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Xerox Holdings Corp. (XRX)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Xerox Holdings Corporation Third Quarter 2023 Earnings Release Conference Call. After the presentation, there will be a question-and-answer session. [Operator Instructions]

At this time, I would like to turn the meeting over to Mr. David Beckel, Vice President of Investor Relations. Please go ahead, sir.

David Beckel

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

Good morning, everyone. I'm David Beckel, Vice President and Head of Investor Relations at Xerox Holdings Corporation. Welcome to the Xerox Holdings Corporation third quarter 2023 earnings release conference call hosted by Steve Bandrowczak, Chief Executive Officer. He's joined by Xavier Heiss, Executive Vice President and Chief Financial Officer.

At the request of Xerox Holdings Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox. During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor and will make comments that contain forward-looking statements, which, by their nature, address matters that are in the future and uncertain. Actual future financial results may be materially different than those expressed herein.

At this time, I'd like to turn the meeting over to Mr. Brandowczak.

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

Good morning and thank you for joining our Q3 2023 earnings call. Before I get to this quarter's results, I would like to start today's call by acknowledging the tragic events unfolding in the Middle East. Our thoughts and prayers are with the victims and their families, which include our local employees, clients and partners. We are all hoping for a peaceful resolution.

In Q3, the successful execution of our strategic priorities resulted in another quarter of growth in adjusted operating income, EPS and free cash flow.

Summarizing results for the quarter, revenue of $1.65 billion declined by 5.7% in actual currency and 7.4% in constant currency. Adjusted EPS was $0.46, $0.27 higher year-over-year. Free cash flow was $112 million compared to a use of $18 million in the prior year quarter. And adjusted operating margin of 4.1% was higher year-over-year by 40 basis points.

While I'm never pleased to report a decline in revenue, this quarter's top line results were largely anticipated. The decline in revenue reflects a relatively stable demand environment for our products and services, offset by declines in certain cyclical, low margin post-sale revenue categories, as well as declines in revenues associated with strategic actions put in place to simplify our business.

Despite a reduction in revenue in Q3, we once again grew operating income and operating income margin on a year-over-year basis. This growth is due to reduction in costs associated with recent business simplification efforts, our ability to offset product cost increases with higher prices, and the purposeful avoidance of revenue opportunities bearing low levels of profitability. As I will discuss, we expect the continued simplification of our business to drive substantial incremental improvement in profit margin and profit levels over the next few years.

Free cash flow improved $130 million year-over-year in Q3 and has increased by more than $330 million year to date. Growth in free cash flow was due in part to a change in FITTLE strategy and its approach to funding new originations, which we expect will generate meaningful amounts of incremental free cash flow for many years to come.

As always, we remain focused on our three strategic priorities: client success, profitability, and shareholder returns. Client success is a strategic imperative for Xerox. Our ability to solve clients' most challenging workplace productivity needs and offset the effects of rising inflation, labor constraints and higher costs of capital with productivity-enhancing solutions helps us not only gain market share in print but expand client wallet share through incremental services.

This quarter, Xerox was recognized as a leader in IDC MarketScape's Worldwide Print Transformation Vendor Assessment for our breadth of transformative workplace technology solutions, both related to and adjacent to print. Our advanced solutions provide us a distinct advantage as we compete for new and renewal business.

This quarter and year to date, service signings grew double-digits in constant currency, led by growth in digital services. Increasingly, digital services such as advanced customer engagement and intelligent document processing are replacing traditional print demand as contracts with existing clients renew. Year to date, the revenue replacement rate for a majority of renewed service contract is 100% or higher despite the ongoing consolidation of print demand as companies adapt to more permanent hybrid workplace arrangements.

Moving to profitability. In Q3, we took additional actions to simplify our operations and improve the efficiency of our cost structure. In August, we sold our 3D print business, Elem Additive Solutions, to ADDiTEC. And in September, we announced the expansion of our relationship with PEAC Solutions, an affiliate of HPS Investment Partners, to include the provision of leasing services to FITTLE's network of independent dealers. Both actions improve the flexibility of our cost base while enabling greater focus on our core capabilities in and around print, digital and IT services.

Finally, shareholder returns. A few weeks ago, we repurchased the roughly 34 million shares previously owned by Carl Icahn and Affiliates, resulting in a reduction of our share count of around 22%. The decision to repurchase these shares was consistent with the capital allocation and shareholder return philosophy, which is to deploy cash in areas providing the highest return for shareholders.

Management and the board of directors believe this transaction will create substantial value for shareholders over time as the reduction of shares allows equity holders' greater participation in the expected earnings growth associated with our transformation, which I will discuss shortly. The transaction is expected to be EPS accretive while preventing the type of market overhang normally associated with an open market disposal of significant equity stakes.

Our three strategic priorities have been instrumental in laying the groundwork for our direction moving forward. On our Q2 call, we provided examples of the ways in which we are simplifying our business to refocus on our core operations of print, digital and IT services. Those actions were critical enablers of an even more significant transformation of our business.

For the past year, with the help of outside experts, we have analyzed our business model, competitive strengths and market opportunities to define an optimal strategic path. And today, we are sharing with investors the preliminary framework for a multi-year strategic transformation plan, which we refer to as Reinvention.

First, let me define what Reinvention means to Xerox. Reinvention is a comprehensive and operational simplification of our business, resulting in a strategic repositioning of the company to take advantage of favorable macro trends, including the digitalization of document workflows associated with the power of AI, while managing the secular headwinds associated with traditional print. Reinvention does not mean we are abandoning our core print business, which we expect to continue generating strong profits and cash flow for many years; Reinvention means building new capabilities on top of a solid print core.

Management and the board believe the most direct and probable path to sustainable growth in profit, free cash flow and shareholder returns requires a structural redesign of our operations, combined with selected reinvestment in capabilities essential to addressing clients' most challenging workplace productivity needs. The workplace has evolved, and Xerox is evolving with it to ensure we power the productive workplace of today and tomorrow. The ultimate goal of Reinvention is to facilitate Xerox' shift from a leader in print technology to an unparalleled technology and service provider.

There are three primary components of the Reinvention. First is a geographic optimization, which entails taking a more selective approach to direct operations in certain markets and, when appropriate, shifting to a partner-led distribution model. This optimization of our go-to-market approach is expected to result in lower revenue initially, but provide a stronger and more profitable foundation from which to grow revenue going forward.

Second is the optimization of our product offering and pricing models. Through the Reinvention, we will streamline our product offerings to maximize profitability and allow greater internal focus on the delivery of products and services that address the evolving needs of a hybrid workplace. We will introduce a more consumer-like, touchless experience to improve client satisfaction and will simplify our pricing models to deliver faster and more effective decisioning when pursuing new and renewal business.

The optimization of our geographic footprint, product offerings and pricing models will, in turn, enable an end-to-end organizational and structural simplification of our business, unlocking the third component of the Reinvention, operating efficiencies across IT, business support functions, and the supply chain.

While the Reinvention is expected to result in a more profitable and streamlined organization, it is not simply a cost cutting program. Equally important, if not more so, is Xerox' ability to transition over time to become a services-led, software-enabled provider of advanced workplace solutions.

A transition of this magnitude requires select investment in organic and inorganic growth opportunities. These investments are expected to be self-funded and will target opportunities to grow our share of wallet in print and print services, as well as high-growth adjacent markets where we have a clear path to win, such as managed IT services for small and mid-sized clients and digital services.

In total, Reinvention is expected to generate substantial improvement in operating income and income margin over the next few years. By 2026, we expect to deliver an improvement to 2023 adjusted operating income of at least $300 million, resulting in return to double-digit adjusted operating income margins. Importantly, this improvement is inclusive of investments in growth, which are expected to drive a more diversified revenue mix with greater exposure to markets with high rates of growth. We will provide more specifics and the phasing of operating income improvements as specific actions are taken in future quarters.

To recap, we are confident in our ability to successfully execute this Reinvention. Project Own It has instilled in this company a culture of continuous operating improvement. Our management team is more than capable of delivering a transformation of this magnitude, and our brand, client relationships and history of innovation give us the right to play and win in digital and managed IT services. Reinvention will not only improve Xerox profitability, but reposition the company for long-term, sustainable growth. And with strong free cash flow supporting our dividend, investors will be rewarded as the strategy progresses.

I will now hand over to Xavier.

Xavier Heiss

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

Thank you, Steve, and good morning, everyone. As Steve mentioned, we delivered another quarter of growth in adjusted operating income and income margin despite a decline in revenue, evidencing our ability to manage profitability amid fluctuations in revenue. The year-over-year decline in revenues this quarter was driven mainly by declines in transactional, non-contractual post-sales revenue components. Equipment revenue declined modestly relative to the prior year due in large part to a reduction in equipment backlog in the prior year quarter.

Turning to profitability. We deliver our fourth consecutive quarter of year-over-year improvement in gross and operating profit margin. Gross margin improved 60 basis point over the prior year quarter, mainly due to the benefit associated with pricing increases and cost efficiency actions, partially offset by a 50-basis point headwind from the termination of Fuji royalties. The increases in product costs were more than offset by improvement in supply chain-related expenses and pricing actions.

Adjusted operating margin of 4.1% increased 40 basis points year-over-year as the effect of lower revenue on gross profit, along with higher compensation and bad debt expenses were offset by close to 400 basis points of improvement from ongoing operating efficiencies and pricing actions.

Adjusted other expenses, net were $29 million lower year-over-year due to higher gains from the sales of non-core business asset and lower non-financing interest expense.

Adjusted tax rate was 7.3% compared to 42.1% in the same quarter last year, largely due to the tax benefit associated with the release of uncertain tax positions on the remeasurement of deferred tax asset in the current year period, as well as a non-recurring unfavorable effect of changes in certain tax elections in the prior year period.

Adjusted EPS of $0.46 in the third quarter was $0.27 higher than the prior year, driven by an increase in the sale of non-core business assets and the lower tax rate. GAAP EPS of $0.28 was $2.76 higher than the prior year, mainly due to an after-tax non-cash goodwill impairment charge of $395 million or $2.54 per share in the prior year. There were no EPS impact this quarter associated with the recent repurchase of share from Carl Icahn and affiliates.

Let me now review revenue and cash flow in more details.

Turning to revenue, equipment sales of $386 million in Q3 declined 1% year-over-year in actual currency or 2% in constant currency. The decline in equipment revenue reflects stable demand conditions, offset by the effect of EMEA backlog reductions in the prior year.

Consistent with recent quarter, revenue trends outpaced equipment installation activity due to favorable product and geographic mix, as well as higher prices. This was particularly true with our A3 product, which experienced unfavorable geographic mix effect in the prior year due to backlog reduction in EMEA. Entry A4 installation were lower again this quarter due to the ongoing normalization of work from home trends.

Post-sale revenue of $1.3 billion declined 9% in constant currency year-over-year and 7% in actual currency. As noted, post-sale declines were mainly driven by reduction in cyclical, transactional items, most notably a significant decline in low-margin paper sales and lower IT endpoint device placements. Post-sales revenue was further impacted by the termination of Fuji royalty and the effect of specific strategic actions, which resulted in lower financing and PARC revenue.

Revenues from contractual print and digital services declined slightly as digital and managed IT services revenue growth was offset by decline in print services for production clients, which have generally been more affected by macroeconomic pressure than office clients.

Geographically, both regions declined in actual and constant currency. The decline in EMEA was more pronounced given the substantial reduction in EMEA backlog in the prior year quarter and a weakening macroeconomic outlook. In the Americas, an increase in equipment revenue was more than offset by a decline in post-sales revenue, due in part to lower sales of the aforementioned cyclical transactional items.

Let's now review cash flow. Free cash flow was $112 million in Q3, higher by $130 million year-over-year. Operating cash flow was $124 million in Q3 compared to a use of $8 million in Q3 2022. The improvements were mainly driven by a net source of cash associated with financing assets and an improvement in working capital. Finance asset activity was a source of cash this quarter of $51 million compared to a use of cash of $54 million in the prior year, reflecting the benefit of our Forward Flow program with HPS, partially offset by higher origination.

Working capital was a source of cash of $27 million, resulting in a $41-million year-over-year increase in cash, driven mainly by a reduction in inventory.

Investing activity were a source of cash of $25 million compared to a use of cash of $33 million in the prior year due to higher proceeds from sale of non-core business asset in the current quarter and the prior year acquisition of Go Inspire.

Financing activity consumed $94 million of cash this quarter, which includes a payment of around $60 million of secured debt and dividend totaling $43 million. In addition, we secured a $555-million bridge loan facility, the proceeds of which were used to repurchase share from Carl Icahn and Affiliates. This facility is expected to be replaced in the near term with an alternative debt instrument.

Turning to segment. FITTLE origination volume grew 9% year-over-year. Captive product originations were up 24%, while non-captive channel origination, which include third-party dealers and non-Xerox vendor, fell 8%, a reflection of the recent change in FITTLE strategy to return its focus toward captive-only financing solutions. As expected, FITTLE finance receivables were down roughly 4% sequentially in actual currency, reflecting the runoff of existing finance receivable on HPS funding of more than 50% of FITTLE Q3 originations. As a result of the change in FITTLE strategy, we expect its finance receivable balance to decline and normalize closer to $1 billion by 2027.

FITTLE revenue was flat year-over-year in Q3 as higher commissions from the sales of finance receivable assets were offset by lower finance income and other fees associated with the decline in FITTLE finance receivable asset base.

Segment profit for FITTLE was $4 million, up $2 million year-over-year, primarily due to lower bad debt expense and lower intercompany commissions. As previously indicated, we expect further improvement to bad debt expense going forward as our finance receivable book decline.

Print and Other revenue fell 6% year-over-year in Q3, primarily due to lower post sale revenue. Print and Other segment profit improved by around 2% versus the prior year quarter, resulting in a 30-basis point expansion in segment profit margin year-over-year, driven by the benefit of price and cost actions, partially offset by lower revenue.

Turning to capital structure. We ended Q3 with approximately $620 million of cash, cash equivalents and restricted cash. Roughly $2.5 billion of the remaining $3.6 billion of our outstanding debt support our finance asset, with the remaining debt of around $1.1 billion attributable to the non-leasing business. Total debt consists of senior unsecured bonds, finance asset securitization, the bridge loan associated with the Q3 share repurchase, and borrowing under our asset-backed credit facility. We maintain a balanced bond maturity ladder over the next few years.

Finally, I will address guidance. Our outlook for full year revenue remains unchanged at flat to down low-single digit at constant currency. We continue to see momentum in demand for our product and services, particularly in the Americas and for our faster-growing digital services. However, in the past three months, we have seen a mild softening of demand for print services and equipment in our European market, reflecting a weakening macroeconomic condition. As a result, we now expect full year revenue to come in at the lower end of our guided range.

As a reminder, we face a difficult equipment revenue compare in Q4 due to a significant reduction in backlog in the prior year. Further, we expect some of the headwinds affecting post-sales revenue in Q3 to persist in Q4. Despite a slight reduction to our revenue outlook, we maintain our guidance for full year adjusted operating margin of 5.5% to 6% due to the successful implementation of ongoing cost efficiency program and the avoidance of low or unprofitable revenue opportunities.

Q4 operating margin is expected to improve sequentially, but will be lower year-over-year as margins in the prior year benefited from an unusual high mix of highly profitable A3 equipment installs. As noted by Steve, we expect significant improvement in operating income margin in future years as we progress along our Reinvention. Finally, we maintain our free cash flow guidance of at least $600 million.

In summary, we remain on track to deliver our full year guidance as we balance a dynamic macroeconomic backdrop with a rigorous approach to managing operating costs. The groundwork is being laid for multi-year improvement in profit and revenue mix, including a return to double-digit operating profit margin, the details of which we will share in the coming year.

We'll now open the line for Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. One moment, ladies and gentlemen, for your first question. And our first question comes from the line of Ananda Baruah from Loop Capital. Your question, please?

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Yeah. Good morning, guys, and thanks for taking the question. So, I guess, there is a bunch of near-term and bigger picture stuff to sort of get into. I guess I'll start with bigger picture. Just with regards to Reinvention, can you talk to any degree to which you're getting a bit of, I guess, I'll call it like a running start into the revenue component of Reinvention? Steve, I think you kind of referred to it as software and services enabled or software and services led. Sort of what's going on there already that we may not be super aware of that might sort of lend itself to Reinvention?

And then, I know you talked about making comments in the future about what rev potential looks like. But can you give us any sense of maybe what, like, the rev growth rates of the areas of the services market and software market, the TAM I guess, looks like today, so, at least, we get a sense of what you guys are shooting against from a TAM perspective? I guess I'll start with those. Thanks.

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

A

Yeah. Yeah. Great questions. So let me make a couple of comments. So first of all, from a Reinvention standpoint, really looking at a comprehensive and structural simplification of our business, right, which strategically reposition us going forward, what does that mean? We're looking at focus areas around geographic optimization, where we can think about how we sell direct versus indirect, use a partner-led distribution models in subscale areas, focusing on simplification of both our product offering and pricing, which will generate more revenue and generate more demand in those areas as we accelerate that.

And then, operating efficiencies. Really looking at our business end-to-end from order-to-cash to hire-to-retire, all across our entire business, and really thinking about both simplification as well as enabling technology in each one of those processes. You heard me talk about where we've embedded AI and augmented reality. And we're seeing significant – not only in terms of productivity, but differentiation in our service model and our service offerings as we go forward. So I set that as the foundation, right?

And from a high level, right, delivering double-digit operating income margins, getting back to that, we thought it's really important that we have to go drive and we get back to double-digit operating income margins. And obviously, we talked about $300 million of operating income by 2026.

What have we already started and what do you see in terms of the run rate and some of the acceleration going into 2024? We've, obviously, been working on – and I've talked about this for a while now – how do we expand our wallet share inside of our existing clients with new products and services, IT services, digital services, and we talked about client success, really focusing on how do we drive outcomes for our clients in many areas that we see in terms of verticals that need productivity help significantly, specifically in areas like we see in healthcare, we see in education, we see inside of law firms and driving very specific solutions.

We are seeing direct results of that strategy in our renewals. And we talked about it, we're seeing our renewal rate – revenue renewal rate over 100% now. What does that mean? That means that as we're seeing some of the secular decline in some of our clients in terms of renewals, we're now topping it up with new products and services that are very specifically led and driven by client success, either in IT services and also at endpoints. I'm talking about services like RPA and security, as well as digital services, which help them with productivity.

So, that's given us a – both a run rate improvement in terms of our revenue and growing inside those existing accounts. And it's also given us a running start in productivity in areas like supply chain, areas like service delivery, areas like our ordering process and order to cash process. Xavier, any other comments?

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

A

Yeah. Just – hi, Ananda. Just to comment on the revenue side or the revenue shift we are expecting here. So, we know the trend on print. The print business is still a strong business for us, generated a lot of margin and profit and cash here. At the same time, you know that we have started the foundation on developing IT services and digital services there. The market growth or the TAM is large. This is large TAMs in this market, IT services is above $600 billion, digital services in the range of $70 billion. And when we look at the data from this market, we are between 5% to 10% growth.

So, at the end of the day, what we are planning to do with Reinvention is to drive the revenue shift from a print only or print-centric company into a company where print would still be present, but also we're targeting higher comp on growing market that will give the revenue or improve the revenue trajectory of the company not relying only on print.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's all really helpful context. Appreciate all of that. That's super helpful. And then, I guess, as a quick follow-up, the sort of the revenue environment for the September quarter that you guys talked about sounds like Europe may have been a little softer than you thought it was going into the quarter. You're not the first ones that we've heard that from. So, that seems to be kind of foundational.

Anything other than Europe that was softer than anticipated that you saw during the quarter? And, I guess, is there sort of any meaningful leverage impact you got from the softer revenue? You guys grew margin 40 basis points year-over-year. But I guess would it have been stronger year-over-year growth – margin growth or expansion if not for the softer revenue? Thanks and that's it for me.

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

A

Yeah. No, no. I think that your comment are fair here. So, Europe has been a little bit worse than what we were thinking here. However, at the same time and you know that since we have implemented Own It, the Own It DNA is still within the company. We have created what we call flexible cost base and we have been as well being able to adjust some of the cost but also being selective in the type of revenue we are targeting there.

I give you an example. We saw certain erosion on margin on I call that noncyclical, not contractual type of business. Simple example is paper and also endpoint solution in IT services. We are not interested in going after like a revenue only with no profitability. As you know it, this team is driven by a very balanced execution mindset models here and we have the discipline on driving our investment, on our revenue call based on strict return on IRR or ROIC approach. So paper, I can quote it here because the paper market is very different to what it was before and we are not willing, as an example, to go after a paper deal with low margin here.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great. Great context. Thanks a lot, guys. Appreciate it.

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

A

Thank you. Thank you, Ananda.

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

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Hi, guys. This is Maya on for Erik. Thanks for having me. Maybe a first question for Steve. Can you talk a little bit about the change in strategy with FITTLE? Earlier this year, we were talking about expanding the portfolio to more third parties, but now it's reverting back to kind of a captive financing solution. So, my first question is how that impacts your receivables factoring program. And second, there was once a thought that you could sell the FITTLE business, but given it's now becoming a captive financing business, that seems less likely. Is that correct that FITTLE would likely no longer be for sale? Thank you and I have a follow-up.

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

A

Yeah. So, let me – and I stated, I think, in previous calls, with the changing interest rate environment, it was no longer palatable for us to leverage our balance sheet in the leasing business. And we changed the strategy mid to late last year and we were no longer going to use Xerox balance sheet for this business and we were going to look for other sources of capital to help us with that business. However, it was extremely important that it is a big component of driving our value in the field that we have the ability to be able to do leasing and bundle pricing in the field with leasing. And so, we turned to HPS and PEAC and we are being – and using them strategically so that we don't leverage our balance sheet.

You're absolutely right. Two years ago, we were trying to target growing that business and potentially it would have been an operation that potentially would have been up for sale. We have reversed that. It is now going back to an internal captive business and we're not expanding beyond just supporting our business. Xavier?

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

A

Yeah. No, you said it, Steve, there on the – Maya, the focus that we have there is to make it an offer that support our business rather than looking at it as a pure, separated business here. As Steve mentioned it as well, our balance sheet, the current interest rate environment make us more than two years ago making this decision here.

And at the end of the day, if I look at the current free cash flow being generated and maybe you spot it when we – I commented what will be the benefit of this transaction. Until 2027, we are expecting the finance receivable balance to decrease up to $1 billion. And if you look at the current situation, $2.6 billion currently, going down there, this will be, over time, free cash flow being generated, supporting and driving the case for also the Reinvention that we are building at this time.

So, at the end of the day, a good decision was made two years ago. This decision is helping us currently from a balance sheet point of view. And we have kept this ability to be captive and develop our business without hurting it.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Thank you. So, maybe just if we take a step back, printing is a secularly declining market. And while I realize that you're leaning into IT and digital service to try and offset some of those pressures, this business is still overwhelmingly print focused. But there is a huge TAM in Asia that's untapped for Xerox with no licensing restrictions in place now. So, why not go after the Asian market and what are kind of the barriers to entry there?

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

A

I think there's a couple of different things. First of all, I've stated a couple of times I think we can grow in our existing accounts with our existing TAM today, both in the EMEA region and here in the Americas region. And so, we've got a tremendous amount of opportunity to grow and just execute on what we already have today. If you take a look at our share, there's a significant share growth opportunity even inside of print. And I believe our services differentiation and our product differentiation, if we execute, we can actually grow TAM.

To go expand into Asia and into other markets, you have to go build the supply chain, you've got to go build the go-to market, you've got to go build a logistics infrastructure in and around spare parts. It's a significant capital outlay to go expand in those margins. Even if you go with partner-led strategy, you still have significant cash and capital outlay. We believe that the focus that we have on the capital that we already have, we could expand and grow operating margins, we've shared with you, significantly faster if we do it in the Americas and EMEA and not expand into that region.

Maya Neuman
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Thank you.

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

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning and thanks for taking my questions. I guess if I can start on project Reinvention. Can you just help us understand when you're thinking about the $300 million of improvement there, how should we think about impact on profitability of a sale or essentially benefit to cost of goods sold or gross profit relative to how much of this is an improvement on OpEx?

And any thoughts around how long these changes on the go-to market take for you and how sort of the timing of this $300 million should we be expecting in terms of the linearity of the improvement through the next couple, three years? Thank you. And I have a follow-up. Thank you.

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

A

Yeah. Thanks, Samik, and thanks for asking a question on Reinvention because this is really a strategic movement for the company and we are pleased to unveil more on this strategy here. So from a profit point of view, as we mentioned it, we are expecting roughly to double, like, the operating margin that we have on profitability until 2026. So it will be like a three years journey that will continue beyond 2026. But we wanted to plant the seed and give you a number so you can, I would say, model and look at the trajectory of the profitability here.

We are expecting the vast majority of the benefit to be in OpEx, although some of it will be in cost of goods sold, but it will be mainly in OpEx because this is where we will rewire entirely the company and look at not only like the key function or some of the function like a go-to market. You have heard about geo simplification. At the end of the day, what does geo simplification is, again, back to this concept of balanced execution on very disciplined way of looking at IRR is where should we be present. It does not mean leaving geographies there, but what is the best go-to-market model we should have in all the countries that we're representing here.

So OpEx will be a key driver there. And obviously, we're expecting, combined with the benefit of FITTLE, free cash flow to go up significantly. As we mentioned it as well, we are expecting this initiative to be self-funded. So we are not expecting to leverage furthermore the company here. As you know it, we have just completed the transaction with Carl Icahn. We are always opportunistic when we are looking at accretive and value accretive acquisition. At the same time, we have a journey and a trajectory which is model now that will create this profit improvement on the $300 million operating profit that we mentioned here.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. And for my follow-up, you did mention the weakness you're seeing in the transactional business, and I think particularly in EMEA is what you're calling out. Just wanted to understand the nature of what you're hearing from your customers. Is it really a budget consolidation and pushing some of those sales out to next year? Or are they rethinking sort of their installed base or something else on a more structural basis on the devices or printer front? Any insights there, please? Thank you.

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

A

Yeah. Let me start. And so, you think about the headwinds that we're seeing, macro headwinds around inflation, around interest rates, around labor. And so, what we're hearing from our clients, and aligns really well with our strategy, and that is, we've got to drive their success through our solutions and products and services. That's why I talk about we could expand in existing clients today and that's why we're seeing our renewal rate higher, so things like robotics as a service, things like digital workflow in terms of driving productivity inside of very specific verticals.

So where we are aligning what we're hearing from our clients, number one, is they're looking for help to be able to offset some of these macro trends and drive more productivity, helping them with the challenges around labor, helping them with the challenge around higher cost of capital, things like as a service and subscription model. All those are actually playing very well into new products and services that we can bring into our clients to help them offset some of the challenges.

Xavier?

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

A

Yes. Back here also to your point, Samik, here. From a macro point of view, so Europe, we are not the only one quoting it there, a little bit of softening. This is not, I call that, a full of decline or more and more – really more than what we are expecting. But we are seeing a softening there. What we have seen as well, I mentioned the paper business. The paper business, just also to clarify, this is not a significant business for Xerox. It's like a very low-single digit number in revenue. But compared to last year where this paper business with certainly some scarcity of paper, we have been able to benefit from last year. This year is not as good and we see more flow of Asian paper currently on the market putting pressure on prices there.

The other element we are monitoring currently is on the high-end production business. This business obviously is highly connected to I would say GDP evolution and the trend on the market here, but also the access to capital for our high-end production customer. And what we have seen recently is a little bit – due to interest rate increasing, a little bit more scarcity on the ability or the capacities that this customer have to invest in this equipment.

Not highly concerned at this stage, but this is something that we are monitoring and we will provide updates during the quarter. All of this, everything that I'm describing here is included in our revenue guidance. And we also expect that we will be able to deliver the profitability and free cash flow guidance that we have maintained compared to prior quarter.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. Thank you.

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

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Thank you, sir.

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

Steven John Bandrowczak

Chief Executive Officer & Director, Xerox Holdings Corp.

Thank you for listening to our earnings conference call this morning. Balanced execution of our strategic priorities has resulted in a simplified, more profitable Xerox, and Reinvention is the next step along our journey towards sustainable improvement in profits and revenue. We look forward to sharing our progress along that journey in future quarters. Have a wonderful day.

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