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XRX - Q4 2014 Xerox Corp Earnings Call

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OVERVIEW:

XRX reported 4Q14 GAAP EPS of \$0.26. Expects 1Q15 adjusted EPS to be \$0.20-0.22.



CORPORATE PARTICIPANTS

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Keith Bachman *BMO Capital Markets - Analyst*

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PRESENTATION

Operator

Good morning and welcome to the Xerox Corporation fourth-quarter 2014 earnings release conference call hosted by Ursula Burns, Chairman of the Board and Chief Executive Officer. She is joined by Kathy Mikells, Executive Vice President and Chief Financial Officer.

During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor. At the request of Xerox Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox. (Operator Instructions)

During this conference call, Xerox executives 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.

Before turning the meeting over to Ms. Burns, Jim Lesko, Vice President of Investor Relations, has a few words.

Jim Lesko - *Xerox Corporation - Corporate VP, VP IR*

Before Ursula begins, I'd like to remind everyone that as a result of the pending sale announced on December 18 of our ITO business to Atos, and having met applicable accounting requirements, Xerox is now reporting the ITO business as a discontinued operation. We will be reporting today our Q4 and full-year 2014 results on a continuing operations basis. Prior-period results have been revised to reflect this change, details of which can be found on our Investor Relations website at www.xerox.com/investor. Ursula?



Ursula Burns - *Xerox Corporation - Chairman, CEO*

Thanks, Jim. Good morning thanks for joining our call. Today we are reporting fourth-quarter and full-year 2014 earnings.

A lot has happened in the last 90 days, and overall we are pleased with where we ended the year. We are reporting solid results that in some places exceeded expectations. I'll give a quick overview of our financials, provide some perspective on the year, and share updates on key initiatives contributing to our results before turning it over to Kathy to go into more detail on the financials.

We delivered strong profit and cash for the year, and we closed strong in Services revenue and margin. Services revenue growth improved through the year, and we saw improved margin performance.

Services signings increased as well, driven by renewals in BPO, and we ended the year with strong Document Outsourcing signings of over \$1 billion. In fact, our Canadian operation closed its largest-ever multimillion-dollar MPS deal with the government of Canada in November.

In Document Technology, we delivered strong margin throughout the year, reflecting both our continued focus on profitability as well as a favorable environment.

And for the fifth consecutive year, we are the leader in equipment sale revenue. Demand has been strong for our iGen and the new Versant products in the US and Europe. These products provide our graphic communications customers with the ability to produce digital color prints at scale with a high level of personalization, quality, and reliability.

As you know, Xerox has been focusing on the segments where we have the most competitive advantage, and we have been steadily shifting our portfolio mix. As an example, we announced the pending divestiture of our ITO business through a sale to Atos. This will allow us to focus squarely on Business Process Services and Document Outsourcing and provide additional capacity to invest further in these businesses.

We've aligned our Services go-to-market model into a set of industry teams, and our delivery model along functional capabilities such as customer care, human resources, consulting and analytics, and transaction processing. We've made progress improving our government healthcare business, and in 2014 we committed resources to maturing our MMIS Enterprise platform.

While we still have work to do, the hard work of the team is paying off. We remain bullish about this market and its opportunities for us.

Innovation is a differentiator for us now and will continue to be in the future. Within customer care, we introduced an intelligent virtual customer care agent that can diagnose and resolve customer inquiries in the same way, if not better than, a human agent would.

Xerox invested in HealthSpot, a pioneer in patient- and provider-driven healthcare technology. As their exclusive BPO partner, we will support HealthSpot as they provide groundbreaking telehealth patients convenient neighborhood locations. It's an important step in the transformation of healthcare and an exciting place for Xerox to be.

In the second half, the Document Technology team launched 20 new products that were well received and are a reminder to the market of our innovation power.

We continue to receive recognition from the industry for business and technology leadership. Gartner, Quocirca, and others recognized us for our managed print and content services, finance and accounting, and BPO. Everest Group named Xerox a leader in its service provider landscape Ranking for the Contact Center Outsourcing Market for the Healthcare Industry.

We are feeling good about our progress. We remain focused on being the best partner to our clients, making Xerox a great place to work for our people, and delivering value to our investors.

Now let's take a look at the results in more detail. We delivered earnings just above our range and grew margin in both our segments and on a total Xerox basis. We are reporting adjusted EPS of \$0.31 and GAAP EPS of \$0.26.

Profit improved this quarter as we made progress in Services. Services margin improved in the fourth quarter to 9.8%, and we continued to benefit from a favorable environment and strong operational management in Document Technology.

On the revenue side, the improved growth in Services to 3% in the quarter is notable, especially considering the impact from the loss of the Texas Medicaid contract. Document Technology revenue declined in line with recent trends.

Acquisitions remain a key aspect of our portfolio management strategy. For the full-year 2014, we invested almost \$350 million in acquisitions.

We are focused on enhancing our Services offerings and expanding our global reach. We have a goal in 2015 to get more done on this front, up to \$900 million in acquisitions, with part of those funds coming from the sale of our ITO business. With that objective in mind, we closed on one modestly sized acquisition since the beginning of the year, Intrepid Learning Systems, which includes a service to ensure companies' employees are equipped with the latest skills and knowledge to improve their business performance.

And underpinning our results in business model is strong cash generation. We closed the quarter with \$850 million in cash from operations and over \$2 billion for the year.

This supported our acquisitions activity, growing dividends, and share repurchases. In fact, we announced today a 12% increase in our annual dividend rate to \$0.28 per share.

Shifting ahead to 2015, our results will be impacted by the recent volatility in foreign currencies. As a result, we have adjusted 2015 guidance to reflect these headwinds. Kathy will go into greater detail on currency in just a moment.

With that, I will turn it over to Kathy; then I'll wrap up and we'll open the call for your questions. Kathy?

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

Thanks, Ursula, and good morning, everyone. We were pleased with the progress we made this quarter. Both Services revenue growth and margin improved; and with the announcement of the planned sale of our ITO business to Atos, we took a key step in our portfolio management strategy.

In addition, our Document Technology business continued to deliver strong profitability. The positive results in Services and Document Technology yielded earnings higher than our expectations and strong cash flow.

I'll cover the segments and cash flow in a moment, but first let me walk through our fourth-quarter earnings. As noted earlier, with the pending sale of our ITO business, my commentary will be on a continuing operations basis, excluding ITO.

Total revenue in the quarter was down 3% at actual currency and 1% at constant currency. This compares to down 2% at both actual and constant currency in the third quarter.

Underlying constant currency growth improved from the third quarter, driven by better Services performance. And as expected, we saw the impact of actual currency rates turn negative in the quarter.

Gross margin of 32.1% was up 10 basis points year-over-year as the positive benefit in Document Technology from productivity initiatives, currency, and pension expense more than offset the greater mix of services at a lower margin. RD&E was modestly lower year-over-year as increased investments in Services were more than offset by reductions in Document Technology.

SAG was lower in both segments as we benefited from productivity initiatives as well as lower bad debt and pension expenses. These improvements resulted in our fourth-quarter operating margin increasing 100 basis points year-over-year and operating profit growth of almost 7%. For the full year, operating profit improved \$72 million, and operating margin was up 60 basis points.

Moving down the income statement, Adjusted Other, net was a \$6 million higher expense year-over-year. Lower gains on sale of assets of \$20 million and ruble-related currency losses of \$5 million were only partially offset by \$19 million in lower restructuring costs.

For the full year, a tough compare resulted in Adjusted Other, net expense coming in \$102 million higher. In 2013, we realized greater benefits from transaction gains and other nonoperational below-the-line credits. In addition, restructuring charges were \$13 million higher this year.

Our equity income was \$41 million in the fourth quarter, down \$2 million dollars year-over-year, driven by the impact of negative translation currency. Our fourth-quarter adjusted tax rate of 25.3% was up about 1 percentage point year-over-year and within our guidance of 23% to 27%.

Adjusted EPS of \$0.31 was \$0.04 higher year-over-year, driven by operating profit growth and lower share count. For the full year, adjusted EPS of \$1.07 was \$0.03 higher, as operating profit growth and lower share count were partially offset by higher Adjusted Other, net expense.

I'll now move to the Services segment slide to review those results in a little bit more detail. Services revenue grew 1% and was up 3% in constant currency, which was 2 points better sequentially. Within Services at constant currency, BPO growth increased to 4% from 2% in the third quarter, with good growth in commercial healthcare payer, electronic tolling, litigation services, and international.

Document Outsourcing was up 1% year-over-year at constant currency, a modest improvement from the third quarter, but under our segment growth objective. We are beginning to see good traction from our next-generation MPS offerings and we are encouraged by the good signings in the quarter.

Overall in Services we are making progress improving growth, and we continue to expect 2% to 4% constant currency Services growth this year. Our growth rate will be lower in the first half, reflecting the impact from the Texas Medicaid contract loss last year, slower first-half Document Outsourcing growth, and expected ramp timing for a couple of large new business contract awards. The Texas loss creates a headwind of about 150 basis points until we lap it in August.

Total signings in the quarter were up 20%, driven by strong growth in renewals, including the large BPO contract renewal that I referenced last quarter, which helped to drive a strong BPO renewal rate of 93%. BPO new business was light as we are still working towards signed and approved contracts for the New York Medicaid and Florida tolling new business awards. We are getting closer on both and continue to expect them to sign in the first half.

Our sales force is now aligned to specific industry verticals, and we're investing in increased sales coverage and training. These actions will positively impact new business signings as we move through 2015.

Document Outsourcing signings of \$1 billion were the highest in recent history, with good growth on both the renewal and new business side. So a good signings quarter for Document Outsourcing, which should enable growth to pick up by the middle of the year.

Shifting to profitability, segment margin was 9.8% in the fourth quarter, which was up 70 basis points sequentially, up 10 basis points year-over-year, and toward the higher end of our targeted 9% to 10% range. We are making progress on our Services initiative and improving execution.

In BPO, we saw multiple lines of business contribute to the year-over-year profit improvement, and Document Outsourcing margins remained strong. Our results in government healthcare were in line with our expectations, and we are seeing positive results from our investments to mature the platform and improve our operational performance. We are confident we're on the right track, and we started some work ahead of finalizing the New York Medicaid contract to ensure we get off to the right start there.

In 2015 our focus will be on accelerating growth and driving a solid 50 basis points of margin improvement year-over-year. In summary, the fourth quarter was the strongest quarter of the year for Services, both in terms of growth and margins, and we're taking the actions required to hit our targeted 2015 core operating results.

With that I will now turn to Document Technology. Fourth-quarter total revenue in Document Technology was in line with our expectations, with constant currency results down 6%, which was consistent with the full-year rate of decline. As expected, the impact of actual currency rates turned on us this quarter, with a negative 2 point impact.

Equipment revenue declines were higher, driven by weakness in Eurasia, reflecting the volatility in Russia's economy, as well as the timing of large account sales. The decline in annuity revenue moderated a bit sequentially, driven by modestly higher supplies demand and a more favorable compare given the prior-year channel inventory reduction.

Similar to last quarter, the finance receivable sales in the prior year was almost a 1 point negative impact to revenue growth.

From a geographic perspective, the US and Europe were relatively stable, while developing markets outside of Russia was a positive contributor to results.

Looking at our product groups, High-End remains the best performing subsegment, reporting annuity growth at constant currency for the third quarter in a row. We saw good traction from the recent launch of our new Versant Entry Production Color product, as well as good growth in our iGen product family.

Mid-Range color activity was relatively flat and consistent with the third quarter, as we continue to lap our ConnectKey launch from last year. Mono declined in line with industry trends.

Entry A4 activity was lower year-over-year given weakness in Eurasia as well as the timing of our Entry product refresh. We launched 11 new products late in the third quarter and early in the fourth. Market reception has been positive, but the timing caused us to only catch a partial benefit in the quarter.

Profitability was quite strong. Our Q4 margins came in above our expectations at 14.4%, resulting in segment profit growth of 14%. This strong performance reflects benefits from restructuring and productivity initiatives, positive transaction currencies that more than offset negative translation impact, and lower bad debt expense, as well as lower pension expense. So another solid quarter for Document Technology.

Now I'm going to turn to cash flow. Before I go through the cash flow, I'd like to make one comment related to the announced ITO sale.

Our GAAP Net income includes a non-cash loss triggered by the pending sale of the ITO business of approximately \$180 million, driven mainly by goodwill allocated to that business. You can see the loss is added back further down in the cash flow statement; so net-net there's no cash flow impact.

Moving on, our cash flow from operations was \$857 million in the quarter and a little over \$2 billion for the year, which was just above our range. As expected, cash flow in the quarter and full year were lower solely due to the impact from finance receivable sales in prior years versus no sales in 2014.

Looking at the full year underlying cash flow, which excludes the impact from prior finance receivable sales, was \$2.5 billion and compares to \$2.1 billion in 2013. The largest driver of the year-over-year improvement in underlying cash flow was a reduction in net working capital resulting from both performance and timing factors, including lower DSO and improved year-end collections, especially in Services, improved terms with a few key vendors, as well as seasonal smoothing of working capital.

Additionally, we have higher runoff from our underlying finance receivables associated with lower originations as well as lower equipment revenue. These year-over-year benefits were partially offset by higher pension funding.

Moving down the cash flow statement, investing cash flows were a \$129 million use in the quarter and a \$703 million use for the full year. For the full year, we spent \$452 million on CapEx and \$340 million on acquisitions.



Cash from financing was a use of \$297 million in the fourth quarter and \$1.6 billion for the year. Included in that full-year amount is \$1.07 billion spent on share repurchases and \$313 million used for preferred and common stock dividends.

Now I'll quickly cover our capital structure. We ended the year with \$7.7 billion in debt, which excludes approximately \$75 million in capital lease obligations related to our ITO business which were reclassified to a discontinued operations liability account.

Applying 7-to-1 leverage on customer financing assets, our allocated financing debt at year-end was \$4.2 billion, leaving core debt of \$3.5 billion. We manage our core debt to maintain a leverage ratio consistent with our investment-grade ratings. Our financing debt has come down over the past few years, driven by finance receivable transactions as well as lower originations.

During 2015, we have two tranches of debt coming due: about \$1 billion in February and \$250 million in June. We continue to be comfortable with our leverage position, and we plan to refinance these notes during 2015, which will result in our year-end debt being roughly flat at about \$7.7 billion.

So our capital structure remains stable; and if we move to the next slide, I'll review where we're at in terms of capital allocation. During 2014, we returned close to \$1.4 billion to shareholders through a combination of share repurchases and dividends.

This equates to approximately 85% of our free cash flow for the year. Those numbers include \$1.07 billion of share repurchases and approximately \$300 million of dividends.

We also spent a total of \$340 million on acquisitions. That's \$185 million higher year-over-year, but shy of our target of up to \$500 million. We obviously have more work to do here, and we are focused on concentrating on a bit larger deals as well as adding more resources into this area.

For 2015, our capital allocation plan is unchanged, and it reflects the redeployment of the expected net proceeds of roughly \$850 million from the ITO sale. On share repurchase, we plan to spend about \$1 billion repurchasing stock in 2015. We continue to view our shares as an attractive price, and it's a good investment.

On acquisitions, we expect to spend up to \$900 million. In keeping with our portfolio management strategy, we're looking to acquire companies that will expand our capabilities in attractive service areas as well as extend our global reach in Services.

As I mentioned on debt, we're comfortable with our leverage position and expect to end the year roughly flat at \$7.7 billion.

Finally on dividends, we are announcing today a 12% increase in the quarterly dividend to \$0.07 per share. This will result in spend of just over \$300 million, with share repurchases effectively self-funding most of the increase.

Before I turn it back to Ursula, I'd like to summarize our expectation for the full year as well as the first quarter. As Ursula mentioned, we've seen a sharp movement in currencies around the world in the last 45 days. Where we'd normally offset modest currency impacts, the dramatic nature of this move creates almost \$100 million of profit exposure year-over-year.

Most significant to us, in this short time the euro has weakened by about 10% versus the dollar and 9% versus the yen; and the Canadian dollar has weakened 7% against the dollar. These currency moves cause both negative translation and transaction impacts. While we continue to look for ways to offset more of this negative impact, we believe it's prudent to capture the current exposure by revising our guidance.

Let me walk you through the details on where we're at on full-year guidance, and then I'll cover the first quarter. On revenue, our constant currency expectations are unchanged versus what we communicated at our November investor conference: Total Company roughly flat at constant currency; Services up 2% to 4%, with growth improving as we move through the year; Document Technology down 4% to 5%, which reflects some improvement as the negative impact of the prior finance receivable sales moderate and we realize more benefit from our product launches late in the second half of last year. However, we now expect currency will have a negative 3 to 4 point impact to revenue for the full year, versus flat to about 1 point



previously communicated, with Document Technology having a little higher impact and Services a little lower, given the geographic mix of the revenues.

On margins, we continue to target a 50 basis point improvement year-over-year in Services, which would put us at the middle of our 9% to 10% range. For Document Technology, we continue to expect to be within our 11% to 13% range, but likely more towards the middle of the range, driven by year-over-year increased pension costs that we've talked about previously, as well as the negative net currency impact.

As a result of the lower expected revenue and actual currency as well as related pressure on Document Technology margins, we expect the flow-through to impact earnings roughly by \$0.06 and, as a result, we are lowering our full-year adjusted EPS guidance by \$0.05, to \$1.00 to \$1.06.

Turning to cash flow, the timing of the ITO sale negatively impacts free cash flow, as we expect to sell the business in the first half and it produces most of its free cash flow in the second. Additionally, currency impacts our cash, presenting another headwind.

We expect to offset some of this impact in 2015, and incremental M&A should offset the ITO impact next year. Net-net, we're bringing down our operating cash flow guidance by \$200 million to \$1.7 billion to \$1.9 billion, and our free cash flow down \$100 million to \$1.3 billion to \$1.5 billion.

Now to first-quarter guidance. In Document Technology, we anticipate revenue declines to be down mid single digits in constant currency, with actual results about 4 points lower given currency rates, particularly the weakening of the euro and Canadian dollar. We expect Q1 Document Technology to continue to deliver very strong margin; but seasonally they'll be lower, and below last year's 12.2%, driven mainly by higher non-cash pension expense as well as negative currency impact.

In Services, constant currency revenue growth will be at the low end of our 2% to 4% full-year guidance range driven by tougher compares, expected timing of ramping awarded new business, and slower Document Outsourcing growth. We expect currency to have about a 3 point negative impact. We expect margins to be seasonally lower, but up modestly year-over-year.

At the consolidated level for the first quarter, we expect revenue will be down 1 to 2 points at constant currency, with 3 to 4 points of negative currency impact. Adjusted earnings per share is expected to be \$0.20 to \$0.22, which includes approximately \$0.02 of restructuring.

The decline versus \$0.26 last year is driven by higher non-cash pension expense, adverse currency, higher OID given a prior-year gain on asset sale, as well as a higher tax rate: 26% planned this year versus 20% last year. That's partially offset by improvements in Services' operational performance as well as lower share count.

Overall, we're making progress in our core business operations, and we'll be working hard to offset the pressure we are seeing from currency. With that, I'll hand it back to you, Ursula.

Ursula Burns - Xerox Corporation - Chairman, CEO

Thanks, Kathy. I want to get to your questions, so I will summarize quickly. Our fourth-quarter shows our strategy is sound and the decisions we've made have put us on the right path forward. We are seeing the benefits of strong operating profit from Document Technology, and improving profits and revenue in Services, where we are making visible progress. Our Services business is now better positioned for future growth.

We know 2015 is already bringing some headwinds. As we mentioned earlier, we are watching the unprecedented movements in currencies, especially the euro, as Kathy outlined. But as always, we will manage with a disciplined approach. We will work hard and make the necessary adjustments to our operations.

Our commitment remains the same, and our diversified portfolio and strong cash flow, combined with our operating model, guides our priorities. In Services, building on the momentum to increase sales and profits through portfolio management, improved productivity, and excellent offerings. In Document Technology, capitalizing on the most advantaged segments of the business to maintain our leadership position in the industry, while maintaining strong profitability. And we will continue to generate healthy cash flow to deliver shareholder value.

Thank you; and now over to you, Jim.

Jim Lesko - Xerox Corporation - Corporate VP, VP IR

Thanks, Ursula. Joining Ursula and Kathy today is Bob Zapfel, head of our Services business. Also let me point out that we have several supplemental slides at the end of our deck. They provide more financial detail to support today's presentation and complement our prepared remarks.

For the Q&A, I ask participants to limit follow-on and multipart questions so we can get to everyone. And at the end of our Q&A session, I will turn it back to Ursula for closing comments. Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) George Tong, Piper Jaffray.

George Tong - Piper Jaffray & Co. - Analyst

Thank you. Good morning. We saw nice Services margin expansion this quarter, both on the year-over-year and quarter-over-quarter basis. Can you discuss what's changed this quarter to yield a positive inflection in Services margins, and the work you have in the pipeline to sustain the positive momentum?

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

Sure. I'll start and then maybe Bob can add some color. Overall, we have been working throughout the year in terms of building initiatives, especially around reducing our overall cost structure from a productivity perspective; looking to get greater growth out of the areas where we have higher margins; and as we pivot forward towards 2015, organizationally: changing our go-to-market approach, focused by industry, and putting together operating capabilities that go across the Company in order to help us drive further productivity enhancements.

One of the factors was clearly our overall government healthcare solutions business, stabilizing for us. It came in, I would say, very consistent with our expectations, and our overall margins came in consistent with our expectations as well.

So we feel good about the fact that our government healthcare business is performing a little bit better. Obviously, we had a lot of pressure in that business in 2014, and it's one of the areas as we look to 2015 that we are expecting continued improvement.

So as you look towards 2015, our fourth-quarter performance I think is right in line with what we expected in Services, and it gives us that much more confidence in our 50 basis point margin expansion expectations for next year. Bob, I don't know if you want to add more color.

Bob Zapfel - Xerox Corporation - Corporate EVP, President Xerox Services

Yes, I would just add we had good cost management generally across-the-board by our teams. And in government healthcare we, as Kathy said, had stabilization and were really able to absorb investments that we were making in advance on New York and still fit, if you will, inside the targeted margins that we want to deliver. So overall, the plays that we've developed relative to global capabilities and managing our cost structure seemed to have reasonable yield last quarter.



George Tong - *Piper Jaffray & Co. - Analyst*

Great. Then as a follow-up, we're seeing Xerox take a more verticalized industry approach in its Services business. Can you discuss progress you are seeing with this initiative, and discuss how verticalization may impact pipeline performance on a near-term and intermediate-term basis?

Bob Zapfel - *Xerox Corporation - Corporate EVP, President Xerox Services*

Let me briefly cover that. This is Bob, obviously. I would say we are seeing already better cross-selling opportunities. So as we go to market, and we've moved out of our large number of independent business units, and we have a sales force that has a broader responsibility of all the offering set to those clients, we're seeing better cross-selling opportunities.

We had the whole team together for a big sales kickoff, and I think that that's off to a fair start.

I would say relative to pipeline, as you saw from our release, our overall pipeline numbers are down marginally. There's a lot of moving parts relative to pipeline, with taking ITO out and trying to count once validated -- as opposed to just earlier in the cycle, once noticed. But I would expect our pipeline to grow during the year as a result of the sales force additions and the focus on customers in vertical markets.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. A question with regard to acquisitions, for Ursula and Kathy -- and I guess Bob too, actually. Given the \$900 million bogey that you've put out there for the year and then the history that we've seen over the past few years, how are you thinking about ramping it up? Is this -- you've got in the hopper a couple of large ones, so you feel like it can be done?

Or -- again, it's a much larger number than you've done in the past. And then if you can't get there, I assume share repurchase is a focus; but would you want to keep the cash for some other purpose? Thank you.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

It's a good question. We have been improving our acquisition flow: \$150 million to \$350 million to \$900 million this year. It will be a difficult run for us, but it is one that we are absolutely committed to. And we are putting in place activities -- meaning people, incentives to the line people, people focused on deals as well -- to make sure that we can actually get up to the \$900 million that we have laid out.

This is a good problem to have, meaning we have the money and we will get a lot of it in the middle of the year, and we want to spend it, and people know. So we are working through it. I won't comment on any deals that we have in the hopper; just to say that we are working on making sure that we can spend all \$900 million.

If we don't spend it -- I'll actually turn it over to Kathy. The strategy that we have is pretty much in place, but she can actually just reiterate it.

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

Yes. One other thing I'd comment on, which I'm sure I've mentioned before, we have a desire to do what I would describe as chunkier deals. We're never going to get there just doing deals at \$25 million at a crack, right? That's just infeasible.



So that's clearly part of the overall strategy. And as Ursula mentioned, the fact that we've loudly broadcasted this hopefully helps to generate a little bit bigger pipeline.

We are also very actively engaging the business people, right? Bob certainly would tell you it's something that's a top priority in the business people, so we are working collectively across the organization in order to make this happen.

Finally on timing, we recognize that this is a big step up for us in 2015 in terms of what we're trying to accomplish. By the way, the incremental money is not coming in the door until the middle of the year, so just a note for folks on that.

So there is a possibility that we won't get 100% of the \$900 million spent this year. Our expectation is we would look to flow that over, in trying to accomplish more in the first quarter of 2016. We've already announced that we are going to do roughly \$1 billion in share repurchases this year.

We ended the year with a strong cash balance to enable us to again be more consistent in terms of being in the market consistently. So that's what we expect to do with the money, and we are all working hard to get it deployed as fast as possible.

Shannon Cross - *Cross Research - Analyst*

Great. Then as a follow-up, can you talk a little bit about what your metrics are around potential acquisitions? How we should think about accretion, what you're focused on from a financial standpoint when you look at prospective acquisitions.

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

First and foremost, we're focused on what I'd call return-adjusted, risk-adjusted returns. We're interested in doing good deals. We've been historically very disciplined; we are certainly not going to change that in our approach. So first and foremost that's what we are interested in.

Of course, we always look at what's the accretive, dilutive nature of the transaction; how much are we paying for it; etc., etc. We're focused on trying to do deals that generate synergies, because then we have more dollars to play with in what's a pretty competitive marketplace.

But those are some of the things that we are focused on overall. And I say before any of the math, we are focused on buying companies that are a great strategic fit for us.

Operator

Mr. Huang, JPMorgan.

Tien-tsin Huang - *JPMorgan - Analyst*

Hey, great. Thanks. It's Tien-tsin. Just want to ask on the Services margin front again, just all the different puts and takes. I know there's a lot of government healthcare expenses, etc., you've got some project delays with Texas and Florida.

So can it be higher if we normalize for government and healthcare and some of these unusual items? Trying to understand what's going on underneath the business in Services on the margin front, if that makes sense.

Bob Zapfel - *Xerox Corporation - Corporate EVP, President Xerox Services*

Well, the overall margins are still lower as a result of our margin dynamics in government healthcare. So without question the Services portfolio runs at an overall higher margin than we publish as a result of the investments that we are still making in government healthcare.



But I think as we said, we've got that stabilized. We had improvement both sequentially and quarter-to-quarter.

But as we are looking to ramp up, you'll remember from the investor conference a reasonable source of our targeted improvement in 2015 this year was coming out of GHS. We talked about that as being 25 to 40 basis points of potential improvement. So that is still our focus and we think we have got strong plans to yield that.

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

One other comment I'd add is, if you went back to the investor conference, along the things that we are targeting -- improvement in government healthcare, delivering productivity through our now horizontal operational capabilities, continuing portfolio management, investing in our platforms -- there is a yield we expect from that beyond 2015 as well, right?

So 50 basis point solid improvement is what we're trying to put up on the board this year, with an expectation that that would continue.

Tien-tsin Huang - JPMorgan - Analyst

Understood. Just my follow-up then on Texas, Florida. How much visibility do you have on the timing of that? To the extent that those things are pushed out, could that have any revenue and margin impact? What's the cushion there? Thank you.

Ursula Burns - Xerox Corporation - Chairman, CEO

I think you mean New York and Florida, not Texas and Florida. But Bob will answer it.

Bob Zapfel - Xerox Corporation - Corporate EVP, President Xerox Services

Yes, we built the 2% to 4% revenue growth commitment that we've made with a plan to get both Florida and New York to come to closure in the first half. We're still very much on track with both of them in terms of meeting the milestones.

So I would say that we are on track with both. They are in our range, and we don't expect either of them to not be successful in terms of us being a partner with those clients, both with Medicaid in New York State and with tolling in Florida.

Operator

Ben Reitzes, Barclays Capital.

Ben Reitzes - Barclays Capital - Analyst

Thanks. Good morning, everybody. I wanted to ask about puts and takes for the guidance a little more for 2015. In the fourth quarter, it looks like bad debt year-over-year was a \$0.025 benefit.

And now, moving into 2015, I was wondering what bad debt was for the year versus currency. If that goes the other way, with what's going on in some of the economies you serve, I was wondering if the guidance actually had offsets for if that goes the other direction. And then I had a quick follow-up; thanks.



Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

Sure. As we look at our fourth-quarter beat in Doc Tech, we recognize that some of the beat is coming out of bad debt; some of the beat was coming out of pension. Right?

So we ended the year at a higher level overall for the full year than what we would have talked about at our investor conference last November. So we're taking that into account then as we look at what the year-over-year changes are expected to be.

So my commentary around -- they were -- as we stare at our margin guidance of 11% to 13%, back at the investor conference I would have been more bullish on the higher end of that range, versus now talking about coming down towards the middle. That's taking into account, Ben, both the fact that bad debt will be a year-over-year headwind for us -- right? We expect bad debt overall, I will call it, the rate of bad debt, to continue to be just fine.

It's improved over the last couple of years and that should continue. But certainly we had a phenomenal 2014 in terms of what the overall bad debt expense is, and so we're reflecting that in our margin guidance.

Ben Reitzes - Barclays Capital - Analyst

Okay, great. Thanks for the clarity. Then just a quick follow-up on Document Technology. Are you seeing price competition from Japan-based competitors who can flow through the benefits of the yen? If so, how is that flowing through your margin guidance as well, which you just commented on for that segment?

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

We have been asked this question I feel like every quarter for the last -- since the yen moved from 85. We haven't seen any meaningful change overall in the competitive environment.

We always have pricing impacts that range 5% to 10%. Clearly big enterprise deals are always more hotly competed; but overall, we haven't seen a meaningful shift in the market.

Ben Reitzes - Barclays Capital - Analyst

Thank you very much.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - Brean Capital - Analyst

Hi, guys. Good morning. Thanks for taking the questions. Just two if I could.

The first is just, Bob, with regard to any potential operating margin impact when you go ahead and sign both New York and Florida. Can you give us some sense of -- that we should expect any standup impact to manifest and what kind of contingencies you might have been able to put in place heading into those? You just seem to have pretty good visibility to standing them up.

Then I guess just the second one is, when you guys announced the sale of ITO, I think the commentary was that at that point you expected to be able to make up any impact to 2016 through the combination of buyback and efficiencies on the EPS line. Now that FX is impacting EPS by about \$0.05 to \$0.06, do you think there's anything you can do as you go through 2016 to make up that incremental \$0.05 to \$0.06?

And those are my two questions. Thanks.

Bob Zapfel - Xerox Corporation - Corporate EVP, President Xerox Services

Ananda, it's Bob. Let me start with the first question. Relative to standing up both Florida and New York, we've built that into our guidance when we shared with you and the rest of the community our target to be a 50 basis points improvement in the 9% to 10% range. We've already absorbed some of that hit in the fourth quarter with New York, because we wanted to invest in advance.

So do we have to? Do we not run at as high a margin upfront in standing new contracts? Absolutely. But that's part of our design and sourcing model, and you should not need to expect any degradation as a result of winning that business.

We want to win it; we plan for it; and we have the cost in our outlook. Kathy, I'll turn to you on the Atos and 2016 question.

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

Yes. At the time that we announced the ITO sale to Atos, we brought our guidance down to reflect the impact of the dilution, which we would only be able to slightly offset this year, with an expectation that we would offset the remainder in 2016. So that's really about getting the share repurchases deployed and getting the M&A accomplished as well as, I'd say, offsetting some of the friction costs associated with the transaction, stranded costs that we then need to attack.

So we're still absolutely there in terms of impacting -- offsetting that impact.

The second question you asked was really about currency and our ability to offset the currency impact. Embedded in our guidance for 2015 already is an expectation we're going to offset a little bit of that impact.

You heard me in my prepared remarks say it's worth a little over \$0.06. We are bringing down our EPS guidance by \$0.05. So we are expecting that we're going to drive harder to offset some of that impact, and it is built in already.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - BMO Capital Markets - Analyst

Hi, thank you. A question and a clarification. The clarification first. Kathy, the \$0.06 that you talk about for FX, does that include the benefit of the yen to cost of goods sold for the printing side? And how much is that benefit in 2015 due to the yen?

Kathy Mikells - Xerox Corporation - Corporate EVP, CFO

It includes everything. So as you can imagine, for any global company, everything is a big everything.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes, you bet.

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

So it includes all the translation impacts, right? We talked a lot about impacts to revenue, and those impacts have some flow-through to profit. The ultimate margin impact of that is a little bit dampened because it's hitting both revenue as well as profit.

And it includes all of our purchasing and the hedging that we do associated with purchasing. So it is all-in.

Keith Bachman - *BMO Capital Markets - Analyst*

My question is -- I'm going to direct it to Bob. If you think about the sale of the ITO business, Bob, if you look back over the last two years -- and I realize you haven't been there over the two years. But if you think about the BPO side of the business, is there a way that you could quantify how that BPO business was tied to ITO?

In other words, when you think about the work of -- how much of the ITO business or the BPO business had ITO tied to it? What I'm really going back to is the thought process around -- how is the sale of ITO going to impact the ability of Xerox to win BPO business as you look forward to?

I understand you can outsource to folks like Cognizant -- or second, I should say, to Cognizant. But I'm just wondering how it might impact your win rate by not having in-house ITO capabilities. Thank you.

Bob Zapfel - *Xerox Corporation - Corporate EVP, President Xerox Services*

Yes. No, I appreciate the question. This was a really big strategic thought for us, because obviously we're betting a lot on our ability to drive growth in BPO and Document Outsourcing. When we looked -- I won't just do the two years; I will go at our portfolio. We had ITO in a little over half of our BPO revenue stream, but at a very, very modest amount.

So most of our big BPO plays had little server management. I'm not on the ITO contracts themselves, which were big contracts for us.

We really have found in the -- I guess we're 30 days plus, 40 days, we have a very good customer reaction. So as we go around with our clients and say our future delivery model includes Atos as a delivery partner, as a piece of this delivery ecosystem, I do not view it as something that's going to compromise or put us at a competitive disadvantage.

They bring a lot of assets relative to the ITO space. And we think that that team is an even better team for our BPO business than going it alone.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes. Fair enough. Okay, thanks for the answer, Bob.

Operator

Brian Essex, Morgan Stanley.



Brian Essex - *Morgan Stanley - Analyst*

Great. Thank you, and thanks for taking my question. I guess the first question for Kathy. As we think about some of the headwinds in particular to cash flow this year, whether it's FX or pension expenses, and we talk about normalized cash flow being over \$2 billion cash from operations, how do we think about how some of those pieces may move? Or how do you think about them as we're forecasting for 2016 and beyond?

Which ones seem -- I guess which ones would you expect to be more prominent in 2015, given where interest rates and FX are? And which -- when might we see a greater inflection, or will we see a greater inflection towards normalized cash flow in 2016 and beyond? Particularly post the sale of ITO.

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

I'm going to just start with a discussion about free cash flow, right? We brought our free cash flow guidance down by \$100 million. Part of that obviously reflects the sale of the ITO business.

We would expect to start to offset that as we do more M&A, basically utilizing the proceeds. So I would call that impact transitory impact, right?

Clearly we've said we think we'll be able to offset some of the currency impacts in 2015, reflected in the guidance that we gave with respect to free cash flow. But the Company is an incredibly, I would say, solid and consistent cash flow producer; and the sale of the ITO business is really just a modest, transitory impact on cash flow.

I'm not going to try and call where currencies go in 2016. But obviously, we're going to do everything that we can to offset the currency impact as much as possible.

Overall, with regard to pension, we are increasing our pension funding this year by about \$50 million. I would expect our pension funding starts to stabilize at that point, unless there is an opportunity to do something more materially with our pension, which at this point I don't necessarily see.

So I think the overall factors around our cash flow are very solid. We've reduced it at the moment for some transitory issues, but I wouldn't expect those to last forever.

Brian Essex - *Morgan Stanley - Analyst*

Okay. Can we get a sense of the capital intensity that ITO accounted for? And where might that have been offset by redeploying those funds into other areas?

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

Yes. Our ITO business was in the Services side clearly our most capital-intensive business; lower ROIC business for us, which strategically is much of -- behind the sale. Not to mention we were a subscale player in ITO relative to some of our competitors.

So from that perspective, its impact on free cash flow is much less than its impact on operating cash flow, which is part of the reason we only brought it down modestly. We'd expect we're going to deploy it into BPO, which is not nearly as capital intensive.

Brian Essex - *Morgan Stanley - Analyst*

Thank you.

Operator

Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Okay, thank you. There are obviously a few moving parts in the Technology Business this year, so I wanted to understand the timing of some of the puts and takes you've talked about. Could you give us a bit more color on how we should think about the revenue trajectory margin path and some of these product cycle dynamics as we progress through the year? And I guess particularly as we think about the dynamics as we move from first half to second half.

Kathy Mikells - *Xerox Corporation - Corporate EVP, CFO*

Sure. As we progress through the year, just in terms of the revenue dynamics going on in Doc Tech, we'll get a bit of a benefit as a result of -- just from a year-over-year comp perspective. You know, not doing the forward receivable sales anymore.

So that had in the third and the fourth quarter about point of negative impact in 2014. So we will get an easier comp towards the back half of the year.

From a foreign currency perspective on Doc Tech with regard to top line, translation impacts to top line have been immediately. The flip side of that is what's going on in transaction impacts. The transaction impacts don't hit us immediately, as a result of our hedging program.

So that's a little bit more back half it gets worse relative to front half as a result. That's obviously a profit and a margin constraint as opposed to a revenue constraint. So hopefully that gives you a little bit of color.

Bill Shope - *Goldman Sachs - Analyst*

That's helpful. Thank you. That's it for me.

Operator

James Friedman, Susquehanna.

James Friedman - *Susquehanna Financial Group - Analyst*

Hi, thank you for taking my question. It's Jamie at Susquehanna. I just had a housekeeping question; I'll ask all mine upfront.

Kathy, I just want to make sure that -- am I correct that the New York Medicaid is not in the signings number at this point?

My next question, for Bob, was if you could comment about the pricing environment. And also, Bob, are there any problem contracts a-la Nevada or Texas that you'd call out at this point? Or if that's too specific if you could talk about the risk management at the Firm overall, thank you.

Bob Zapfel - *Xerox Corporation - Corporate EVP, President Xerox Services*

I can probably answer all of those. So yes, Jamie, you're right: New York is not in those signings numbers, neither New York nor Florida. And while our overall signings were strong and the numbers were very positive, we do need to get new business ramped up; and that's a big piece of that.

Relative to the problem contract question, I would say we've made real progress in terms of the new systems implementations. We've got a strong team that we've added in 2014 that's really been driving that.

You can never say never in terms of an issue in a given implementation. But overall we've made very good progress there, and we are optimistic that we won't have big financial hits as a result of future problem contracts.

Jim Lesko - Xerox Corporation - Corporate VP, VP IR

Thanks, Bob. Thanks, Jamie. If we could have the last question now, operator? Thank you.

Operator

Jim Suva, Citigroup.

Jim Suva - Citigroup - Analyst

Great. Thank you and congratulations. The signings number was very impressive for the quarter. A lot of times there is seasonality to them, and maybe some deferrals that come in and things like that. So if you look at one quarter, the snapshot is very, very impressive.

If you look at a trailing 12-month quarter run rate, you still have down 13%-ish for a trailing 12 quarters. Can you help us bridge the gap of that trailing 12 months versus a very strong quarter, and the outlook for surfaces and your confidence to grow that Services? Thank you.

Bob Zapfel - Xerox Corporation - Corporate EVP, President Xerox Services

Jim, no, I would agree. We were happy with the quarter and the year-to-year growth that we had in the quarter. But still, as you represented, we are down double digits on a trailing 12-month basis.

Again, the big piece that would have changed that is if we would have had a little bit earlier timing in either New York or Florida. But those are in front of us as opposed to already booked and in our signings numbers.

But the renewals have been really strong. We have seven out of the last eight quarters in BPO that we've been over 90%, so we are very positive on the renewal rates. And it's really a new business, getting more traction in our new business initiatives, and we believe we will do that in 2015.

That is a critical, critical element for us, maybe more on our 2016 revenue than on 2015. But it's a critical element for us, and we are very focused on it.

Jim Suva - Citigroup - Analyst

Great. Then as a quick follow-up, you have a couple big contracts, and on the call you made some references to New York and Florida that are not in the signings; and I understand that correctly. But once they come into signings is there also a little bit of a timing item we should be aware of as far as when they get included into your revenues?

I.e., like immediately when they sign, then the next day you can start to recognize revenues? Or is there a -- hey, you signed it; then you have to sit down and talk about phases and timing and sometimes a quarter or two?

Because each of those look to be quite substantial and I don't want to get too excited -- or maybe I should -- that they immediately start to enter the revenue stream.



Bob Zapfel - Xerox Corporation - Corporate EVP, President Xerox Services

Yes. No, we generally begin to recognize revenue pretty quickly, but there is a ramp. So it's that you're not at full annualized revenue in the first quarter after the signing.

But I would expect in both, and the way we've built our track is we expect in both New York and Florida to sign in the first half, to then start a revenue flow. Not -- as an earlier question -- not at high margins, but that's all built into our guidance.

But it does take a little bit of time, typically about two quarters, before you get to the annualized run rate.

Jim Lesko - Xerox Corporation - Corporate VP, VP IR

Thanks, Bob; thanks, Jim.

Jim Suva - Citigroup - Analyst

Thanks for your clarification.

Jim Lesko - Xerox Corporation - Corporate VP, VP IR

Thank you. That's all the time we have for questions today. Thank you for your interest. And Ursula, anything more to wrap up?

Ursula Burns - Xerox Corporation - Chairman, CEO

Yes. In summary, we have a clear and consistent plan in place, and in 2014 we were successful in advancing our strategic initiatives. We have a focused management team -- you've heard from them today -- prepared to deliver the plan.

And in 2015 we are committed to enhancing our overall Services business while maintaining our market leadership in Document Technology. Additionally, we will continue to make investments to move the business forward.

Jim Lesko - Xerox Corporation - Corporate VP, VP IR

Thanks, Ursula. That concludes our call today. If you have any further questions, please contact me or any member of the Investor Relations team. Thank you. Have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Have a good day, everyone.



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