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DXC.N - Q3 2018 DXC Technology Co Earnings Call

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OVERVIEW:

DXC reported 3Q18 GAAP revenues of \$6.186b and non-GAAP diluted EPS from continuing operations of \$2.15. Expects FY18 constant currency revenue to be \$24.0-24.5b and non-GAAP EPS from continuing operations to be \$7.50-8.00.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

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Jonathan Ford

Paul N. Saleh *DXC Technology Company - Executive VP & CFO*

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Rod Bourgeois

PRESENTATION

Operator

Good day, and welcome to the DXC Technology Third Quarter FY '18 Earnings Call. Today's call is being recorded.

At this time, I would like to turn the conference over to Mr. Jonathan Ford, Head of Investor Relations. Please go ahead, sir.

Jonathan Ford

Thank you, and good afternoon, everyone. I'm pleased you're joining us for the DXC Technology third quarter fiscal 2018 earnings call. Our speakers on today's call will be Mike Lawrie, our Chairman, President and Chief Executive Officer; and Paul Saleh, our Chief Financial Officer. The call is being webcast at dxc.com/investorrelations, and we've posted slides to our website, which will accompany the discussion today.

Slide 2 explains that the discussion will include comparisons of our results for the third quarter of fiscal 2018 to our pro forma combined company results for the third quarter of fiscal 2017. The pro forma results are based on the historical quarterly statements of operations of each of CSC and the legacy Enterprise Services business of HPE, or HPES, giving effect to the merger as if it had been consummated on April 2, 2016. As a consequence of CSC and HPES having different fiscal year-end dates, the pro forma combined company results include the results of operations of CSC for the 3 and 9 months ending December 30, 2016, and of HPES for the 3 and 9 months ending October 31, 2016.

Slide 3 informs our participants that DXC Technology's presentation includes certain non-GAAP financial measures and certain further adjustments to these measures, which we believe provide useful information to our investors. In accordance with SEC rules, we have provided a reconciliation of these measures to their respective and most directly comparable GAAP measures. These reconciliations can be found in the tables included in today's earnings release as well as in our supplemental slides. Both documents are available on the Investor Relations section of our website.

On Slide 4, you'll see that certain comments we make on the call will be forward-looking. These statements are subject to known and unknown risks and uncertainties, which could cause actual results to differ materially from those expressed on the call. A discussion of risks and uncertainties is included in our quarterly reports on Form 10-Q and other SEC filings. I would like to remind our listeners that DXC Technology assumes no obligation to update the information presented on the call, except as required by law.

And now I'd like to introduce DXC Technology's Chairman, President and CEO, Mike Lawrie.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Okay. Thank you, everyone, and thanks for your interest in DXC. I know there's a lot going on today. As is my custom, I will share 4, 5 key points; and then Paul will go into a little more detail. And then we'll open it up to any of your questions.

Third quarter non-GAAP EPS was \$2.15. Adjusted EBIT was \$927 million, and adjusted EBIT margin was 15%. And we generated \$686 million of adjusted free cash flow in the third quarter. Our revenue in the third quarter was \$6.186 billion on a GAAP basis. All revenue comparisons exclude the impact of purchase price accounting and a onetime contract reset USPS last year. And on that basis, revenue was down 4% year-over-year and was up 0.6% sequentially. And in constant currency, revenue was down 5.9% year-over-year and was up 0.8% sequentially. Sequential revenue growth reflects strong add-on in project sales in the quarter, and our book-to-bill for the quarter was 1x.

Our digital revenue grew 13% year-over-year and was down 3.3% sequentially, reflecting contract milestone achievements in the second quarter. Year-to-date, digital revenue was up 16%. Industry IP and BPS revenue was down 0.4% year-over-year and grew 1.1% sequentially. In the third quarter, our digital book-to-bill was 1.1x, and our industry IP and BPS book-to-bill was 1.6x, including a large BPS life insurance deal that was completed in the quarter.

Now during the third quarter, we continued to achieve merger integration milestones. We're on track to deliver \$1.1 billion or more of year 1 cost savings, which implies roughly \$1.6 billion of run rate cost savings exiting fiscal 2018. The separation of our U.S. Public Sector business and combination with Vencore and KeyPoint continues to progress. But today, we filed the Form 10 and now expect the deal to close in May to allow the necessary SEC reviews.

Finally, for fiscal 2018, we continue to target revenue of \$24 billion to \$24.5 billion in constant currency. And we are increasing our fiscal 2008 (sic) [2018] target on non-GAAP EPS to a range of \$7.50 to \$8.00, reflecting additional synergy realization this year. And our adjusted free cash flow target remains 90% of adjusted net income.

Now let me go into a little more detail on each of those points. As I said, third quarter non-GAAP EPS was \$2.15. The effective tax rate was 28.7%. Third quarter adjusted EBIT was \$927 million. Now adjusted EBIT margin was 15%. This was up 550 basis points year-over-year. And EBIT margin was up 180 basis points sequentially. All sequential margin comparisons adjust for the onetime catch-up impact of lease reclassifications during the second quarter.

Now the EBIT improvement reflects ongoing cost actions we're taking, consistent with the synergy plans outlined at our Investor Day. Our delivery teams continue to scale and accelerate our bionics program to drive productivity through increased automation. These efforts address both internal labor as well as third-party contractors. We also enhanced our workforce management process to more cost-effectively deliver existing business while staffing the required labor for new business.

In supply chain, we continue to tighten controls on contractor spend, resulting in the elimination or conversion of thousands of contractor roles. We're also executing several initiatives to optimize nonlabor spend, including ongoing rate negotiations, vendor consolidation, demand management and reductions in maintenance expense.

Collectively, third quarter cost actions generated approximately \$130 million of in-quarter savings, which means we're on track to deliver the \$1.1 billion or more of in-year synergy realization versus our target of \$1 billion. And adjusted free cash flow for the quarter was \$686 million or 110% of adjusted net income. Now for the year-to-date, adjusted free cash flow was \$1.87 billion or 114% of adjusted net income.

Now turning to revenue in the third quarter. Revenue was \$6.186 billion on a GAAP basis. Revenue was down 4% year-over-year, adjusting for the USPS contract reset in fiscal 2017. Sequentially, revenue was up 0.6%. In constant currency, revenue was down 5.9% year-over-year and up 0.8% sequentially. Total bookings in the third quarter were \$6 billion for a book-to-bill of 1x.

Now as I mentioned, historically, ES experienced significant revenue headwinds each November. Through our focused add-on sales and project work, we were able to offset those headwinds and grow revenue sequentially overall.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

In the third quarter, GBS revenue was \$2.315 billion. GBS revenue was down 4.6% year-over-year and was up 0.2% sequentially. In constant currency, revenue was down 6.6% year-over-year and was up 0.4% sequentially. And the book-to-bill was 1.4x in the quarter.

And in the quarter, GBS segment margin was 18.6%. This was up 470 basis points year-over-year and 220 basis points sequentially. This margin improvement reflects the impact of cost takeout actions, including the reduction of management layers, improved utilization of project-based resources and third-party labor optimization.

In the third quarter, GIS revenue was \$3.145 billion. GIS revenue was down 4.7% year-over-year and was up 0.4% sequentially. In constant currency, revenue was down 6.8% year-over-year and up 0.7% sequentially. GIS revenue reflects the continued management of headwinds in the legacy infrastructure business and client transformations leveraging digital offerings in cloud and security. GIS bookings of \$2.245 billion represented a book-to-bill of 0.7x in the quarter.

Now in the quarter, GIS segment margin was 14.7%. This was up 520 basis points year-over-year and 120 basis points sequentially. This improvement reflects cost actions and, as I said earlier, process automation.

In the third quarter, USPS revenues were \$726 million. And during the third quarter last year, we had a large onetime contract reset that provided roughly \$100 million of revenue in the quarter. Now excluding this benefit, UPS (sic) [USPS] revenue was up 0.9% year-over-year and up 2.3% sequentially. USPS bookings were \$527 million for a book-to-bill of 0.7x, reflecting the typical lumpiness of contract awards timing in the industry.

The USPS segment margin in the quarter was 15.2%, which was up 350 basis points year-over-year and 210 basis points sequentially. Now I'll provide an update on the separation of the USPS business and the combination with Vencore and KeyPoint in a few moments. DXC also in the quarter continued to expand its client base by adding 24 new logo deals greater than \$1 million in total contract value.

Now let me move to our digital, industry IP and BPS results. As we discussed, digital cuts across all 3 DXC's reporting segments of GBS, GIS and USPS, and includes enterprise cloud apps and consulting, cloud infrastructure, analytics and security. Digital revenue was up 13% year-over-year and down 3.3% sequentially, reflecting contract milestone achievements in the second quarter. Year-to-date, digital revenue was up 16%, and the book-to-bill was 1.1x in the third quarter.

Enterprise cloud apps and consulting revenue was up 25% year-over-year; and book-to-bill in the quarter was 1.2x. The enterprise cloud apps team continues to drive growth through an expanded portfolio of quick-start offerings. These offerings allow us to rapidly understand the client environment and develop more impactful, large-scale transformations.

Cloud revenue was up 13% year-over-year, and book-to-bill in the quarter was 1x. Analytics revenue was up 2.4% year-over-year, and the book-to-bill in the quarter was 1x.

Recent wins include a deal with a large German bank as well as deals with 2 major automotive companies. The auto companies are leveraging our analytics capabilities to significantly shorten R&D cycles and to more effectively manage data and generate insights from autonomous driving programs.

Security revenue was down 3.5% year-over-year but was up 12% sequentially. As we've said before, and we are continuing to invest to grow this business through the expansion of our security consulting capabilities. We also launched new offerings, including identity access management as a service and a ransomware consulting diagnostic to address the increase in cybersecurity threats. And the book-to-bill in security in the quarter was 1.1x.

Industry IP and BPS includes our IP offerings in health care, insurance, travel and transportation and banking as well as our industry Business Process Services business. Industry IP and BPS revenue was down 0.4 year-over-year and was up 1.1% sequentially. Book-to-bill was 1.6 in the quarter, including a large, full-service BPS life insurance deal.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Industry IP revenue was down 1.8% year-over-year and was up 1.8% sequentially, and the book-to-bill was 0.6. BPS revenue was up 1.4% year-over-year, roughly flat sequentially. The book-to-bill in the quarter was 2.8x, again reflecting the large insurance deal as well as new logo contract with a state Medicaid agency, which is, I might add, our 23rd state Medicaid account.

Now as I previously discussed on earlier calls, we formed a new digital business team to jointly develop digital transformations with our clients, leveraging assets from across the company and our partnerships. And we're scaling this model to more than 50 accounts over the next few months. In our pilot accounts, we increased digital pipeline by 30% and created several new opportunities valued at more than \$200 million each. We also leveraged these initial engagements to develop a DXC digital framework, which aligns DXC assets, capabilities and partner offerings to create a reusable digital transformation blueprint. This allows us to quickly shape modular transformation road maps to define clear business outcomes for our clients while unlocking greater share of wallet and overall revenue growth for DXC.

A recent Harvard Business Review survey found that more than 1/3 of the companies do not believe their internal IT organizations are capable of executing their digital agendas. And as a result, digital transformations typically result in expanded revenue opportunities for IT services providers like DXC. We also launched 5 Digital Transformation Centers globally, including the recently announced New Orleans Digital Transformation Center. And in the quarter, we continued to expand our partner offerings, including digital insurance as a service on AWS, bundling DXC's industry-leading insurance applications with business process and infrastructure services to create an integrated solution with a simplified consumption-based pricing structure. This allows insurers to launch consumer-oriented products quickly while delivering a streamlined customer experience across new business, servicing and claims.

We also sold our largest Microsoft Azure deal to date, an expanded renewal with a major consumer products company that included transformation from legacy infrastructure environments to hybrid cloud. And we continue to focus on upskill and training our work force on digital capabilities. More than 105,000 DXC employees have completed training programs through DXC University, with a heavy focus on cloud infrastructure, cloud native applications, DevOps and agile. And overall, our employees have completed 385,000 courses and programs so far this year.

Now turning to our fourth point here. We continue to achieve merger integration milestones and to execute on the build, sell, deliver operating model we previously discussed. We're on track to deliver \$1.1 billion or more of year 1 cost savings and roughly \$1.6 billion of run rate cost savings exiting fiscal 2018. The additional savings were primarily driven by workforce optimization actions, including the acceleration of management reductions and the global deployment of our automation program, bionics.

We're underway on the operational separation of the U.S. Public Sector business to operate as a stand-alone company and the integration of that company with Vencore and KeyPoint. We've conducted a series of integration summits, bringing together leaders from each part of the new company. The operating model for the new company is finalized, and we also recently announced the senior leadership team, and the Form 10 registration statement was filed today. And at this time, we expect the deal to close in May based on the anticipated SEC review process. And as I said before, prior to the deal close, we will have an Investor Day for the new company.

Now just to conclude before I turn it over to Paul. For fiscal 2018, we continue to expect revenue to be \$24 billion to \$24.5 billion in constant currency. And we are increasing our target for non-GAAP EPS to a range of \$7.50 to \$8.00, reflecting the additional synergy realization this year. And our adjusted free cash flow target remains 90% of adjusted net income.

So with that then, I'll turn it over to Paul, and then we'll be back for any questions that you might have.

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

Thank you, Mike, and greetings, everyone. Before I review our third quarter results, I'd like to take a moment to clarify the basis for our financial presentation.

First, the pro forma results for Q3 of last year conform to the same methodology we used in the first 2 quarters. And as such, all references to the unaudited pro forma statement of operations for the prior year include the results of operations of CSC for the 3 and 9 months ending December



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

30, 2016, and of HPES for the 3 and 9 months ended October 31, 2016. Also, prior year pro forma non-GAAP results assume a flat quarterly tax rate of 27.5%.

In addition, fiscal '18 third quarter results reflect the impact of a deferred revenue write-down for purchase price accounting, whereas the prior year pro forma does not. Lastly, non-GAAP results exclude restructuring, integration, amortization of intangibles and onetime tax items consistent with CSC's non-GAAP method from prior years. And with that, I will now cover some items that are included in our GAAP results this quarter.

In the current quarter, we have restructuring costs of \$213 million pretax or \$0.56 per diluted share. These costs represent severance related to workforce optimization programs and expense associated with facilities and data center rationalization. Also in the quarter, we had \$94 million pretax or \$0.23 per diluted share of integration and transaction-related costs. Year-to-date restructuring, integration and transaction costs amounted to \$879 million pretax or \$2.23 per diluted share, which is in line with the \$1.3 billion spend envelope we laid out for fiscal '18.

In the third quarter, amortization of acquired intangibles was \$149 million pretax or \$0.36 per diluted share. Pension and other post-employment benefit actuarial and settlement gains were \$17 million in the quarter.

Third quarter results include the benefit from the provisional impact of U.S. federal tax reform, including the repricing of our deferred tax liabilities, offset by tax accrual required under the new tax rules. We're still awaiting further guidance from regulatory agencies on the interpretation of the U.S. tax reform provisions, including those related to global intangible low tax income and the base erosion anti-avoidance tax. Still early to tell, but overall, we expect tax reform to provide a moderate tailwind.

Now let's turn to our third quarter result in more detail. Revenue in the quarter was \$6.186 billion on a GAAP basis. Purchase price accounting reduced revenue in the quarter by \$34 million, representing a write-down of deferred revenue. For the fiscal year, the deferred revenue write-down for PPA is now expected to be \$214 million versus our prior estimate of \$230 million.

All revenue comparisons exclude the impact of purchase price accounting and a onetime contract reset in USPS of \$105 million last year. On that basis, revenue was down 4% year-over-year and up 0.6% sequentially. In constant currency, revenue was down 5.9% and up 0.8% sequentially.

EBIT in the quarter was \$927 million after adjusting for restructuring, integration and amortization of intangibles. Adjusted EBIT margin on that basis was 15% compared with 13% last quarter, but that is after normalizing for the onetime catch-up benefit of lease reclassification we recorded in the second quarter. This improvement reflects cost actions we're taking to optimize our workforce, extract greater supply chain efficiencies and rationalize our real estate footprint.

In this quarter, we continued to rebalance our workforce. We reduced our labor base by an additional 3% in the quarter through a combination of automation, best shoring and pyramid correction. We also continue to rebalance our skill mix, including the addition of 5,300 new employees and the ongoing retraining of the existing workforce.

In supply chain, we're extracting greater procurement efficiencies. We leveraged our digital analytics capabilities to mine over \$2 billion of statement-of-work spend data, identifying specific opportunities to reduce demand, improve rate compliance and consolidate suppliers. In real estate, we eliminated 1.3 million square feet of space during the quarter, and for the year-to-date, we've reduced our total square footage by roughly 17%. In total, we delivered \$130 million of incremental cost takeout in the quarter and are on track to achieve \$1.1 billion or more in in-year savings, which translates to around \$1.6 billion of run rate savings exiting fiscal '18.

Non-GAAP diluted EPS from continuing operations in the third quarter was \$2.15, adjusted for onetime tax items, restructuring, integration and amortization of intangibles. Year-to-date, our non-GAAP diluted EPS was \$5.66.

In the quarter, our non-GAAP tax rate was 28.7%, reflecting our global mix of income and certain tax attributes in key foreign jurisdictions. Year-to-date, our non-GAAP tax rate was 27.9%, which is in line with the non-GAAP target for tax that we have for the full year of 25% to 30%. Bookings in the quarter were \$6.02 billion for an overall book-to-bill of 1x. Year-to-date, revenue was \$18.26 billion, adjusted EBIT was \$2.48 billion and bookings were \$18.24 billion for a book-to-bill ratio of 1x.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Now let's turn to our segment results. Global Business Services revenue was \$2.3 billion in the third quarter. Excluding the impact of purchase price accounting of \$6 million, GBS revenue was down 4.6% year-over-year and was up 0.2% sequentially. In constant currency, revenue was down 6.6% year-over-year and up 0.4% sequentially.

In the third quarter, GBS profit was \$431 million, and profit margin was 18.6% compared with 16.4% in the second quarter. This margin improvement reflects cost takeout actions, including reductions in both internal and third-party labor expenses.

Our GBS bookings were \$3.3 billion in the quarter for a book-to-bill of 1.4x. Year-to-date, GBS revenue was \$6.9 billion. Segment profit was \$1.1 billion for margins of 15.9%, and our booking were \$8.1 billion for a book-to-bill of 1.2x.

Turning now to Global Infrastructure Services. Revenue was \$3.1 billion in the quarter. Excluding the impact of purchase price accounting of \$26 million in the quarter, GIS revenue was down 4.7% year-over-year but was up 0.4% sequentially. In constant currency, revenue was down 6.8% year-over-year and up 0.7% sequentially.

In the third quarter, GIS segment profit was \$463 million, and profit margin was 14.7% compared with 13.6% in the second quarter, normalizing for the onetime catch-up impact of lease reclassification last quarter. The profit improvement reflects the impact of cost actions we're taking to drive greater operating efficiencies, including best shoring, labor pyramid rebalancing, benefits from our bionics automation program and supply chain savings.

Bookings for GIS were \$2.2 billion in the quarter for a book-to-bill of 0.7x. Year-to-date, GIS revenue was \$9.3 billion. Segment profit was \$1.222 billion -- billion, and margins was 13.2% for -- and our book-to-bill -- booking were \$8.8 billion for a book-to-bill of 0.9x.

Now turn to the -- turning now to the U.S. Public Sector. Revenue there was \$726 million in the quarter. USPS revenue was up 0.9% year-over-year and up 2.3% sequentially. USPS segment profit was \$110 million in the quarter, and profit margin was 15.2% compared with 13.1% in the second quarter, normalizing for the onetime catch-up impact of lease reclassification this past quarter. The margin improvement was driven by a reduction in indirect costs and award fees associated with successful program executions and milestone achievements.

Bookings for USPS were \$527 million in the quarter for a book-to-bill of 0.7x. Year-to-date, USPS revenue was \$2.1 billion, segment profit was \$296 million, margin was 14% and our bookings were \$1.4 billion for a book-to-bill of 0.6x.

Turning to other financial highlights for the quarter. Adjusted free cash flow in the quarter was \$686 million or 110% of adjusted net income. This reflects ongoing improvement in working capital management. Adjusted free cash flow excludes proceeds from receivable securitization programs. Year-to-date, adjusted free cash flow was \$1.87 billion or 114% of adjusted net income.

Our CapEx was \$481 million in the quarter or 7.8% of revenue, reflecting the reclassification of operating leases to capitalized leases. Year-to-date, CapEx was \$1.29 billion or 7.1% of revenue of which 1.7% was associated with the reclassification of operating leases to capitalized leases.

During the quarter, we returned \$51 million of capital to our shareholders in dividends. Year-to-date, we have returned \$189 million of capital to our shareholders in the form of \$123 million in dividends and \$66 million in share repurchase.

Cash at the end of the quarter was \$2.9 billion. Our total debt was \$8.5 billion, including capitalized leases. Net debt-to-total capitalization ratio was \$25.8 billion -- 25.8%, excuse me.

So in closing, we continue to target revenue for the fiscal year to be \$24 billion to \$24.5 billion in constant currency. We're increasing our full year target for non-GAAP EPS from continuing operation to a range of \$7.50 to \$8.00, reflecting the additional synergy realization this year. Our EPS target continues to assume a tax rate of 25% to 30% for the full year. U.S. federal tax reform will likely provide a moderate benefit in the fourth quarter. And we still expect the full year tax rate to be between 25% to 30%. Our adjusted free cash flow target for fiscal '18 remains at 90% of adjusted net income.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

And with that, I'll now hand the call back to the operator for the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Ramsey El-Assal with Jefferies.

Unidentified Analyst

This is [Damien] on for Ramsey. I just wanted to ask you. I know you had said you're going wait to -- some guidance on tax reform before giving official guidance for the rate, but you mentioned that it was going to be a tailwind. So just on free cash flow then, can you talk about how we should think about your use of those proceeds from tax reform in the context of your broader capital allocation strategy you've already laid out?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Yes, I would -- this is Mike. And then Paul, you can chime in here. The terms of the capital allocation model, that's not going to change. So we're going to continue to stick with that as we go forward here and conclude this year and get into our next fiscal year. Paul, you may want to add something to that.

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

Yes. Well, I think the tailwind that we expect is a couple of points, I think. So it doesn't change the way we...

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Doesn't change the capital allocation model.

Unidentified Analyst

Got it. And just as a follow-up then. I wanted to ask, just on the run-off rate of the legacy infrastructure business, what are your expectations in terms of the long-term rate of decline there? Should we expect the decline to moderate at some point as the sort of less sticky business falls off, and it leaves a more hardened book of business?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Yes, I think we have -- to be candid, we've seen a little less revenue dis-synergies, and we have been a little more successful than we had planned in terms of offsetting the decline in the legacy infrastructure business. We've been more successful offsetting that with cloud and some of our other digital offerings. So that has gone, in all candor, a little better than what we had modeled and what we had communicated. Now as we look out into next year, we're going to run a lot of the same plays that we ran this year. So we're ramping up our investment in digital skills, both the retraining of our people as well as the recruiting of our people. We're significantly investing in the number of accounts we're trying to take through our digital transformation road map and blueprint. So we're going to continue with the same play that has given us some of the success around offsetting that decline in the traditional ITO business.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Operator

We'll go next to Arvind Ramnani with KeyBanc.

Arvind Anil Ramnani - KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst

Just had a couple of questions. Revenues came in slightly above, and bookings came in at \$5.5 billion, which is an uptick from prior quarter. Is this reflective of a healthier demand environment? Or is it more to do with seasonality? And also, can you provide kind of a broader context to how the market is responding to the combined entity, including the partnerships you've been putting together? And how you feel reshaping your capabilities relative to what clients are looking for?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Yes. Listen, I'm going to start with the back part of that first. Our partners have responded very well to this. I mean, we are a large, independent, end-to-end services company. We're the ideal partner for many of our technology partners to get there their technology and their solutions to market. So that is moving along at a very good pace. And frankly, those partnerships are deepening every week, every quarter as we go forward. And it gives our clients unprecedented choice and the ability to avoid a lock-in, which is increasingly important to them as they continue to progress through this next phase of the industry around digital capabilities. I would say, in terms of the -- so that's the business partner side of this, Arvind. In terms of what we're seeing, I'm -- to be honest with you, I just spent 2 weeks on the road. I was in Japan, and I was in China and India and Singapore. I got to tell you, I have never in my life been -- I could be downtown Tokyo talking with clients or Beijing the next day. They are all talking about the same thing. I have never witnessed this in my life. They all understand the impact of these digital technologies and how that is transforming their industries that they operate in front of their very eyes. They all have plans to do this. They all are very cautious and skeptical as to whether they have the skills internally to do this. And the Harvard Business Review study did nothing more than confirm that. We're seeing good growth in all parts of the world. I mean, when's the last time you saw Europe and Japan and China and India and the U.S. all growing? So I'm pretty optimistic about the longer-term demand profile. Now there's a lot of work to do to capture that demand, and I don't want to, in any way, shape or form, minimize the amount of work ahead. But there clearly is a good opportunity, and we are continuing to transition our business to much more digital, much more of our industry IP and BPS businesses that we have been investing for some time.

Arvind Anil Ramnani - KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst

That's great to hear. And just a quick follow-up. Clearly, you're ahead of kind of pace on your cost targets, and you had time to settle in and really get this integration underway. Just trying to get a feel about the acquisition now versus a year ago. And specifically beyond the numbers, can you qualitatively talk about the integration process? And any lessons learned on having owned the HP services business for close to a year?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Well, I think there's the -- there's a lot of lessons to be learned. One, we did a lot of upfront planning on the integration. And frankly, that went well. Like every other integration, when you get into all the details, there's a lot of things under the covers that you have to address as you begin to integrate the company. So I mean, for example, in March, we'll go to a consolidated Workday platform on all our human resources. That is a very important next step in unifying all of our human resource systems, processes and just allow us to better serve and manage our employee base. And that will continue for the next several years as we integrate all these systems. But I think the biggest lesson learned is that detailed planning and then sticking to a very disciplined integration process is absolutely imperative. And we're prepared to be able to course correct as we find new things, and we're always finding new things. But at the end of the day, from my vantage point, this was a merger that has not only generated significant synergies, as we are witnessing in terms of the results that are being published in here, but really is allowing us to respond and scale, and scale, not only for our partners, but able to scale for our clients. And we think that's going to have long-term benefit.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Operator

We'll go next to James Friedman of Susquehanna.

James Eric Friedman - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

It's Jamie at Susquehanna. I'll just ask Mike 2 upfront in the interest of time. So now that we have 3 of the 4 quarters, it suggests that the final quarter's going to grow year-over-year, if my math is right. Could you just contextualize that, remind us what happened in the fourth quarter of last year if there's any callouts there? That's my first one. And then with regard to the Form 10, thank you for that. My recollection is the intended timing -- I don't mean to complain, but my recollection was the original timing was the end of March. I know stuff happens, Mike, as you say. But why are we thinking May now instead of March? Those are my 2, the year-over-year and then the timing.

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

Yes, I will take the second one first. Yes. We had -- I had communicated we thought we'd close this transaction at the end of March, early April, and that was the schedule. And candidly, we had some issues getting the accounting firm approved to be able to do and audit all the numbers in USPS. And we lost about 30 days in getting that accounting firm approved. And we've completed that work now, and that is about 30 days behind. And we filed the Form 10 today, and I am allowing the necessary time for the SEC review and approval process, so that's why I'm now saying the month of May.

Paul N. Saleh - *DXC Technology Company - Executive VP & CFO*

Yes, and I think on the other question about last year, I think you're absolutely right. I think if you look at it, we will -- at this level, we would be posting some revenue growth on a year-over-year basis. And as you look back at the, historically, HPES, on their fourth quarter, which usually is the November to January quarter for them, they typically saw a significant decline sequentially because at their quarter end of October, you saw a lot of onetime or accelerated revenue recognition. And so you saw a price down or other kind of a decline sequentially. I think last year was close to a few hundred million dollars sequentially. And this year, I think, as you could see, we've been able to mitigate those kind of declines, both project work and mitigating (inaudible).

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

And acceleration in the digital offering growth, because we are seeing the digital offering grow.

Paul N. Saleh - *DXC Technology Company - Executive VP & CFO*

You're absolutely right. At these levels, we would show growth year-over-year.

Operator

Our next question will come from Brian Essex with Morgan Stanley.

Brian Lee Essex - *Morgan Stanley, Research Division - Equity Analyst*

I just wanted to address maybe tax reform. And maybe if you could parse those comments on USPS versus DXC pro forma post spin. Any consideration for post spin? Would DXC be a meaningful beneficiary of tax reform? And then as a part B to that question, does it impact at all the amount of synergies that you anticipated long term, understanding that maybe some decisions around transfer pricing and taking advantage of low-cost tax jurisdictions may have played a part in some of those numbers?



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

No, those are very good questions, so I'd like to break it into its pieces. For USPS, obviously, they would be a U.S. tax filer, and they will benefit from the new tax reform there. The rates will be about 21% federal and then maybe about 4-or-so percent for the state and local. So in total, they would be at a 25% versus -- otherwise, they would have been closer to the 39% rate. So for them, that's a good deal for the newco. For DXC, we certainly are going to be benefiting from a lower tax rate, as we said. There are other things in the tax reform that play into it. There are some taxes on foreign earnings, minimum tax on foreign earnings. There are also some minimum tax on payment to non-U. S. subsidiaries, that kind of are countervailing type of forces there. So it's a balancing act. We're revisiting many of our tax position to make sure how do we optimize in the current environment. In fact, what's really interesting is now our foreign taxes are higher than in the U.S., except for the U.K. So we have to rethink a little bit more the entire transfer pricing, as you well correctly pointed out. And -- but net-net, at this particular point in time, it's still a tailwind overall for DXC remainco, if you think about it, the company on the commercial side.

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

And Paul, I'd just add one other thing and -- is that I think, longer term, not only is there a tailwind associated with it, but I do think it will allow us to simplify our structures. So over the years, we create a lot of legal entities and other structures to try to optimize tax on a global basis. And I do think this tax reform, one of the benefits will be the ability to simplify that structure. And that has a lot of downstream benefits when you're running a large, global corporation that has -- that is dependent on the number of people and employees that we have in so many other countries. So when you add that all up, I think it's definitely going to benefit DXC post the spin. And as Paul said, there's no question that it's going to have a healthy USPS business and Vencore and KeyPoint.

Brian Lee Essex - Morgan Stanley, Research Division - Equity Analyst

Right. And are you seeing any of that on the discretionary side of customer budgets at this point? Just to kind of follow up on that.

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

No.

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

It's just too early.

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

No, I'm not seeing that. But what I'd tell you, I was interested. I mean, even in visiting with clients on a worldwide basis, many have indicated to me that they see it as positive, that it'll actually help their businesses as well. So overall, I've got nothing but positive feedback from clients on a worldwide basis.

Operator

We'll take our next question...



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

One second. I was going to build on that because I think there is a part of the tax reform. There is the immediate opportunity for some of our customers to expense qualify PP&E expenditures. So for some of them, it may be just really an encouragement in a sense. Because they could get 100% depreciation on some qualified equipment.

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

That's yet to play out.

Paul N. Saleh - DXC Technology Company - Executive VP & CFO

Yes.

Operator

We'll take our next question from Rod Bourgeois with DeepDive Equity Research.

Rod Bourgeois

I want to talk about digital mix aspirations. It's encouraging, in addition to all of the synergies on the cost side, that you guys have multiple efforts internally to drive more digital sales. So my question is, do you view acquisitions as a major avenue to drive your digital mix higher going forward? Or are you feeling like your organic sales efforts are looking sufficient to keep moving the needle on the digital front?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Yes, that's a good question, Rod. I think we will probably continue to acquire, to build out that capability. We did that this year with Tribridge and some other ServiceNow acquisitions that we've done. So within our capital allocation model, we've always said that we'd like to buy 1% or so of revenue growth around acquisitions. And those acquisitions have been targeted in the digital area. So that will continue as we go forward. So I mean, we're pleased with the organic. We're seeing really good growth in some areas. I mean, we're seeing 24%, 25% growth in our enterprise cloud apps business. So that stuff like ServiceNow and Microsoft and SAP and Oracle, we're really pleased with that. We're seeing good growth in our cloud infrastructure business. That gets masked a little bit with the headwinds associated with the traditional ITO business. We're investing big time in the cybersecurity business. Prior to the merger, there had been a disinvestment in that, and we're reinvesting in that. And we're also really investing -- this is more on organic basis, Rod. We're investing in our existing client. So we are appointing what we're calling digital account teams. So we're actually beginning to move in a direction of having one team responsible for the legacy or the run environments that we have, and then a separate team that is focused, in many cases, on disintermediating and driving digital platform growth. And we'd concluded that this digital business requires a different mindset. It's a different culture. It's a different thought process. And most of our teams are fully employed and busy in just maintaining and running the systems that we have responsibility for. So we're making a big, organic investment around trying to ignite those digital sales, and we're beginning to see some results. I think I said in my commentary, we're going to scale that to 50 accounts. We're seeing good pipeline growth. Now pipeline growth has to get converted into revenue. Don't misunderstand me. But all of those are encouraging signs as we look out.

Rod Bourgeois

Great. So on a related note, do you have a good metric to track progress in cross-selling to your existing clients, particularly in the digital arena? I guess, what I'm getting at is you have still some compression on traditional work that's going on across the industry, but you're also pursuing scope



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

expansion as some of that legacy work runs off. Is there a metric to track that? And if there is, is it tracking right now in the right direction amidst all of the cost savings that are going on?

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

Yes, yes, that's also very good question. We track something called ABR, which is annual billed revenue. And we started that this year. It really is around our new offerings. So think of this primarily as our digital offerings, and also around incremental project work that we're trying to drive within our existing base. Now that ABR metric is still immature, so I am not ready to report publicly on it because I'm just not ready to do that because I want to see a little more history and data points. What I will tell you is that, that ABR has been increasing now 3 quarters in a row. So we saw really sort of a baseline in the first quarter, and we're seeing good growth in the second quarter, and we saw good growth again in the third quarter. But I'm not ready to report that as a metric yet until I'm comfortable that, that ABR could be linked to what we see running through the P&L. So we've done some initial work on this. And we think that in the first quarter, what the sold in ABR, 90% of that has actually shown up in the P&L in the second, third and fourth quarter. The ABR that we sold in the second quarter, we're seeing a yield of 70-some percent, and so on and so forth. But it's not ready for prime time yet. But those are encouraging for us internally, and organically, encouraging signpost for us.

Rod Bourgeois

All right. Well, that ABR has a nice ring to it. And the 3 quarters in a row trend, that sounds great. Look forward to hearing more about that later.

Operator

Our next question will come from Jim Schneider with Goldman Sachs.

James Edward Schneider - *Goldman Sachs Group Inc., Research Division - VP*

Maybe just kind of stepping back on the cost synergy side for a second. Can you maybe talk about, out of the broad buckets that you've identified, obviously, it's very good to see the overall aggregate number go up and guide the synergy number for the full year. But if you look at the individual buckets, clearly, some upside in the headcount and workforce rebalancing piece of it. But can you maybe talk about some of the other buckets? And where you're running ahead of plan, where you think you could end up with a little bit more synergies on a longer-term basis? And where these might be actually a little bit behind plan?

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

Yes. I think, let's start with we're behind. Where we're behind a little bit is in the supply chain, that procurement savings. And not that we aren't going to get them, but they were a little more delayed than we thought. So the aggregate number, we're still very comfortable with, but the realization of that is coming a little later. So we'll continue to see some of that flow through next year. We still have quite a bit of work to do with our subcontractor base and how we manage that contingent labor force. So I'd say there, we are behind. An area where we're ahead and are very pleased about is bionics, and that's our automation, our lean methodologies and our sort of advanced analytics. That is having a bigger impact on the business than what we had anticipated, positive. And we, frankly, see that continuing. And I see this continuing not through the fourth quarter or just through fiscal '19. I see this as a long-term trend, and we're really getting comfortable with that. So that was probably the biggest overachievement. It was an investment we made at the behest of our delivery organization early in the year. We sort of put a lot of money behind it. And it has paid off handsomely, and we're going sort of full speed ahead. The other thing we've done is our whole agile process methodology that we are using internally to reengineer some of our processes, and then we'll take that methodology externally and package that up as an offering for our clients. We see that as very promising. So I think the big area we're behind was around procurement, not that the absolute number isn't there, but the timing was more skewed to the right than what we had anticipated. And then on the automation or bionics side, we're clearly ahead. I'd say, from a real estate standpoint and fiscal asset standpoint, we're probably slightly ahead of where we thought, but not materially. And



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

then the harmonization of policies and all that stuff is pretty much what we thought it would be. But we are seeing a little better yield on the synergies, and that's why we increased our in-year synergies, and we increased our exit synergy rate exiting fiscal '18.

James Edward Schneider - *Goldman Sachs Group Inc., Research Division - VP*

Great. And then maybe kind of building on some of the question that were asked earlier on digital. I mean, if you look and combine all those targeted focus areas for you, industry, IP, BPS, enterprise cloud, analytics, security, et cetera, as you look into next year, can you maybe give us some kind of signpost as to how much of the mix of that might represent based on all the trends you're seeing underlying in bookings today?

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

Well, we'd like to see the digital business begin to approach a 17%, 20% sort of range of our total business. The IP business, I don't have a number right off the top of my head. But somewhere...

Paul N. Saleh - *DXC Technology Company - Executive VP & CFO*

15% -- 16%, 15% to...

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

15%, 16%. The BPS business, particularly insurance, is growing. We just signed another major deal in the third quarter, and we've got most of the accounts that needed some remediation. That is almost completely behind us now. If you remember, last year, we talked about the investment we needed to make in the insurance BPS business to remediate and get some more solid methodologies. We made that investment, and that, too, is beginning to pay off for us.

Operator

We'll go now to Jason Kupferberg with Bank of America.

Jason Alan Kupferberg - *BofA Merrill Lynch, Research Division - MD in US Equity Research & Senior Analyst*

I want to ask a question about margins. Real strong in the quarter, 15% adjusted EBIT. I'm guessing you probably had your, call it, 1% help from the lease reclasses. So maybe I'll call it 14%. And I think the fiscal '20 guide from last year's analyst day was to get to 14% to 15% in that out-year. And so you're kind of there, if my math is right. So I just wanted to see if there's any other considerations we should be thinking about as far as where that multiyear target could go.

John Michael Lawrie - *DXC Technology Company - Chairman, President & CEO*

Well, yes, I think, one, you're accurate. We are seeing a little bit better margin expansion this year than what we had anticipated, and that's largely due to the increased synergies that we got and also the fact that we had a little less revenue runoff than we had expected this year. So those are the 2 factors that conspire to expand the margins a little faster this year. I'm not ready to update the model. What I am going to be taking a look at pretty carefully is what we think the impact of automation is going to be longer term. And that's a wildcard because, frankly, it's something I'm excited about because for the first time in a long time, I'm seeing operating leverage in this business. I have not seen -- I've been in this business 30 years, services business, and I've never really seen true operating leverage. And we're beginning to see some of that operating leverage be introduced into a labor-based business through automation. So I think that -- I think the investment we're making in reskilling our people are all critical factors in helping to expand the revenue payment as well as drive incremental synergies, which then results in a better margin performance.

FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

Jason Alan Kupferberg - BofA Merrill Lynch, Research Division - MD in US Equity Research & Senior Analyst

Okay. I'll also ask a quick follow-up on digital, too. I mean, since you broke it down in a helpful fashion. I mean, analytics and security, I guess, are maybe the Achilles heel right now relative to some of the other areas of digital. What's the outlook there? Is that where you'd maybe focus some of the M&A energy?

John Michael Lawrie - DXC Technology Company - Chairman, President & CEO

Yes. I mean, the cyber business, I got -- I'd tell you, when I look back at it, that business was disinvested in prior to the merger. And that was one of the things we discovered post merger. And we have been working pretty hard to reinvest in that. And we are beginning to see sequential growth, so I'm pretty confident that, that will come back. We are definitely attracting now some really good talent in the cyber business. The analytics business, I think, we see some very strong capabilities. We were -- I was in India last week looking at some of the innovation coming out of our analytics labs there. In my opening comments, I talked about some of the things we're doing with auto companies. And a lot of this analytics capability really scales across many accounts and many industries. So we're in the process of what I'll call harvesting some of the unique one-off things we've done and now packaging up those one-off things so that they can be scaled across multiple industries and multiple accounts. And in many instances, many instances, the analytics business is sort of an entry point into other digital offerings that can be sold. And it's instructive because we're using some of that analytics capability ourselves. As we take a look at metrics around our delivery business, particularly infrastructure business, we're using some of this analytics capabilities to better understand our business, which is then driving greater insights into where we can add automation and where we can do other things, lean out the business, et cetera. And we're applying that analytics also to our own business processes. While we're doing all this, we're reengineering some of our most fundamental business processes, how we hire, how we recruit, how we onboard, how we train, how we retain. That whole end-to-end process around people is absolutely critical to a business that is people-based. The way we procure. I mean, we're doing thousands of transactions now that are smaller volume. That required a complete rethink of our procurement process and how we manage a higher number of low-value transactions. And we've used our own analytics capability to try to understand that so we make more prudent decisions. So I'm confident those businesses are going to perform better as we move forward.

Operator

And that concludes today's question-and-answer session. Mr. Ford, at this time, I'll turn the conference back to you for any additional or closing remarks.

Jonathan Ford

Yes. Thank you for joining our call, and we'll close the call now.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.



FEBRUARY 08, 2018 / 10:00PM, DXC.N - Q3 2018 DXC Technology Co Earnings Call

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