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Veritas Capital to Acquire DXC's HHS Business Call

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PRESENTATION

Operator

Good day, and welcome to the DXC Conference Call. Today's conference is being recorded.

At this time, it is my pleasure to turn the conference over to Shailesh Murali. Sir, please begin.

Shailesh Murali ***DXC Technology Company - Head of M&A and IR***

Thank you and good evening, everyone. I'm pleased that you are joining us for the DXC Technology's call regarding today's announcement. Our speakers on today's call will be Mike Salvino, President and CEO; and Paul Saleh, our CFO.

We will make certain comments on the call that 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 these 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, of course, as required by law.

And now I'd like to turn the call to DXC Technology's President and CEO, Mike Salvino. Mike?

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

Shailesh, thanks so much, and good evening, everyone. Thanks so much for joining the call. I'm pleased that we continue to execute the plan that we outlined in November, especially in this volatile environment.

Today, we announced that we've reached agreement to sell our U.S. State and Local Health and Human Services business to Veritas Capital for $5 billion in cash. The transaction is an important first step in our business and focusing on the enterprise technology stack. The transaction progressed much faster than we originally anticipated, but we are absolutely delighted to partner with Veritas Capital, the leading investor in health care and government sector.

Now let me turn it over to Paul to talk a little bit about the transaction, and then he'll turn it back to me for some closing comments.

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

All right. Thank you, Mike, and good evening, everyone. So as Mike mentioned, we agreed to sell our State and Local Health and Human Services business to Veritas Capital for $5 billion in cash. And this represents a valuation of 3.5x trailing 12 months revenue of $1.4 billion. So this is just quite an outcome in such a volatile environment.

We expect the transaction to close no later than the third quarter of fiscal '21. The transaction is subject to customary closing conditions and the receipt of certain third-party consents and regulatory approvals. So the transaction is not subject to any financing conditions. All financing commitments are already in. The purchase agreement will be filed publicly in the coming days.

Now given the volatile market environment, it is important for us to strengthen the balance sheet and maintain a financial position consistent with an investment-grade credit profile. And so as a result, we will now use the after-tax proceeds of approximately $3.5

billion to pay down debt. Now we're continuing to pursue strategic alternatives for the other 2 assets, and our plan is to use any proceeds from those transactions to primarily reduce debt. Now this is a change to the capital allocation model we used as part of our fiscal '22 framework back in November.

Now consequently, we are withdrawing our fiscal '22 forecast estimates that we shared with you previously. I can say also that right now, we remain on track to deliver on the financial targets for fiscal '20, and we are continuing to work on our fiscal '21 plan, and we'll provide the financial targets for fiscal '21 in May as part of our year-end earnings call.

I'll turn your call back to Mike.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

Thanks, Paul. As we talked about in February, we talked about us doing and conducting detailed regional business reviews focused at the account level to develop our plan for 2021. Although the work is not 100% complete, I wanted to highlight 2 things that have changed.

First, the environment, obviously, is more volatile than it was 5 weeks ago. Second, early indications from the review suggest a higher-than-anticipated impact from previously terminated accounts and price concessions. This, coupled with the lack of sales earlier this year, is making fiscal '21 more challenging for us. We'll continue to do the work in '21, and we'll give you a full update in May concerning these numbers.

In closing, I continue to be very encouraged about the progress we're making against our plan to focus on our customers, our people and our operational execution. On customers, we continue to turn challenged accounts around, and we are creating the Virtual Clarity IT estate plan so that we can aggressively get in the market with our customers.

Second, on the people front, we continue to attract high-quality talent. We announced Ken last Friday, and Ken's focus will be on simplifying and standardizing our offerings and strategic partnerships so our sales team can be more focused in terms of what we are selling to our customers.

Finally, on operational execution, we are finalizing our plans to ensure the right utilization around our people that perform offering, sales, accounts and delivery around our key customers. This will help us optimize our cost.

Now what I'd like to do is turn it back to the operator for any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from James Faucette with Morgan Stanley.

James Eugene Faucette ***Morgan Stanley, Research Division - Executive Director***

Great. I just wanted to ask 2 quick follow-up questions. The first is if you can give a little more color in terms of the nuance that you're seeing in the market right now and how much of the kind of slow selling start do you think is related to the macro environment versus just DXC's own operational -- its own operations, excuse me.

And then my second question is, can you give us a little bit of an outline of how we should think about depreciation and amortization on a run rate basis once the deal and disposition is closed?

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

Do you want to take the second one first?

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

The depreciation and amortization at this time, I think I can only talk to you about the business that we just really, right now, agreed to sell to Veritas Capital. And I think it is not going to be a meaningful decrease in our depreciation and amortization, maybe about, I think, 100 and -- 300, excuse me -- sorry, 1 second. $30 million? $30 million, forgive me. $30 million out of our depreciation and amortization, so not much. And we'll update you on the other 2 assets at the appropriate time.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

And then on sales, James, look, the net-net is -- when -- we would obviously like to prefer to do orals, right, face-to-face. When you don't do orals, face-to-face, you don't build appropriate relationship and so forth. That's an industry-type thing. But we're working virtually. A lot of cases, we're still seeing clients face-to-face. Do I think that's going to elongate the sales process? It may. And that's, right now, what we're dealing with. I think everybody can appreciate the environment that we're in is a little bit different, and we're feeling our way through it.

Operator

Our next question will come from Lisa Ellis with MoffettNathanson.

Lisa Ann Dejong Ellis ***MoffettNathanson LLC - Partner***

First one for me is for Paul. Can you just give us a sense of the margin revenue growth and free cash flow contribution of the HSS (sic) [HHS] business that's coming out?

And then second one, yes, just around -- and Mike, this might be for you. Can you kind of remind this group, because DXC, obviously, has not existed as an entity for that long, how we should think about if we do go into an IT budget slowdown given the nature of DXC's service lines, how we should -- I would imagine less exposure to discretionary IT spending, et cetera. So how does it typically perform during an IT budget slowdown?

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

No, I think we'll give you more update on the MMIS financials in due course. It was a business that was growing slightly. And I can tell you that the margins were higher than, obviously, the average of the company.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

And then in terms of an IT spend slowdown, right, when you look at our business and you look at the stack, right, when we do IT on-prem then we do cloud, we also deal with rationalizing and modernizing the applications, and then we do the analytics and the advisory services. The discretionary services that are there, we don't have a lot of what I would consider consulting dollars. And when companies tighten their belts from a cost standpoint, they usually will look to reduce costs and outsource more.

From our standpoint, right, we are absolutely trying to take advantage where we can to deal with the sales process. But I come back to -- I keep talking about these IT estate plans, all right? And these IT estate plans are -- enable us to be very curious with our customers in terms of what they need to do next to reduce cost and to shore up environments from an on-prem standpoint and also a cloud environment.

Operator

Our next question will come from Jason Kupferberg with Bank of America.

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

Mike, I just want to see if you could go a little deeper on some of those early indications you were previewing that could impact next fiscal year, I guess, some contract wind-down, some price-downs. I just want to make sure we have the kind of the pieces. I know nothing is finalized but just want to make sure we understand the dynamics there because it kind of sounded like those dynamics may be kind of separate from the virus and the latest change in the macro. But just want to make sure we're interpreting that accurately.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

So Jason, like I said, I mean, what we've seen so far is a higher runoff from terminated and price concessions than we had originally planned. That coupled with us not performing well from a sales standpoint earlier this year have created headwinds. And look, the reason why we came prepared to highlight a number of things today was because of the fantastic outcome we had with this business. And like both Paul and I said, we're going to work on the numbers now, and we'll give you more information in May.

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

Okay. And then just as a follow-up, are you still comfortable that the 3 deals collectively will generate the $5 billion in after-tax proceeds and that all could close by the end of this calendar year?

And then if you can just say a quick word on why this transaction is going to take maybe upwards of 9 months to close. It doesn't seem like you need that many approvals. So I just wanted to understand the nuances there.

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

Yes. I think a couple of things. Number one, we are still confident in our ability to generate those kind of after-tax proceeds. Obviously, the market is quite volatile. But we're -- as you can see from the prior -- the transaction we announced today that we were able to get a favorable outcome out of that because we also have -- those are very good assets, premier assets that are up for kind of strategic consideration.

In terms of the close, I think we said no later than the third quarter of fiscal '21. Our objective, obviously, is to close as fast as possible. It's less about those other approval than was much as us being able to separate the business fast enough and get carve-out financials in time just to be able to execute that. We're all out working diligently and at pace to be able to achieve that outcome. And so hopefully, we'll be able to -- we won't be surprised, and we meet an aggressive time line that we had set for ourselves previously.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

Jason, the thing I would add so far is, look, in the short term, all right, this marks the second thing, right? When we put out our plan in November, right, we obviously talked about the new plan for the rest of the year. We did a nice job delivering against Q3 now, right? We've knocked down one of our first deals. And what we need to do is continue to execute, right, both in the short term, along with the rest of this year as we separate these businesses. So I like the plan we have put in place, and it's one that we can deliver on.

Operator

Our next question comes from Ashwin Shirvaikar with Citi.

Ashwin Vassant Shirvaikar ***Citigroup Inc, Research Division - Director and U.S. Computer and Business Services Analyst***

I just wanted to get maybe an update from you. You mentioned last time you'd complete the assessment of top 30 accounts and so on. Given what's been going on in the market, is that process still expected to be completed on time? Any updates on that? And -- yes, let me stop there, and there's another question after that.

Michael J. Salvino ***DXC Technology Company - CEO, President & Director***

Okay. So thanks for that. So the 40 challenged accounts, we're absolutely working that on the plan that we set. We said the majority of them would be completed by the end of March, and then they would all be completed in the first half of '21. And so far, so good as it relates to dealing with those 40 accounts.

Ashwin Vassant Shirvaikar ***Citigroup Inc, Research Division - Director and U.S. Computer and Business Services Analyst***

Got it. And then you reiterated your 2020. I just wanted to confirm that with all of the targets, the revenue, non-GAAP EPS as well as the adjusted free cash flow, you're still confident on the 80% plus of adjusted net income.

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

Right now, yes.

Operator

Our next question comes from James Friedman with Susquehanna.

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

Let me congratulate you. This is a great outcome. Just a couple of questions. So Paul, should we anticipate any stranded costs from the transaction? I remember -- this isn't your first rodeo. We had a couple of these divestitures before, asset sales. How should we be thinking about stranded? Was this really run as a separate entity?

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

No, this one was a -- I mean obviously, it's a U.S.-based business. So it was a little bit different than the other 2 businesses that are much more global in nature. So there's still, though, some intermingling because of the common financial system that we run and some of the other support IT system that we run. But that being said, we're actively working just again to, first of all, separate the business and to -- and be able to convey that asset to Veritas Capital as quickly as feasible.

As far as stranded costs, as everything, we're going to -- once we know all the -- we separate the business, we will be able to look at all those costs. And as usual, we'll address them appropriately. And we've had that track record previously, and that's what we intend to -- what will intend to do.

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

And then in terms of the -- your prepared remarks, Paul, with the debt versus the equity, could you say what you said again? Because I -- so are you saying now that you anticipate, and I don't want to misquote you, that the other 2 asset sales will likely be directed towards debt? Or did I hear that wrong? Because the stock's down a little bit.

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

Yes. I think what I was trying -- what I said is, first of all, the first transaction, about $5 billion, the after-tax proceeds from that asset will be -- from the sale will be directed to reducing debt. And what I said also that in this environment, right, the responsible thing to do is to be really quite defensive and to strengthen our balance sheet and maintain a strong financial position consistent with an investment-grade profile. And as a result of that, additional proceeds from the sale of assets will be directed primarily to reduce debt at this point.

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

Got it. And then -- so was Veritas the buyer of your U.S. Public Sector business? Or am I confusing the companies? And if so, I guess -- if not, it's moot. But if so, will that help the boarding process? Like, would that accelerate because they know these businesses already?

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

I think we merged our -- we actually merged those private U.S. -- PS business with 2 companies that were owned by Veritas, Vencore and KeyPoint, to form Perspecta. I think Veritas has an incredible track record in building companies and supporting companies, investing in companies in the Public Sector business. And so they're very well connected. And superbly couldn't be happier with the quality of the home for our own State and Local Health and Human Services business. So that would -- they have great relationship, both at the state and the federal government level, and it would be very helpful for the transaction to proceed.

Operator

All right. Thank you. At this time, I would like to turn the call back over to Mr. Shailesh Murali for any closing remarks.

Shailesh Murali ***DXC Technology Company - Head of M&A and IR***

Thank you very much, and thank you, everyone, for joining us. Talk to you all soon.

Operator

Thank you, ladies and gentlemen. This concludes today's teleconference, and you may now disconnect. Please enjoy the rest of your day.