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XRX - Q1 2014 Xerox Corporation Earnings Conference Call

EVENT DATE/TIME: APRIL 22, 2014 / 2:00PM GMT

OVERVIEW:

Xerox announced 1Q14 revenue down 2% and adjusted EPS of $0.27. Management decreased 2014 adjusted EPS guidance to $1.07-1.13, and reduced 2Q14 adjusted EPS guidance to $0.25-0.27.

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CORPORATE PARTICIPANTS

Ursula Burns *Xerox Corporation - Chairman, CEO*

Kathy Mikells *Xerox Corporation - EVP, CFO*

Jim Lesko *Xerox Corporation - VP, IR*

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

CONFERENCE CALL PARTICIPANTS

Bill Shope *Goldman Sachs - Analyst*

Shannon Cross *Cross Research - Analyst*

Ben Reitzes *Barclays Capital - Analyst*

Ananda Baruah *Brean Capital - Analyst*

Keith Bachman *Bank of Montreal - Analyst*

Jim Suva *Citi - Analyst*

George Tong *Piper Jaffray - Analyst*

Kulbinder Garcha *Credit Suisse - Analyst*

Tenzin Wang *JPMorgan - Analyst*

PRESENTATION

Operator

Good morning and welcome to the Xerox Corporation first quarter 2014 earnings release conference call, hosted by Ursula Burns, Chairman of the Board and Chief Executive Officer. She is joined by Kathy Michaels, 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. After the presentation, there will be a question and answer session. (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. At this time, I would like to turn the meeting over to Ms. Burns. Ms. Burns, you may begin.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Good morning and thanks for joining our call. Today we are reporting our first quarter 2014 earnings that reflect the benefits of our diversified portfolio and improved performance across a number of areas including ITO, document technology, and document outsourcing. And, within BPO, our commercial business, especially commercial healthcare showed good results.

We did have challenges in the quarter, especially in the area of government healthcare, which I will get to in a few minutes. Let's begin with a review of our 2014 priorities.

The first priority is growing revenue. Today, services represent 57% of our revenue and we continue to expect that number to grow up to 2/3 by 2017. The shift over time will drive improved revenue growth. To realize this growth, we need to strengthen and differentiate our portfolio.

We participate in some very attractive segments of the services and document technology markets. We are investing in these areas to increase the value we bring to our customers. I was very encouraged by what I heard from our customers a few weeks ago at our event called Simple at Work. Over 800 customers got to see all that Xerox has to offer, the innovation we are bringing and the commitment we have to solving their real-world business problems.

What I heard from them was very positive. They are eager to understand all of our offerings and work more with Xerox.

Another priority for us is to improve our cost structure and eliminate areas of underperformance. We have made great strides on this in document technology over the past few years, and we are on the path to do the same for services.

Key to executing on these priorities is having a strong team to drive long-term results. We have a very seasoned team of executives with good subject matter expertise. We have brought in proven leaders to broaden our perspectives and execution capabilities.

A few weeks ago I announced the appointment of a new head of our services business, Bob Zapfel, and the retirement of Lynn Blodgett. I want to thank Lynn for his service and dedication to Xerox, and welcome Bob, who is with us on the call today. Bob and his team are focused on the areas where we know we can and must improve.

He will lead the implementation of our services five-plank strategy, which includes driving our cost initiatives, while supporting investments in areas where we see opportunity and benefit to our customers. Opportunities like global growth, where we are seeing progress.

And across both segments, services and document technology, we have a team focused on supporting our customers, our investors, and our people.

Our final priority is to continue to focus on capital allocation to deliver shareholder returns. We have a business that -- with very strong cash flow and we are committed to deploying that cash in a balanced way to drive shareholder value now and in the future.

Moving on, I would like to share my perspective on Q1 results. A few positive takeaways from the quarter: we reported adjusted EPS of $0.27, which was above our guidance. Operating margin was up year-over-year by more than a point and operating profit grew double-digits, driven by document technology and document outsourcing as well as improvements in commercial BPO and IPO. And we generated over $250 million of cash in the quarter, which positions us well for our full-year objectives.

We repurchased $275 million in shares and we are increasing share repurchase expectations for the year. Some challenges did persist on a couple of fronts. Revenue declined 2%. Although this is an improvement from quarter 4, and is within our expected range for Q1, it is below our full year objective. So we will need to continue to see improvement, especially in the second half when we lap some of the near-term headwinds.

And we came up short in services margins, which I know is an area of keen focus for investors, and I can assure everyone an area of intense focus internally. The shortfall is driven by incremental cost incurred in our Medicaid and health insurance exchange implementation.

Kathy will add more detail, but know that we are committed to doing what is needed to get these systems stood up, and we are confident that these investments will pay dividends down the line in this very attractive market segment. As we deal with challenges in this business and work to remedy the issues for the future, we need to reset our guidance expectations. We will go through the specifics in a moment.

It is important to note that we are making margin progress in other areas. For instance, we saw good margin improvement year-over-year in our commercial BPO and ITO businesses, and I am extremely pleased with the revenue growth and margin improvements in commercial healthcare, but we have much more work to do.

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

Kathy Mikells - *Xerox Corporation - EVP, CFO*

Thanks, Ursula, and good morning, everyone. I would like to start by walking through our earnings. Overall, we were pleased with our growth in operating profit and the related operating margin improvement in the quarter.

Our core operating results came in a bit better than expected, driven by strong margin expansion in our document technology segment, with a gain on the sale of real estate and lower tax rate also aiding our EPS beat versus guidance.

We saw positive results and trends in a number of areas within services, but disappointing results within our government healthcare business cost us to miss our services segment margin guidance for the quarter and adjust down our services margin expectations for the year. I will walk through this in greater detail when we get to the segment review.

Revenue in the quarter was down 2% at both actual and constant currency. This was better than the 4% constant currency revenue decline in Q4 as both document technology and services revenue growth rates modestly improved.

Gross margin of 30.2% was down 30 basis points year-over-year as improvements in document technology was not enough to offset the incremental pressure on services margins. Ongoing productivity initiatives as well as lower pension expense yielded significant improvements in both SAG and RD&A. As a result, our operating margin expanded 110 basis points to 8.6%, enabling operating profit growth of 13%.

Moving down the income statement, adjusted [on the net] was $72 million, an increase of $59 million year-over-year. The drivers of the increase were higher OID and higher restructuring expense. OID was up year-over-year; the largest factor was that this year's gain of $30 million associated with the real estate sale was less than the prior year's $37 million litigation reserve reduction. We have been working on the real estate sale for some time and expected it would close in 2014, but a bit later in the year, so it aided our beat this quarter.

Restructuring was $27 million, which was $35 million higher than in 2013 and about $0.01 higher than our guidance. Adjusted tax rate of 22% was in line with 2013 and under our guidance due to favorable audit resolution, which were a discrete item in the quarter.

Adjusted EPS of $0.27 was flat year-over-year and above our guidance range of $0.23 to $0.25, with the upside coming from document technology profitability, the real estate gain and tax rate, partially offset by higher restructuring.

With that, I will move to the services segment slide to review those result in more detail. Services revenue growth was flat year-over-year, which was a modest sequential improvement from Q4, when services revenues were down 1% in constant currency, although it was short of our 1% growth target.

Document outsourcing continues to grow mid-single digits. ITO was slightly up and BPO was down a couple points as good growth in commercial healthcare and international were offset by student loan runoff, lower volumes in customer care and transportation, and less inorganic contribution.

Turning to signing, signings were up 1% on a trailing 12-month basis, but were down year-over-year. As we highlighted on our Q4 call, we had a challenging signings compare this quarter as our Q1 2013 was one of our highest signings quarter in recent memory.

That said, signings in the quarter were a bit softer than we expected. New business signings were down 7% year-over-year as we saw some decision delays and shift of contracts to Q2.

New business pipeline remains very strong, up 9%, and we expect sequentially higher signings in 2Q, although once again we faced a relatively strong year-over-year compare.

Total contract value from renewals were quite a bit lower year-over-year, despite a renewal rate of 91%. Both new business and renewals can be lumpy, and the lower renewals in the quarter were a function of fewer renewal decisions. So, all in all, renewals are not a concern and we would have liked to have seen a little bit better new business growth, but we feel we are well-positioned as we enter the second quarter.

Shifting to profitability, segment margin was 8.6% in the first quarter, down 70 basis points year-over-year and lower than our target of 9.3%. The year-over-year decline and outlook shortfall is driven by incremental costs associated with the rollout of our new government healthcare and Medicaid system, and implementation of the Nevada healthcare exchange. The work involved with implementing these new platforms is significant and we faced greater challenges than anticipated getting new clients to a good level of operating performance and then costing down the ongoing maintenance of the program.

While we are making progress on improving our operational performance, it is costing more than we expected and it's going to take us more time before we can lean out the resources supporting these projects.

We are making good progress in other businesses within services. Excluding the higher than anticipated government healthcare costs, services margin would have been flat year-over-year, with improvement in document outsourcing and our commercial businesses, where we saw benefits from our cost actions, roughly offsetting headwinds from student loan runoff and lower volumes in some areas.

Turning to guidance, we are resetting our expectations for services. On revenue, we continue to expect services revenue growth to improve sequentially as we move through 2014, driven by signings ramp, moderation of headwinds impacting BPO, and greater inorganic contribution, averaging mid-single digit growth in the back half of the year.

Taking into account the slower start, with flat revenue growth in Q1 and later ramp in new business and acquisitions, we believe full-year services revenue growth will be approximately 3%.

Given the Q1 margin performance and expectation for continued higher costs in government healthcare, we expect full-year services margin to be down and in the range of 9.4% to 9.8%, which compares to our original expectation for a 50 basis point improvement to approximately 10.3%. Government healthcare was an area where we had expected good year-over-year profit growth, specifically in the back half of the year when we expected to get significantly reduced cost.

Our Q1 experience was just the opposite, as we had to dedicate incremental resources. We are taking a number of actions to address the issues. In the past few months, we have brought in a new leadership team for government healthcare, an experienced chief development engineer from our technology group, as well as Bob to run Xerox Services.

We are enhancing our program management under a single point of accountability that also serves to enable quicker learnings across different implementations of the same platform. We know it is going to take us longer and will cost us more to get these implementations right, and we are committed to do that in support of both our current and future customers.

I will now turn to document technology. Revenue in document technology was down 4% in actual currency and 5% in constant currency. We saw a consistent performance in the US from improvement in Europe and ongoing weakness in developing markets.

Equipment sales revenue was down 4% year-over-year and supplies was down 3% year-over-year and improved sequentially from down 9% year-over-year in the fourth quarter. In addition, our previous finance receivable transactions negatively impacted revenue growth by about a point.

Looking at our product group, high-end had positive equipment revenue growth again this quarter, driven by strong color install activity. Midrange also continued to show good color install activity, driven by ConnectKey.

Finally, entry, although impacted by weakness in developing markets, did show improvement from the fourth quarter.

Looking to margins, document technology margin was very strong at 12.2%, which was 340 basis points higher year-over-year. This improvement reflects the ongoing benefit from cost and efficiency savings, lower pension expense, and a currency benefit from the weak yen. In addition, we had a relatively easy prior year compare.

The strong margin performance resulted in operating profit growth of 34%, despite the revenue decline, so good overall performance for document technology. Looking toward the second quarter, we saved some more difficult compare especially in equipment revenue, given the timing of last year's ConnectKey product launch. And we continue to expect document technology to have revenue down mid-single digits with good margin, although most likely not at Q1 levels.

With that, let's turn to cash flow. Cash flow from operations was quite strong at $286 million in the quarter, which compared with an $87 million use of cash in the first quarter of 2013. The year-over-year improvement was driven by working capital.

Accounts receivable and accounts payable were the largest factors year-over-year, reflecting, in part, timing benefits related to our efforts to continue to smooth out working capital. Inventory was better year-over-year as we had higher than normal buildup of inventory in the first quarter of 2013 related to the ConnectKey launch timing.

Moving down the cash flow statement, investing cash flows were $120 million use in the quarter. We spent $103 million on CapEx and $54 million on acquisitions. In January, we closed on Invoco, a German customer care company, which supports our international expansion.

We have had a better start in M&A this year, but had hoped to get a bit more done by this point. The pipeline continues to look good and we are close on a few opportunities, so our full-year expectation to spend up to $500 million in 2014 is unchanged.

Cash from financing was a use of $349 million and includes $275 million spent in share repurchases and $74 million in preferred and common stock dividends. Wrapping up cash flow, we have a good start and our full-year guidance remains $1.8 billion to $2 billion of operating cash flow with a more even distribution through the year. Q2 cash flow will be down year-over-year, but overall cash flow for the first half should be roughly in line to the prior year.

Moving to the next slide, I will walk through our capital structure. We ended the quarter with $8 million in debt, which is consistent with our beginning of year balance. We have $1.1 billion in debt coming due in May, $200 million of which we pre-funded as part of last December's note offering. We plan to refinance the remaining $850 million throughout the year.

Applying 7-to-1 leverage on customer financing assets, our allocated financing debt is $4.4 billion, leaving core debt of $3.6 billion. Financing debt has come down over the past few years driven by the finance receivable transaction as well as from lower origination. As we previously indicated, we don't plan to do any finance receivable transactions this year, and thus, we expect finance debt to be relatively stable. We manage our core debt to maintain a relevant leverage ratio consistent with our investment grade rating.

We continue to expect to end of the year with about $7.8 billion in total debt with a reduction simply reflecting the $200 million that we pre-funded last December.

Additionally, it is worth noting that we amended our $2 billion revolver to extend it through 2019 with more favorable pricing. We feel good about our stable capital structure, and if we move to the next slide, I will review where we are on share repurchases and dividends.

Our strong cash flow and beginning of year cash position enabled us to repurchase $275 million or 25 million shares in the quarter. We now anticipate doing at least $700 million in share repurchases for the year. Share repurchase has been a consistent element of our capital allocation plans the past few years and, as a result, we have reduced shares outstanding by a net 17% since 2010.

As part of our commitment to creating value for shareholders, we announced last quarter a 9% increase to the quarterly dividend to $0.0625 per share, which is effective for common dividends payable on April 30. We will spend about $300 million on dividends in 2014. So combined with share repurchases, we are targeting to return at least $1 billion to shareholders this year.

Before I turn it back to Ursula, I would like to summarize our expectations for Q2 and full year. We are pleased with the performance of document technology and expect continued strong margin, albeit likely than lower Q1, and relatively stable revenue decline, with a somewhat more difficult compare in Q2 given the timing of last year's new product launch. So overall, document technology is on track with full-year margins expected to be up modestly year-over-year.

Within services, we are seeing good results in document outsourcing, commercial healthcare, international, and other commercial BPO businesses, reflecting the progress we are making implementing five-plank strategy for improved margins and growth. But required additional spending in our government healthcare business has triggered a revision to our guidance.

We expect Q2 services revenue and margin to improve sequentially with lower margin year-over-year, given the strong 10.2% prior year compare. As I mentioned earlier, for the year, we expect to be between 9.4% and 9.8%.

At the consolidated level, for Q2, we expect revenue will decline approximately 2% and adjusted earnings per share of $0.25 to $0.27, which includes approximately $0.02 of restructuring. And, for the full year, given the change to our outlook for services, we now expect consolidated revenue to be flat to slightly down year-over-year and adjusted earnings per share of $1.07 to $1.13, which compares to our previous earlier guidance of $1.10 to $1.16.

With that, I will hand it to you, Ursula.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Thanks Kathy. I want to get to your questions, so I will quickly summarize our performance. First quarter performance reflects how our portfolio mix benefits our business. Our profits in document technology helped offset the shortfalls that we faced in government healthcare solutions.

Our distribution and international expansion is extending our reach to more customers around the world, and our strong cash flow allows us the flexibility to increase the value we bring to customers by investing in growing vertical markets.

We are consistent in our priorities and our focus and continue to strengthen our management team. And we are executing on our five-plank strategy in services, designed to promote revenue growth and improved margin.

Despite the current pressure on the government healthcare, we are optimistic about our healthcare business overall. They are at good growth and profitability on the commercial side and room for improvement on the government side.

We will capitalize on the most advantaged segments of the document technology business to maintain our leadership position in the industry. And we will continue to use our healthy cash flow to deliver shareholder value.

Thank you and now over to you, Jim.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks Ursula. 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 yourself to one follow-up question so we can get to everyone. 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) Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Thank you. So I have a question for Bob, whom I believe you said was on the call, and perhaps Ursula as well. Given the challenges and the volatility we have seen in the services segment, particularly on the margin line, could you give us some early thoughts on the changes we might expect to see in the management of the business and how that will hopefully produce more predictable results going forward?

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Why don't I start, and then I will turn it over to Bob? One of the important things that we did when we outlined the five-plank strategy was to do that from a broad-based leadership perspective. So, not only in services, but including the leadership of the Company -- the CFO, the head of strategy, myself, and obviously the head of services.

So the strategy that we have in place for margin improvement and revenue growth in services is one that is in place and will continue. What we realized at the time, though, is that we needed to change our implementation process and cadence. We did a couple of things there. One is a structural change inside, which is not that much interest to the external world, but was really important to how we manage the business for transparency and clarity across many different lines of business and many different implementations.

Second, and probably first, foremost, was we looked at our leadership team and the capabilities that we had there and made sure that we understood if we had any gaps and, if we had gaps, we actually went out to fill them.

Three areas we had to look at to improve and we did. One was, we brought in a new head of our government healthcare business, and he has brought in leaders underneath him to help assure that we can have this standard implementation across the many different implementations that we have around the nation, both in MMIS and in our health information exchanges.

The second thing that we did was we actually moved some technical resources that we had from our technology business to our services business to manage these platforms, which are fairly complicated. And the third, and most important, was that we started searching for and we brought on board a new leader to actually implement the five-plank strategy, somebody who had experience in doing this type of management structure and process, and that was Bob. So let me turn it over to Bob now.

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

Thanks, Ursula. Yes, Bill, I would just add -- I mean, I had the good opportunity before coming and joining the Xerox team to really in the due diligence understand the five-plank strategy. And it really matched my experience base in terms of how do you drive value for clients by transforming your delivery model.

Service is at the core a delivery business. And we are still in the relatively early part of the journey, but a journey that is very well mapped out to drive best practices across our units through improved process standardization, automation to take work out of the workflow, and leveraging a global talent pool.

So, on your question of volatility, I really think as we mature our process, we will be even more predictable. And it was part of what made Xerox and the services business very attractive for me personally.

Bill Shope - *Goldman Sachs - Analyst*

Thanks. And congrats on the new role, Bob. Outside of the services segment, the technology business, we are obviously seeing some positive surprises. Should we be -- I understand that this quarter was a bit of an outlier in terms of the margin strength, but should we be thinking about tech segment margins that are potentially sustainably above the ranges you have given us in the past when we think about our modeling longer-term?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

So I am not going to attempt to give 2015 guidance this early in 2014, but we are really pleased by the performance that we are seeing in the technology business. We had commented in the back half of last year that the technology business had really stabilized, and we have a great focus on driving profitability and margins in the technology business with ongoing restructuring plans. So we feel good about the margin we produced this quarter.

In my commentary about the second quarter, I clearly said we expect continued strong margins, albeit expect it to come down a little bit from where we are in Q1. So overall, we are really pleased. We expect we will be up a little bit year-over-year in technology margins, and know we expect continued good performance there.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Bill. If we could have the next question, please.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

I had another question on services, and maybe Bob wants to jump in, or Ursula. As you look at what's happened in Nevada and the challenges and that, has it changed your thought regarding government healthcare opportunities? And how do you view the landscape, given what we have seen, not just with [the rocks] but obviously other companies as well?

Ursula Burns - *Xerox Corporation - Chairman, CEO*

I'll take it, and Bob can follow-up if need for it. The government healthcare market is relatively large and it's definitely growing. The demographics are all tailwind for it, all in favor of government health. The majority of our healthcare business is not government healthcare, and the majority of that is not new platforms.

Let me just break it into two parts so that we can parse out where we are having the challenges and what we are doing to fix it. And therefore I think it will help you understand why we are still so bullish on the market. MMIS is one large amount of engagement that we have. This is a long and historic business for ACS, and now Xerox. It's Medicaid. We've been in it for many, many, many years, and we have been managing on a platform that is an old platform.

When a platform is in, it lasts for many years -- ten, fifteen years plus. And after you stand it up, the business on an ongoing basis is very predictable and fairly profitable -- actually, very profitable. Where we are today on Medicaid is that we are implementing a new set of platforms around the nation.

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The most famous one is California, which we are engaged in, we have been engaged in for many years. And California is going fairly well. And MMIS is actually going pretty well. And we are now at the point where we are starting to lean out our implementation on California and drive it to increased profitability.

MMIS, we also have some new implementations as well. And those new implementations, which some of them started late last year, a couple later this year, and one in 2015, and more to come, I'm sure, will be going through the same process of implementing the new platform and then leaning it out and driving it towards profitability.

MMIS is an area that is a challenge, but it is not a large concern for us. We know our path forward there. The place that is the biggest challenge for us right now is the health information exchanges, and it is the one that we lead on, and that is Nevada.

And this is a brand-new platform; it is a one of a kind implementation for us. So far, to date, this is the only place that we have done it. It has not gone well. We are working very hard and closely with the client to make sure that we do two things.

One is stand it up to the client's assurance and comfort -- that we do that. And we are doing that very well and aggressively with leadership in Nevada. But, also, lean it out as we go forward.

That is taking a lot longer than we thought, as Kathy said and as I said, and as you are hearing probably when you read the newspapers, taking a lot longer than we thought. And it's taking more resources than we thought.

As we clean that out, we will do the same thing. As we stand it up, we will lean it out and then we will drive it toward more stable operation and profitability.

On health exchanges as well, though, we are involved in a lot of other states in varying ways, not implementing the platform, but handling transaction processing, handling call center, doing some specific logicals in health exchanges in six or seven states. They are going very well.

So the focus area for us in health exchanges is fixing Nevada. If we do that, we should be able to actually fly on a go forward basis in the implementations that -- solid implementations that are going well. And on MMIS, it is literally just about continuing on the improvement path that we are on, which is very good already and driving towards profitability.

So it's a good market, a growing market, and one that I don't think we can actually step away from, I know we can't step away from, because we have a history of success in this business.

Shannon Cross - *Cross Research - Analyst*

Great. Thank you. Then my next question is just for Kathy. You maintained cash flow guidance, but you are lowering services margin. So can you just give us some ideas of what is supporting that decision; where the incremental drivers of cash flow will come from?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

Sure. And so I will start with our first quarter cash flow was very strong performance, so I feel good about where we are starting the year. If you look at, I'll call it overall income obviously bringing down services margin, that is at least partially offset by pretty strong margins that we are seeing within document technology.

And even within services, some of the reduction in overall income is coming from slower implementations, which are a non-cash change that we are taking. So, overall, that plus top line is coming down a little bit more and that gives us another working capital benefit. I feel really comfortable we will be able to hit our full year guidance.

So we are not going to see nearly as much flow through to cash flow as you are seeing kind of from the income statement.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Shannon. If we could have the next question, please.

Operator

Ben Reitzes, Barclays.

Ben Reitzes - *Barclays Capital - Analyst*

Can you just talk also on cash flow about your efforts to smooth it out, meaning make it less volatile? Obviously, the cash flow in the first quarter is a greater percentage of the total than usual. And what is going on there as well to make it smoother as we go throughout the quarters? And will you still have the big hockey stick in the fourth quarter, Kathy?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

We will still have in the fourth quarter a big push, Ben. What you are seeing is largely payable timing being smoothed out during the course of the year. As I look at our first quarter, I feel really good about gains that we are making in terms of just receivable days outstanding, which I am certainly expecting are going to hold for the year.

So while you will see for a quarter over quarter sort of year-over-year movement, that is going to just result in a little better cadence of overall cash flow during the course of the year. So we are still going to be, I'll call it seasonally peaking in 4Q. But yes, less so than you have seen us in past years.

Ben Reitzes - *Barclays Capital - Analyst*

Okay. And then, I was just trying to quantify the hit from the new guidance on the EBIT line. I was thinking, just backing into your services guide, and it is like $60 million to $80 million and less operating profit in terms of when you add up revenue -- the lower revenue and the hit.

And then I was wondering, is there an incremental restructuring on top of that which also accounts for the lower guidance for the year? I am just trying to tally it up to get to the $0.06 -- or to the $0.03 or so in the range, and trying to get the EBIT numbers right.

Is that about the way to think of it? And what is the incremental restructuring versus what you were thinking on previously before this call again?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

Yes. And so we had given guidance on restructuring kind of roughly similar year-over-year, and that really hasn't changed. If you look overall in services, we are taking the biggest hit in terms of operating earnings there as a result of the change in services margin coming down.

So we had initially said we thought we would see a 50 basis point improvement. If you look at the range I am now providing, in the middle of that range it would be down 20 basis points. So call it a 70 basis point change relative to where we started. That is worth about $80 million in terms of overall operating profit.

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Now, I expect document technology is offsetting a little bit of that, right, because we clearly saw really strong first-quarter gains in terms of overall margin, and I suggested I thought we would be up modestly now in doc tech margin year-over-year. And so you're getting a little bit of an offset there.

And then if you just kind of look to what other things changed to get us to a full year change of, call it, down $0.03, we are doing a little bit more in share repurchases. So we started out a little stronger in terms of the timing of those share repurchases and we have upped our guidance now from $500 million to at least $700 million, and so we get a little bit of pickup there as well.

Ben Reitzes - *Barclays Capital - Analyst*

Thanks for that. That was good detail. Appreciate it.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Ben. If we could have the next question, please.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital - Analyst*

The first one for me, Ursula, is -- and maybe Kathy -- just sort of could you walk through the contribution, or I guess the different buckets of impact to the services growth for the quarter and what do you think the underlying reasons for those were? And I have a follow up. Thanks.

Kathy Mikells - *Xerox Corporation - EVP, CFO*

Okay. I'll go ahead and take that. When I look at topline, we had initially targeted that we thought we would be up 1%. We ended up being flat.

There is really two different things contributing there. Fuller ramp, so both within some of the healthcare implementations that are taking us a little longer, so the new ones that were standing up are having a slower ramp. And we saw a little bit of overall volume decline, specifically within transportation. That is, in part, weather related and also due to some slower ramp there.

And then, finally, I would point to M&A. While we started out the year stronger than we did in 2013, we are still getting a relatively low contribution from M&A -- less than half a point. And about is clearly below where we would like to see it.

So while I feel good about the pipeline, we are close to a couple of opportunities, I still feel good about our ability to get closer to spending $500 million for the year. It is coming on a little slower than we had hoped.

Ananda Baruah - *Brean Capital - Analyst*

Got it. Thanks. And then, with regards to buyback -- and congrats on raising the range there -- what -- philosophically, how should we think about you executing the rest of the buyback through the year? I think the idea was to do it more rapidly through the year this year, commensurate with cash flow and you had a really strong Q1. So how should we think about strategy on buyback?

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Kathy Mikells - *Xerox Corporation - EVP, CFO*

Yes. I think that is exactly how you should continue to think about it. In contrast with last year, where we really did essentially all of our share repurchases in the back half and very heavily weighted to the fourth quarter, we intend to continue to be in the market throughout the year with our share repurchases.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Ananda. If we could have the next question, please.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *Bank of Montreal - Analyst*

I am going to follow Ananda's question on growth and I was hoping, for my first question, if you could talk about your confidence surrounding, Kathy, I think you said 3% revenue growth in services. And while you are doing that, if you could address a few things: A, the bookings looks -- was weak this quarter, and I think you said it is going to be down on a tough compare. What does that suggest about the longer-term growth -- B, pricing?

And then, C, also ITO; I question the strength of ITO as we get to the back half of the year when you are really, I think, anticipating a pretty dramatic increase to mid-single digits in the broader services category. So if you could perhaps just talk about your confidence interval on services, and then I have a follow-up. Thank you.

Kathy Mikells - *Xerox Corporation - EVP, CFO*

Okay. So, on services, I feel really good about our renewal rate -- 91%. We had a 92% renewal rate last year. In this quarter, our new business was a little softer than I had hoped, down 7% for the quarter.

We had something that is taking us a little longer to get the contract on. I feel pretty good about second quarter, clearly mentioned that we expect to see sequential improvement. We do have a tough compare.

I mean, in the second quarter 2013, we were up total contract value 40% year-over-year. So it's a little bit of a tough compare from that perspective, but we should benefit from the strong signings that we saw last year.

And so overall, I continue to feel really good about our organic growth. And I like some of the places that we are seeing good organic growth. In the first quarter we had double-digit growth in Europe overall, within services, and a piece of that was inorganic. But even our organic growth was up actually double-digits, so very strong growth there as well.

So we are feeling pretty good about the sequential improvement that we expect to see over the course of the year. And, again, while I said M&A started out to a slow start, I feel good about the pipeline. We are close on a couple of deals.

And then, finally, some of the other things we are doing, we mentioned in our investor day last November that we have a big push on improving our overall mix of business. And so you referenced ITO growth slowing, which has clearly been expected and anticipated by us. We are adding a number of salespeople into the businesses where we have higher margins. We recently announced hiring another 60 salespeople, so we are making investments to ensure that we get the organic growth we are expecting.

Keith Bachman - *Bank of Montreal - Analyst*

Okay. Thank you, Kathy. For my follow-up, just philosophically, Xerox has had a couple of quarters of disappointment in services and you are bringing in new leadership, exciting new leadership. How do investors take some comfort in the fact that Bob is having a new role, will be digging underneath the covers, and could uncover some additional areas that he is not comfortable with, is the guidance the right guidance?

In other words, you are asking Bob to step into a position and you are providing guidance at a position which presumably he hasn't had a chance to really dig underneath the covers. Or is that inaccurate perception and we should assume that Bob has kind of blessed these numbers and this guidance?

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

Keith, this is Bob. So, no, I would say that in the first 22 days here, I have been through these numbers in excruciating detail. I have had a chance to be out with clients and with the Xerox team as well. But, no, I am on the call and on the hook.

And I think from an investor standpoint, we appreciate that you are going to measure us based on our results. So -- but, this is not a -- I am not inheriting somebody else's call in terms of what we are committed to deliver. The 100,000-person services team and I are on the line for what we have covered on the discussion today.

Kathy Mikells - *Xerox Corporation - EVP, CFO*

And I would add a little bit to that, Keith. When I look at the first quarter and kind of peel back the layers of our performance, the additional spending we had within government healthcare was truly what caused us to miss our guidance on services segment margin for the first quarter. If I look across the business -- I mean, we had very good margin expansion.

In document outsourcing, we had margin expansion. In ITO we had a margin expansion. In commercial BPO, obviously our government transportation business is where the student loan pressure shows up. But overall, we are seeing exactly what we expected in terms of services margin expansion outside of the government healthcare solutions group.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

It is an important point. It is an important point I will just ring in here. Bob has been here for 21 days, fortunately came on board right during the time that we have to actually look at our go forward commitments, and so he was actively involved there, one, bringing up what Bob said.

And what Kathy said, if you look at the parts of the business, excluding government healthcare, for the calls -- the part that we called that would come down in government transportation solutions group, literally we are expanding margin in every other line of business. The biggest business that we have, commercial BPO, which is about 75% of our business, margins expanded to the point where we had planned them to. ITO, they did as well. In document outsourcing they did as well.

So we do have an isolated issue here. It is a big one, one that we are in front of, but not one that causes us to adjust the rest of the business areas and the path that we had going forward there.

Keith Bachman - *Bank of Montreal - Analyst*

Fair enough. Thanks guys.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Keith. If we could have the next question, please.

Operator

Jim Suva, Citi.

Jim Suva - *Citi - Analyst*

I guess a concluding comment is, hey, it could have been a lot worse. So anyway, I guess you could laugh about that a little bit.

But, when I think about it, is it really that Xerox misestimated the amount of persons, bodies, and hours that needed to be on this to get this state healthcare exchange up and running? Is it the state is asking you to do more than what was originally planned or it is more complicated than what you thought? Or how come Xerox seems to be the one eating all the costs on this? Or am I just misunderstanding the key issues here?

Ursula Burns - *Xerox Corporation - Chairman, CEO*

So, it is a combination of many things. And I would not think -- I don't think it is fair, or the government would think, Nevada would think that we are the only ones eating all the cost here. I think they probably feel a little bit of a sting as well. But it is a combination of things.

One, it is clearly that we misestimated. And I will say that we misestimated the amount of energy and effort that it would take to, one, get the system defined right. This is jointly between the state and us. One, to do that. And then once you get that, to stabilize it to the point where the operations are predictable that we could understand what volumes would come in at what time -- what number of people would try to enroll on certain days.

Something that you have seen, unfortunately, across a lot of the health exchanges is just a flood of people on any given day, any given time, it is just not predictable. So we had something to do with just not understanding fully -- not predicting fully what could happen at any given time.

But it's also a change in requirements. It is a new set of laws that we are trying to develop a system around. It is a combination of many things here. But I want to make sure that I leave the call with the understanding that Xerox is responsible for it and has to be responsible for fixing it, and we are going to do that on behalf of the government of Nevada.

And that is what we will -- we will do MMIS different. We are pretty comfortable with what we have to do there. We have a couple of implementations that are going fairly well. We know how to clean it out, we know how to move. It's taking a little bit more time, but it is not as unpredictable as Nevada has been.

Jim Suva - *Citi - Analyst*

Okay. And then, Kathy made a comment about M&A and the pipeline being strong there, yet M&A continues to come in softer than expected. And many investors like the M&A and the accretiveness of it.

Kathy, is it just so much of your effort has been diverted to trying to fix the services business? Or why would this M&A additions continue to take longer and longer and longer, yet the pipeline continues to be healthy and healthy. It seems like there is some type of disconnect there about we have heard this story before. And what is the delay here?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

So I will start with, M&A actually started out stronger this year than it was in 2013. So while I am also pointing to M&A as we had hoped to get more done at this point than we have been able to get done, on a year-over-year basis, just the Invoco deal alone is in excess of the services deals that we did in 2013.

So it isn't that M&A isn't improving and on a good track. It is just not going as fast as we would desire it to go. And it is more timing, I would say, than revising our overall expectations in terms of what we think we will get done this year.

And so we have one decent sized deal, I'd say, under our belt. We did another deal, but it was relatively small in this quarter. And so it is not going to give us all that much in terms of revenue and profit, but we are close on a couple of things and I do feel good about our ability to get more done.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

And Kathy is not distracted. I mean, she has a team that works on this that is pretty much separate from the rest of the operational areas of the business. We are focused on this at a level of intensity that is pretty high. We are not going to do, as we say it, all the time, but we say it continuously, any deal that we don't think we can manage and bring in comfortably into the Company, and we are not going to do a deal that is not going to fit into strategic growth areas that we have. And we do have a pipeline that is pretty good now and, as Kathy said, some that are tilting towards the end in the coming quarters.

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

Yes. I would just add that I think our process is really strong. So, on your comment on whether people would be distracted, we largely wouldn't be looking to do it in the space where we have had the government healthcare solutions problems that we have talked about so extensively. And I would say the process in terms of the discipline, what is the economics, how does it fit from a growth standpoint, is very strong. So they don't happen overnight and we still have more that we see that we will be able to drive.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Jim. If we could have the next question, please.

Operator

George Tong, Piper Jaffray.

George Tong - *Piper Jaffray - Analyst*

Kathy, you touched on this earlier, but could you provide some additional color on the progress of your various margin initiatives in services outside of healthcare in terms of productivity initiatives and off-shoring efforts? And if you were to think about excluding healthcare, giving us a sense of what margins for services would be for the full year?

Kathy Mikells - *Xerox Corporation - EVP, CFO*

So I will speak a little bit more to the quarter as opposed to the full year, and then I will come back to circle back to the full year. So I really appreciate the question because, overall, the additional costs and resources we have had to pour into government healthcare really overshadowed, I think, the good progress that we are making elsewhere.

Clearly, we had pointed to at our investor day in November a big push on, I'd say, both shifting labor offshore and in order to get benefits from those lower costs, as well as just improving efficiencies overall. Really both of those things targeted to try and get labor costs as a percent of revenue down, which is a big part of the push toward margin expansion.

And so I feel good about the progress that we made in the quarter there, again excluding the incremental cost that we poured into government healthcare, both in terms of moving people offshore and hiring more offshore as we attrite people in the US. But I would say, especially, George, in terms of just getting enhanced productivity and putting more money toward work in terms of restructuring. So I feel very good about that.

Other planks of our five-plank strategy, international expansion, I think the Invoco acquisition and ongoing organic growth seems to be going very well. I spoke to some of the things that we are doing to push up growth rates organically and some of our more advantaged businesses with higher margins.

So if I look across our five-plank strategy, I feel good about what we are doing to execute. And if you put government healthcare aside, that was worth 70 basis points in the first quarter. If you look at the adjustment we have made to full year, it is basically a 70 basis point adjustment on full-year from where we had originally started, thinking we were going to get 50 basis points of expansion. So I think we are on track in terms of making progress outside of government healthcare.

George Tong - *Piper Jaffray - Analyst*

That's very helpful. Thank you. And, for my follow-up question, Ursula, could you discuss the leverage you are seeing from past government healthcare platform implementations and what kind of leverage you expect once Nevada Health Exchange and other current MMIS implementations have been fully stood up?

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Right. So we have a business where we actually operate MMIS systems in 12 states today plus the District of Columbia, maybe a little bit higher -- maybe 13 states. But 12 states plus the District of Columbia, we implemented those states under a platform many years ago and those states and operation of them -- smooth operation and very profitable business for us, and very happy customers in the states.

These platforms, as I said, take a little bit of time to stabilize. Obviously, a little bit more difficult than on a new MMIS than on the old one. They last a very long time -- a decade, decade and a half, easily. And if you look at our history there, we expect, as we stabilize the new MMIS enterprise platform in the states that we have won and that we continue to compete for, then we will have a mirror -- essentially a mirror of the government health MMIS business that we had in the past on the go forward basis.

If we didn't do a new platform, by the way, we would not be able to compete very effectively for this business. So it is a necessary thing to do to hold our position in the enterprise space.

On health exchanges, we operate in a number of states -- six or seven states, generally in a partnership fashion -- a consortium fashion -- with other providers doing other pieces. In those implementations, we are coming along. They are delivering as we expect. The profitability and the model is as we expect.

In Nevada, as I said, in the new exchange, that's the place that we are going to have to stabilize, and it will take us a little bit more time to do. And we are figuring it is going to take us for the rest of the year to get this all straightened out and so that is (inaudible).

So I think healthcare, historically, government healthcare, historically, and on a go forward basis is -- will be very profitable and is very attractive, and we continue to expect it to be. Commercial healthcare is a winner for us already -- growing revenue, ahead of where we expect and expanding margins.

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So commercial healthcare, broad participation there, a big business for us -- actually, bigger than government healthcare business, and a very profitable business for us. So we expect this whole space of healthcare to actually be a good business for us -- continue to be a good business for us as we go forward.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, George. If we could have the next question, please.

Operator

Kulbinder Garcha, Credit Suisse.

Kulbinder Garcha - *Credit Suisse - Analyst*

I just wanted to ask a question really about the cost of these government contracts in the sense that it looks like, if you're margins would otherwise have been [flat], it should probably cost about $20 million more in costs this quarter, maybe $80 million for the year. Are those in the ballpark, firstly?

And then, beyond that, as you win new government business, I'm trying to think about the synergies you might have. And like could it be the case that next year you go for more of this type of business, you win more states or more exchanges or however you want to describe it, and those costs meaningfully drop to zero?

Or would there be an ongoing level of cost that Xerox got hit with as we go through a learning curve? I know it's probably a hard question to ask because every contract is different. I'm just trying to think of what level of visibility you have as you try and build out this government business. Thanks.

Kathy Mikells - *Xerox Corporation - EVP, CFO*

So let me start with, first, you mentioned, hey, was government healthcare -- did it cost you about $20 million in the quarter and about $80 million for the year? And my answer to that is, yes, year-over-year it cost us $20 million in a quarter. And as we look to full year and our revisions to services margin, which I talked about earlier, that is for us to now anticipate and build into our overall guidance and expectation of just higher costs in government healthcare throughout the year.

As we look forward to incremental implementation, our expectation would be that we will get better at incremental implementation. I mean, as we were bidding on new work, we are taking the learnings that we have had to date into consideration in looking forward and bidding on new specifically MMIS platforms in other states.

As it relates to Nevada, I think it is really important to understand, we actually participate in a handful of other state healthcare insurance exchanges. We just don't play this role in terms of being the primary on the implementation of the platform. And, in those other states, we are doing really well in terms of supporting call-center work and other BPO claims processing work and the like. And so that continues to be, I think, both a strong business for us today and a good opportunity on a go forward basis.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks. If we could have our last question now, please.

Operator

[Tenzin Wang], JPMorgan.

Tenzin Wang - *JPMorgan - Analyst*

I was trying to be quick because I want to build on a couple of past questions. First, the confidence in the second quarter signings, you mentioned some customer decision delays. Can you elaborate on that? Is that cyclical and broad-based and has that persisted in April? And then I have a follow-up.

Kathy Mikells - *Xerox Corporation - EVP, CFO*

And so as we look at signings in the second quarter, we are expecting we're going to see sequential improvement relative to the first quarter. But the other thing I mentioned is we also have another tough comp year-over-year. So last year, signings number was about $3.7 billion and at that point it had been up 40% year-over-year. So I am expecting good sequential improvement.

Tenzin Wang - *JPMorgan - Analyst*

Okay. And just the higher cost tied to government healthcare, I know you had a lot of questions a little bit like deja vu to me, but any risk in meeting SLA milestones? Is the state cooperating?

And then just trying to understand if you're spending enough. I know $20 million is a big dollar amount, but just wanted to make sure we are covered here in terms of any other future surprises.

Ursula Burns - *Xerox Corporation - Chairman, CEO*

So I think from the MMIS perspective, I am very comfortable with spending what we need to spend. MMIS spreads across many different states, so it's a small increment spending per state. I think we have that pretty well comprehended.

In the Nevada exchange, we have comprehended a fairly big chunk of additional spending throughout the year and I think that we have comprehended that well in this go forward guidance. So I don't believe that we have much additional upside or downside, depending on how you do it -- downside in marginal -- I'm sorry; in cost. We have actually comprehended a fairly large amount for the rest of the year.

Jim Lesko - *Xerox Corporation - VP, IR*

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

Ursula Burns - *Xerox Corporation - Chairman, CEO*

Xerox is focused on serving our customers very well, a major point of pride and, of course, from my optimism and confidence in the coming quarters. We are focused on the customers and ensuring that they are doing well. I am confident that we have the right strategy, the competitive strength, a skilled and proven leadership team with some new, exciting members, and the motivation to help our customers be more successful.

Jim Lesko - *Xerox Corporation - VP, IR*

Thanks, Ursula. That concludes our call today. If you have further questions, please contact me or any member of our investor relations team. Have a good day.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may now disconnect. Everyone, have a good day.

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