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DXC.N - Q1 2019 DXC Technology Co Earnings Call

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OVERVIEW:

DXC reported 1Q19 GAAP revenues of \$5.282b. Expects FY19 revenues to be \$21.5-22.0b and non-GAAP EPS to be \$7.75-8.15.



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PRESENTATION

Operator

Good day, and welcome to the DXC 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 DXC Technology's First Quarter Fiscal 2019 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 posted slides to our website, which will accompany the discussion today.

Slide 2 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 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 3, 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. Mike?



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

Okay. Thank you, everyone. Thanks for your interest in DXC.

As my usual practice, I have 5 points I'd like to make, and I will then briefly go into those a little more and then turn the call over to Paul, who will provide a little more color and depth, and then we'll open it up to any questions that you might have.

But first of all, all the results and targets and comparisons exclude the U.S. Public Sector business.

In the first quarter, non-GAAP EPS was \$1.93, adjusted EBIT was \$803 million, and adjusted EBIT margin was 15.2%. And we generated \$321 million of adjusted free cash flow in the first quarter. Our revenue in the first quarter was \$5.28 billion on a GAAP basis, revenue growth of 1% year-over-year. In constant currency, revenue was down 1.8% year-over-year, and the book-to-bill was 0.9x for the quarter.

In the first quarter, digital revenue grew 21% year-over-year, primarily driven by growth in our cloud business. And building on that momentum, today, we announced an agreement with Amazon Web Services to build a new strategic DXC AWS integrated practice to deliver IT migration, application transformation and business innovation to global enterprise clients.

Industry IP and BPS revenue grew 1.8% year-over-year, and in the first quarter, digital book-to-bill was 1.6x, and industry IP and BPS book-to-bill was 0.8x.

During the first quarter, we completed the separation of our U.S. Public Sector business and creation of Perspecta. We also announced the acquisition of Molina Medicaid Solutions, a Medicaid management information systems business. We continue to execute on our synergy plan, we're on track to deliver on our full year savings target, and I'll talk a little bit more about our longer-term synergy plans in a few moments.

And then finally, for fiscal '19, we continue to target revenue of \$21.5 billion to \$22 billion and on a non-GAAP EPS of \$7.75 to \$8.15. Although we are trending to the upper end of that EPS range. And we continue to target adjusted free cash flow of 90% or more of adjusted net income.

Now let me just go into each of those points, just a little more detail. As I said, first quarter GAAP EPS was \$1.93. The effective tax rate was 24.8%. First quarter adjusted EBIT was \$803 million, and the adjusted EBIT margin was 15.2%, which was up 430 basis points year-over-year.

GBS segment profit margin was 18.2%, and this was up 610 basis points year-over-year. And in GIS, our segment profit margin was 15.4%, which was up 630 basis points year-over-year. The margin improvement reflects continued execution of our major synergy levers, including workforce optimization, supply chain efficiencies and facilities rationalization.

Adjusted free cash flow for the quarter was \$321 million or 58% of adjusted net income, reflecting the timing of our sales commission payments and prepaid software enterprise license agreements. And as I said, we continue to expect adjusted free cash flow to be 90% or more of adjusted net income for the year.

Revenue in the first quarter was \$5.28 billion on a GAAP basis, up 1% year-over-year, and in constant currency, revenue was down 1.8% year-over-year. And as I said, the book-to-bill in the first quarter was 0.9x.

In the first quarter, GBS revenue was \$2.2 billion, down 2.4% year-over-year. The year-over-year decline was primarily driven by the completion of HPE and HPI integration projects associated with their respective separations as well as the completion of several application contracts in the U.K. This was partially offset by 14% growth in enterprise and cloud applications and 18% growth in analytics. And the GBS book-to-bill in the quarter was 0.9x, reflecting the continued shift to digital solutions.

In the first quarter, GIS revenue was \$3.07 billion. GIS revenue grew 3.4% year-over-year, reflecting a continued moderation of the decline in the ITO business as well as strong growth in cloud infrastructure, security, and workplace and mobility. We are leveraging joint pursuits with key strategic partners such as Dell, AT&T, Microsoft, HPE and VMware to sell add-on services in our existing accounts to help mitigate headwinds in the ITO business.

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And our cloud business grew 42% year-over-year, reflecting continued client demand for multi-cloud solutions. And in particular, we're seeing strength in the financial services sector where we're implementing several large-scale infrastructure transformations leveraging our IP offerings. The GIS book-to-bill in the quarter was 0.8x.

Now let me move on to our digital business and our industry IP and BPS results. Digital revenue was up 21% year-over-year, and the book-to-bill in the quarter was 1.6x. We are seeing a good enterprise spend environment in digital. We had double-digit year-over-year growth in each of our digital offering families with the largest growth coming from cloud.

We are continuing to build on this momentum in cloud with today's announcement with Amazon Web Services. We're expanding our existing partnership by establishing a new strategic DXC - AWS Integrated Practice. We're seeing increased client demand for industry-based solutions leveraging cloud technologies. The DXC - AWS practice will deliver enhanced levels of performance and productivity for our industry IP services running on AWS, allowing clients to realize improved service quality as well as cost savings that can be reinvested in digital solutions. The integrated practice also encompasses joint development, marketing, sales and delivery of AWS and DXC solutions. This practice complements our ongoing cloud work with other partners such as Microsoft Azure and VMware.

Enterprise cloud apps and consulting continues to show strong traction. During the quarter, we closed Microsoft Dynamics deals with the State of Michigan and a large Australian health client. We won these deals by providing flexible systems that enable rapid progress and process reconfiguration to meet constantly evolving regulatory requirements.

We're also leveraging our quick-start offerings to generate expanded opportunities, including large Salesforce, ServiceNow and Workday implementations. And as an example, we're integrating a major aerospace and defense client's ServiceNow HR module with Workday to modernize service platforms and significantly improve employee experience for 230,000 employees.

Industry IP and BPS revenue grew 1.8% year-over-year, driven by 5% growth in our industry IP offerings, where we're seeing strong demand in financial services and health care. BPS revenue was roughly flat year-over-year, and the industry IP and BPS book-to-bill in the quarter was 0.8x.

We continue to invest in the business and in attracting and developing our digital workforce. For example, we are conducting digital boot camps where employees as well as our client executives are provided training on topics such as artificial intelligence, analytics and machine learning.

We're also expanding our digital transformation customer experience centers. We host clients in these centers to jointly develop digital transformation road maps with DXC's digital specialists, leveraging our visualization capabilities, transformation blueprints and pre-configured solutions. Our clients get actionable transformation plans, and DXC builds a deeper understanding of the client's challenges and targeted outcomes.

We're investing to scale our digital General Manager capabilities, and we've aligned these digital advisers against 70 of our largest accounts. And they're engaging with cross-functional leadership in these companies to proactively drive transformation agendas leveraging DXC's partnered capabilities and solutions.

We continue to invest in our digital portfolio, including our Bionix offering. This offering leverages analytics and artificial intelligence, lean process design and leading automation capabilities to optimize complex IT and other cross-functional processes. This reduces costs, eliminates human error, minimizes disruptions and accelerates business outcomes. Bionix drives significant impact for our installed client base, and we're also using it as an entry point into new clients.

And we're working with our strategic partners to broaden the training curriculum for employees and provide access to market-leading technology innovations. Our teams work together to create integrated training content primarily focused on digital capabilities and industry expertise. And we've implemented certification programs for both our go-to-market and for our delivery organizations.

Now turning to my fourth point. In June, we announced the acquisition of Molina Medicaid Solutions from Molina Healthcare. This expands our business supporting state agencies in the administration of Medicaid programs and adds to our health care IT portfolio. Combining the Molina



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business with DXC's existing platforms will provide opportunities for us to expand the margins in this business while also enhancing the services we can provide to state agencies and Medicaid recipients.

And as I mentioned, we are executing on our synergy plans for the year. I also believe there's opportunity for further margin expansion longer term. These include location, mix shift, labor pyramid optimization, automation and continued supply chain efficiencies.

On location mix, roughly 54% of our employees are in nearshore and low-cost locations. We're planning to increase that mix by 10% to 15% in our traditional business. We're also making progress off-shoring work provided by third-party contractors, while at the same time investing in our digital centers in the U.S., the U.K. and other countries. We're hiring into our global delivery centers and leveraging our graduate program to continuously refresh our talent base and improve our labor pyramid. Our objective is to have 40% of our workforce in the bottom 3 layers of our organization, and we currently only have 29% of our workforce in these layers.

And automation will be a meaningful deliverer and driver of additional savings. For the first time in my career, we're achieving operating leverage in this business. Historically, incremental revenue and IT services required matching level of additional labor investment. By automating core processes and tasks, we are able to scale client volumes and revenue without increasing variable costs. We're also leveraging artificial intelligence, machine learning and bots to predictively avoid and resolve incidents to eliminate labor from many processes. This allows us to expand margins while also improving client service levels.

We'll continue deploying these productivity actions to our supplier base to capture similar efficiencies in our third-party labor spend and to in-source and offshore critical skill sets. We believe that long term our Dynamic Talent Cloud will allow us to have access to a broader pool of skilled talent, which accelerates onboarding and deployment of client assignments while reducing the need for us to engage large outsourcing providers. We believe that these actions will continue to support margin expansion in the coming years. We'll provide updated targets at our upcoming Investor Day, which is now scheduled for November 8 in New York City. We'll provide more details on this event over the coming weeks.

Now before I turn this over to Paul, just to reiterate, for fiscal 2019, we continue to expect revenue to be \$21.5 billion to \$22 billion, and we also continue to target non-GAAP EPS of \$7.75 to \$8.15. And as I said before, we are trending to the upper end of that range. And we expect adjusted free cash flow to be 90% or more of adjusted net income.

And with that, I'll turn it over to Paul for a little more detailed commentary, and then we'll open it up for questions. Paul?

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

Thank you, Mike, and greetings, everyone.

Before I review our first quarter results, I'd like to clarify the basis of our financial presentation.

First, our fiscal 2018 results have been restated to reflect the spinout of the U.S. Public Sector business as if the transaction had been completed on April 1, 2017. And for comparison purposes, prior year results assume a flat quarterly tax rate of 28%. In addition, all first quarter results and fiscal 2019 targets exclude the U.S. Public Sector business.

Non-GAAP results exclude special items such as restructuring, integration, separation and amortization of intangibles, consistent with DXC's non-GAAP method from fiscal 2018 and CSC's non-GAAP method from prior years. And with that, I will now cover some items that are excluded from our non-GAAP results this quarter.

In the current quarter, we had restructuring costs of \$185 million pretax or \$0.50 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 \$70 million pretax or \$0.19 per diluted share of integration, separation and transaction-related costs.



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In the first quarter, amortization of acquired intangibles was \$135 million pretax or \$0.35 per diluted share. First quarter results also exclude \$33 million from the provisional impact of U.S. federal tax reform or \$0.11 per diluted share.

Excluding the impact of these special items, non-GAAP income before taxes from continuing operations was \$750 million, and our non-GAAP EPS was \$1.93.

Turning now to our first quarter results in more detail. Our GAAP revenue in Q1 was \$5.282 billion versus \$5.236 billion in the first quarter last year. Adjusted EBIT in the quarter was \$803 million. Our adjusted EBIT margin was 15.2% compared with 10.9% in the prior year. This year-over-year improvement reflects ongoing cost actions in line with the synergy plans we previously discussed.

During the first quarter, we continued to optimize our workforce. Now we've reduced our total headcount by an additional 3.7% in the quarter even though we hired more than 6,000 new employees to support our continued shift to digital and drive location mix and pyramid improvements. The headcount reduction was driven by automation, overhead rationalization and productivity improvements.

In supply chain, we continue to drive additional procurement efficiencies. This includes vendor rationalization, rate optimization, contract conversion and detailed reviews of thousands of purchase orders. Over the last year, we've consolidated roughly 30% of our vendor base.

Turning to real estate. We eliminated an additional 700,000 square feet of office space during the quarter, and we remain on track to rationalize 1.5 million square feet of office space this year and 9 data centers for fiscal '19.

In total, these actions contributed \$33 million of incremental synergies during the first quarter. When combined with the carryforward savings, net of investment in the business, these actions contributed to the year-over-year profit improvement of roughly \$230 million in the quarter.

During the first quarter, our reinvestment in the business was about \$30 million. That included the continued global deployment of our Bionix program, acceleration of our digital go-to-market capabilities and further development of our industry IP cloud platforms.

In the quarter, our non-GAAP tax rate was 24.8%, reflecting our global mix of income and certain tax attributes in key foreign jurisdictions. And for the full year, we still expect a tax rate of 24% to 28%.

Now turning to our segment results. GBS revenue was \$2.21 billion in the first quarter. This compares with \$2.27 billion in the prior year. Our first quarter GBS segment profit was \$403 million, and our profit margin was 18.2%. This compares with 12.1% in the prior year. GBS margin improvements reflect cost takeout actions, including the ongoing deployment of Bionix and also labor reductions.

GIS revenue was \$3.07 billion in the first quarter versus \$2.97 billion in the first quarter of last year. GIS segment profit in the first quarter was \$474 million. Profit margin was 15.4% compared with 9.1% in the prior year. Now the profitability improvement primarily reflects the impact of cost actions we've taken to drive greater operating efficiencies, including best shoring, labor pyramid rebalancing, benefits from our Bionix automation program and supply chain savings. Also contributing to the favorable margin comparison was roughly 1 point of benefit from the opt-to-cap lease reclassification which took effect during the second quarter of last year.

Turning to our other financial highlights for this quarter. Our adjusted free cash flow in the quarter was \$321 million or 58% of adjusted net income, and this reflects the timing of sales commission payments as well as prepaid software enterprise licenses. Adjusted free cash flow excludes any proceeds from receivable securitization programs.

Our CapEx was \$368 million in the quarter or 7% of revenue, reflecting advanced purchases of licenses as well as equipment for the full year.

During the quarter, we paid \$51 million in dividends, and we repurchased \$324 million of shares for a total of \$375 million in capital returned to shareholders. For the full year, we expect to allocate more of our operating cash flow to shareholders through share repurchase.



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Cash at the end of the quarter was \$2.6 billion. Our total debt was \$7.05 billion, including capitalized leases, for a net debt to capitalization ratio of 23.7%.

So in closing, we had a solid start to the year, and we're on pace to deliver against our financial targets for the fiscal year.

I'll now hand over the call to the operator for the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Darrin Peller with Wolfe Research.

Darrin David Peller - *Wolfe Research, LLC - MD & Senior Analyst*

Let me just start off. I mean, between Microsoft and Salesforce and just many others, Workday, et cetera, it's pretty clear that your -- this partnership model you're setting up is helping you set up well for the next few years. Maybe you could just talk about how this differentiates your model versus some of your competitors. And if you can actually comment a bit more on this new Amazon deal, what type of opportunity this can bring. I think that was pretty interesting to see.

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

Yes, that's a good question. We do think this is a major differentiator. This is a -- not only a business imperative but a labor of love. What separates this from others is, one, we can offer the best solutions that the industry has to offer. We are not beholden to anyone. Point two, all of our offerings, whether it be our analytics offerings or our workplace or our mobility, all of those solutions are built with our partner's technology and solutions. What we do is we integrate them into an end-to-end solution that we then jointly, and I underscore the word jointly, take to market. In many of our engagements, the client really can't differentiate between us and the partner. And we have found that when we are fully integrated as one team in front of the client, our win rates are significantly higher. The other thing that this partnership model brings is innovation. So we are constantly refreshing our capability, and we're leveraging their R&D spend. Our margins can't sustain huge R&D investments. Now we're investing in things like Bionix and some of the other things we've talked about, but the Microsofts and the AWSs and the HPEs spend billions on R&D. We can leverage all of that R&D, integrate that capability and jointly take that to our clients. So this is really a critical differentiator when you show up and talk about digital transformation where clients don't particularly want to get locked in to one solution. And then we have a very robust management system around this that manages joint pipelines and closure plans and solution, et cetera, et cetera. The AWS practice is an integrated practice, meaning we will be using AWS people as well as DXC people, and we will jointly and seamlessly go-to-market in accounts where we jointly decide to go. And we'll go as one integrated team to help those customers not only modernize their infrastructure but more importantly, move their applications to that modernized infrastructure. That's where the cost savings are. I mean, it's one thing to build a cloud, that's interesting. What's really important is moving the applications, the remediation, in many cases, the elimination as well as the building of cloud-ready applications. That's where the savings are. That's where the process changes are. That's what we mean by the digitization of the modern enterprise.

Darrin David Peller - *Wolfe Research, LLC - MD & Senior Analyst*

All right. That's really helpful. I mean, to characterize what you're saying, it seems like you're cutting some costs but you're reinvesting in areas. And then you're, to some degree, scaling out by partnering with some of the -- and leveraging your partners despite some of the other areas, you come back on that will hopefully allow you to grow. Is that fair?



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

That is the theory, and it gives us the access and visibility to more opportunities that we could see with our own sales force, because now, we have other sales forces that are seeing those opportunities and are bringing us in. In some cases, we're jointly paying our integrated teams as if they were one. So this is not only for our existing clients but it's also for new clients. And this helps us attract new clients, which is critical to our growth plans over the next couple of years as we continue to moderate the ITO business and move into new areas.

Darrin David Peller - Wolfe Research, LLC - MD & Senior Analyst

Okay. That's really helpful. Just one quick follow-up, Paul. We saw the GIS segment turn positive here. I mean, what was that organically, I guess? And then I know you mentioned that the legacy outsourcing revenue decline impacts are moderating. So I guess, how much of that -- how much left -- where are we on that now?

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

Well, I think we still are seeing that some -- in the traditional business, declining, being offset by some of our digital -- the cloud business picking up within -- and our workplace also and security, that those businesses are lumped within the GIS business. And so -- but there was very -- we're seeing that, as Mike mentioned, a moderation basically of the decline in our traditional business.

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

Yes, I think there's really -- I'd add to that. And then there's another major initiative we have underway, and it's what we call the delivery-led growth initiative. So we're using our tens of thousands of delivery professionals out there to look for add-on work, and this is primarily in our ITO base. So one, that is helping to offset some of the traditional decline in the ITO business. The ITO business is still declining, and that's driven by the normal productivity improvements, price-downs that we encounter every year. But we're beginning to offset that with some of this add-on work from our delivery teams as well as the growth in some of these new digital offerings, particularly cloud. We saw a 40%-plus growth in the cloud business this quarter. Those are starting to become meaningful numbers that offset that decline in the ITO business. And we're cautiously optimistic as we look out the balance of this year. But it's still early, there's still a lot of work to do, but it was absolutely encouraging to see this in the first quarter.

Operator

Our next question comes from Bryan Keane with Deutsche Bank.

Bryan Connell Keane - Deutsche Bank AG, Research Division - Research Analyst

Just want to ask about the Amazon deal. I know, Mike, in the past, you've talked about AWS and Azure going in and taking share and maybe going after some of the -- that ITO business. So just thinking out loud, doesn't this cannibalize some of that ITO business that you have? And how's the revenue model going to work with the partnership with AWS?

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

Well, first of all, it does cannibalize the ITO business. But in my way of thinking, you've got 2 choices. You're going to let somebody else cannibalize you or you can do it yourself. We're doing it ourselves. What is unique about what we're doing with Microsoft and what we're doing with Amazon is we're also going in and beginning to move applications. And that application movement is essentially net new business for DXC. We're doing some of this with Deutsche Bank. So we will go in and we will work on not only providing a more modernized IT infrastructure around cloud but then moving the applications that can take advantage of that lower-cost, more productive, more nimble as-a-service infrastructure. So our long-term revenue model is to do this ourselves and, in the process, take on this additional workload around applications, and over time, give us growth as

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opposed to just a steady declining ITO business. So in short, what we're doing here, Bryan, is we are proactively engaging with our clients as opposed to waiting for them. And this is a critical part of what I'll call this multi-cloud strategy. I mean, not everyone is going to put all of their workload on a public cloud. And most large enterprises, they have a combination of private clouds and public clouds. And what we're doing with AWS is to bridge that. So we have private cloud offerings, but now, we've got very strong integrated cloud offerings with AWS and Microsoft Azure and VMware and others. So this is really a continuation of what we have been doing, but this is now more formalized where we've made some commitments back and forth to one another, and most importantly, put a management system in place, and we are integrating each other's resources in front of the client.

Bryan Connell Keane - *Deutsche Bank AG, Research Division - Research Analyst*

Okay, helpful. And just as a follow-up, I noticed bookings were down 25% year-over-year. Some of that's timing and some of that just might be where the pipeline falls. Can you just give us some color on that? And then Paul, on the EPS beat, you're doing better than expected for the first quarter. Why not just push the guidance up, because now, analysts will adjust their models down for 2 through 4 in order to stay within the range?

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

I'll let Paul talk about the EPS range, but in terms of the book-to-bill, you're -- there's 2 things going on here. One, we are beginning to deemphasize a little bit TCV. And I've said this on calls before, I've not been a huge fan of TCV because it encourages big assets to go into contracts, which, as we continue to move to more of a capital-light model, is not what we're trying to get done. Two, the drop ratio, meaning the revenue that comes out of TCV is notoriously volatile. You sign a big TCV contract in the first quarter, you make it \$0.10 or \$0.15 of that, that year. So we're beginning, and I underscore the word beginning, to move our sales force. And what I mean by move, pay to what we call annual billed revenue, where we are paying them based on deals that they sign that we are able to bill, meaning bill them for revenue and collect revenue, in the next 12 months. Now we're not ready -- we don't have numbers on that. We don't have a lot of history on that, so we aren't reporting that. But we are beginning to move the sales force in that direction because we think it is a more reliable measure of revenue going forward than TCV. So that's part of it. The other part of it is the lumpiness. There were some large deals that we thought we're going to close in the first quarter and were closed in the second quarter. That sort of normal thing. The big issue is on the digital growth. And there, we are seeing very strong book-to-bills of 1.6, and we're seeing literally an explosion in the number of deals that we're doing under \$5 million, which is exactly the strategy. It is more clients, more smaller deals that can scale over time.

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

As far as the EPS is concerned, Bryan, is that we are -- we made some great progress in the first quarter. It's particularly when I look at the cost, the synergies. But it's still too early in the year just to change the outlook. We said that we are trending towards the upper end of the EPS range right now, and we're going to have to see how things develop over the coming quarters.

Operator

We'll take our next question from Rayna Kumar with Evercore ISI.

Rayna Kumar - *Evercore ISI Institutional Equities, Research Division - MD*

It's good to see the improvement in the constant currency revenue in GIS. When do you expect to see overall constant currency revenue growth?



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

Well, that's a great question. It's really hard to predict exactly when that's going to occur, to be quite honest with you. We still have -- as I mentioned in GBS, we have some of the projects that were associated with the separation and the integration around HPE and HPI. Those are running off. Those will continue with us for the next couple of quarters because those were projects that lasted almost all of last year. And as I mentioned, we've got some completion of projects in the U.K. Now underneath that, we're seeing some good growth around application modernization, which I would expect to accelerate with the announcement today around AWS. And I think we've mentioned this before, we're putting a lot of our health care intellectual property on Microsoft Azure. So we're beginning to take some of that intellectual property that we have, particularly in our financial services, insurance and health care business, and begin to move those applications as well. So I think it's a really hard thing to predict exactly when that is, but that's really the story behind GBS. And as I said on GIS, we're encouraged by the add-on work that we're getting. We're seeing good increase year to year on that, which is offsetting some of the traditional clients in ITO as well as the growth in the cloud business. So I would say we're sort of on track for what we plan to do here, and I can't pinpoint exactly when that crossover point will be. However, when we do get together for the analyst meeting in November, we'll go through our best guess of how that's going to play out over not only the coming quarters but the next couple of years. So we'll be able to share what we think is going to happen from a revenue perspective as this digital business grows and when that will begin to offset the traditional decline in our ITO business as well as the progress we're making on synergies, but more importantly, the progress on automation. I can't -- I cannot underscore this enough. This is a game-changer in the IT services business. I mean, this business is going to change because it introduces operating leverage. I'm being cautious. We've automated some of the simple stuff like call centers, and we've seen great productivity improvements or cost reductions. Now we're beginning to get into some of the trickier things around the end-to-end IT processes around IT operations. And we're beginning there. We're encouraged by what we see. That's why we're making a big investment. But I think this is going to be a game-changer that will not play out in a quarter or 2, but it's going to play out over a longer period of time. And that's why we are investing significantly in that -- in those automation capabilities.

Rayna Kumar - Evercore ISI Institutional Equities, Research Division - MD

That's very helpful. What are you seeing out there for pricing trends in some of the new bookings you have both in the GBS and the GIS businesses?

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

Well, listen, in the mature businesses that have already commoditized, there's tremendous price pressure and tremendous competition. This is a strong IT spend environment. There's no question about it. We see strong economic growth. We foresaw that from a macro standpoint in the United States. But within that, that spend is bifurcated. In other words, the spend on traditional IT is not as robust, and the clients are looking for simplifying those IT structures, saving money so they can be reinvested in these digital solutions. That's why we're investing in our go-to-market. We're investing in our partnerships. We're investing in our solutions around that digital business. But that digital business, although pretty good growth, 21%, 22% this quarter, is still not sizable enough to offset the traditional decline we see in those legacy businesses. In the digital business, is price competitive? Yes, but it's much more sensitive to the skills and the capabilities that you can bring to the client and their confidence in your ability to help them transform their business processes and, in turn, their enterprises. So one is more of a value game -- so digital is more of a value game from a pricing standpoint, whereas the more traditional business is much more a scale business and much more commoditized at this point.

Operator

We'll take the next question with -- from James Friedman with Susquehanna.

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

It's Jamie from Susquehanna. I had a more housekeeping-related question, Paul, and then for Mike, something about the delivery side. So Paul, I'm sorry, I don't see it in the slides. I didn't hear you call it out, but with regard to the stranded costs, I thought you had said \$85 million was the target. I was just wondering, was that in this quarter or is there more to come? That's my first one, and I'll just ask the other ones upfront. Mike, with regard to the delivery, you gave that 54% metric. Thank you for that. You also shared about the pyramid that 20 -- I don't want to misquote you, but the



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bottom tier of the pyramid. I guess, my question is, how should we anticipate the delivery organization moving over time? If you're saying 54% today, what could that potentially look like?

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

Okay. I'll -- go ahead, Paul.

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

On the stranded costs, we said about -- it's about a \$20 million a quarter, and it will be -- as you'll remember that Perspecta took place sometime in late May. It took place in late May, and so we got onto this cost takeout for the G&A, the stranded costs and others, and it will be almost gone by the second quarter. Now on the...

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

On the mix, first of all, we'll continue to remix what I'll call the traditional business. So we'll continue to move that more commoditized business scale business. At the same time, the new digital business is much more onshore. It requires much more customer intimacy. That's why we're building out our big New Orleans digital delivery center, and we've made commitments to add thousands of jobs in the United States. We're doing the same thing in the U.K. We're doing the same thing in Australia and other parts of Europe. So again, these are 2 different businesses with different characteristics. The digital solutions are different. It's critical to have the best capability from a technology standpoint. That's where the partners comes in. Skills are absolutely critical. I mean, the biggest sort of bottleneck, in my opinion, in that business right now is skills, getting the skills. That's where things like the talent cloud come in and some other things that we are doing. But that business is more onshore than it is offshore. The labor pyramid -- roughly speaking, I'll give you a couple metric. Don't hold me exactly to this number because it probably isn't exactly accurate. Paul is already telling me be careful. But I mean, for every roughly 10 points of movement in this traditional business, it's somewhere around \$400 million. So it is pretty significant. That's point one. And in the lower part of the pyramid, as you make a big commitment to hiring graduates, which we are doing, this is new. I mean, we've been a business largely made up of employees that have come from other companies as we -- as they've outsourced. We're making a huge commitment to hiring graduates globally. We'll hire somewhere between 3,000 and 5,000 graduates this year. Those are the people that we are training along with our partners and deploying along many of these digital solution opportunities. And we've got, as I said, only about 29% of our workforce in the lower part of that pyramid. We'd like to increase that. And that can also amount to tens of millions of dollars as we re-pyramid. And we're building career paths with -- for these graduates that come in. So it's really a remix, if you will, of the business. So there's a lot of moving parts here, but fundamentally, the traditional business is commoditized, it's a scale business, continue to drive productivity through automation and move as much as you can to low-cost centers. The digital business, much more onshore, much more customer intimate, and we're making big investments in those centers. Not in the centers themselves but then in the hiring and re-skilling of people that we have to deploy against those opportunities. And that gives you some rough metrics of what that equates to in savings.

Operator

Our next question comes from Brian Essex with Morgan Stanley.

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

Paul, maybe if you can address -- and I know that you're not going to give us an update until the Analyst Day on the medium-term guide. But how should investors think about the \$2.25 billion or so longer-term rationalization that you outlined at the last Analyst Day? Any way we can kind of qualitatively address that in terms of how far through that process you are? Is there more to come in fiscal '20? And what might -- how might we think about the magnitude of those rationalization efforts?



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

I think, Mike -- Brian, Mike has already alluded to it in his comments. There are more upside that we see, particularly in the -- beyond this year. And we'll be outlining those in a little bit more detail. I think if I were to look back at the Investor Day versus what we do today, I think we made -- we were more surprised by the pace of improvement that we saw as a result of the Bionix program itself. There's still a lot of work to be done, as Mike again indicated, in the pyramiding and to the offshoring of certain talents, right, particularly coming from our (inaudible) business. And we still have work opportunities to take greater -- to extract greater efficiencies, particularly from our data centers. We didn't do much in that arena in the past year. And this year, I've pointed to about 9 data centers that are going to be rationalized, but there's more work to be done in that...

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

And I'd just add, Brian, to what Paul said. One, I think there's a lot of process improvements. I mean, we still have gotten a lot of tools, processes from combining these 2 companies. I mean, this was -- I mean, everybody thinks this was a pretty smooth integration, and at one level, it was. But underneath the covers, I mean, there's still a lot of duplication and inefficiency. Now we're moving at pace with things like redesigning our procurement systems, our whole -- our recruiting and our integrated workforce management and how we do that. So I think there's opportunities there. And then the big opportunity that we are going to comment more on in November after we sort of figure this out a little more than is figured out right now, is the supplier base. I mean, 30% of our work is done by suppliers, meaning third party. And nothing more -- not nothing, relatively little has been done on dealing with that. So when you have 30% of your labor costs tied up with contractors, we think there's a lot. We haven't even applied Bionix yet to that supplier base. We haven't -- as we begin to develop the talent cloud, there's an opportunity to begin to source some of those skills and capabilities through the talent cloud as opposed to third parties. Again, this isn't -- you're not going to see this in the second quarter. You're going to probably see it in the third quarter. But these are areas that, when we did our analyst meeting prior -- or right after the acquisition, we didn't see, and we now see. And we're beginning to work on this. And that's what we think we'll be able to quantify in a little more detail and update when we get together in November. But to answer the question, I think longer term, I think there is upside here in terms of efficiencies, productivities -- productivity and margin expansion.

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

Yes, that was my understanding. I got a lot of investor questions on it after last call so appreciate it. Appreciate the incremental color. And then maybe a follow-up on the MMIS deal, where do you think those margins can go? I know that we've seen -- given Conduent, and prior of that, Xerox' involvement in that space, the margins were kind of in the high single-digit, 10% range. Can you get it above company average margins now that you've kind of -- I'm assuming those contracts are stood up and you're just going to run them. How should we think about that business?

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

Yes. I -- to answer your question, we do think there's an opportunity to expand margins. And you said it exactly right. This stuff has all been treated as individual one-off things. I got to do make sure everyone knows. We have not closed on this transaction yet, so there's a limited amount we can do. But the thesis, the hypothesis behind this is we can begin to scale this business just as we have scaled the ITO business. So we think there's sharing that can be done. We think there's common processes that can be shared across these different contracts. So yes, we think there's leverage, and we do think there is margin expansion. And frankly, that was part of the business case that led to the proposed acquisition.

Operator

Our next question comes from Arvind Ramnani with KeyBanc Capital Partners (sic) [KeyBanc Capital Markets.]

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

When I think of operating margins, how high can you run your margins? Those are 20% when I sort of think out more than the immediate term?

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

Well, listen. I think you have to break this down. First of all, we will cover this in a little more detail when we get together in November. But I mean, obviously, you're going to see -- we saw huge improvement year-to-year. And that's not surprising because we've just started this time last year on the synergy programs, so you're seeing significant jumps. And I do think that moderates a little bit as we go through the year. However, what is new, and I've just articulated, is we are seeing new levers that can be applied longer term. So in other words, there is potentially another leg to what we're able to do from a margin standpoint as we attack these processes, we attack other parts of IT operations, as we apply this to our application business and as we apply it to our BPS business and we apply it to our supplier base. Those are big areas. We have not applied a lot of this Bionix capability to our BPS business yet. We have not applied much of it to our application business yet. And then as I said, we haven't applied much of it to our third-party labor supplier. So those are 3 very significant businesses and sources of cost and labor that we think we can apply what we've learned last year. But that's more of a medium-term story, and that's what we will cover in a little more detail when we get together in November.

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

Yes. I know you provided a lot of color on the AWS partnership and it certainly seems like a pretty big deal. Can you maybe help us kind of quantify how large this can be? And secondly, should we expect similar type of deals with the other cloud providers, other SaaS providers?

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

Yes, I mean, basically, we already have this in place with Microsoft Azure. We have this in place with VMware. We're beginning to work with Google and others. So yes, I think you can assume that over time, we would do similar things. And again, this is my point about being an independent services provider as you can work with all these. And frankly, our clients are going to have multiple clouds. They're not going to have one. Not only going to be public and private, they may have multiple public clouds. They may have multiple private clouds. So you're making the case for why an independent, at-scale services company is so important as we move into this next phase of the industry. In terms of the size, I don't know. We've got a business case that we've put together that's candidly fairly modest in the first year. We've got to scale up. We've got to hire. We've got to build a management system around this. We've already got a pretty good pipeline so we'll see how that progresses and closes over the coming quarters. Yes, I think this will start out modestly and grow over time. But I think this is a \$1 billion-plus opportunity over time. Not the second quarter, pardon me.

Operator

We'll take our last question from Jim Schneider with Goldman Sachs.

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

I was wondering if you can maybe -- if you think about the different cost synergy areas you laid out, as you stand here today in fiscal '19, which are the categories where you feel you have the most confidence in tracking towards the high end or even exceeding as you get to the end of the year?

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

I think it will be still in the labor area that we have been really looking out as we talked about the migration of certain positions to lower-cost market. It could be nearshore or offshore. It doesn't have to be that only -- so that's one. The second one is the pyramid. Every layer of the pyramid, just continuing to make more progress in reducing the average cost. The deployment of Bionix at scale in various other businesses and expanding that reach are the areas that we see clearly. There are obviously some procurement opportunities that we are also targeting, and they're being deployed. The data centers, as I mentioned to you, is already in flight. So those have incremental benefit. That being said, also the state -- what Mike was



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talking about in terms of contractor, it takes a little bit more careful thinking just because we need just to sometimes in-source some of those talents or we have to just really be able to apply some of our methodology onto that type of work force. And so -- and it's a very specific -- it's a little bit more longer term. I think it's been a little bit -- it's going to be a little bit more harder worker to do, but I think it's doable there. I think we're getting very encouraged by early signs there. That being said, I also want to tell you that we're reinvesting in the business. It's not just about cost reduction. We are -- as we mentioned, across the way, we're putting quite a bit of investment in our digital transformation ourselves and up-skilling our employee base and also training them and also attracting new talent, our go-to-market strategy, putting our offering with our partners. Those areas, and Mike mentioned the transformation centers, that we have digital centers where we'll bring our customers to those and ideate with them on their transformation journey. Those are investments that we believe will also bear fruit for us for the long run.

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

I think that's well said. Just to conclude, it is a balance here. Yes, you've got to continue to drive productivity in your traditional business, but the same time, make a big investment in where the market is going. And the key message we're trying to make here is yes, there is margin expansion opportunities. Yes, there's more we can do there. But at the same time, we see a great opportunity, not only for our clients but for our employees as well as our partners as we continue to scale out this digital business.

So again, guys, thank you very much for your interest in DXC. And we'll be talking soon and then we'll get more details out on the Analyst Day in November. Thank you very much.

Operator

Thank you, ladies and gentlemen. This concludes today's conference call. You may now disconnect.

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