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DXC.N - Q3 2019 DXC Technology Co Earnings Call

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OVERVIEW:

Co. reported 3Q19 GAAP revenues of $5.178b, non-GAAP income before taxes from continuing operations of $786m and non-GAAP EPS of $2.23. Expects FY19 revenues to be $20.7-21.2b and FY19 non-GAAP EPS to be $8.15-8.30.

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PRESENTATION

Operator

Good day, everyone, and welcome to the DXC Technology third quarter conference call. A reminder that today's call is being recorded.

And at this time, I'd like to turn the conference over to Jonathan Ford, Head of Investor Relations. Please go ahead, sir.

Jonathan Ford *- DXC Technology Company - Head of IR*

Thank you, and good afternoon, everyone. I'm pleased you're joining us for DXC Technology's Third 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've 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 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 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 annual report on Form 10-K 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.

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

Okay. Thank you, and good afternoon, everyone. As usual, I have my 4, 5 points to make, and then, I'll turn this over to Paul. And then, we'll have plenty of time for any of your questions.

First, non-GAAP EPS in the third quarter was $2.23. Adjusted EBIT was $840 million and adjusted EBIT margin was 16.2%, and we generated $503 million of adjusted free cash flow in the third quarter. In terms of revenue in the third quarter, revenue was $5.178 billion on a GAAP basis. In constant currency, revenue was down 2.6% year-over-year and was up 4.3% sequentially. Bookings were up 3% year-over-year and 22% up sequentially for a book-to-bill of 1.1x.

A third point around digital. In constant currency, our digital revenue grew 16.9% year-over-year and 9.5% sequentially, driven by strong bookings in the first half of the year, particularly in cloud. Digital bookings in the quarter were up 85% year-over-year for a book-to-bill of 2.1x. Bookings were very strong across all digital offering families, and cloud has 3.3x book-to-bill in the quarter. Industry IP and BPS revenue was up 2.6% year-over-year and 6% sequentially, and the industry IP, BPS book-to-bill was 0.8x.

Fourth, we continued to make strategic investments in digital assets and capabilities. As you know, we recently announced our plan to acquire Luxoft, a global at-scale digital innovator, with differentiated offerings and platforms, deep vertical expertise and a world-class digital talent workforce. Luxoft has over $900 million in revenue, and has been growing at strong double-digit rates. We also announced our plan to acquire the services division of EG, one of the leading integrators of Microsoft Dynamics 365 in Northern Europe.

And then, finally, for fiscal 2019, we continue to target revenue in the range of $20.7 billion to $21.2 billion, and we're raising our non-GAAP EPS target to a range of $8.15 to $8.30.

So let me just go into a little more detail on each of those points before I turn it over to Paul. As I said, the third quarter non-GAAP EPS was $2.23. The effective tax rate was 20.4%. Third quarter adjusted EBIT was $840 million, and the adjusted EBIT margin was 16.2%, up 160 basis points year-over-year and 30 basis points sequentially. This margin improvement reflects continued execution of the levers that we have previously discussed.

GBS segment profit margin was 18.2%, which was down 10 basis points year-over-year and 70 basis points sequentially. This reflects the investments we're making to accelerate digital hiring and expand our digital transformation capabilities.

In GIS, segment profit margin was 17.5%, up 320 basis points year-over-year and 120 basis points sequentially. The GIS margin expansion was driven by our ongoing global deployment of Bionix, delivery center rationalization and the benefit of some final milestone achievements on a few of our contracts. And adjusted free cash flow for the quarter was $503 million or 81% of adjusted net income.

Now let me go to revenue. As I said, revenue in the third quarter was $5.178 billion on a GAAP basis. In constant currency, revenue was down 2.6% year-over-year and was up 4.3% sequentially. Bookings were up 3% year-over-year and 22% up sequentially, for a book-to-bill of 1.1x. Since the end of October, we've hired over 1,000 digital employees. And as we previously discussed, we centralized digital hiring efforts with a strong focus on our digital transformation centers. These roles include AWS and Azure architects, data scientists, and DevOps engineers, and others. We've also identified an additional 2,000 current DXC employees to be reskilled in digital technologies. We're rapidly correcting the hiring delays that we discussed in the second quarter and will continue to accelerate hiring and training efforts in support of our fastest-growing capabilities.

Now I also believe that the Luxoft acquisition will allow DXC to accelerate its digital hiring efforts and reduce the time to fulfill digital demand for clients. Luxoft's established digital delivery footprint will also improve the client proximity for many of DXC's digital capabilities.

In the third quarter, GBS revenue was $2.17 billion, down 4% year-over-year in constant currency and up 3.7% sequentially. The year-over-year decline was driven by the ongoing headwinds in legacy application services as well as the completion of several large transformation projects we've previously discussed. GBS bookings in the quarter were up 3.1% sequentially, for a book-to-bill of 1x.

GIS revenue in the quarter was $3 billion. GIS revenue was down 1.5% year-over-year in constant currency, and was up 4.8% sequentially. The sequential revenue growth reflects the good progress made in our digital business, including cloud infrastructure, cybersecurity, and our digital workplace offering. Overall, GIS bookings were up 38% sequentially and the book-to-bill in the quarter was 1.1x. This reflects continued strength in our cloud and digital workplace offerings, and the bookings associated with them.

Now let me turn to digital industry IP and BPS. In constant currency, digital revenue was up 16.9% year-over-year. Digital bookings continue to be very strong with a 2 to 1 -- 2.1x book-to-bill, driven by our cloud infrastructure, and as I said, our digital workplace offerings. Our digital pipeline is also up more than 90% year-over-year, which reflects the strong demand we're seeing toward digital solutions. For example, we signed a large deal with a European automotive manufacturer that includes analytics, multi-platform cloud, and security. The solution includes deep learning and simulation platforms designed to accelerate the R&D for autonomous vehicles. We're the only provider who could demonstrate the ability to deliver these infrastructure and analytics capabilities at scale.

In constant currency, our cloud infrastructure business grew 32% in the quarter and was up 13.4% sequentially. Again, reflecting the strength of our cloud bookings during the first half of the year. Book-to-bill in the quarter was 3.3x, including expanded deals with a major European bank, and the automotive manufacturer I just highlighted.

Our security business grew 4.5% year-over-year in constant currency and 11% sequentially, driven by strong growth in Northern Europe and Asia. Book-to-bill in the quarter was 1.4x, including a deal with a large financial services provider, where DXC is partnering with CrowdStrike to provide managed endpoint threat detection and response services. We're also seeing increased demand for our operational technology security solutions in the manufacturing and energy sectors.

Enterprise cloud apps and consulting grew 2.7% year-over-year and 3% sequentially. Bookings in the quarter were strong and the book-to-bill was 1.4x. Wins in the quarter included a ServiceNow deal with a major U.S. food manufacturer. The solution leverages Platform DXC, and will migrate their existing IP services management processes on to a ServiceNow platform. We also won SAP S/4HANA deals with a European satellite operator and a multinational technology company.

In constant currency, industry IP and BPS revenue was up 2.6% year-over-year and 6% sequentially, reflecting the acquisition of Molina Medicaid Health Solutions, which expanded our business supporting state agencies in the administration of Medicaid programs, and adds to our overall health care IP portfolio.

Now moving to my fourth point. We continue to make investments in digital assets and capabilities. As we discussed in November, we acquired argodesign, the digital design consultancy based in Austin. Argodesign will enhance DXC's capabilities in interface design and user experience, which are key elements in developing and delivering digital transformation solutions and scale. During the third quarter, we also completed the acquisitions of BusinessNow and TESM, which will further expand our industry-leading ServiceNow practice.

As we said, we recently announced the planned acquisition of Luxoft Holding. We believe this transaction will create significant value through revenue synergies and access to a broader pool of digital talent. Luxoft strengthens DXC's portfolio of digital offerings with proven capabilities in high-growth areas, including analytics and business intelligence, user experience, IoT, and blockchain. Luxoft also has a very strong outsourced engineering business.

Luxoft has highly-skilled digital workforce of more than 13,000 people, and as I said earlier, an established digital recruiting engine. More than 80% of Luxoft's workforce has a Master's Degree or Ph. D., and their engineering talent is primarily housed in central and eastern European delivery centers. This market provides a significant source of digital talent. We're estimating 2 to 3 -- $300 million to $400 million of incremental revenue for the combined company by fiscal year '22. We believe there's an opportunity to expand wallet share with each company's respective clients. Further, we'll be able to expand Luxoft's existing platforms into additional geographies and industries. Luxoft's digital talent acquisition capabilities will also accelerate DXC's ability to capitalize on digital demand from our clients. And we'll remain on track to close the Luxoft transaction by the end of June.

And in January, we announced a plan to acquire Microsoft Dynamics' practice of EG. The combination of EG with DXC Eclipse will extend DXC's leadership as a global Dynamics 365 systems integrator and will greatly enhance the scale of DXC's capabilities in the Nordic region.

And then, my final point before I turn it over to Paul is we expect additional sequential revenue growth in the fourth quarter. We're still targeting revenue in the range of $20.7 billion to $21.2 billion, although we are currently trending towards the lower half of that range, given some of the currency headwinds that we see. We're increasing our non-GAAP EPS targets to a range of $8.15 to $8.30, reflecting our accelerated pace of share repurchases, and a lower tax rate than originally planned.

So I'll turn it over to Paul, and then, we'll be back for questions.

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

Thank you, Mike, and greetings, everyone. As usual, I'll start by covering some items that are excluded from our non-GAAP results.

In the quarter, we had restructuring costs of $76 million on a pretax basis or $0.21 per diluted share. These costs represent severance related to workforce optimization programs, particularly in complex countries, and also expenses associated with facilities and data center rationalization. Also in the quarter, we had $107 million pretax or $0.29 per diluted share of transaction, separation, and integration-related costs, including the acquisition of Molina. Year-to-date, restructuring, transaction, separation and integration costs amounted to $723 million pretax or $1.94 per diluted share.

In the third quarter, amortization of acquired intangibles was $134 million pretax or $0.35 per diluted share. Excluding the impact of these special items, non-GAAP income before taxes from continuing operations was $786 million and non-GAAP EPS was $2.23.

Now before I turn to our third quarter results in more detail, I'd like to point out a correction that we included in the non-GAAP section of our press release regarding adjusted free cash flow. In the second quarter, DXC expanded the use of its receivable facility, and should have excluded the benefit of that expansion from adjusted free cash flow. Year-to-date, adjusted free cash flow has now been revised to accurately reflect the net impact of the receivables facility, and that resulted in a $223 million net cumulative reduction year-to-date. As a result of that correction, adjusted free cash flow for the first 9 months was $1.2 billion or 68% of adjusted net income.

Now let me move on to our third quarter results in more detail. GAAP revenue in the third quarter was $5.178 billion, a sequential increase of 4.3%. Adjusted EBIT in the quarter was $840 million. Adjusted EBIT margin was 16.2%, reflecting the progress we're making in our margin improvement plans. For the fiscal year, we remain on track to deliver our $575 million cost takeout target.

During the quarter, we continued to optimize our workforce and drive procurement efficiencies. We reduced our headcount by roughly 3,000 people during the quarter, and that is excluding sub (inaudible) and the Molina acquisition. Year-over-year, total headcount (inaudible) over 14,000, driven by ongoing productivity efforts, including our Bionix automation program.

In supply chain, we're driving procurement efficiencies, including increased use of consumption-based purchase agreements for infrastructure and software. We also have expanded our category management capabilities to better leverage our strategic suppliers and consolidate vendors.

Turning to real estate. We eliminated an additional 1.5 million square feet during the quarter. And we've also closed 7 data centers and are on track to exit 2 to 3 additional data centers this fiscal year. We're also reinvesting in the business this fiscal year, including the acceleration of digital hiring, continued deployment of Bionix, expansion of our digital transformation centers and the continued build-out of key offerings,including AWS and Microsoft Azure solutions.

In the quarter, our non-GAAP EPS tax rate was 20.4%, reflecting our global mix of income and the timing of certain changes in tax attributes in key foreign jurisdictions. For the full year, we now expect the tax rate to be at the lower end of our previous range of 24% to 28%, and that implies a tax rate of slightly above 30% in the fourth quarter. Year-to-date, revenue was $15.5 billion. Adjusted EBIT was $2.4 billion (inaudible) was 15.8%, and booking were $14.9 billion for a book-to-bill of 1x.

Turning to our segment results. GBS revenue was $2.17 billion in the third quarter, a sequential increase of 3.7%. In the third quarter, GBS segment profit was $395 million, and profit margins was 18.2%, and that is including the investment we are making in expanding our digital capabilities. Year-to-date, GBS revenue was $6.5 billion, segment profit was $1.2 billion, margin was 18.5%, and bookings were $6.4 billion for a book-to-bill of 1x.

GIS revenue was $3.01 billion in the quarter, up 4.8% in constant currency, sequentially. GIS segment profit in the third quarter was $528 million. Profit margin was 17.5%. Now the segment profit margin for GIS reflect the impact of actions we're taking to drive greater operating efficiencies, including delivery and data center rationalization, as well as the benefit of final milestone achievement on a few contracts. Year-to-date, GIS revenue was $9 billion, segment profit was $1.5 billion, margin was 16.4%, and bookings were $8.5 billion, for a book-to-bill of 0.9x.

Now let me turn to other financial highlights. Adjusted free cash flow in the third quarter was $503 million or 81% of adjusted net income. As I previously covered, year-to-date adjusted free cash flow was $1.2 billion. Year-to-date free cash flow performance is impacted by an increase of 5 to 6 days in days sales outstanding, driven primarily by extended payment terms on large traditional contracts. Now we have efforts underway to improve our working capital performance, and to incentivize our (inaudible) to be even more focused on collections. However, given the time remaining this fiscal year, we're revising our adjusted free cash flow targets for the year to 70% to 80% of adjusted net income.

Our CapEx was $153 million in the quarter or 3% of revenue, including the benefit of asset dispositions. Year-to-date CapEx was $829 million or 5.4% of revenue. Cash at the end of the quarter was $2.5 billion. Our total debt was $7.56 billion, including capital leases, for a net debt to total capital ratio of 26.9%. Following the announcement of the Luxoft acquisition, all 3 rating agencies reaffirmed DXC's rating and outlook.

Now during the third quarter, we paid $54 million in dividends, and we've repurchased $797 million in shares for a total of $851 million in capital returned to shareholders. Year-to-date, we've returned $1.4 billion of capital to our shareholders in the form of $159 million [in cash dividend] and $1.2 billion in share repurchases. In the fourth quarter, we expect to continue to return capital to shareholders, but at a more moderate pace.

In closing, we continue to target revenue in the range of $20.7 billion to $21.2 billion. Although given our current -- the currency headwinds that we're seeing, we're trending toward the lower half of that range. We've raised our EPS target range to $8.15 to $8.30, reflecting the pace of share repurchases and a tax rate that's trending toward the lower end of our targeted range.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll go first to Jim Schneider at Goldman Sachs.

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

Mike or Paul, I was wondering if you could maybe talk a little bit more about the labor fill-in. It sounds like that digital hiring is progressing well. But can you maybe talk about at what point -- is it one, 2 or 3 quarters out, you feel like you'll be in a position to kind of fully get staff and get traction on all the digital work that you've already booked? And maybe talk about kind of when you kind of get normalized run rate to where you want it to be.

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

Yes. I think we will get there, probably, in the early part of next fiscal year. Think of that as the first half. We've made -- we talked about this at the end of the second quarter. We clearly fell behind in the hiring. And we've made a big investment in the processes, and our tools, and frankly, much better planning at the account level. I can't tell you what a little discipline does because that gives us a much better demand signal. And then, we are able to turn the hiring machine and the processes on to get that done. The other thing to tell is we -- Jim, have centralized a lot of this digital hiring. So we've put a very thorough skills taxonomy together, and we're hiring these people into our digital delivery centers. And then, we're deploying those people as the projects get firmed up and signed by the customer. That's a whole different process than trying to do this account by account. We're also seeing a significant improvement in the quality of the people and the skills that we're bringing in. So I think to net this out, I think we'll get to more of a steady state in terms of hiring sort of the first half of next fiscal year. But we'll continue to remix the workforce. I mean, Paul talked about 14,000 reduction is true, but on the other side of that is we've hired thousands of people into these new businesses. And that remix of the workforce, both the reskilling of existing as well as bringing new people in, that's going to continue for a long time. So I think these digital delivery centers, I think that's helped us. We're getting better candidates. The tools, the processes, the discipline, and frankly, people see that we're attracting, they see really good career opportunities in digital as they look out over the next medium to longer term. And one other point is probably a longer answer than you're looking for. But I mean, Luxoft has really helped in terms of their brand and their reputation in the digital space as well. So I think this was a strong signal that we were serious about really jump-starting or catapulting us and our skills into a slightly different space than where we were prior to the second quarter. Paul, I don't know if you want to add anything...

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

No. Mike, I think you captured it. Also, as we do this, the demand, actually, our bookings are growing 89% on a year-over-year basis, and also our pipeline is growing rapidly.

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

That's good color. So I wanted to follow up on what you just kind of left with, which is bookings. Clearly, good to see that recovery there. Can you, maybe, talk a little bit about -- although we know the GIS bookings can always be very lumpy, can you sustain that same level of bookings strength you saw this quarter into the next couple of quarters based on your kind of visibility? Maybe talk about the pipeline, especially very near term? And then, anything you can say relative to any potential new logos or how much you see kind of digital playing into the near-term bookings environment?

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

Yes. Listen, the big deals in GIS are lumpy. That's not going to change. I mean, are we working on a lot of big deals? Yes, we are. When exactly are they going to close? I don't know. That gets a little lumpy. I think it can continue in the fourth quarter, and even into the first quarter based on what we see in the pipeline. But the more important trend is underneath that. And that is what I'll call shorter duration project work. I think I've mentioned this before, but we now are compensating many of our people in our delivery organization for what we call delivery-led growth. These are shorter-term projects where we can assign people very quickly and generate incremental revenue. Our digital projects are largely of shorter duration. They usually start out smaller, and then, tend to expand and scale over time. So the dynamics of our bookings are changing as our business model and portfolio begins to shift on a total reliance on big deals, big TCV deals. That reliance is beginning to diminish as we move the portfolio to a much higher number, higher volume of digital projects. We consider that good. When we looked into Luxoft's book of business, it's the exact same profile that we're beginning to experience in our business. So that, I think, bodes well as we go forward.

Operator

And next, we'll move to Joseph Foresi at Cantor Fitzgerald.

Joseph Dean Foresi - *Cantor Fitzgerald & Co., Research Division - Analyst*

So I had kind of a -- well, to be as straightforward as I can be, Mike, you've been known as somebody who has been very good at unlocking shareholder value. As you look at the balance between potentially doing more acquisitions, divestitures or other ways of unlocking shareholder value, maybe you can give us some insight into what your thought process is around that, over the short and long term. Are you more likely to be in the digital market to continue to buy stuff, divestitures, picking on acquisition for cost cutting?

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

Yes. Listen, we're always looking for ways to enhance shareholder value, you know that. You said that. We have all options on the table all the time. Candidly, I don't see a lot of divestitures as I look out because we have really remixed the portfolio quite dramatically over the last couple of years. I do think we'll see some more smaller tuck-in type acquisitions, particularly, in the digital space. So assuming we get the Luxoft transaction completed, there's a whole series of smaller opportunities that can be added to that business model. We continue to look for areas where we can strengthen our IP portfolio, like we did with Molina in health care. Or continuing to look at other practices to strengthen our, really, very strong position in Microsoft Dynamics 365 as well as ServiceNow where we've made significant investments. So I'd say that part of our capital allocation model that we've talked about will continue. And then, of course, the mix of returning share -- returning money to our shareholders as we've done, we've returned over $1 billion. We obviously thought our stock was a very good buy and have continued to plow money into that as well. So I don't see any major changes in the capital allocation model as we go forward. We've got to tighten up, as Paul said, on our working capital management, particularly our days sales outstanding, and that's difficult because there is a pretty strong push to try to extend those terms, particularly on these large ITO contracts. And it's another thing, as we look out longer, we see working capital moving in our favor. These shorter-term projects have a propensity to pay in a much quicker cycle than many of these large ITO contracts. So that's how we're thinking about it going forward, is we've got a capital allocation model, we're going to stick with that. We're very pleased with the Luxoft transaction. We think it's a quality acquisition at a fair price. And I think there'll be things that we'll be able to add on to that platform as we go forward. Does that answer your question?

Joseph Dean Foresi - *Cantor Fitzgerald & Co., Research Division - Analyst*

It does. And then, just a second one for me. On the digital, as you start to play catch-up, maybe you can help us understand what advantage you have in trying to displace an Accenture? Or is this merely a massive shift that everyone can participate in? I'm just trying to get your thoughts around sort of what the crucial piece of the puzzle is as we try to accelerate it.

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

Yes. That's a good question. Listen, that's a good question. First of all, I think the market is expanding very rapidly, and I think there is plenty of room for everyone to play. And if you look at the results of many of the players in this space, they're all relatively strong. The thing that I think really came to life for me was, this came around Luxoft in particular, is the different space that they are in. They are much more in what I'll call the business executive space, taking on digital projects that candidly, one DXC didn't see, and in many cases, weren't really considered because of the brand reputation we have around being able to run infrastructures and big application sets, those kinds of things. That is really going to change. And then, the underlying thing that's so important is all of these smaller digital projects ultimately have to get integrated into mainstream IP in order to really see the transformative benefits of these digital projects. And that's what our unique value proposition is. And we're staying with that along with our partners. And our partners bring a lot to the table here. And again, the Luxoft acquisition. Many of our partners work with Luxoft. And our clients are all, all on a digital journey, different places in that journey, but all on that digital journey. So as I said many, many times, this is a generational shift, and there is plenty of addressable market for everyone to participate in right now.

Operator

Moving next to Rod Bourgeois at DeepDive Equity Research.

Rod Bourgeois - *DeepDive Equity Research - Head of Research and Consulting*

It appears that your digital investments have caused your GBS margin expansion to somewhat taper off here. I'm wondering if you can dimension how much extra digital investment you're now making perhaps compared to where you were a year ago. And if you could also help gauge how much of that digital investment is prone to the kind of the new normal of investment versus an extraordinary investment that you're making now as you ramp up this digital talent engine.

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

Well, listen, we've talked about the margin, but not much, we're 30 basis points or something like that. So yes, Rod, to answer your question, we are making a slightly larger investment in the hiring of these digital skills than we have before. And that became very apparent to us as we exited the second quarter, some of those issues. So we have ramped that up. I wouldn't call this a new normal. I think we will get to a more, as I said earlier on a previous question, we'll get to much more of a steady-state as we continue to remix our workforce. So in many cases, what you're seeing here is you're continuing to see an expansion of some of the margins in GIS because frankly, that's where a lot of the remix is taking place, and you're seeing a slight deterioration in the GBS margins. Overall, the margins for the company continue to expand. So I think it's a broader picture. It's going to be a remix. I don't think we'll continue with this sort of extraordinary effort to bootstrap ourselves in the digital hiring. But I honestly hope we have the demand going forward long term that we continue to do that. And in many cases, we're hiring teams of people, not just individuals, because a lot of these digital projects require scrum leaders, they require data scientists, they require software engineers. So more and more, as we remix this business portfolio, these aren't individual skills that get applied. They're teams that get applied to a digital business solution. And that's a different way of managing your workforce as well.

Rod Bourgeois - *DeepDive Equity Research - Head of Research and Consulting*

Got it. And then, hey, on the demand side, in the part of your business that's project-based and more reliant on discretionary spending, are you seeing any change in demand pattern? Any hesitation on client decision-making or pullback in capital spending at all?

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

I am not. I mean, the digital demand remains pretty strong. There isn't a -- I just got back from a -- one of my trips and met with quite a few CEOs. I mean, everyone knows they got to do this. And again, our value proposition is we come in, and we help clients figure out how to reduce the operating expenses of their existing IT estate, okay? And there isn't a CEO that I've met that is not interested in it. And this isn't just pie in the sky. I mean, this is things like Platform DXC, which is our architecture with our partners. It's Bionix. It's all of those things that we can do. And then, we go to our clients and say, we want to be able to participate in many of these digital projects. And we usually start out with a simple, what we call, ideation process where we get the client and us together. That's why we've made this investment on this Digital Transformation Center. So we go and we problem-solve. That usually results in some sort of statement of work or project that may not be huge. Some of these are measured in hundreds of thousands of dollars, not millions. But you go in, you rapidly prototype that, you demonstrate that it works, and then you take the next step and you begin to scale. And that's how we see more and more of that occurring every day, every week, every month. And frankly, I think it's a much healthier business mix as we move forward. But yes, that does involve some investment in these digital delivery centers, and people, and teams, and so on, and so forth. But that's not going to impact the overall margin profile of the company as we go forward.

Operator

And we will go next to Jason Kupferberg at Bank of America Merrill Lynch.

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

So it's certainly nice to see the reacceleration in the digital revenue growth. So that 17% number, where do we go from here? Are you expecting some further near-term acceleration, just as the hiring scales?

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

Yes. Listen, I -- listen, I'm really pretty pleased with the progress we made this quarter in terms of sequential revenue growth, continued very good strong performance in digital, while continuing to drive margin expansion. I'm very pleased with that. But I want to do even more. So I'm not really going to be happy until I see the digital business growing 20%, 21%, 23%. I think it can happen. Now I think it will continue to require us to go to market differently, source these opportunities differently as I just explained with Rod's question, and then, continue to hire into that demand. As I said, we use this annual billed revenue as sort of a metric internally. It's not ready for prime time yet in terms of audibility. But we use it internally. And we have seen an acceleration of this as we've gone through this year. I mean, the first -- we got off to a fairly slow start in the first quarter. We picked up some steam in the second quarter. Third quarter is the first quarter we've actually made our internal objectives around our digital sales. So we're beginning to see that pick up steam. Now we got caught short, as we fully admitted, we got caught a little short because the demand got out a little bit in front of our ability to then source the people. And as I said, sourcing people is not individuals, it's more teams. And sometimes, you can't get started with these projects until it's a whole team. It doesn't do any good to have just the data scientists show up for analytics, if you also require software engineering as well. So that's the gap that we are closing. But I think the demand is there. This is a generational shift. We're making acquisitions. We're making investments. We're beginning to see that revenue tick up a little bit, we're beginning to see the sales tick up so those are encouraging signs. But I can promise you, it's not going to be a straight line here as we go forward. There's always going to be some twists and turns in the road, but we're really comfortable with the business model that's beginning to emerge.

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

So just to follow up on the supply side of that. So beyond the 1,000-plus, I think you said you already hired since the end of October. If you think about what you still need to hire as you try and complete the backfill process, I think you said through the first half of fiscal '20, how much of that additional hiring to come is going to essentially be kind of retraining of some existing DXC personnel versus net new headcount?

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

I'd say just over the next couple of months, I'd like to hire another couple of thousand people in digital, and we want to retrain a couple of thousand. So right now, I'd say it's somewhat of an even mix between reskilling as well as hiring. And then I think the other thing that we'll have a little better insight on is, once we get the Luxoft transaction closed and we begin to understand that hiring platform, and how that works, that will also bring a new dimension to our digital skills.

Operator

And we'll go next to Bryan Keane at Deutsche Bank.

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

Just wanted to ask about the new adjusted free cash flow guidance of 70% to 80% of adjusted income. I think previous guidance before was 90%-plus conversion, going towards 100%. So just want to understand the differences now from the model today versus previous? And then, how do we get back to 90-plus percent free cash flow conversion in the future?

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

Yes. I think we what it is, is just the days sales outstanding. We saw an increase in DSOs of about 5 to 6 days. That represents roughly about probably $300-plus million in the sense of cash usage that we need to go and attack. I think it's just -- again, the fourth quarter is always also -- the year-end, calendar year-end. It's usually not the best -- everybody hangs on to their cash for balance sheet purposes. But having said all of these things, we must do a much better job at working capital and we have just really marshaled the entire organization. All my CFOs around the world are now just really on point to just really drive collection and particularly past due also. We were expecting to have done a little bit better job on past due receivables. And we saw little bit of a pause here. But it's on us, and we're going out and trying to get that rectified ASAP. Longer term, it doesn't change the guidance that we have given and the targets of 90% or 100% by 2022.

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

In short, this is more operational than it is model issue. And we did see -- we had a lot of volatility in the market, as you guys well know, in December. And what we did see is people holding on to their cash a little more tightly, if you will. We did the same thing, by the way, from a payable standpoint. So again, I think this is more operational, around days sales outstanding. That's fixable. It doesn't change the model long term.

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

Okay. And then just as a follow-up. Looking at Molina and some of the other acquisitions that have been completed or about to be completed, how will that fold into the model? And will that help revenue a little bit in the fourth quarter and beyond?

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

I think not much in the fourth quarter. Some of it showed up in the third quarter. I think all of it was very consistent with the model that we gave you before that acquisition. Again, aside from Luxoft, which was a little bit off to the side right now. It was about a 1% to 2% of our top line coming from this acquisition. Molina contributed about $50 million but it was part of what we had given you in terms of what we were expecting to do in the second quarter, and we came in a little bit better overall for the business and from a revenue standpoint in the second -- in the third quarter.

Operator

And we'll go next to Darrin Peller at Wolfe Research.

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

Just when we look at the digital trends that, obviously, are accelerating as you talked about. Can you just give us some more color on the sourcing of that with regard to the partnership model that we've talked a lot about it -- or you guys have talked a lot about in the past. I'm curious to hear how has that's been trending recently, in terms of the additive to the digital bookings we're seeing, and now the conversion to revenue.

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

Our sales bookings -- we track a couple of things with our partners. I don't want to get overly complex here, but sort of sales WIP, meaning where we are partnering directly and go-to-market together, sell through stuff that we actually sell-through or they sell through us or we sell through them. And then, what I'll call sell-to. And in every one of those categories, this year is the first year I've seen it, where we're beginning to see an increase. And it's playing out. So we will sit down with a Microsoft, or we'll sit down with an AWS, or we'll sit down with an AT&T, and we will select accounts where we're going to work together in that account. Now what we're finding is when we do partner more deeply like that, when I say partner, I'm talking about joint proposals. Not 2 separate proposals that get stapled together in the lobby before we make the presentation. I'm talking about an integrated proposal. And we're seeing win rates go up dramatically, and I mean, dramatically like 20 points when we do that. Now that is not only obvious to us, but it's also becoming clearer and clearer to our partners. Our partners do source incremental opportunities that we can go after. And already, already, just in working within the regulatory framework of what we could do with Luxoft, see all kinds of opportunities. We've identified through just some joint work that we've been able to do. Again, within the construct of what we can do from a regulatory standpoint, hundreds of millions of dollars of opportunities that we never saw before. So yes, I think the partners and I think some of the acquisitions that we are doing, some of the things we've done with PwC that we've talked about in the past, all these are contributing to us seeing more opportunities. And that's driving then the hiring not only of our services people and -- but also our sales because we're increasing our sales force at the same time because you need the sales force now to begin to qualify and help put all these proposals together. So we are increasing that. We talk about digital skills and certification, and all the other programs that we have with our partners to retrain DXC people. But we'll, at the same time, we are hiring, we're increasing our sales force. This is the first time we've done this in years, because we see the opportunity to deploy them around meaningful opportunities.

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

All right. That's great to hear. And just quickly, you mentioned Luxoft again. But look, I mean, have you had any chance to speak to either your clients or Luxoft clients further since it was announced? And in terms of just feedback and how they feel about it?

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

Yes. I have. I've spent quite a bit of time doing that as a matter of fact. They view it as very positive. They see the business rationale behind it. We're trying to keep this as separate as possible for obvious reasons. Most -- I got to tell you, I mean, the -- it's more -- it's done quite a bit to change the brand perception of DXC, that we're really serious about this. I went out to the Consumer Electronics Show out in Las Vegas. I'd never -- I haven't been there in 5 years. And I was just amazed that customer feedback in the projects that we are working on with Luxoft. So yes, we've gotten positive feedback from our partners. We've gotten positive feedback from Luxoft clients, and certainly our clients. Now having said that, there's a wait-and-see. There's not that much we can do right now. So right now is more talk than it is actual action. But we'll certainly get into that once we get the transaction closed. And we're in the process now of planning all the revenue synergies and all the other things that go along with getting prepared to close the transaction.

Operator

And that's from James Friedman at Susquehanna.

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

This is Jamie. I just want to ask you about the Q4 assumptions. So Paul or Mike, if I look at the midpoint of the implication on the Q4, it's $120-plus million above consensus. I realize you're talking about some FX challenges, but even at the midpoint of the lower half, you're still above. And my question is, how should we be thinking about cadence? You talked a lot about milestones like both of you used that word a couple of times in your prepared remarks. Are there milestones into Q4 that you're anticipating that'll release some of the revenue?

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

No. What I'm looking at, to be quite candid, is continued sequential growth. That's what I am interested in. I want to continue to see this business grow sequentially quarter-over-quarter. Then underneath that, I'm looking very carefully at where we are with our digital revenue, what that pipeline looks like, what the sales performance is. And then, I'm also looking very carefully at the runoff, and price downs, and when those price downs occur in our ITO market. So it's a fairly -- not complex, but it's a reasonably involved formula. And at the end of the day, the most important thing I'm trying to drive across the company is continued sequential growth and continued strong, digital performance underneath that. Now, our IP portfolio is also beginning to grow. It's not growing as much as it needs to grow, but it is beginning to grow. So Jamie, that's what I'm looking for, is continued sequential growth as we go forward.

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

Okay. Just ask one follow-up on this Slide 11. You don't have to look at it. You know what I'm talking about. But the CapEx as a percentage of revenue, that was a big theme, especially in the CSC days. 3% seems low, but since there are conversations about the free cash flow, I was just wondering, like, how should we be thinking about that going forward? Because I'm just wondering what the sustainable run rate of that is.

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

We indicated, if you remember, that our goal was to be in the 5%, 7% longer term as a percentage of revenue. This quarter was a little bit more unusual because we had a -- some asset dispositions that helped to offset the CapEx. But I would say to you, somewhere in the 5%, 6% it's -- would be a good number to use.

Operator

And that does conclude the question-and-answer session. I'll turn the program back to our speakers.

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

Okay. Thank you, guys. Thank you.

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

We'll close the call now. Thank you, operator.

Operator

Thank you. And once again, that does conclude today's conference. Again, I'd like to thank everyone for joining us today.
