss how we are approaching this new opportunity since we've been using traditional AI capabilities for many years.

Third, you'll recall, we discussed back in late March, 3 important pillars critical for our medium to long-range journey. Portfolio rationalization, payments or specifically real-time or instant payments, we talked about several key growth areas with a specific call out in Government Healthcare and a particular focus on our Medicaid platform, we call CMDS or Conduent Medicaid Suite, a production-ready application portfolio supporting states migration from large legacy MMIS systems to a digital cloud-hosted SaaS platform.

And fourth, I'll discuss what we're seeing in the marketplace and the impact on our clients and our associates. So let's start with an intro into Steve's reports. In the second quarter, Conduent delivered healthy financial results as we continue to meet or in this case, exceed, what we previously positioned for you.

Despite a somewhat challenging macroeconomic situation, which I'll talk about in a minute, we posted $915 million in revenue with a 10.2% adjusted EBITDA margin or $93 million versus $87 million in Q2 2022, otherwise stated, an 80 basis point lift year-on-year. There are a lot of moving parts in those numbers, certainly aided by a strong quarter for Government and our BenefitWallet business.

Sales and Net ARR also came in strong, enhanced by a large Transportation deal, which Steve will discuss in a minute. Like others, we're excited about the advances in Generative AI. Certainly, the benefits and the risks are being discussed and debated on a global scale.

Now I don't want to add to the hype as there is enough of that to go around. That said, we know that over time, meaning months and years, it will become increasingly clear regarding cost, benefit, risks and opportunity. Our early read is that Gen AI, while different in terms of the ability to generate content by using large amounts of data and compute power is largely a continuation of work underway, despite claims to a new product-oriented approach, at least with respect to our Business Process as a Service industry. There is no question, however, that Gen AI will enhance productivity in our industry. It will drive better answers faster and it will create better outcomes for our clients.

Our view thus far, although we continue to learn is that Gen AI will enhance our already AI-enabled platforms, such as our Vehicle Passenger Detection System in Tolling and Public Safety and our Fraud Detection System in Payments or our Patient Re-enrollment predictive analytics in Pharma through our IntelliHealth platform. Among many others.

We have a team of strategy, technology and operations experts evaluating and instituting pilots and developing a white paper, which in conjunction with several of our large clients will determine investment needs and impacts. We don't see this as a revenue substitute, but more as a way to expand into value chain adjacencies. And since most of our services are delivered in BPaaS environments, where clients are paying for outcomes, not labor substitution, there should be upside, but there's so much more to come that is undiscovered.

You should know that we're approaching this in a very thoughtful, outcome-based manner, where clients' needs are met most efficiently and as a continuum of service versus a new value stream, which frankly has not been perfected for many obvious reasons like privacy and regulations. Now also in late spring, Steve and I detailed our "March for Growth and Value Enhancement" and how several key elements come to play.

We said we believed our portfolio was too wide. We're not deep enough or nimble enough and sometimes brought with it assets that were either not core or would not grow over time without too much focus or investment. We are well into that journey to solve that situation through a series of thoughtful potential divestitures.

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We also said we are focused on payments with a particular emphasis on real-time or instant payments. We invested significantly in real-time and instant payments through our partnership with BNY Mellon and utilizing our upgraded Integrated Payments Hub. We're now the first and only BPO company to be processing transactions through the Federal Reserve's recently announced FedNow service.

Our clients' endpoint bills and our clients' need to process disbursements real-time with good funds and reduced cost can be enabled by our platform, which helps connect and decision routing between all financial institutions within the United States.

Finally, we said our cloud-native enabled technology in state distributed government Medicaid disbursements and claims is unsurpassed in capability and flexibility, and we're now winning more business in that space.

We're in full implementation with our biggest client win to date, the state of Texas, the state we've been eager to win back business from. We're in implementation mode with several others and in contract negotiation with another very large state. All in all, we are executing on the plan we described to you back in March and are proud of our progress.

With respect to what we're seeing in the marketplace, it's a mixed bag. On one hand, we see buying appetite quite strong in our Government and Transportation segments. The ability to grow there is a function of our skill and ability to implement, coupled with improving leadership. Regarding the Commercial segment, we're feeling some of the same macro headwind pressures many of our peers are discussing. Some of our clients tend to be a bit more defensive versus offensive relative to buying commitments and volume projections.

Even with clients where we outperformed the competition, of which there are many, we're seeing a larger share of a smaller pie in the Commercial space. So it's in times like this where we simply need to double down on our efforts to pursue new logos in the Commercial space. The workplace itself seems to have settled into the new normal regarding work from home, work from work, even in our production environments. It feels like we're now over the new target. With this phenomenon and the economic growth slowness, we find associate turnover to be flat to down in our production ranks and down in our management ranks.

There's no one thing that will drive associate satisfaction and retention by itself. It will always be a combined work in progress. But we are proud to have been recognized for the second year in a row, but now globally, as one of Newsweek's Top 100 Most Loved Workplaces for 2023 and recognized by Forbes as one of the Best 500 Employers for Diversity for the third year in a row.

Now I just mentioned 4 things: our financial performance; our posture on Generative AI; the progress on our 3 strategic pillars; and what we're seeing with our clients and our associates.

And as I've said, we're very proud of all of this. Regarding outcomes that matter most, sales and client retention were strong. Associate retention improved. We won some big deals, and Steve will talk about those. And our revenue and adjusted EBITDA performance was good. Winning means all of that, coupled with the continued execution of our strategic initiatives, and that's what we intend to do.

I'll now ask Steve to take you through the breakdown of the results and the outlook overall and within the segments. But with a particular eye on that juxtaposition of sales, macroeconomic conditions, backlog and our portfolio rationalization efforts.

Steve, I'll now turn it over to you.

Stephen Henry Wood - *Conduent Incorporated - Executive VP, CFO & Principal Accounting Officer*

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. Q2 sales results were enhanced by the closing of our large Transit deal for the state of Victoria in Australia. This long-duration deal initially valued at around $1 billion of total contract value contributed $65 million to our strong ACV bookings of $208 million in the quarter. That $208 million of ACV represented a 16% growth year-over-year and 66% sequentially against Q1.

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I'll talk in a minute about some of the specifics on the Transit deal in terms of how we're laying out the recurring versus the nonrecurring pieces of the revenue and our initial expectations on timing of revenue.

Before that, I'll point out that in the first half of 2023, we are roughly flat year-over-year for ACV. We have a strong pipeline of deals in the second half of the year, especially as we had some decent sized deals push into the second half. In addition to Transportation being strong in the quarter, our Government segment had a good ACV sales quarter as well. Both Government and Transportation segment bookings are well above the first half of 2022.

Offsetting that, our Commercial segment bookings were lighter for a second quarter and below last year, both for Q2 and the first half. In the Commercial segment, we're seeing longer decision-making cycles and slightly more cautious buying behavior we think driven by broader macro concerns. The pipeline is still strong, but the deals are taking a little longer than expected to close, and it's changed our likely mix of full year sales.

Let me double-click now on some of the revenue characteristics of the state of Victoria Transit deal and how this plays into the various numbers on these sales metric slides. In our revenue definitions, we distinguished between nonrecurring revenue, NRR and annual recurring revenue, ARR. One of the things that this does is to help isolate large implementation efforts, which typically occur on some of our Transportation and Government Healthcare deals. These can be multiyear implementations, but eventually these roll off and the revenue transitions to what we refer to as operations and maintenance, or O&M, which we recognize as ARR.

We expect the nonrecurring implementation piece of the Transit deal to represent approximately $200 million to $250 million in NRR, which we expect to recognize over an implementation period of up to 4 years. There's a fragment of that at the very end of 2023, but it's largely revenue that will benefit 2024 through 2027.

The balance of the revenue is recorded as ARR and will recognize roughly ratably over the period of the contract, again, starting at the very end of 2023 as we take over the operation of the existing service. You can see the significant impact to our TCV metric on this slide and the NRR metric on the following slide. Annual recurring revenue or ARR was similarly up 11% as compared to Q2 2022, benefiting from the Transit deal with an offset from lower Commercial bookings.

The Net ARR activity metric, our combined measure of wins, losses, pricing effects and other contractual changes, was again positive for the quarter at $137 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.

As part of this metric, we again experienced lower levels of notified losses, consistent with some of the themes we laid out in our Investor Briefing recently. Very briefly on Slide 6, you can see here again some of the impacts of that Transit deal that I referenced. Overall, we're pleased with the sales results for the quarter. And once again, the segment level variability is a function of the breadth of our business.

We've had a strong first half of the year in our Government and Transportation segment sales, and we believe those businesses have strong defensive characteristics against broader macro trends.

Now let's look at the financial results for the quarter. Turning to Slide 7. Revenue for Q2 2023 was $915 million as compared to $928 million in Q2 2022, down 1.4% year-over-year or 1.5% in constant currency. This was slightly better than how I laid it out for you in last quarter's earnings, driven by a timing item in the Government segment that I'll cover in a minute, that we expected would resolve and land in the third quarter.

Other than that, we were right in line with our own topline expectations for the quarter. Within the quarter, BenefitWallet gave us a $17 million lift year-over-year as compared to Q2 2022, and this was offset with a $9 million headwind in the quarter from the tail of government stimulus. Those were the discrete items, and the balance was a mix of some volume headwinds in a few of our larger clients and the improved timing of new business ramp offset by losses from prior years.

Like I said last quarter, 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.

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Adjusted EBITDA was $93 million for the quarter as compared to $87 million in Q2 2022. And the adjusted EBITDA margin of 10.2% was up 80 basis points year-over-year as compared to Q2 2022.

This was a little better than we expected and how I laid out on our last earnings call. The government revenue segment timing item came with 100% fall-through and the effect of interest rates on our BenefitWallet business as well as ongoing cost initiatives are the additional contributors that drove adjusted EBITDA performance.

Let's now turn to Slide 8 and go over the segment results. For Q2 2023, Commercial segment revenues were $471 million, up slightly as compared to Q2 2022. BenefitWallet drove a $17 million increase year-over-year, and new business ramp and add-on sales were offset with losses from prior years. There were also some negative CX volume impacts from some of our larger clients, and we're seeing some evidence of softening in outlooks in travel, logistics and telecoms, which appear macro related.

Adjusted EBITDA for the Commercial segment in Q2 2023 was $72 million, up 56% as compared to Q2 2022 and the adjusted EBITDA margin of 15.3% was up 550 basis points year-over-year. The fall-through on BenefitWallet was a significant contribution, along with continuing work on operational efficiency.

For the Government segment, Q2 2023 revenues were $270 million, down 3.2% as compared to Q2 2022. The year-over-year impact of the runoff of government stimulus was $9 million in the quarter, which largely explains the year-over-year effect. We had strong volumes in our Government Payments business and sales ramp from implementations in our Government Healthcare business, which also benefited from a catch-up of revenue that was previously constrained as we cleared a contractual protest.

This discrete item was worth $6 million in the quarter, top and bottom line and against this, there were offsets from the effect of prior year losses. Adjusted EBITDA for the Government segment in Q2 2023 was $77 million, down 1.3% year-over-year. The adjusted EBITDA margin was 28.5%, up 50 basis points year-over-year and benefited from the margin fall-through on the Government Healthcare item.

Transportation segment revenues for Q2 2023 were $174 million, down 2.8% year-over-year, driven by losses and slightly lower implementation revenue as compared to Q2 2022. For the Transportation segment, adjusted EBITDA for the quarter was $13 million as compared to $24 million in Q2 2022, and the adjusted EBITDA margin was 7.5%, down 590 basis points as compared to Q2 2022, but up sequentially on Q1.

As I said last quarter, we expected the Transportation segment margin to start to recover in Q2, and it did. We're expecting that to continue to normalize in the second half of the year as we transition several projects through go-live and begin to deliver on the large Transit contract later in the year.

Let's now turn to Slide 9 and discuss the balance sheet and cash flow. Our total liquidity position remains strong with over $1 billion in cash and available revolving credit facility. We ended the quarter with approximately $505 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 stayed constant at 2.1 turns, well within our target range of 2 to 2.5 turns. Our debt maturities are long-dated, and we have no significant debt repayments until 2026. Capital expenditure in the second quarter was 2.8% of revenue as compared to 2.7% in the first quarter. We're continuing to find opportunities to drive efficiencies in our capital investment programs and as you'll see on the next slide, we slightly revised down our full year expectations on capital spend.

We're still expecting our $29 million federal tax refund related to 2018 to be received in 2023.

We launched our initial share buyback program late in the second quarter and repurchased approximately 267,000 shares at an average price of $3.29. As a reminder, at the end of Q2, we have approximately $74 million remaining on our 3-year $75 million approved program.

Let's now turn to Slide 10 to look at our 2023 outlook. While we are not changing our outlook on revenue and adjusted EBITDA, we do now expect to be below our midpoint of the range for the full year. On revenue, the driver here is the mix shift of new business bookings in the first half of the

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year, which I talked about earlier. It's simply the higher relative share of Government and Transportation deals that will take slightly longer to come out of backlog as compared to Commercial deals, which ramp to revenue quicker. And so that mix shift means that we'll now see some of that revenue in early 2024.

With that mix shift in bookings in the first half of the year comes slightly different expectations for segment revenue growth trajectories in 2023. We now expect Commercial and Transportation to be a little bit lower and Government to be better compared to how we laid it out at the beginning of the year. I talked about the drivers for Commercial earlier. And in Transportation, I'd say it's the slower start to the year, which catches up as we deliver these projects over the goal line, with some of that now being in 2024. Government is benefiting from strong volumes in Payments as well as good progress on delivering the sales backlog of large state healthcare MMIS deals into revenue.

For adjusted EBITDA, it's a function of the slightly lower revenue outlook for the reasons I laid out above, and we're working hard to offset that with continued cost efficiency throughout the second half of the year.

Looking at the third quarter, we're expecting revenue to be in the range of $915 million to $925 million, and adjusted EBITDA margin probably slightly below our full year guided range, and we'd expect this to be the low point to the year. There's no change to our expected adjusted free cash flow outcome for the full year. And finally, I'll point out that we've made some minor adjustments to some of our other modeling assumptions for the balance of the year.

So Cliff, if I summarize it, I'd boil it down to these 3 things. I'd say we're positive on the trajectories we're seeing in Government and Transportation with a lot of in-flight implementations and a strong backlog of work to deliver, and we've got a good pipeline of opportunities in both segments.

In Commercial, the pipeline is good, but we're having to work harder to keep deals moving forward, and there's a sense of caution in buying behavior and some lighter volume expectations in areas you'd expect to be impacted by some level of pullback due to macro factors.

And then finally, I'd say that we laid out at the end of March a portfolio rationalization approach that would drive incremental value above a solid base case, and we've been working very diligently during the quarter to advance that strategic theme across a number of fronts. And we'd expect to be able to come back in the second half of the year and provide updates on some of those items.

So that concludes my financial review for Q2 2023, and Cliff, I'll hand it back to you for any closing comments.

Clifford A. Skelton - *Conduent Incorporated - President, CEO & Director*

Thank you, Steve. As I said, this was a really strong quarter for Conduent. We're certainly proud of that. We continue to manage through the macroeconomic factors we have in front of us in our Commercial business. But our pipeline and our sales remain strong, and we're achieving significant milestones on many large implementations.

As always, we're focused on delivering for our clients, and we thank them for their business and loyalty. I'd also like to thank our 60,000 hard-working associates who take care of those clients every day.

Finally, this all demonstrates that our team is executing the strategy we had outlined earlier in the year and building momentum against what we told you back in March. As always, please reach out to our Investor Relations team if you have any questions. Thank you all very much for joining us today.

Operator

Thank you. This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and enjoy the rest of your day.

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