THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

XRX - Q3 2017 Xerox Corp Earnings Call

EVENT DATE/TIME: OCTOBER 26, 2017 / 2:00PM GMT

OVERVIEW:

Co. reported 3Q17 revenues of $2.5b, GAAP EPS from continuing operations of $0.67 and adjusted EPS of $0.89. Expects 2017 adjusted EPS to be $3.28-3.44 and 4Q17 adjusted EPS to be $0.84-1.00.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Jeffrey Jacobson *Xerox Corporation - CEO & Director*

Jennifer Horsley *Xerox Corporation - VP Investor Relations*

William F. Osbourn *Xerox Corporation - Executive VP & CFO*

CONFERENCE CALL PARTICIPANTS

Ananda Prosad Baruah *Loop Capital Markets LLC, Research Division - MD*

Jim Suva *Citigroup Inc, Research Division - Director*

Kathryn Lynn Huberty *Morgan Stanley, Research Division - MD and Research Analyst*

Mark Alan Moskowitz *Barclays PLC, Research Division - Research Analyst*

Matthew N. Cabral *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Paul Coster *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Shannon Siemsen Cross *Cross Research LLC - Co-Founder, Principal and Analyst*

Steven Mark Milunovich *UBS Investment Bank, Research Division - MD and IT Hardware and EMS Analyst*

PRESENTATION

Operator

Good morning, and welcome to Xerox Corporation's Third Quarter 2017 Earnings Release Conference Call, hosted by Jeff Jacobson, Chief Executive Officer. He is joined by Bill Osbourn, Chief Financial Officer.

During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor.

At the request of Xerox Corporation, today's conference call is being recorded. Other recording and/or rebroadcasting of this call are prohibited without the express permission of Xerox. (Operator Instructions)

During this conference call, Xerox executives will make comments that contain forward-looking statements, which by their nature, address matters that are in the future and are uncertain.

Actual future financial results may be materially different than those expressed herein.

At this time, I would like to turn the meeting over to Mr. Jacobson. Mr. Jacobson, you may begin.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Good morning, and welcome to Xerox's Third Quarter 2017 Earnings Conference Call.

During today's call, we will provide an update on the quarter as well as our expectations for full year 2017.

Overall, we delivered a solid quarter. Revenue decline improved sequentially, and earnings expanded year-over-year, with margins and cash flow both in line with our expectations. We still have work to do, but we're making headway on our strategy. We're gaining traction in our rollout of our ConnectKey products, as September was our strongest month in the quarter. We also saw improvement in our Managed Document Services results. Both of these factors will help us pivot more over time to our strategic growth areas.

Let me walk you through an overview of our third quarter financial results. Third quarter GAAP EPS from continuing operations was $0.67, and adjusted EPS was $0.89, up 6% from the same quarter a year ago. Adjusted EPS excludes $0.22 per share of after-tax costs related to the amortization of intangibles, restructuring and related costs, as well as certain retirement-related costs.

Revenue of $2.5 billion was down 5% year-over-year or 5.9% on a constant currency basis. We are starting to see new equipment flowing through as we gain momentum into the fourth quarter and 2018.

Post sale revenue was 79% of total revenue, and declined 3.9% or 4.8% at constant currency. We expect stable post sale revenue coming over time as equipment revenue improves and placements grow.

Adjusted operating margin was 12.2%, down 40 basis points year-over-year and in line with our expectations. Strategic Transformation benefits largely offset transaction currency and lower equity income, putting us on track to achieve our full year margin objective of 12.5% to 13.5%. Operating cash flow from continuing operations included $671 million in pension contributions. Bill will go into more detail on cash flow. Overall, we have made great progress this year optimizing our balance sheet, which will support both a strong cash flow in the future as well as our investment-grade credit profile. It's also important to note that excluding pension contributions, operating cash flow increased $44 million year-over-year. So a good operating performance.

And finally, we ended the quarter with a healthy cash balance of $1.8 billion, which includes the $475 million used in October for the early redemption of the 2018 senior notes. So overall, solid results that position us for continued improvement in Q4 and into 2018.

Throughout the quarter, customer and partner feedback continued to be overwhelmingly positive, whether it's about our wide array of Managed Document Services, our industry-leading Graphic Communication Solutions or our new line of smart, secure ConnectKey-enabled workplace assistants. This positive feedback translated into increasing ConnectKey orders in September, from single A4 devices going into an SMB to large MPS contracts at the world's biggest enterprises.

All 29 of our new ConnectKey office products are now available and shipping to customers around the globe and with sales momentum building as we expected entering the last quarter of the year.

Here are just a few quick examples: A world leader in the pharmaceutical industry renewed and expanded a multiyear Managed Document Services contract across 76 countries, adding more than 2,200 of our new A3 and A4 ConnectKey printers; a channel partner in Italy secured an MPS contract with a leading chemical company, replacing 400 competitive printers with 300 of our new AltaLink and VersaLink devices; and in Switzerland, a leading professional services firm signed an MPS deal that includes 130 AltaLink and VersaLink devices.

Applications are a clear competitive differentiator for our new ConnectKey workplace assistants, and we reached a meaningful apps milestone during the quarter. There are more than 0.5 million ConnectKey apps now installed on Xerox devices globally, marking a 66% increase since the product launches at the end of March. That is 200,000 additional apps that have been installed on our new AltaLink and VersaLink MFPs since their introductions. This is significant, as a large majority of these apps ship with our new devices. So it's another key indicator of their brisk customer adoption rate.

Finally, ConnectKey is the only print solution containing the power of industry-leading McAfee security protection. McAfee whitelisting technology, which constantly monitors and automatically protects against malware attacks, comes embedded in all Xerox AltaLink products. We've chosen to partner with best-of-breed companies like McAfee instead of building our own capabilities. As almost all of our customers already use McAfee, they feel more comfortable that McAfee solutions are embedded in our platform.

We're also squarely focused on the growth opportunities in the attractive high-end digital color part of the market, where Xerox has been a leader for more than a decade now. At the largest U.S. graphic communications trade show, PRINT 17 in Chicago in September, our industry-leading innovation was behind multiple product introductions, including MUST SEE 'EMS Award winners: the Trivor 2400 high-fusion inkjet press and the iGen 5 press with white dry ink. And sales were brisk, with deals for the iGen, the Brenva HD production Rialto 900 inkjet presses, as well as the new

Versant 180 and 3100 presses. Our third MUST SEE 'EMS Award winner at the show was for Xerox Specialty Imaging, a fraud deterrent technology that helps protect sensitive printed data.

In September, we also announced a reseller agreement for Xerox to market and sell the Fujifilm J Press 720S, a sheet-fed inkjet press, in the U.S. and Canada. This further expands our inkjet portfolio with the addition of a wider format press.

I'll turn the call over to our CFO, Bill Osbourn, to cover our financial results in more detail. Bill?

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Thanks, Jeff, and good morning, everyone. I will start on Slide 6, with an overview of our financial performance, which I would characterize as showing progress and in line with our operating expectations, with the benefit of the timing of a lower tax rate and the gain from the Grenoble sale more than offsetting lower equity income and placing us above our targets for net income and adjusted EPS.

As Jeff reviewed, the revenue rate of decline modestly improved versus Q2, driven by both equipment sales and Managed Document Services, and we're beginning to see some positive revenue dynamics from currency, which has been a headwind for some time.

Turning to profitability. Adjusted operating margin of 12.2% was down 40 basis points, as overall cost productivities only partially offset negative transaction currency, lower equity income and the impact of lower revenue. Within adjusted operating margin, gross margin expanded, driven by post sales and the benefits of our Strategic Transformation program, which more than offset a decline in equipment gross margin driven by transaction currency impacts that are lessening but remain negative.

R&D as a percentage of revenue was 10 basis points better, while SG&A as a percentage of revenue was up 60 basis points year-over-year as a result of higher revenue declines and some headwinds, including higher compensation and benefits, only being partially offset by Strategic Transformation.

Lastly, as stated previously, within our definition of an operating income is equity income, almost entirely related to Fuji Xerox, which was down year-over-year.

Turning to the below-the-line items. Other expenses, net of $17 million was $33 million better year-over-year, driven by lower interest expense of $13 million, not quite as large of a year-over-year benefit as last quarter, given the September note issuance, and a gain of $13 million from the sale of our Grenoble research center that we announced at the end of June and which hit in the quarter.

Adjusted tax rate of 19.4% was below our full year range of 25% to 28% and was lower by 3.6 percentage points year-over-year, driven by the favorable resolution in the quarter of a couple of tax matters, an approximate positive $0.03 impact year-over-year to adjusted EPS.

Overall, adjusted EPS of $0.89 was up $0.05 from Q3 2016, as the lower tax rate and the benefits from our strategic actions more than offset the impact of lower revenues and equity income.

GAAP EPS was $0.67 in the quarter. The difference between our GAAP and adjusted EPS includes our normal adjustments around restructuring and related costs, non-service retirement-related costs and amortization of intangible assets.

Turning to the next slide, I will drill down more on revenue. I'll begin with a few high-level comments. Equipment revenue declines in Q3 improved sequentially as expected, with the strongest year-over-year performance in the quarter coming in September. The best performance in the quarter came in the developing markets and the U.S. in SMB-focused channels, including Global Imaging Systems, while higher declines continued in the longer decision cycle areas of large enterprise and public sector.

Post sale revenue declined 3.9% or 4.8% in constant currency in the quarter. We saw improvement in supplies revenue declines and Managed Document Services revenue. This, however, was more than offset by lower other sales, including sales of third-party IT equipment and lower page volumes in some areas of the business. As previously noted, there's a lag between the installs of new products and the flow-through to future post sale revenue improvement.

I now will take you through some more details. From a geographic sales channel perspective, North America was down 5.2% or 5.7% in constant currency and represented 61% of our revenues. International represented 34% of total revenue and was down 3.1% or 5.1% at constant currency, reflecting higher declines in Europe that were partially offset by growth in developing markets. The remaining 5% of our revenues is in other, with the largest piece, over 50%, being in our OEM business.

Within equipment, midrange saw the greatest improvement sequentially, reflecting the full availability of new products. Entry and high-end, however, remained weak. Entry equipment revenue continued to be impacted by the lower mix of products and the transition to the new portfolio, as not all of the higher value products were available for the full quarter.

Additionally, we saw continued growth in developing markets. However, it decelerated as we lapped easier compares.

Within high-end, we saw a good performance in entry production color from the new Versant products. However, that was more than offset by declines in other high-end product segments, driven in part by higher Q3 2016 sales following the every 4-year drupa tradeshow.

Lastly, to round out the revenue discussion, we were pleased that Managed Document Services revenue turned back to growth, up 2.2% in actual currency or 1.2% in constant currency, and comprised 34% of our total revenues.

Within MDS, the SMB-focused channels, XPPS and GIS, which comprise almost 25% of our MDS revenues, grew double digits, while the more mature large enterprise segment, where we are the market leader, had modest declines.

I'll now shift to discuss our key performance metrics, a few of which I have already touched on. Revenues from strategic growth areas to date are flat at constant currency, an improvement from the down 1% for the first half, and comprised 40% of our total revenues year-to-date, a 2-point mix shift from the year-ago period. The improved performance was driven by the better MDS growth I just commented on, and we expect that trend to continue as the new product impact takes greater effect. We continue to target to shift our revenue mix to these strategic areas by approximately 3 points every year.

Turning to installs. We saw improvement across most product areas in Q3. Installs grew in entry, although once again at a weaker mix given the better performance in developing markets, where units tend to weigh towards the lower end of the portfolio. Also driving lower mix was the fact that the higher-end new ConnectKey A4 products were only fully available at the end of the quarter. Midrange installs were flat in color and declined in mono. We saw sequential pickup in a number of areas, and we expect this trend to continue into Q4. At the high-end, installs were down in mono, where the market continues to decline. And within color, results were mixed. We saw growth in entry production color and aqueous production inkjet, which was offset by declines in other areas, driven in part by the drupa compare I mentioned earlier.

MDS signings, which as a reminder, reflect only our enterprise business and don't include SMB, were $606 million in the quarter and were down 6.7% year-over-year and down 10.7% on a trailing 12-month basis, both at constant currency.

Renewal rate was 85%, and overall in line with expectations. The year-over-year decline in signings was consistent with Q2, and looking forward, the 90-day pipeline shows good expansion year-over-year, and we expect Q4 signings to improve from trend.

Work remains to get back to consistent growth, but underlying trends are turning in MDS, supported by the new products and investments.

The last key measurement area is Strategic Transformation. We continue to be very pleased with our results to date, and we are on track to deliver at or above our target of $600 million of gross savings in 2017. This is an important program, and one that underpins our strategy to expand margins and support investments to improve the revenue trajectory. We have a disciplined program, which as I expanded on last quarter, includes initiatives that span the enterprise. It's hard work, and a never-ending journey, enabled by business and process improvement and simplification, evolving technology and optimization with partners. I'm often asked what will be the target for 2018, and whether there's an upside to the initial $400 million we laid out at our Analyst Day last year. Our sights are clearly set on continuing to drive productivity improvements, and we are currently building out the plan for 2018, which we'll be in a position to give an update on during Q4 earnings in January once we can finalize the baseline for what we accomplished in 2017.

Before moving on to cash flow, I'll cover the trends and what we expect for the full year and fourth quarter. The total revenue decline of 5.9% in constant currency in Q3, improved from Q2 as we anticipated. On an actual currency basis, the improvement is greater, as we saw for the first time in 13 quarters, currency turned to a benefit on revenue, a positive dynamic we expect will continue, at least in the near term. On a constant currency basis, we continue to expect full year revenue declines in the mid-single digits, with Q4 expected to represent the best revenue performance of the year.

Operating margin was seasonally lower than Q2, but remained in line with our objectives and reflected a continued negative impact from transaction currency, 60 basis points in Q3, which we expect will moderate further in Q4. For the year, we remain on track to be within our full year range on adjusted operating margin of 12.5% to 13.5%, with peak margins in Q4.

On tax rate, we are maintaining our full year adjusted tax rate guidance range of 25% to 28%, and we anticipate the Q4 tax rate to be at the higher end of the range.

Lastly, in looking at adjusted EPS, with a quarter left in the year, we are narrowing to the high end of our full year adjusted EPS range by $0.08, resulting in a revised range of $3.28 to $3.44, which implies an $0.84 to $1 range for Q4. This guidance reflects continued progress on our strategy and includes the necessary investments to position us well for the future.

We benefited from the timing of the lower tax rate and Grenoble sale that both came in Q3, and we'll be taking a portion of that benefit to fund further investments in quarter 4. These include our expectation of a greater mix of entry products that carry negative margin upon sale, but attractive post sale margins down the line, as well as higher investments in both sales and infrastructure to support our 2018 objectives.

I will now shift to discuss cash flow. Operating cash flow was a use of $383 million in the quarter. The use of cash reflected significant pension contributions of $671 million in the quarter, which included the incremental voluntary $500 million we announced in September. The large pension contributions reflect our continued focus this year on optimizing our capital structure, and on the pension side, narrowing the unfunded gap, which will be a benefit to future operating cash flows and will reduce future pension contribution variability.

If you pull out pension from cash flow for both years, operating cash flow would be up $44 million in the quarter. The drivers of this underlying cash flow performance included: Relatively flat year-over-year pretax profit; working capital, which was a modest higher use of cash year-over-year, reflecting the new product buildup and also a modest inventory increase due to the hurricanes; and financing assets being a greater source of cash as a result of lower equipment sales in recent quarters as well as lower financing penetration.

Investing cash flows were a use of $4 million, with CapEx spend of $23 million largely offset by proceeds from the Grenoble sale of approximately $20 million. Cash from financing was $908 million and included proceeds from the $1 billion September senior note issuance, of which $500 million went towards the previously mentioned incremental pension contribution and $475 million was used in October for early redemption of a portion of our 2018 senior note. Financing cash flows also included $68 million in dividends, common and preferred.

Before I go to the capital structure slide, I would like to spend a few minutes on updates we're making to our operating cash flow guidance. There are several moving pieces to cash flow that I would like to walk through in terms of their impact to our guidance.

To begin, underlying operating cash flow is running above expectations, as just discussed, giving us confidence to raise cash flow guidance by $100 million. More than offsetting this increase is a reduction from the incremental $500 million contribution to domestic pension plans that was funded with debt, as we announced in September. Lastly, we are announcing that we will be eliminating a majority of our accounts receivable sales or factoring programs, which will have an approximate negative $350 million impact to cash flow in Q4.

As background, we have had in place since 2009 accounts receivable sales programs where we sell short-term trade receivables, generally with payment due dates of less than 60 days. This has had a nominal impact on cash flows in recent years, as the largest benefit comes on the program startup. We no longer have a need for this working capital tool, and as a part of the Strategic Transformation program to simplify the business and reduce costs, we are eliminating the majority of these programs. This will give us annual savings of approximately $10 million, but does result in the one-time timing impact to cash flow that I just discussed.

2017 has been a year of optimizing our balance sheet, and I view this as another positive step in improving our capital management that will benefit the business going forward.

The net impact of these three changes is that we now expect cash flow from operations to be in the range of negative $50 million to positive $150 million for the full year 2017. This update to operating cash has essentially no impact on our available cash for capital allocation, as we always had an unallocated element of opportunistic spend in our guidance. We are also modestly adjusting our 2017 capital allocation to reduce expectations for CapEx by $50 million, as we are running under our full year target, with the shifting of some IT projects to be more pay-as-you-go operating expenses versus CapEx. At the same time, we are increasing our M&A target by $50 million, raising it to approximately $150 million. We have spent $76 million year-to-date and are targeting to close a couple more tuck-in deals before year-end. Factoring in all of these movements, we continue to anticipate ending the year with a cash balance of over $1 billion. I feel good about the progress we have made this year in strengthening our capital structure, and we plan to provide, during our Q4 earnings call in January, our capital allocation plans for 2018.

Before I turn it back to Jeff, I will quickly touch on our capital structure. We ended Q3 with $6 billion of debt. Within that, financing debt remained largely consistent at $3.6 billion quarter-over-quarter. However, core debt increased by $1 billion to $2.4 billion, reflecting the $500 million debt we took on to fund the pension and $475 million we used in October for the early redemption of a portion of the 2018 notes, replacing debt with a coupon of 6.35% with 3.625% coupon debt. The replacement of pension liability with core debt is largely leverage-neutral. So overall for the year, we have improved leverage, driven by the $300 million debt reduction we did earlier this year, and we will continue to manage our debt balance leverage position to maintain our investment-grade profile.

So to summarize, we continue to make progress on our objectives, and are on track to deliver on our full year expectations.

With that, I will hand it back to Jeff.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Thank you, Bill. Let me wrap up the presentation with a few closing remarks. Our third quarter results reflect continued progress on key performance measures and put us on track to meet our full year objectives. Revenue trends are beginning to improve. However, we are still in the early phase in our strategy to turn the revenue trajectory.

Our Strategic Transformation program is a critical enabler to supporting both revenue improvement and margin expansion, and I'm pleased with the strides we have made, with opportunities still in front of us. And finally, I cannot overemphasize the importance of the work we have done on the capital structure front and the key actions we have taken, including paying down debt, putting more towards the pension and ending accounts receivable sales programs, which will make us an even more financially secure and strong company for the future.

We'll now open up the line for questions. Jennifer?

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Thanks, Jeff. Before we get to your questions for Jeff and Bill, I will again point out that we have a number of supplemental slides at the end of our deck, which provide more financial details to support today's presentation and complement our prepared remarks. (Operator Instructions) At the end of our Q&A session, I will turn it back to Jeff for a few closing comments.

Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Shannon Cross with Cross Research.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

I have 2 questions. The first one is given all of the movements on cash flow, can you give us an idea of sort of how you are thinking about 2018? Not -- I know you're not going to give specifics. But if we think about what the one-timers were this year versus what we will see next year, the fact that you sort of raised your operational cash flow guidance and reduced your CapEx for this year, just how should we think about the trajectory of cash flow for next year? And then I have a follow-up.

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Shannon, it's Bill Osbourn. Good question. So a few things. You're right, we're not going to give detailed guidance on '18, but a few things to think about in light of what we've done this year. First of all, the factoring, just as I said in the prepared comments, are the ceasing of the sales of short-term receivables is a onetime timing issue. It sort of gets pulled forward short-term -- cash-related short-term receivables of 30 to 60 days. When you started up the program, it had a favorable impact back in 2009. It hasn't had much of an impact in recent years, plus or minus. But now that we're ceasing a majority of it, it will have that $350 million approximate negative impact this year. It will have no impact to run-rate cash flow for next year. As far as other things to think about when you're looking towards next year, if you recall, we originally had talked about pension contributions over a 2-year period being in the $800 million range, $350 million this year, $450 million next year. The incremental pension contribution we made this year with the debt that we issued in September, brings down those future contribution levels to more normalized levels. Not to give an exact amount, but historically, in the $200 million range, where, as you know, I think before, most people were modeling, you know, $450 million, $500 million for next year. But the thought is for it to be a more constant, stable number in the future, in the $200 million range. As far as CapEx, our CapEx is primarily related to IT-type spend, and we've been seeing more and more, as we go to cloud-based solutions, that it's ending up being more OpEx-related IT than CapEx historically. I would still think we'd be in the CapEx range, $100 million, $150 million. M&A-type deals. We target tuck-in type deals, especially in the GIS arena. And we've said, that could be anywhere, $100 million, $200 million in a given year, depending on the number of deals we do in that. So those are sort of big picture-type items with respect to cash as we think about future years. But we'll be more explicit, obviously, in the January earnings call.

Shannon Siemsen Cross - *Cross Research LLC - Co-Founder, Principal and Analyst*

Okay, great. And then, can you talk a bit -- I don't know, maybe Jeff, talk a bit about what's going on in terms of operating margin? It was a bit light this quarter. You mentioned on the SG&A side, some pressure from higher compensation and things like that. How do we think about SG&A? And how do we think about the cost-benefit sort of rolling through, so that you can be back in that range that you guided to for full year?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, so if you look at it, Shannon, as you know, we were 12.2% for the quarter, and we're 12.3% for year-to-date. So our full year guidance is 12.5% to 13.5%. So really within the expectations that we thought we would be. If we think about it, we had 60 basis points of currency headwinds. We had a little lower equity income on a year-over-year basis. The productivity came in where we certainly thought it would be, and it offset our normal revenue declines. So we're really well on track for where we expect to be for our 12.5% to 13.5% guidance.

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, I'd agree with everything Jeff says. Just to remind you, Q4 is seasonally the highest quarter of the year, it's from an adjusted operating margin perspective. And based upon quarter-end September 30 rates, we do expect a moderating impact of transaction currency in the fourth quarter versus what we saw in Q3.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Shannon.

Operator

Our next question comes from the line of Ananda Baruah of Loop Capital.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

Can you hear me okay?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, Ananda, we can hear you fine, thank you.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

Okay, great. Two for me as well, if I could. I guess, the first is, just going back to the new equipment shipped kind of across the portfolio that you -- that actually, I guess, drove volume up Q-over-Q. You mentioned a number of things. Could you guys call out, or point out, I should say, which were specifically most impactful? And which you believe to be specifically most impactful going forward? That'd be really helpful.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, sure, Ananda. So look -- Yes, let me try and cover it in a broad sense and give you the detail so that everybody can have an overview of where we are. And again, I'd say we're right on pace with where we thought. So if I were to look at the second half of last year from an equipment revenue standpoint as well as the first 3 quarters of this year, we've been down at 10% constant currency consistently, awaiting for the portfolio to come out. So as you know, or I believe you know, the lower end of the A4 products or our entry products came out in the first quarter of this year. And what you're seeing is, you're seeing the benefits of that in the installs. So our color installs were up 23%, black-and-white installs were up 26%. But that really benefited the most our developing markets, where we're really mixing down into the lower end of entry. So our developing markets actually had growth. If you then think about the May, June time frame, or later in the second quarter, is when we brought out all 17 of our A3 products. So we started to see some benefit from that, an improvement to a decline of 8.5% in our midrange products. And the benefits came, Ananda, I would say, really in the shorter sales cycles. We'll start seeing more and more of that in the longer sales cycles, especially in larger enterprise, public sector, et cetera. But you know, I would say even there, as we indicated last quarter, our 180-day new business pipeline was up significantly. And that's now migrated to, continue to be up in our 90-day new business pipeline, which we said all along would benefit us in Q4. So we certainly expect, overall, to see our strongest equipment sale revenue in the Q4, as well as our strongest and significant improvement in signings in Q4. And we take some confidence in that based upon what we've seen in September, and what we see in our direct backlog. With regard to the higher-end A4 products, or the higher-value, if I can call it that, A4 products, those came out more in Q3, with the final coming out in September. So we'll start seeing the benefit of that as well. So we've known all along that Q4 is where we need to start showing the significant improvement. We have confidence in that, based upon what we're seeing in the backlog, based upon what we're seeing in the pipeline and based upon what we saw in September, where we were -- where we improved the decline in our equipment by more than half of what our normal run rate has been.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

And that's really helpful. Just a quick clarification on that. Where in that, just for our benefit, does the mid-production, light-production units, like the Versant, which I think was -- you guys were enthusiastic about, the Brenva and like that, where do they fall in that?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, so that would be in the high-end. So you saw the installs down 2%, and you saw the high-end revenues down about 12%. The Versant did very well. So actually, Versant did extremely well, and the inkjet did extremely well. We had a tough year-over-year compare, if you look at things like color press and iGen, because remember, we were comparing against drupa last year, which is the every 4-year trade show. So we expect to see improvement there in Q4.

Ananda Prosad Baruah - *Loop Capital Markets LLC, Research Division - MD*

And then just a quick second one is, can you just give us some sense of where the cost savings -- how you've chosen to use the cost savings year-to-date? That's it for me.

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, so from a cost savings perspective, really, I group it into 3 buckets when I think about it. First of all, just to follow on with what Jeff was saying about the new A4s at the higher-end becoming available in Q3, fully available. As everyone knows, there's a razor blade model on the A4s. We've had the lower-end ones available since pretty much the beginning of the year. The higher-end A4s are -- came out in Q3. We expect to be selling those in greater quantities, and to the extent we do that, there are upfront losses upon sale, typically that are made up, more than made up and profitable over the life of the equipment. So that's one area of investment that we expect to continue pushing an increase even into Q4. Second area deals with IT infrastructure investments. And some specific examples, as I said, the spend is tending to be more OpEx than CapEx, and just due to the nature of the type of IT solutions we're doing. But first of all, channel partner business is an area of focus, a strategic growth area, and we're building up our back-office business platforms to support that business. Also, our service delivery, we're looking -- we're building up a next-generation service delivery platform. And then there's just other general IT infrastructure, whether it's with respect to supply chain, data analytics, et cetera. All those types of items support the business today, and going forward we believe in the future. And then finally, the third bucket that I have -- that I view as far as just a type of investment, it really goes to the direct selling or the selling cost, both from a direct sales force perspective, we've been increasing the number of direct salespeople during the year and plan to continue on doing that, and also the support of our channel partners and recruiting those channel partners are also -- there's a cost to that, that we believe will benefit the future.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Ananda.

Operator

Our next question comes from the line of Paul Coster of JPMorgan.

Paul Coster - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Yes. Two please, with a sort of longer-term perspective to them. First one is, on the MDS -- in the MDS segment, I think about 25% revenue now is coming from the mid-market. What can that share be over the course of time? And how do you get there? And then on R&D, your R&D is still one of the biggest in the industry focused on printers. It feels like you've kind of been through a big product cycle. What's next? Are you going to start doing what some of your competitors are doing, move into adjacencies? Or is it just more of what we've seen to date? So some kind of breakdown of the R&D would be useful.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, sure, Paul. Let me try and address that for you. So first from an MDS standpoint, we were very pleased that we improved from the decline of 3.9% last quarter to the growth of 1.2% this quarter. As we indicated last time, there was an aberration in the equipment sales, where we were down 24% in MDS. That improved significantly, with still more room to improvement. The post sale in MDS did grow. So we were pleased to see that. And our channel Managed Document Services was up about 12%. So good double-digit growth, stronger than the market there. Actually, twice as strong as the market there. As Bill indicated, the actions we're taking there, between the new products, our new multibrand resellers and the SMB expansion, in addition to the new logo hunters, and we brought on about 30 in North America. And we're not just adding feet on the street in our own direct world, but our resellers are also adding feet on the street, and we're helping support them in doing that. So we're making good progress there. And the SMB part of Management Document Services is obviously a big part of our strategic growth areas. With regard to research and development, we're trending at about 4% of our revenue in research and development. That's been pretty stable. We put a lot of time -- we look at research and development in terms of capital, and everything needs a good return on investment. So to your point about where we will be pivoting, I don't think there is any question. One of the things that we're very excited about, now that we're 10 months into this separation, is having Palo Alto Research Center back 100% dedicated to us. For 6 years or 7 years prior to that, it was predominantly dedicated to our business process outsourcing firm, which was spun off, and now that's 100% back to us. So yes, we will be pivoting into things with more in inkjet, more in print electronics, more in the Internet of Things, certainly more into packaging. Now those investments will take a little longer time, obviously, because commercials -- commercialization cycles are longer. But when we look at our business, our strategy all along was to say, what we call Phase 1, be very strong on Strategic Transformation, make this business as productive as it can be, as cost-efficient as it can be. Take some of that to the bottom line. Take some of it to invest in the future. Phase 2 is exactly where we're at now. All these 29 new products coming out, and now let's begin to show the change in that revenue trajectory. Phase 3 will be pivoting to some of the things that I think you were just referring to, what can be the second and third leg in the Xerox stool going forward.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Paul.

Operator

Our next question comes from the line of Katy Huberty of Morgan Stanley.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

First, just a quick clarification. The strength that you saw in September, was that just the ConnectKey products? Or was that across the equipment portfolio? And then, can you comment on whether that order strength continued into October? And then I have a follow-up.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, so we'll stay on Q3, I think best, Katy. But -- so it was in our 29 new products, and it was in, also what I'll call the high-end of inkjet, and it was Versant. So we certainly saw it there with the new products that we brought out, both in the high-end as well as in the 29 new products. As I said, the reason we have confidence is because of what we've seen with September. We actually had signings growth in North America. So we're starting to see some of the benefits of that. We're starting to see our pipeline build with our new logo hunters, and the products are just being very well-received by our channel partners as well, especially with the apps. So everything in terms of the detailed reviews Bill and I do with the team gives us the confidence that Q4 will show significant improvement in our equipment sales revenue line as well as in our total revenue line.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

Okay. And then just as a follow-up, how are you thinking about the weaker dollar? Is there an updated view as to the currency impact to EPS in 2017? And then, does that become a tailwind -- does currency become a tailwind in 2018? And would you expect to flow that through to the bottom line? Or do you take that upside and potentially raise [that debt]?

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, Katy, it's Bill. A couple of things. I'll talk a little bit about Q4. Don't want to go too much into '18 guidance yet, but as far as -- you look at quarter-end rates, we do expect a moderation of the transaction currency impact in Q4 based upon quarter-end rates. And also from a revenues perspective, translation perspective, Q3 was the first quarter in 13 quarters that we actually had a favorable impact from currency of about 1 percentage point, and we're expecting that to improve into Q4 based upon quarter-end rates. So yes, we are expecting a moderating impact or improvement with respect to currency. We look at -- it's one of the things we factor into all the things, pluses and minuses is that, how much we invest into the company and how much we let go to drop to the bottom line. So can't really give you a specific answer in that component, but certainly, it's one of the factors that we look at as far as investment, incremental investment versus allowing it to drop to the bottom line. And '18, we'll see where rates are at the end of the year. We'll clearly have a view and comment on that in the January earnings call.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Thank you, Katy.

Operator

Our next question comes from the line of Steve Milunovich of UBS.

Steven Mark Milunovich - *UBS Investment Bank, Research Division - MD and IT Hardware and EMS Analyst*

Great. First of all, I want to talk about M&A in the channel. Can you talk a bit about what you're seeing in the dealer space in terms of valuations? Are you seeing competition from other dealers or private equity? And is consolidation in the dealer channel likely to affect industry dynamics in terms of either pricing pressure or the nature of contracts?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Steve, this is Jeff. So we've seen some consolidation or some resellers being acquired in Europe, and as you're probably aware, that certainly has been one of our strategies in the North American market with our Global Imaging channel. So we've done a few this year. It's part of our strategy as we go forward. As we look in M&A and our overall capital allocation strategy as we go forward, it will probably continue as part of it. We're also -- believe very much in some of the M&A if we do -- when we do it, we certainly want it to benefit the total business, and that it could be an igniter from a technology standpoint than just being a channel acquisition. So -- but channel acquisition is definitely a part of our strategy. We've been very successful with Global Imaging. And what we're seeing is, certainly, the multibrand resellers that we have, that are -- we're now bringing on -- we brought on about 45 so far, equally split between North America and international. They've been very excited about our new products, because they're really looking at these as workplace assistants, coherency between our A3 and A4, mobility, benchmark security, cloud enablement. And then, they're really leveraging the apps, which is what they like as well.

Steven Mark Milunovich - *UBS Investment Bank, Research Division - MD and IT Hardware and EMS Analyst*

And then I just wanted to check in on the large enterprise space. It's fairly saturated with declining pages. Is there much risk that some of those customers shift over time to lower-cost A4?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Well, the industry, to a large extent, is moving to A4, but what you find there, that would actually benefit us to some extent, because the vast majority of our business in the enterprise is now Managed Document Services. And when we didn't have as competitive an A4 as we do now, it caused us to put in more A3 when we were architecting the solution. And therefore, that would hurt our margins to some extent. So some of these deals that you're now seeing us win is very significant for us, because we're able to put in more A4 devices, which is actually a benefit. Where you're starting to see some of the industry go down, it's more in the desktop printers, and we tend not to play there as much, which is also a benefit for us and perhaps not as much to others.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Steve.

Operator

Our next question comes from the line of Matt Cabral of Goldman Sachs.

Matthew N. Cabral - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Yes, I wanted to circle back to the earlier discussion on operating margins. I guess, looking at the implied Q4 guidance, if I assume an improving revenue performance to get to down mid-single digits, it still implies margins are flat to down year-over-year, even to get to the high end of the range. So, I guess with that in mind, why wouldn't you start to see some better leverage, given the revenue declines are improving and front-loaded restructuring that you had to start off the year?

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, I don't think I want to get that specific within the range of 12.5% to 13.5%, Matt. But you know, we've done our modeling and our expectations for Q4, and based upon -- as everyone knows, Q4 is seasonally our best quarter of the year from a revenue perspective, from an ESR perspective, in particular, and from total revenues. And based upon what we see happening in from a -- expect to happen from a transaction currency perspective, that we are very comfortable with the 12.5% to 13.5% operating margin range.

Matthew N. Cabral - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. And then Bill, as a quick follow-up, in the past, you've talked about this potential that you see within working capital. Can you just give us an update on where you stand with some of those initiatives? Then, if possible, maybe quantify the size of the opportunity that you see over time?

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, so working capital is -- it is an area of great emphasis of management for the company. Inventory receivables, aside from the ceasing of the AR receivables program, is still managing receivables on an ongoing basis. Inventory, we're going through a period of time where we're transitioning product lines from the old to the new. It has some impact, but we expect to work through that by the end of the year. So there's clearly opportunity there. Don't want to size the exact, but it's an area that we clearly believe we'll be able to work on.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Thanks, Matt.

Operator

Our next question comes from the line of Mark Moskowitz of Barclays.

Mark Alan Moskowitz - *Barclays PLC, Research Division - Research Analyst*

Two questions, if I could really quickly. I want to follow back up on the channel commentary to Steve's question. Can you give us a sense in terms of the A4 opportunity? Is that creating any sort of conflict, like currently with your installed base of partners? Is that why you're having to maybe get more acquisitive? And then the second piece is around your confidence that equipment sales, the rate of decline, can improve. Is that because you have more contracts in hand entering the fourth quarter or the month of October than you have historically? Or what else gives you that confidence?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Mark, I'm sorry. I just missed the last part -- your original question on the A4 part broke up a little bit. Could you just repeat that part of it, please?

Mark Alan Moskowitz - *Barclays PLC, Research Division - Research Analyst*

Yes, sorry about that. I was just kind of curious in terms of go-to-market with A4 that is a little newer here with Xerox after being away from that market for a good number of years. Is that creating sort of channel conflict with your partners? And is that why you're having to maybe increase the M&A expenses or expectations going forward, because you may have to actually be more acquisitive related to A4 type of partners from a channel perspective?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

No, so not at all. So no, it's been part of our strategy. Look, we only have about a 5% market share in A4. And when we were, what I'll call it a 2 division company, basically we were managing the business more for profits, more for cash, and we're still doing that, don't get me wrong, but we believe now that we have a much more cost-competitive A4 portfolio, with the 12 new products that we just introduced. Not only will it benefit us in Managed Document Services, as I said, it'll give us much more opportunity, especially with the coherency in A3, and it should actually improve our gross margins in that space because we'll be able to architect the solutions differently, it will also enable us to bring on more channel partners than we have in the past, because we've always been the leader in A3 and everybody wants our A3 solution. But now when resellers go to market, they need both an A3 and an A4 solution. So we'll be able to provide both to them. And the fact that we now have at least 45 new partners coming on, with more to come, says that they really like what they're seeing in the products, and there's a lot of excitement in it. And again, can we just -- your second part of the question there?

Mark Alan Moskowitz - *Barclays PLC, Research Division - Research Analyst*

Your go forward...

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

I think it was regarding confidence on Q4 ESR.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Confidence on Q4, thank you. The reason we have confidence is, when I look at the way the backlog that we have going into Q4 is the best we've been positioned, certainly this year and probably over the last 14 months. When I look at what we have in terms of the pipeline for signings, which will benefit us from a signing standpoint in Q4 and then certainly into next year. When I look out at the new resellers that we're bringing on, and when I look at our new logo hunters that are just going after new business, it does give us the confidence. And obviously, seeing the September results that we had the benefit of seeing, it was a bit of a trend breaker for us over the last 5 quarters. So that's what gives us the confidence.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Thanks, Mark.

Operator

Our next question comes from the line of Jim Suva of Citi.

Jim Suva - *Citigroup Inc, Research Division - Director*

Two questions. I'll ask them both at the same time. The first one is on the free cash flow guidance taking down. I think that was unexpected by investors, and you clearly laid it out this quarter. But I guess the question is just, you unexpectedly brought it down. I guess, are there other things you guys are considering that maybe we should be bracing for as we look ahead, that could impact free cash flow for a modeling perspective? And then my second question is, on MDS, you mentioned that the signings you expect to go up next quarter in Q4. Do you mean up year-over-year or quarter-over-quarter? Because I believe quarter-over-quarter it's generally up.

William F. Osbourn - *Xerox Corporation - Executive VP & CFO*

Yes, Jim, it's Bill. I'll answer the first question regarding the free cash flow guidance. The way that we look at it really is that the underlying cash flow, actually, we feel very good about what's happened year-to-date, the progress we've seen as far as the underlying cash flows in the company. We actually raised, based upon the original basis, the $700 million to $900 million range to $800 million to $1 billion based upon that. But as far as -- the surprise is actually the $500 million. When we did the debt or the note issuance back in September, we disclosed that $500 million of the $1 billion note was going to be used for this, and revised the cash flow guidance at that time for that $500 million, which we view as a positive because it's allowing us to have more stable pension contributions going forward as opposed to having certain required amounts being higher. Like this year, it was $350 million, next year $450 million, $500 million. So we believe that it will be more stable going towards the future. So that $500 million we put out there in the September time frame, and as far as the ceasing of the short-term sale of receivables, we believe, just from the Strategic Transformation perspective, the savings associated with that, whether it was the interest costs, whether it was the effect of borrowing or the administrative costs, that, that working capital management tool just wasn't for the -- needed, except there's a limited part that's left. And we see that as a positive from a savings perspective, $10 million going forward. So yes, there is the onetime timing. But as I explained in Shannon's initial question, it's just a timing, a pull forward cash, 30 to 60 days. And as far as ongoing run rates, it really has no impact on '18. And as far as other things being thought about or considered, really nothing. I mean, as far as from a -- I laid out some initial thoughts regarding '18 cash flow considerations when answering Shannon's question, and really, nothing else other than that.

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

Yes, and Jim, on the signings, if you go from a constant currency basis, on a year-to-date basis, we declined about 7%, with growth in the renewals and declines in the new business. We expect to see the new business improving in Q4. So we expect to have strong improvements versus the year-to-date signings that we've seen in Q4 for sure.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Jim.

That's all the time we have for questions today. We appreciate the interest of everyone who has tuned in. Jeff, anything to wrap up?

Jeffrey Jacobson - *Xerox Corporation - CEO & Director*

No, I just wanted to thank everybody for your questions. As I mentioned last quarter, we are keenly focused on the work ahead of us. We're positioning ourselves to reverse our revenue trajectory trends over time. We understand the market, and our success will come by operationally laying the building blocks to capture share of the growing workplace marketplace and increase our participation in the expanding high-end color market. We continue to make headway on our strategy, and are confident in our ability to meet our full year commitments. We look forward to updating you on our progress. Thanks so much for joining the call.

Jennifer Horsley - *Xerox Corporation - VP Investor Relations*

Great. Thanks, Jeff. And that concludes our call.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Everyone, have a great day.
