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Xerox Holdings Corp. (XRX)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation Second Quarter 2023 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions] At this time, I would like to turn the meeting over to Mr. David Beckel, Vice President and Head of Investor Relations. Sir, the floor is yours.

David Beckel
Vice President & Head-Investor Relations, Xerox Holdings Corp.

Good morning, everyone. I'm David Beckel, Vice President of Investor Relations at Xerox Holdings Corporation. Welcome to the Xerox Holdings Corporation's second quarter 2023 earnings release conference call hosted by Steve Bandrowczak, Chief Executive Officer. He is joined by Xavier Heiss, Executive Vice President and Chief Financial Officer. At the request of Xerox Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the expressed permission of Xerox. During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor, and will make comments that contain forward-looking statements which, by their nature, address matters that are in the future and are uncertain. Actual future financial results may be materially different than those expressed herein.

At this time, I would like to turn the meeting over to Mr. Bandrowczak.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

Good morning and thank you for joining our Q2 2023 earnings call. I am pleased to report another quarter of year-over-year growth in revenue, profits, profit margins and cash flow. Consistent with recent quarters, these positive results reflect our team's balanced execution amid a dynamic macroeconomic backdrop.

Summarizing results for the quarter: Revenue of $1.75 billion grew 0.5% in constant currency and 0.4% in actual currency. Adjusted EPS was $0.44, $0.31 higher year-over-year. Free cash flow was $88 million compared to negative $98 million in the prior-year quarter. And adjusted operating margin of 6.1% was higher year-over-year by 410 basis points. This quarter and throughout this past year, demand for our products and services has remained resilient, particularly for our value-added print and digital services and among our mid-market clients. Our ability to consistently deliver growth in revenue, profits and cash flow through a challenging operating environment is the result of an intense focus on three strategic priorities: Client success, profitability, and shareholder returns.

A benefit of renewed focus on client success – beyond the positive impact on revenue and profits is an employee base that genuinely seeks to empower clients and partners with essential products and services for today's workforce. At Xerox, we see the evolving hybrid workplace as an opportunity to improve clients' productivity and employee satisfaction levels with solutions such as secure cloud print for a distributed workforce, automated document and information workflows and streamlined multi-channel customer communication, to name a few.

A thriving hybrid workplace requires advanced technology solutions from trusted technology providers like Xerox. This quarter, Xerox was recognized by Quocirca as a leader in cloud print services, positioned as a leader for both strategic vision and depth of service. We also advanced our leadership position in Quocirca's assessment of leaders in the print security market, an important distinction as clients place increasing importance on data security.

Xerox's leading technology and our ability to deliver solutions in-and-around multi-functional devices helped win new business with existing clients and win new clients. This quarter, we won a renewal with a leading healthcare service company, increasing annual contract value by close to 40%. Through our understanding of this client's needs and our broader healthcare vertical expertise, we were able to design an integrated customer engagement solution that improves and automates patient communications processes. We also won a new business at a global chemical company, displacing a large competitor in the process, by offering an advanced print management solution that will improve print compliance and security, while reducing system-wide print cost by 15% to 20%.

An important enabler of client success is a deeper understanding of Xerox's value proposition among clients and partners. In Q2, we launched a new integrated brand and demand generation campaign, We Make Work, Work. This is the most significant marketing campaign the company has launched in many years and is meant to drive awareness of Xerox's digitization and workflow solutions that solves clients' pain points in a dynamic hybrid workplace. This quarter, we also held our first Global Partner Summit since the pandemic, hosting close to 400 channel partners. The event showcased Xerox's commitment to its partner ecosystem and demonstrated how Xerox can grow with our partners to provide secure, sustainable and cloud-ready solutions built for the new era of AI and digital transformation.

It is clear our value proposition is resonating with clients. In the past six months, we experienced a meaningful improvement in services signings momentum. Year-to-date, signings are up double-digit in constant currency and revenue retention rates remain solid. Further, the greater appreciation of our workflow solution is helping drive equipment market share. In Q1, the latest quarter of market share data availability, Xerox gained 2 points of global market share in the markets in which we compete with strong performance in A3 and production.

Moving to profitability. In Q2, we grew our profit margin year-over-year for the third consecutive quarter. This improvement in margin reflects specific actions taken to drive profitable revenue growth, optimize our operations and offset product cost inflation with price increases. We continue to look for ways to streamline and focus our operations. We recently sold Xerox Research Center of Canada or XRCC to Myant Capital Partners, a leading textile computing company with a shared mission of advancing material-based innovation.As with PARC, this transaction provides Xerox with greater focus and financial flexibility to pursue growth opportunities adjacent to our core operations.

Improvements in profitability and cash flow costs accrue directly to shareholder value. In the current market environment, we believe the most prudent use of cash has been the reduction of our debt balance and in the second quarter we reduced our debt balance again. Year-to-date, we have lowered total debt outstanding by around $600 million. Our shareholder return policy remains the return of at least 50% of free cash flow back to our shareholders. We will provide more direction on how we plan to deploy free cash flow as cash flow is generated throughout the year.

Before I turn the call over to Xavier, I'd like to reflect on some of the actions Xerox has taken to position the company for long-term profitability and sustainable growth. In the past year, the company has experienced significant change, not all of which may be apparent to investors. Through a calculated set of actions taken, we have bolstered our operating and financial discipline and attuned our business model to a market that has been permanently altered by changes in workplace behavior post-pandemic. In doing so, I strongly believe we have the operational and financial foundation from which we can sustainably grow our print, digital and IT services revenue.

Starting with operating discipline, the rigor and operating system instilled by Project Own It provides the key building blocks from which this foundation could be built. Learnings from that program have now been institutionalized at Xerox, including the use of advanced technologies such as RPA, augmented reality and AI to drive continuous operating efficiency and data-driven decision-making. Internally, we use more than 600 bots to conduct 7 million transactions per quarter. These bots reduce resources required to process manual and repetitive tasks and improve client response times.

In our service delivery function, we use augmented reality and AI to improve remote solve rates, infield decision-making and service delivery profitability. And when CareAR and AI are incorporated into our service offerings, we see meaningful improvement in client satisfaction.

One of the most significant decisions I have made in my time as CEO was the appointment of John Bruno as COO. John has a strong track record of leading transformational and strategic change across a range of industries. After joining the company in November, he moved quickly to redesign our strategy and further solidify our operating model, establish a number of new operating committees tasked with making the complex and difficult decisions required to drive balanced execution and reposition Xerox for long-term success.

When transforming a company in challenging operating environment, focus is critical. That understanding led to a number of transactions, including the exit of our Eloque joint venture, the spinout of Novity and Mojave, the donation of PARC to SRI International, and more recently the sale of XRCC to Myant. These transactions freed up the financial resources and managerial capacity needed to direct our efforts more concertedly towards advancements in workplace technology solutions while allowing each of the respective teams to align with organizations that will give them the capacity and resources needed to stay focused on their areas of innovation.

Last but not least, investments in our people. As we place more importance on client centricity and client success, we need to do more to recognize and enable our employees' success. Accordingly, in the past year, we reinstituted a number of compensation and career development programs that were placed on-hold during the pandemic, including the VISTA program, which provides learning and advancement opportunities for some of our most promising, up-and-coming talent.

Financial discipline is equally important in providing stable base for growth. In the past year, we have taken a number of steps to improve profitability, financial flexibility and balance sheet strength. Following the pandemic and through recent operating challenges, we have been laser-focused on profit margin. Strategic actions targeted at pricing and product mix have improved base level profits and we plan to further bolster profitability through changes in compensation practices that emphasizes transaction and deal margins, thus allowing our sales team to focus their attention on delivering value for clients rather than compete for commoditized business.

Through the PARC donation, we fundamentally changed our approach to research and development, lowering our R&D cost base while maintaining access to world-class research. The technology exploration and innovation programs signed with SRI and PARC provides an on-demand access to scientists, engineers and researchers that will enable new technologies that are more closely aligned with our print, digital and IT services focus.

The Receivable Funding Agreement we signed with a subsidiary of HPS Investment Partners last December significantly improved our free cash flow generation and lowered FITTLE's reliance on Xerox's balance sheet to provide funding for lease originations. Accordingly, we have lowered our debt balance by around $760 million over the past 12 months, while improving our financial outlook providing incremental capacity to fund future growth opportunities.

It has been a challenging year for sure, but I am more optimistic about Xerox's future and growth opportunities than at any point in the past five years. In the past year, I have spent a significant portion of my time meeting directly with some of our most important clients and partners. From those conversations, it is clear clients trust Xerox and look to us to help them solve their most pressing workplace challenges. Recent discussions have shifted to emerging technologies such as generative AI that will further stress the need for secure workplace solution like ours that help optimize company data and workflows.

With clients trust and an institutional knowledge of our clients businesses and industries, we have a clear path to win. We aim to expand existing clients' share of wallet and win new client business by delivering advanced print, digital and IT solutions. Moving forward, investors should expect us to continue evolving and reinventing our business as we shift our mix of revenue towards services that addresses the more complex, hybrid work environment. Success along this path will be driven by a service-led, software-enabled approach to improving client business outcomes and a brand strategy more closely aligned with repositioned Xerox.

To recap, it is the early days of reinvention of our company but progress is already apparent. Balanced execution against our strategic priorities is driving momentum in service signings and operating efficiencies giving us the confidence to increase our profitability and cash flow outlook for the year.

I now hand it over to Xavier.

Xavier Heiss

Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

Thank you, Steve and good morning, everyone. As Steve mentioned, we delivered another quarter of growth in revenue and profits, driven by resilient demand for our equipment and services, normalizing supply chain conditions, and benefits from price increases and ongoing cost efficiencies efforts. In Q2, revenue was slightly higher year-over-year in actual and constant currency. Growth was driven by equipment sales, once again reflecting a stable demand environment, improved product supplies and favorable mix. Growth from equipment sales was offset by a decline in post-sales revenue, which was mainly driven by non-contractual items.

Turning to profitability, we delivered our third consecutive quarter of year-over-year improvement in growth and operating profit margins due to higher equipment sales and favorable equipment mix, price increases enacted in prior periods, lower logistic cost and ongoing cost reduction effort. Gross margin improved 210 basis points over the prior-year quarter, mainly driven by improved product mix, lower supply chain-related cost, specifically container and air transportation cost and benefit associated with recent price and cost efficiency actions. These benefits were partially offset by unfavorable currency effect on around 50 basis point of impact from lower Fuji royalties. Q1 2023 was the last quarter we recognized revenue from Fuji royalties.

Adjusted operating margin of 6.1%, increased 410 basis points year-over-year driven by 450 basis point of improvement from ongoing operating efficiencies and pricing actions, and 300 basis point from supply chain-related improvement, including a more favorable product mix. Partially offsetting these benefits were unfavorable effect from currency, lower FUJI royalty income and higher year-over-year bad debt and compensation expenses.

Adjusted other expenses net, were $9 million higher year-over-year due to a $16 million benefit associated with the defined contribution pension plan refund in the prior-year quarter, partially offset by lower interest expense.

Adjusted tax rate was 20% compared to 18.5% in the same quarter of last year.

Adjusted EPS of $0.44 in the second quarter was $0.31 higher than the prior year, driven by higher adjusted operating income, partially offset by a pension benefit in Q2 2022 and a slightly higher tax rate. GAAP loss per share of $0.41 was $0.36 higher than the prior year, due mainly to $132 million charge associated with the donation of PARC and higher restructuring and non-service retirement-related cost.

Let me now review revenue and cash flow in more detail. Turning to revenue, equipment sales of $420 million in Q2 rose 14% year-over-year in constant currency or around 15% in actual currency. Growth was driven by better availability of product, particularly in the Americas and for our higher margin A3 devices. As expected, backlog has now returned to normalized level. We will no longer provide detailed backlog information as it is being managed in the normal course of business and we do not expect change in backlog to materially affect result going forward.

Consistent with recent quarters, revenue growth outpaced equipment installation due to the favorable mix and pricing. Installation growth was strongest for our high-margin A3 product and color production equipment. Entry A4 installations were down year-over-year due to the ongoing normalization of work-from-home trends. Post-sales revenue of $1.3 billion fell around 3% in actual and constant currency year-over-year. Post-sale declines were driven by lower IT, hardware and paper sale, lower finance income and the elimination of Fuji royalty and PARC revenue.

Revenue from contractual print and digital services, our largest and more stable source of revenue was down slightly. Growth in digital services, including the benefit of a recent acquisitions, and benefits of pricing improvement, were offset by a slight reduction in our serviced fleet. Geographically, both regions grew total revenue in actual and constant currency. EMEA grew faster than the Americas due to higher post-sales revenue growth, including the prior year acquisition of Go Inspire.

Let's now review cash flow. Free cash flow was $88 million in Q2, higher by $186 million year-over-year. Operating cash flow were $95 million in Q2 compared to a use of $85 million in the prior year. Improvements were mainly driven by growth in operating income, a one-time contract termination payment in the prior year and the net source of cash associated with financing assets. Finance asset activity was a source of cash this quarter of $210 million compared to a use of cash of $35 million in the prior year, reflecting the benefit of our receivable funding program with HPS, partially offset by higher finance asset origination activity.

Offsetting these benefits, working capital was a use of cash of $248 million, resulting in a $183 million year-over-year increase in cash use, driven largely by the timing of purchases and payments. Inventory was a source of cash of $76 million, reflecting recent efforts to reduce inventory following disruption to our supply chain. Investing activity were a use of cash of $5 million compared to a source of cash of $13 million in the prior year due to lower proceed from asset sales, partially offset by lower CapEx. Financing activity consumed $220 million of cash this quarter, which includes a net payment of approximately $174 million of secured debt on dividend totaling $43 million.

Turning to segments. Beginning this quarter, we revised the presentation of our segment measures, transferring revenue and cost associated with operating lease from FITTLE to our Print and Other segment. This change was made to better reflect differences in ownership and oversight for these type of leases between segments, including the effect of the Receivable Funding Agreement with HPS. The result is a reduction to FITTLE segment revenue and profit.

FITTLE origination volume grew 36% year-over-year. Captive product origination were up 45% on higher Xerox equipment revenue, particularly in the mid-market. Non-captive channel originations, which includes third-party dealers and non-Xerox vendor grew 26%, a function of growth in new dealer relationships and third-party equipment originations.

As expected, FITTLE finance receivable were down 9% sequentially in actual currency, reflecting a run-off of existing finance receivable and HPS funding of around 40% of FITTLE Q2 origination. FITTLE revenue grew roughly 5% in Q2, mainly due to higher commission associated with the sales of finance receivable assets, partially offset by lower finance income and other fees, a result of a decline in FITTLE finance receivable asset base.

Segment profit for FITTLE was zero, down $6 million year-over-year, primarily due to higher bad debt expense, reflecting year-over-year origination increase. As noted last quarter, we expect improvement to bad debt expense going forward as our finance receivable book declines.

Print and Other revenue was essentially flat year-over-year in Q2. Print and Other segment profit improved $78 million versus the prior-year quarter, resulting in a 470-basis point expansion in segment profit margin year-over-year, driven by improved product supplies, lower logistic cost, favorable mix, and the benefit of price and cost actions.

Turning to capital structure, we ended Q2 with around $570 million of cash, cash equivalents and restricted cash, a reduction from Q1 levels, mainly due to the net repayment of secured debt. Net core cash of around $50 million was down from the prior quarter. $2.6 billion of the remaining $3.1 billion of our outstanding debt supports our finance assets with the remaining debt of around $500 million attributable to the non-leasing business. Total debt consists of senior unsecured bond, finance asset securitization and borrowing under our asset-backed credit facility. We have a balanced bond maturity ladder over the next few years.

Finally, I will address guidance. Our outlook for revenue remains unchanged at flat to down low single-digit and continues to reflect a stable demand environment with some contingency for potential macroeconomic weakness.

As a result of recent improvements in the macroeconomic outlook, and momentum in our services signings, we now expect full-year revenue to come in at the upper-end of that range.

Regarding operating margin, we are increasing our outlook for full-year adjusted operating margin by 50 basis points to a range of 5.5% to 6% due, in large part, to a stronger-than-expected realization of operating efficiencies and revenue mix. Regarding the implied trajectory of operating margin in the second-half of the year, it is important to note that operating profit margin in the first-half of the year benefited from favorable equipment mix, and one-off credit to bad debt expense, one quarter of Fuji royalties, the timing of price increases relative to incremental product costs, and lower labor costs associated with open positions.

This benefit may not repeat in the second-half of the year. The indicated range of profit margin outcome reflects the degree to which macroeconomic uncertainty could affect our operating profit for the year. Q3 adjusted operating income margin is expected to be lower than Q4, reflecting seasonality. We continue to work diligently to identify incremental cost efficiency and expect the benefit of a more flexible cost structure to drive incremental margin expansion beyond 2023. Finally, we are also increasing our guidance for free cash flow from at least $500 million to at least $600 million. This increase reflects an improvement in expected operating income and incremental sales of finance receivable. Our financial result and improved outlook validate that we are on the right path with a focus on our three strategic priorities: client success, profitability and shareholder return.

We now open the line for Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. One moment. And our first question comes from the line of Ananda Baruah from Loop Capital. Your question, please.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah. Hey, guys. Good morning and thanks for taking the question. I guess two, if I could. The first one is certainly for Steve and could be for Xavier as well. You guys continue to sort of put up resilient topline as you talked about, Steve, and this looks like it's lining up to be, call it, the fourth year in a row where you're sort of at $7 billion in revenue. And I was wondering if there's anything sort of structural about the market that you think has shifted.

You've talked about a lot of what Xerox has done kind of to address post-COVID world and some of the newer tech trends. But I guess I'd love your bigger picture thought on what previously had been for many years a declining market, and now in the last three years has been flattish or at least the company's performance has been flattish. And it looks like we're looking at like a fourth straight year of $7 billion in revenue.

And I have a quick follow up too. Thanks.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah, Ananda. Great. So, on the macro side, we have shifted significantly, as I said, over the last year towards client success. And really what that means for us is thinking about the hybrid workplace and the distributed workforce, how do we drive productivity and how do we drive efficiencies and help our clients in the macro headwinds that they're seeing. So, if you think about headwinds on inflation, headwinds on use of capital, our solutions and what we're driving is to help them solve their solutions. And that's a strategic shift for us in bundling around our equipment, our software, our cloud solutions and so forth.

Second is really driving digital services. As we start to see more and more companies think about their own digital transformation, digital journeys, we have a tremendous position to go play there around secure and data, unlocking value inside of that data. and so it's a very strategic shift for us. And so while we are focusing on obviously the macro trends of what's happening in the print industry, more importantly the opportunity and the areas that we can play. I talked about trust and I talked about how our clients depend on us to help drive their future workplace and we've been very, very successful in driving digital services and expanding inside of existing accounts. Xavier?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Ananda, just to complete from a revenue point of view, what we see is equipment revenue remains strong and the demand for our products, specifically A3 remain very strong which drive revenue. You know we pushed some price increases as well. So this is supporting revenue.

The other positive news is on post-sales. Post-sales and the contracted revenue, our customers signed contract for usually a length of five years there. The signings and the resilience we see in this post sale revenue stream is quite strong currently here. This is the reason why we are quite upbeat with the current revenue trajectory and we have upgraded or improved our guidance because we believe we will be closer to a flat situation compared to the low single-digit decline we had as a range before.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

And you guys, you mentioned on the call, I guess, in the prepared remarks a few minutes ago Steve sort of like a strategy shift towards services. And I think you used the term reinvention as well. So is that incremental to what you last showed at the Analyst Day? Is there something that's sort of afoot right now? Maybe since John has come in, this incremental from the go-forward that you'll be talking to us about?

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Yeah. So we'll be talking about in the future. But we've talked about very specific vertical solutions and horizontal solutions in our existing customer base. And we gave examples of working in universities and education, working in the medical industry, working in the law firms. And so we have been digging deep into where are the areas that we have products and services, software and solutions, think about security, think about the world of AI and how do we continuously evolve in that space and drive value for our clients and we really focus on client success. When I talked about freeing up both financial and management capacity, that's exactly what we're doing, really focusing on specific how do we drive client success with products and services. And you will see a lot more from that – from us in the future.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

All right. That's great. I have one quick last one. Just a clarification. When you mentioned these at the opening – at the prepared remarks, the resiliency in sort of in customer demand. You also then mentioned small, medium business. Is it small, medium business more resilient than enterprise, or are you just – was it just pointing out that also small, medium businesses they're resilient?

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

It's balanced, but we're finding stronger resilience there in SMB today, while we're seeing some of the large enterprises pull back a little bit, not change, but maybe defer some of the installs and defer some of the installations. But, in general, SMB was strong from us.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great. Got it. Thanks so much.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Erik Woodring from Morgan Stanley. Your question, please.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thank you. This is Maya on for Erik. Steve, if we just take a step back from the quarter and think bigger picture a little bit, we're largely past that normalization of return-to-office and hybrid work, so meaning that the activity we're seeing today outside of the cycle-related dynamics is something of the new normal. So I know you touched on this a little bit earlier but how should we think about kind of normalized revenue growth margins and business mix going forward and is there a path to revenue growth? And if so, when should we expect that? And do you believe that normalized gross and operating margins should be in a post-COVID world? I know this is kind of the message you had provided at Investor Day. But since there's been so much change in the last 12 months, it'd be helpful for us to understand how you think about some of these metrics over a multi-year period. And then I have a followup. Thank you.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

A

Sounds great. Thank you for the question. So let me start with the macro and then have Xavier comment on some more specifics. So really take a step back, I really believe today the workforce and the hybrid workplace is really trying to continuously drive productivity and transformation and we're seeing CEOs and companies really trying to figure out what this new normal looks like and how do we drive more productivity in that space. And it's not one-size-fits-all. And so what we've been doing is really focusing and working on how do we drive the efficiency in the workplace of the future. That's something we have in our DNA and we've done for the last 50 years and we have a right to play there as we start to see digital transformation in large enterprises, in SMB and what are the areas and products and services that we can grow. So I don't think the chapter has been written in terms of what the new normal is. We're still evolving and I think it will continue to evolve as we try to drive more productivity and we try to drive more value inside of this new hybrid workplace. Number one.

Number two, you really think about next-generation technology, whether it's AI or ChatGPT or the future of robotics or augmented reality. The reality is the underpinning of that is significant amounts of data. And we play really well in that data, securing it and having the ability to be able to orchestrate it. And so when you start to hear things like how the companies drive more productivity with these new tools, whether it's AI, whether it's RPA, augmented reality, we are playing really well and really trusted in helping our clients there.

So we see significant growth and significant opportunities in the hybrid workplace as companies are really trying to figure out their new norm and driving productivity going forward. Xavier?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.
A

Yeah. [indiscernible] (00:36:57). To give color on this, specifically for 2023, what we are expecting here is that still a strong mix on the – you have noticed you see it in quarter one, quarter two, and quarter four last year as well, we have been able to mix up by having products, higher margin product, higher revenue product with some price increases to support it and grow from an activity point of view, from market share, but also from a revenue point of view that drove the revenue growth that we are seeing here.

At the same time, as I mentioned it earlier on, the post-sales revenue stream is still strong here and we are delivering and supporting essential services for our customer and we see that into a contractual trend that we have, signing are strong and as well revenue. Renewal rights that we are observing with client is also show the attachment rate and the retention of our revenue.

Finally, from a margin point of view, as we mentioned it and you have seen this in the guidance, we are upgrading the guidance for this year from 5% to 5.5% to 5.5% to 6% there to just show the confidence that we have in the activity I've just described and the ability of the team to deliver operational efficiency and drives the mix up.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC
Q

Great. Thank you. And then just a followup to that actually, so you had previously guided kind of 2Q operating margins to high 4%, low 5%, but obviously came in above 6%. Where did the most significant upside come from the quarter and why is that not sustainable as we look into the back-half of the year, given your guidance kind of implies operating margins contract in the second-half despite cost cuts?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.
A

Yeah. So I will comment it in two parts: So if you look at the first-half, we have had, during the first-half, some what I call one-off item that were supporting the margin. Specifically, we have had the benefit from Fuji Xerox royalty, which is roughly 50 basis point benefit. It was only in quarter one. It won't repeat anymore here. At the same time, we have had some bad debt release or bad debt [indiscernible] (00:39:11) during the first quarter, low bad debt in the second quarters. So this is also items that we are not expecting to repeat. But at the same time, we are still confident that the reason why we upgraded the guidance, we are still confident in maintaining this overall margin for the second-half of the year in a range which is around 5.5%, potentially above this one.

So that's the reason why we improved the guidance and we are still focused on driving both operational efficiencies but also ensuring that the revenue mix and margin mix come at the expected level so we can drive overall operating margin up and free cash flow.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC
Q

Great. Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Samik Chatterjee from JPMorgan. Your question, please.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my questions. I guess, for the first one, I'm just curious how you're thinking about seasonality through the remaining two quarters of the year? I know you mentioned seasonality to be lower for 3Q, but more curious if you can dive into that for equipment sale, the $420 million of revenue you reported in this quarter, is that sort of – is there a tailwind there from backlog digestion? And should we expect normal seasonality even in relation to equipment sales for the rest of the year or should we be sort of looking at it ex-backlog? Maybe any insights on what that underlying demand is looking for equipment sale relative to the revenue profile you have now, which might be benefiting from backlog? I have follow-up, please.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yeah. Hi, Samik. So, seasonality, as we mentioned it in the comments, we are expecting Q3 as usual. That means this is not a surprise, as usual to be a little bit softer than Q4. As you know, Q4 is a very strong quarter, it is usually where we have the also higher mix of margin of equipment under the larger deals being signed towards the end of the year. So we are expecting it to be slightly below.

But, if you look at equipment revenue growth even on the post-sale side, we are not expecting to have like a significant decline. If you remember last year in Q3, this is where we started to have supplies coming back on track, so the compare versus Q3 will be very different compared to the compare versus Q1 and Q2 here. From a margin point of view, as I commented earlier on, we are still – if I remove the ones-off there, we are still expecting to get the margin in the range of 5.5% to 6% for the full-year, which imply potentially a softer quarter three. But a very strong Q4 as we have always delivered.

I will comment lastly on the normalizing on where we are today. Backlog, as we mention it, we will not report any more in backlog because we are now back to normal from a backlog point of view. So there is a little bit of refresh in backlog. Some of it was the end of quarter two. But we do not expect the backlog being a key contributor in Q3 and Q4. And finally just from I call that the usual seasonality of revenue just to summarize Q3, little bit softer than Q4.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. Got it. And then, Xavier, on the cash flow, you've done I think around $150 million of free cash flow in the first-half if I'm calculating it right, and that leaves about $450 million to be done in the second-half. Can you just walk us through sort of the half-over-half, how you're thinking about working capital, finance receivables, sort of what plays into that significant improvement into the second-half?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

Yes. So this is also aligned with the traditional seasonality we have. If you remember last year with – last year and the year before, very similar pattern, so second-half is much stronger. It's specifically related to items like working capital, and payables. This quarter, we have a year-over-year impact of payables simply because last year we have higher purchase. Some of the supply chain were, I would say, released, which make us having higher purchase in Q2 for revenue recognition in quarters three here. So, working capital will normalize. We will have some, I would say, tailwind coming from accounts payable. Inventory, you noticed it this quarter, was also a tailwind, with a reduction of close to $80 million. So we would see this being driven here. So that's the operational part.

So the second part is on finance receivable, as expected, the strategy is working, we are continuing our forward flow program with HPS. No surprises here. This is planning as expected and we've got the full benefit of now having close to 40%. It was 40% this quarter. 40% of our origination being funded by HPS, which support the free cash flow and is helping the balance sheet as you have noticed it as well.

Just my last comment, we paid down the secured debt of roughly $180 million. So if you look at the leverage ratio of the company, it has improved significantly compared to last year.

Samik Chatterjee
Analyst, JPMorgan Securities LLC
Q

Okay. Okay. Got it. Thank you. Thanks for taking the questions.

Operator: Thank you. One moment for our next question. And our next question comes from the line of Shannon Cross from Credit Suisse. Your question, please.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

Thank you very much. I just have a couple. The first is, I'm curious and I am not sure what you can talk about, but what the benefit or impact could be from the banning of the Ninestar products into the US? I know you were sourcing some things from Lexmark. So I'm just curious is this potentially a positive since people won't be able to get stuff in or is it just sort of a non-starter? Thank you.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.
A

Yeah, Shannon. I think a couple of things. First of all, we are constantly looking at our supply chain and making sure we're adhering to all regulatory and government requirements around the world and Ninestar was no different than that. And we immediately looked at and made sure that we continued to be a good corporate citizen around the world. From a materiality standpoint, it wasn't material for us in the quarter and going forward we should be just fine.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

Okay. Thanks. And then I'm curious how do you think about your cash balance and then use of cash? You have about I think $560 some-odd million worth of cash right now. You used to run at a higher level. Company is smaller. Wondering what you think your cash balance needs to be? And then as you have cash come in in the second-half of the year, how should we think about usage there versus the debt repayments, which clearly you've done a good job of reducing your debt load but you still have about $1 billion over the next couple of years. Thank you.

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.
A

Yeah, Shannon. Good questions there. So we are good with the cash balance, that means this level of $500 million and above is a level where we should be. So we managed. We have seasonality within the quarter of cash but this is the right level for us here.

Regarding our use of cash, as you know it, our policy has not changed. Shareholder distribution of at least 50% of free cash flow. We are mainly focused on paying down or paying the dividend. So this is roughly $180 million of dividend. And we will be, I will say, comment later on when we will generate the $600 million of free cash flow, how we'll have the use of cash. I just would like to comment on one topic. We do not have board authorization on share repurchase, so we are not planning to do share repurchase and any cash that we can use or we are willing to use here will be to support the business development.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

So does that mean you're looking more at M&A or just internal like ramping up CapEx?

Xavier Heiss
Chief Financial Officer & Executive Vice President, Xerox Holdings Corp.

A

We are looking at any opportunity. It could be organic. It could be inorganic. M&A is part of the list.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

Thank you.

Operator: Thank you. And this does conclude today's question-and-answer session. I'd now like to hand the program back to Steve Bandrowczak for any further remarks.

Steven John Bandrowczak
Chief Executive Officer & Director, Xerox Holdings Corp.

Thank you for listening to our earnings conference call this morning. We continue to face dynamic operating environment as workplace behavior and technology needs evolve to accommodate a rapidly changing hybrid work environment. In the past year, we have bolstered our operating and financial model, solidifying a foundation from which we can grow as we help clients solve their most pressing workplace challenges. I thank you each for joining our Q2 earnings call. Have a wonderful day.

Operator: Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.