THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

XRX - Q3 2014 Xerox Corp Earnings Call

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

OVERVIEW:

XRX reported 3Q14 adjusted EPS of $0.27. Expects 2014 adjusted EPS to be $1.11-1.13. Expects 4Q14 revenue to decline about 3 points and adjusted EPS to be $0.30-0.32.

CORPORATE PARTICIPANTS

Ursula Burns *Xerox Corporation - Chairman and CEO*

Kathy Mikells *Xerox Corporation - CFO*

Jim Lesko *Xerox Corporation - Corporate VP of IR*

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

CONFERENCE CALL PARTICIPANTS

Tien-tsin Huang *JPMorgan - Analyst*

Shannon Cross *Cross Research - Analyst*

Ben Reitzes *Barclays Capital - Analyst*

George Tong *Piper Jaffray - Analyst*

Keith Bachman *BMO Capital Markets - Analyst*

Ananda Baruah *Brean Capital - Analyst*

Brian Essex *Morgan Stanley - Analyst*

Jamie Friedman *Susquehanna Financial Group - Analyst*

Jim Suva *Citigroup - Analyst*

Kulbinder Garcha *Credit Suisse - Analyst*

PRESENTATION

Operator

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

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

During this conference call, Xerox executives will make comments that contain forward-looking statements which by their nature address matters that are in the future and are uncertain. Actual future financial results may be materially different from those expressed herein.

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

Ursula Burns *- Xerox Corporation - Chairman and CEO*

Good morning and thanks for joining our call. Today we are reporting third-quarter 2014 earnings and in addition to sharing our performance, I will update you on progress that we are making against our overall strategy and how we are positioning ourselves for the future.

Overall our business model is healthy. We have the benefit of a strong annuity business, a diversified portfolio and healthy cash flow. We delivered earnings at the high end of our range and grew margin on a total Xerox basis.

We are making progress. We are the leader in diversified business process services and we are maintaining leadership in our Document Technology business and we are investing in both businesses for the future. Here are some specifics on the progress that we are making.

We remain the leader in Document Technology and its strong profitability continues to help fuel our growth initiatives. We announced 17 new products during the third quarter meeting market demand for continued innovation in this category. We continue to strengthen our position in Services. We are implementing a new operating model and client coverage strategy to improve signings performance and productivity.

We continue to strengthen our leadership and apply talent to areas where we see the greatest market opportunity. We are bringing greater value to our Services clients with the use of advanced analytics that deliver insights gleaned from our delivery model. A good example is in commercial healthcare which was a standout again this quarter. Here we recently launched Juvo, an advanced analytics platform that allows hospitals to analyze every aspect of the clinical cycle of care.

Our document outsourcing business is getting external recognition as well. Our three-tier Managed Print Services strategy was called out by IDC for innovative leadership. The Xerox Merge system, which uses data analytics to optimize parking demand and meter pricing, was a winner of the 2014 Promising Innovation in Transport Award. So across both Services and Document Technology, we remain focused on our important stakeholders delivering, value for our investors, being the best partner to our clients, and making Xerox a great place to work for our people.

Here is a look at our results and my perspective. We are reporting adjusted EPS of $0.27 which is at the high end of the range that we set. Our Document Technology business came in above expectations while Services margin results were lower than planned. On the revenue side, Services grew modestly and Document Technology declined in line with our expectation.

Our operating margin is up year-over-year driven by strong margins in Document Technology. Services margins were up sequentially but lower than we anticipated as a result of higher costs in government healthcare as well as ongoing strategic investments. We continued to use our strong cash flow, almost $600 million in the quarter, to deliver value to stakeholders through dividends and share repurchases.

We are raising full-year guidance for share repurchases to approximately $1 billion and we are making disciplined acquisitions targeted at enhancing our services capabilities. Most recently, we acquired Consilience Software, Inc., a case management and workflow automation software provider for government agencies.

We have a talented and dedicated team which we continue to strengthen. Our goal remains to provide leading products and services for our clients and deliver the operational results expected of us.

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

Kathy Mikells - *Xerox Corporation - CFO*

Thanks, Ursula, and good morning, everyone. There were a number of pluses and minuses in the quarter but overall we delivered roughly in line revenue and EPS at the high end of our range with strong cash flow. We took a bit of a different path to achieve that outcome with Document Technology profitability coming in stronger and offsetting lower Services profitability.

I will cover both segment results as well as cash flow separately but first, let's walk through earnings.

Revenue in the quarter was down 2% at both actual and constant currency. In total, segment revenue trends were largely as expected with Services up modestly and Document Technology down mid-single digits. Gross margin of 30.8% was down 70 basis points year-over-year driven by a decline in Services as well as the greater mix of Services at a lower margin.

RD&E was lower year-over-year as increases in Services were more than offset by productivity driven reductions in Document Technology.

SAG was lower in both segments as we benefited from productivity initiatives as well as lower pension expense. These improvements more than offset the lower gross margin and resulted in operating margin expansion of 10 basis points year-over-year. Operating profit in total was roughly flat as margin expansion basically offset the impact of the revenue decline.

Moving down the income statement, adjusted other net was $29 million higher year-over-year. Within that, OID was $35 million higher reflecting a real estate gain in the prior year as well as higher litigation reserves this year. Restructuring of $28 million was $7 million lower year-over-year and in line with our guidance.

Adjusted tax rate of 26.8% was 1 point lower year-over-year and at the high end of our guidance range of 25% to 27%.

Adjusted EPS of $0.27 was a cent higher year-over-year as growth in Document Technology operating profit roughly offset the decline in Services and below the line, higher OID expense was more than offset by lower share count.

I will now move to Services segment slides to review our results in more detail.

Services revenue grew 1% and was flat at constant currency which was about 1 point lower sequentially reflecting the impact of the Texas Medicaid loss that we discussed last quarter. Within Services, BPO growth increased to 2% from 1% in the second quarter with good growth in commercial healthcare, litigation services and international.

ITO declined 3% due to the impact of lower prior ITO signings as we have become more selective in where we participate in that business with our main focus on improving our margins and profit there.

Document Outsourcing was flat year-over-year with continued strong growth in our SMB offerings offset by lower equipment sales in enterprise. We expect Services' topline growth to remain constrained in the fourth quarter as several large new deals that have been awarded are taking longer to get to contract and some new business decisions that have been deferred are also delaying the ramp of new work. This is negatively impacting signings as well which were down year-over-year.

We had previously anticipated better signings results throughout the second half but are now seeing the shift to the fourth quarter and early 2015 reflecting the decision in contracting delays. We have a strong pipeline of 7% year-over-year and are continuing to ramp up sales hiring and training.

Renewal rate in the quarter was 82% which is modestly below our target range of 85% to 90% driven by a lower ITO renewal rate.

The BPO renewal rate was above 90% in the quarter albeit with less renewal opportunity. We have a large BPO contract renewal that has been awarded and is in the process of being contracted so that should help our fourth-quarter renewal rate and signings.

Shifting to profitability, segment margin was 8.9% in the third quarter which was up 30 basis points sequentially but fell short of our target to get something north of 9.2%. We did see solid sequential margin expansion in BPO even when adjusting out the government healthcare Nevada HIX impairment charge from last quarter.

In Document Outsourcing, our margins are quite good but are seasonally lower in the third quarter. And in ITO, we took a temporary hit in margin as we proactively restructured a few contracts seeking to improve the mix and profitability of that business.

Within government healthcare, we are making good progress but expense levels are still high as we continue to invest to improve the performance of the first platform implementation of our new Medicaid platform. These impacts were more contained in the third quarter but are still a headwind year-over-year.

We have been realigning the Services organization to better leverage our scale, gain efficiencies and improve customer value. We are aligning the organization to specific industries to improve our go-to-market approach and have consolidated management of operational capabilities to achieve scale benefits. We believe this structure will also enable improved execution.

We continue to bring in additional new talent under Bob's leadership and are focused on accelerating productivity gains and delayering our old SBU management structure.

In the fourth quarter, we expect further sequential margin improvement. However, we are moderating our expectations in light of our third-quarter results and investments required as we push forward with our Services strategy. We expect margin to be between 9% and 10% for the quarter.

With that, I will review Document Technology. Revenue in Document Technology was down 6% at actual and constant currency and was in line with expectations. Equipment revenue declines moderated versus the second quarter and although annuity declines were a bit higher, this was due entirely to the impact of finance receivables sales in the prior year which had a 1 point impact to revenue growth.

From a geographic perspective, trends were generally consistent with last quarter with the US stable, Europe improving, and developing markets weak but with moderating declines.

Looking at our product groups, we are seeing very positive results in the high end with growth in both equipment and annuity revenue. High-end annuity revenue grew the past two quarters which is encouraging as it reflects increases in MIF and pages in this important segment.

Mid-range was in line with overall Document Technology declines while entry performance was weaker. The third quarter was a very strong quarter for new products with 17 products launched and an additional three launched in October. We extended our very successful ConnectKey platform into a number of entry multifunctional devices as well as into Color and Mono midrange products. By further extending the platform, we provide even more options for our customers looking to leverage our strong mobile, security and app development. This should position us well in the fourth quarter and as we enter 2015.

Document Technology margin in the quarter was 14% resulting in operating profit growth of 9% despite the revenue decline. The strong margin performance reflects benefits from restructuring and cost initiatives as well as continued favorable mix, positive transaction currency, and lower pension expense. Although mix may not be as favorable in the fourth quarter, we expect continued strong margin performance, down sequentially but up year-over-year.

As we look to 2015 based on today's rates, we would expect currency transaction benefits to continue. However, pension expense will be a significant headwind. Pension settlement expense this year is expected to come even lower than we previously anticipated declining about $100 million year-over-year. The further decline relates to changes in the discount rate used to determine benefits with the rate recently published for 2015 coming in lower than 2014. This naturally motivates individuals to wait to take their lump sum in 2015 when the benefit will be higher and will shift more costs for us into next year.

This is the opposite phenomenon from what we experienced from 2013 to 2014 when the discount rate increased and it adds non-cash volatility to our earnings. With the discount rate declining, we expect about $105 million of additional non-cash settlement expenses next year.

Our Technology segment margins have been running well above our long-term guidance of 9% to 11% and even with the pension headwind, we would expect we will be above the high end of the range again next year.

I will turn now to cash flow. Cash flow from operations was $595 million in the quarter and $1.2 billion through September. As expected, cash flow in the quarter was lower than prior year due to the positive impact of $316 million last year from the finance receivables sales versus a net negative impact of $102 million this year due to the loss of collections from previous sales.

Underlying cash flow which excludes the impact from prior year's finance receivables sales was $697 million in the third quarter and $1.5 billion through September. With cash from operations we continue to see the benefit from working capital which included some timing benefits within accounts payable this quarter so overall it was another strong operating cash flow quarter.

Moving down the cash flow statement, investing cash flows were a $128 million use in the quarter. We spent $112 million on CapEx and $25 million on acquisitions for the recently announced Consilience acquisition, a provider of case management and workflow automation software that will strengthen Xerox's suite of offerings to state governments.

Additionally in the third quarter, we exited the Xerox Audio Visual solutions business, a small Audio Visual business that was non-core and flowed into our other segment results.

Cash from financing was a use of $417 million and included $251 million in share repurchases and $83 million in preferred and common stock dividends.

So to wrap up cash flow with three quarters done, we are well-positioned to deliver on our full-year cash flow guidance of $1.8 billion to $2 billion of operating cash flow which equates to $1.3 billion to $1.5 billion of free cash flow. As a reminder, we have no finance receivables sales planned in the fourth quarter as compared to proceeds of $247 million in the fourth quarter of 2013.

Now I will quickly cover capital structure. We ended the quarter with $7.7 billion in debt and in line with our original guidance we continue to expect to end the year with about $7.8 billion in total debt. Applying 7 to 1 leverage on customer financing assets, our allocated financing debt is $4.2 billion leaving core debt of $3.5 billion.

We manage our core debt to maintain a leverage ratio consistent with our investment grade credit rating while financing debt has come down over the past few years driven by the finance receivable transactions as well as lower originations.

So we have a pretty stable capital structure and if we move to the next slide, I will review where we are at on share repurchases and dividends.

With our strong cash flow to date and taking advantage of our high beginning of year cash position, we steadily repurchased shares this year for a total of $730 million or 61 million shares through September. We continue to view our shares as a good investment and we are increasing our full-year share repurchases to approximately $1 billion.

Our full-year guidance for dividend payments remains about $300 million and reflects our current quarterly dividend of $6.25 per share. When combined with the share repurchases, we now expect approximately $1.3 billion to be returned to shareholders this year.

Before I turn it back to Ursula, I would like to summarize our expectations for the fourth quarter and full year.

We expect Document Technology to continue to deliver strong margin, up year-over-year in the fourth quarter but down sequentially driven by the new product launch timing and mix with full-year margin above 13%. Revenue declines remained down mid-single digits in constant currency and down an additional 2 points at actual currency in the fourth quarter given the recent strengthening of the dollar relative to the euro.

As I detailed earlier, we are continuing our investments and improvement actions in Services and expect our fourth-quarter margins to expand sequentially to approximately 9% to 10% with revenue growth flat to up 1% with about a point of negative currency impact. At the consolidated level for the fourth quarter, we expect revenue will decline about 3 points including 1 to 2 points of negative currency with adjusted earnings per share of $0.30 to $0.32, which includes about $0.02 of restructuring. And for the full year, we now expect adjusted earnings per share of $1.11 to $1.13.

As we look to 2015, our EPS expansion will be constrained due to the volatility of non-operational pension settlement expenses that I discussed earlier.

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

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Thanks, Kathy. I want to get to your questions so I will summarize quickly.

Our third-quarter shows our strategy is on track but we still have areas for improvement. We are seeing the benefits of strong operating profit from Document Technology while we position our Services business for future growth.

Our annuity-based operating model, diverse portfolio and strong cash flow combine for a healthy and resilient business model.

We will finish 2014 with a focus on three priorities. In Services, improving growth and profit through portfolio management and improved productivity. In Document Technology, capitalizing on the most advantaged segments of the business to maintain our leadership position in the industry while maintaining strong profitability. And we will continue to generate healthy cash flow to deliver shareholder value.

Thank you and now over to you, Jim.

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

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

For the Q&A, I ask participants to please limit follow-on and multi-part question so we can get to everyone. At the end of our Q&A session, I will turn it back to Ursula for closing comments.

Operator, please open the line for questions now.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Tien-tsin Huang, JPMorgan.

Tien-tsin Huang - *JPMorgan - Analyst*

Good morning. Thank you. Just wanted to first ask about the signings and the visibility there. What is driving the push out and the project ramps and the signings? Is it a cyclical issue or maybe client priorities changing? Any color there would be great.

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

This is Bob. I think you have to break it into big deals versus more traditional and I think on the big deals side of it, we have seen elongated process largely associated really with competitors protesting and those cycles running longer. So on the big deal components, we are very happy with our success rate. They are taking longer to get to closure.

On the more traditional volume of pursuits, our win rate remains very strong in the third quarter. Of the top 20 deals that we were pursuing, we didn't lose a single one but our in-quarter conversion rate was lower than typical and I would say that is a little bit of a function of where there is more that we need to do and that we are investing in relative to our salesforce and helping them get the larger deals or those top 20 deals over the goal line.

So hopefully that is responsive to your question.

Tien-tsin Huang - *JPMorgan - Analyst*

As we think about fourth quarter and I guess for the full year, is there a new view on your signings target for this year, what needs to be achieved in order to see some growth next year? And also just trying to understand a little bit more as a follow-on within ITO, within ITO, it sounds like you did some contract restructuring. Can you size that and is there more to do there? That is all I had. Thank you.

Kathy Mikells - *Xerox Corporation - CFO*

So if you look overall and the trends as I mentioned in my prepared remarks, we have basically seen a slippage of when we were expecting to see year-over-year improvement in signings and so as we look to the fourth quarter, we would expect to see year-over-year improvement. I mentioned that we had one large renewal which should occur in the fourth quarter, that should help both our renewal rate as well as our overall signings.

With regard to ITO, which I think was the second part of your question, we are really managing ITO as a niche business looking to really have deals where we are partnering ITO with BPO and we are getting an overall I would say good margin performance from that support but not really chasing what I would call bigger commoditized deals in ITO. And as a consequence of that, we certainly expect that we are going to have a lower overall growth rate in ITO.

Now we are still winning new business in ITO. We won a new contract this quarter in ITO so it is a business that we absolutely are continuing to pursue but we are being more selective in terms of what we are pursuing.

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

If we could have the next question please.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. I had a question with regard to restructuring both on the Document Technology side as well as on Services. Just how are you thinking about restructuring as you go into 2015? What kind of opportunities do you think you are seeing because it seems like you basically reinvested some of the upside this quarter on the Document Technology side into Services. So how do we sort of think that all flows through and we see the opportunities in 2015? Then I have a follow-up. Thanks.

Kathy Mikells - *Xerox Corporation - CFO*

Sure, Shannon. So if you look at restructuring, the first thing I would say is we don't [ex-item] restructuring. A big part of the reason we don't ex-item restructuring is especially within our technology business, it is the regular course of our business. I think we are incredibly disciplined and very good about it. So when you look at what we have done so far this year we have done about $0.02, kind of every quarter. We just guided to doing another $0.02 in the fourth quarter and so I think you can continue to expect as you look forward that we are going to have those kinds of restructuring charges regularly.

In terms of the mix of restructuring charges, I'd actually expect that we are going to see a little bit higher mix toward services. Clearly one of the things that we need to do is further ramp up productivity initiatives and so I would expect to see that mix change a little bit. But I will just remind you that from an expense perspective, we are always going to be technology-heavy because those tend to be our higher cost workers and we will continue to do a lot of work there.

Shannon Cross - *Cross Research - Analyst*

And maybe, Bob, can you talk about specific areas you think you can improve within Services? And again, how -- like what have you seen over the last several months that you have been there and how are you sort of thinking about opportunities in 2015?

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

Yes, Shannon, so I think from an improvement standpoint at the macro level, the two areas that I would call out most visibly is we really do think that we can improve our sales conversion and we are taking a number of actions there. One is beefing up the sales team in terms of adding to the hiring. The second is a more aggressive sales training program that we are leveraging.

So I would say one thing that I have kind of concluded after seven months is that there was more that we could do there. Ursula says to me if you are winning all the time, you are not covering enough because you should have a mix of wins and losses in the marketplace so we are trying to broaden our coverage.

And then I think the second area that I would call out that we have been on but that we will be ramping up the pace is we have moved to a global capability model around our delivery teams and kind of away from 2500 strategic business unit structure to more managing delivery globally and we believe that we can leverage that to drive productivity increases that is part of what Kathy shared as we think about going forward. So those would be the two main things.

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

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

Operator

Ben Reitzes, Barclays.

Ben Reitzes - *Barclays Capital - Analyst*

Good morning. My question is around some of the things you said around 2015. It seems like there is a $0.06 hit year-over-year due to pension vis-a-vis prior expectation. And I was wondering if we could talk about at today's rate what currency, if there is a bottom-line hit to currency, what that is heading into next year and the next quarter? And potentially if you have to have lower services margins than expected, what that hit would be?

Basically I know you guys want us to wait for November 11. Where I'm getting at is the Street is at 120 for next year and if I pile these hits up, then the EPS starts to look pretty flat unless the share count is materially lower for 2015. And I know you are going to want to say that at the analyst day but I'm wondering what you are trying to message with 2015 on this call given all those puts and takes I just articulated. So if you could just explain that, Kathy, that would be great. Thanks.

Kathy Mikells - *Xerox Corporation - CFO*

Sure. So I am going to start by saying you just articulated a whole lot of puts and takes and so I will try and cut a little bit to the bottom line. And we are obviously still wrapping things up and are going to talk in a lot more detail as you mentioned at our November investor conference.

So first, you are right. With regard to pension settlement expense, I think we are trying to articulate a couple of things. So we now have visibility to this. We print a discount rate once a year. In the third quarter we do our actuarial work and then we get visibility to pension expense. Importantly this is a highly volatile thing, our pension settlements expense. It has to do with nuances of our pension plan, the fact that we offer a lump sum and lots of people take it, etc. But it is a non-cash item. I think if you look overall at Xerox's cash conversion rate net income to free cash flow, we have a cash conversion rate above 100% and we have very, very strong cash flow.

If I look to currency which is the other large item that you mentioned which we are getting benefits from this year, if I look at where rates are at today with our currency transaction benefits really flowing from the yen, if I look at where rates are at today, our currency benefits should hold next year. If anything I would say maybe a little bit positive but certainly as I look at rates right now, they should hold next year.

I talked about currency for the fourth quarter from a translation perspective and so that is putting some headwinds overall on topline. Those headwinds don't have a real material impact in terms of bottom-line results for us. So that gives you I think a little bit of a feel for some of the puts and takes. And I'd come back and say importantly I think you can continue to see our very strong cash flow results this year, our reiteration of guidance on strong cash this year and as we look forward next year, we expect to have continued very good conversion rate and cash flow.

Ben Reitzes - *Barclays Capital - Analyst*

Did I miss it, did you reiterate the long-term services ranges? Are we going to address -- in terms of margins, are we going to address that at the analyst day in terms of where we will be in the future on the long-term services margins and your ability to be in that range?

Kathy Mikells - *Xerox Corporation - CFO*

So we will address that at investor day but we haven't changed the expectation long-term for our Services business.

Operator

George Tong, Piper Jaffray.

George Tong - *Piper Jaffray - Analyst*

Good morning. Thanks for taking my questions. On Services margins, can you discuss what positive or negative surprises you saw in the quarter and what provides confidence Services margins can step up in the fourth quarter?

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

It is Bob. From a negative surprises standpoint obviously we came in a little bit short of where we had committed that we would come in. And I would say from a negative surprise standpoint, we did make choices to invest more in a couple of the MMIS contracts and as Kathy referenced, we had a couple of IT outsourcing restructurings that we felt we could stay within the envelope of what the firm had committed in terms of overall earnings and position ourselves for better profit downstream and IT outsourcing.

On the positive side, we are really having really strong success in our commercial healthcare business both in terms of revenue growth and margin. And as Kathy mentioned, I think in the prepared, some of our other Europe in particular strong revenue growth and margin improvement and our HR and learning and litigation business also performed exceptionally well. So it was a mix of upsides and downsides.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

If I can, George, one other thing that Bob has done is we have kind of loosened the reins on his ability to hire at all levels of the Company a little bit independent of matching cost decreases to the labor increases. So he is hiring at the high levels, at the intermediate levels and as he said earlier, in sales. We need to get the talent in across the board and we are not being cheap on that or we are not skimping on that.

George Tong - *Piper Jaffray - Analyst*

That is very helpful. We have seen several quarters now of margin improvement in your commercial BPO business. Can you go into a little bit more detail on what drove that improvement and what levers you have for further expansion?

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

I think the main levers for future expansion are what we are doing relative to these global capability organizations that we have formed to really drive best practices sharing across our delivery model. So that has been a multi-quarter initiative on our part. We are largely complete and we see that as a way to capitalize on productivity initiatives right at the delivery model which is the vast majority of our resources. Sales is a relatively small proportion of our headcount and the vast majority of our team is in delivery so I would say going forward that is where we would get the yield.

The previous improvement really more related to the labor initiatives around Optimus that you have visibility to from our investor meeting in previous calls.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *BMO Capital Markets - Analyst*

Good morning, team. Bob, two for you if I could. The first one is can you win in BPO with subscale ITO? A lot of the vendors, Accenture and GenPac and others are really talking about bundling their IT capabilities with BPO to lead for successful engagements and market share wins. Xerox has a bit of a different strategy where your ITO is subscale. If more of the business does get aggregated, does Xerox have the platform to be successful?

I understand your BPO is a little bit different than some of the vendors but I just wanted to hear your thoughts on strategy as you look at the parts that Xerox brings to the table relative to the competition. And I have a follow-up. Thank you.

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

Yes, I do believe we can win because in our BPO business when ITO is a component of it, the competitors that we face are not generally stronger in that ITO element and I would say, Keith, that the decision is made on the platform and the strength of the BPO offering. So ITO in an integrated BPO play is really not the determinative or decisional characteristic. And again when we are competing in our BPO business, our win rate is very, very strong and ITO is an underlying element of that.

And as either Ursula or Kathy mentioned previously, we had a nice big new logo ITO win in the quarter as well that was not directly tied to a BPO value prop but was a pure IT outsourcing play in the marketplace.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. My follow-up and thanks for that answer. My follow-up is your trailing 12-month signings are down about 17%. Can you grow services next year?

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

Yes, but we are concerned about trailing 12-month signings being down at that level as well. So part of what has happened though is that when you are not signing the really big deals, your term on the signings shortens because it is the $0.5 billion deals that tend to have a long term and we have been winning much more with the shorter-term deals. So the correlation of revenue and signings is not quite the way that maybe we would have seen or modeled in the past. We are focused on driving signings improvement but even with the trailing 12-month dynamics that you referenced, we believe we can grow revenue and improve our revenue performance.

And as we have said, BPO we are now on our third consecutive quarter of improvement in our revenue dynamics even with the signings -- signings results that you referenced.

Kathy Mikells - *Xerox Corporation - CFO*

The only other thing I would mention is on new business, our trailing 12-month is down about 6%.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital - Analyst*

Thanks for taking questions. Congrats, guys, on the pretty solid quarter. Two if I could. I guess the first is a follow-up on Services for Bob and for Ursula. I guess in the context of how you expected the environment to feel, I guess specifically BPO, as we entered the year, does the environment still feel the same?

And there was a comment earlier that you are not changing your long-term view of your Services business model but has there been anything that shifted in the context in the environment of what your mid single-digit, the 5% to 7% single digits revenue growth model is predicated upon? Love to get your thoughts there and then I have a follow-up.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

I will just start with the environment question. I think that overall at the high level, we are not seeing major shifts in the business environment from a services perspective. I mean clearly at the big deal, I think that Bob talked about some of the dynamics that you have with the very large deals where there is more of a propensity at least we have seen it for people who move to actually protest and to actually hang in there a little bit longer. That is not what we have seen in the past but I think that may be what we would be living with in the future. We are still confident on our ability to pull those deals out.

We have been awarded them but that is one thing but the rest of the business I think is operating pretty much like we would have expected it to. We are refining our approach particularly in ITO. We spent a couple of questions on this already. ITO can grow but the margin contribution of ITO is something that is lower than the range that we want to actually play in and we are actually smaller there. So we are being very selective about how we approach ITO and our change in that market space will actually change some of the revenue dynamics. And for the positive we think some of the margin dynamics on a go forward basis and then I will have Bob take the rest.

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

The only thing I would add is I think when I'm out of the marketplace with the teams and with the clients, there is still a very good in my view, high level of interest in leveraging partners in what I would call shared services. So ITO I think the dynamics are a little bit different in terms of trailing growth rates based on market dynamics.

BPO, when you look at the areas that we have leadership positions in, I would view them as still -- I am pleased that I wouldn't have a view that the overall client interest is less than I expected when I joined the firm.

Ananda Baruah - *Brean Capital - Analyst*

Got it. Thanks for that. And then just quickly for Kathy, the raise on the buyback, you have had capacity over the last couple of years to do something in the neighborhood of $1 billion and you sort of entered the year with a similar guidance of about $700 million. What is it about raising the guidance to $1 billion right now on this quarter that gives you -- you have the cash flow to do it so I know that gives you confidence. But I guess I'm asking has there been a philosophical shift within your approach to capital allocation that can continue forward as we go on here? Thanks.

Kathy Mikells - *Xerox Corporation - CFO*

So, no overall philosophy change whatsoever. If you look at where we are at on the acquisitions, we have done a little over $300 million for the year. I expect that will get at least one or two things over the finish line before the end of the year, but they are small. So right now, I think we will end up under spending against our up to $500 million. We are not going to end up spending $500 million as I look out now, and clearly I think we have a very good history of to the extent we under spend.

We shift that under spending towards share repurchases, and that is clearly part of what we have done. As I mentioned, we entered the year with a quite strong cash balance. That put us in a very good position to have a much more, I would say, consistent approach to share repurchases this year relative to last year. You will recall we were very backend loaded. But overall, I think our philosophy is very consistent and we will continue to have a very balanced approach with regard to capital allocation.

Operator

Brian Essex, Morgan Stanley.

Brian Essex - *Morgan Stanley - Analyst*

Good morning, and thank you for taking the question. I was wondering if I could point a little bit towards the printing side of the business. And it looks like we have had a few quarters of accelerated decline in that business, and I am just kind of taking a look at how it is lumpy from quarter to quarter.

And given the new product releases and how you are positioning and restructuring in that business, do you think you could hit an environment where you have low-single-digit declines as opposed to mid-single-digit declines? And if so, what would it take for that to happen?

Kathy Mikells - *Xerox Corporation - CFO*

So right now, we are consistently saying we expect mid-single digits. If you look at what is going on year over year, specifically third and fourth quarter, we have a little bit of headwind because last year we did these finance receivables sales and that generated a $20 million gain in each of the third and fourth quarter last year. So that was worth about a point of revenue growth or revenue headwind on growth this year.

We do have, I would say, quarter to quarter timing differences largely associated with things like product launches, with people kind of waiting for a new product launch. So we certainly get quarter-to-quarter differences, but at this point we see pretty stable declines in the mid-single-digit range. On an actual currency basis, I mentioned that will be a little higher in the fourth quarter as a result of the dollar strengthening against the euro, but we are seeing pretty consistent trends in the business.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

I think if you look at our share from a share perspective, you will see us marching along pretty consistently from a share perspective as well. So I don't think that there's anything that you can read into or that we read into, market dynamic changes and our positioning in the market. We are a strong leader and I don't think that we are losing any position in the marketplace.

Brian Essex - *Morgan Stanley - Analyst*

Maybe one for Bob. It sounded like you had a pretty strong pipeline growth. I know the commentary was around, there was some large deal in elongation of signing cycles. Is that pretty much concentrated whether it is in terms of government healthcare business or is it a larger secular trend or is there a situation where you get past a lot of these large deals and maybe those signings accelerate and lead to better bookings through the end of the year? Maybe if you can provide a little bit of context, the mix of what is occurring in those signings.

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

Yes, I would say on the larger deals, it is not concentrated in government healthcare but it is public sector. It is both our government healthcare business and our broader public sector business where we have had relatively large opportunities that again we are pleased with being selected but getting to contract is taking longer.

Operator

Jamie Friedman, Susquehanna.

Jamie Friedman - *Susquehanna Financial Group - Analyst*

I wanted to ask first, Bob, with regard to --there is a distinction between push outs and protests -- and protests seem to be the way of the world these days. So my question is if you were to add back the two large protests plus the renewal, can you give us an estimate of where signings would have been in the quarter?

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

Each of the three large opportunities that we are referencing is over $500 million in total contract value and they would aggregate to close to $2 billion. But I would be careful to not now kind of add that to the third quarter. We were not expecting all of that yield in the quarter but that is the size of the three large transactions that we have been talking about.

Jamie Friedman - *Susquehanna Financial Group - Analyst*

Okay, thank you. And then, Kathy, with regard to the discount rate, for people with a longer-term investment horizon, rates move around each year -- I realize that they are down in the discount rate that you are calculating for the third quarter. Could you share with us some sensitivity analysis say that we are up 100 basis points next year, where would that leave the pension obligation? Thank you.

Kathy Mikells - *Xerox Corporation - CFO*

Sure. So where we see the most volatility in our pension expense is in the pension settlements expense line item and that is where people can really change their behavior, either delay or accelerate the timing of taking their lump sum. If discount rates were more stable, I would expect to see something closer to about $100 million of pension settlement expense annually.

Jamie Friedman - *Susquehanna Financial Group - Analyst*

Got it. Thank you.

Operator

Jim Suva, Citi.

Jim Suva - *Citigroup - Analyst*

Thanks very much and I have one question and I guess it is hard for me to direct if it should go to Ursula, Kathy or Bob but feel free all of you to chime in. On one hand, I am very pleased to hear that Bob has the ability to hire more talent in investment services because I think that is what is really needed. But then on the other hand, when I see kind of the trailing 12-month signings down thinking about the ramping of the New York Medicaid contract and I'm sure you don't want to have issues when that ramps or stands up.

It simply starts to think about does this mean that service margin should they continue to be under pressure or is it more -- and I will comment on Bob's view on this -- is it more an issue that Xerox has misaligned costs or too many low end contracts or contracts that are (technical difficulty) variables to protect Xerox profits and therefore you have some changes and Xerox has to eat the costs because they weren't appropriately contracted out with more details?

If you can just kind of help us around this big strategy question around strategy for Xerox and Bob you are new and Ursula and Kathy have been striving to get Xerox Services up. Just kind of this whole big topic of strategy and what is going on and what is going forward with Services?

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

Jim, this is Bob. Let me go first and then obviously Ursula or Kathy can add color as well.

I would not say that we have severe contract misaligned cost challenges. Any services business is going to have a little bit of a bell curve of higher margin deals that are further in the maturities cycle and entry deals that take a little bit of time to ramp up. We had a handful of situations in IT outsourcing that we tried to address in the third quarter but I wouldn't have a point of view that we are out of balance on that score.

And if I go back to just your initial observations of about adding talent, I would add one piece of color which is we are really pleased. I mean I am really pleased that while we have a very strong team in place today broadly, as we are trying to grow we are trying to add some incremental leadership to the firm and the interest level and accept rate when we have been out trying to add a person to help us in this new area or that new area has been phenomenal. So I feel good about both the existing talent that I had the pleasure of joining and in the selective places we are looking to add to our leadership, a very, very strong interest level and accept level of the people that we have offered roles to.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

My only add is revenue engine going. Cost base perfected by our move to this global capability. There is no other magic here and there is no structural contract issues or anything like that. It is a fairly normal business. It is hard to kind of get it totally contained. We are focusing on the [amount] -- how much can we bring through these capacities that we have and making sure that we signed more business and that is where Bob's energy and efforts are focused.

Jim Suva - *Citigroup - Analyst*

Great. Thanks so much for the clarity.

Operator

Kulbinder Garcha, Credit Suisse.

Kulbinder Garcha - *Credit Suisse - Analyst*

Thanks. Most of my questions have been answered. It was just on Services margins. This year what are approximately the Medicaid costs being assumed or you are facing and how long do those last -- is that headwinds into next year as well? Thanks.

Ursula Burns - *Xerox Corporation - Chairman and CEO*

The Medicaid costs, let me have Kathy get a little bit more specific. But they have been a big headwind for us. A major portion of the shortage that we see in margins is driven by the Medicaid investments but we are seeing sequential improvement in those investments even though they are high.

Kathy Mikells - *Xerox Corporation - CFO*

The investments have been incredibly large. I will just point to the impairment that we took last quarter which was $20 million. If we look at this year over year, it has been a big headwind for us every single quarter. I mean in total, we are probably approaching a $100 million number year-over-year. It has been a huge investment for us and it has been a big expense year-over-year.

Now as we look forward right to 2015, the fact that we have invested so much in 2014 should help us in 2015 which doesn't at all suggest that we are not going to need to continue some level of higher investment as we have a few more implementations that are still underway. But from a year-over-year basis, this should start to become a tailwind for us.

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

I would just add so we are driving for significant year-over-year improvement in that component of our portfolio but it will not be at our target long-term margins next year. So we will be coming off of an unfortunately poor compare that we are delivering this year. We expect to drive visible improvement in 2015 but not already be to our long-term kind of target margins against that portfolio of our business.

Kulbinder Garcha - *Credit Suisse - Analyst*

Thank you.

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

That is all the time we have for questions today. We thank you for your interest and, Ursula, anything more to wrap up?

Ursula Burns - *Xerox Corporation - Chairman and CEO*

Our goal is to have the solid foundation in place so that we can support our changing business and the changing needs of our clients while still delivering value for our shareholders. I believe that we are on track to do just that.

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

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

Operator

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