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DXC Technology Co. (DXC)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good evening. My name is David, and I will be your conference operator today. At this time, I'd like to welcome everyone to the DXC Technology Q3 FY 2022 Earnings Call. Today's conference is being recorded. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there'll be a question-and-answer session. [Operator Instructions] Thank you.

John Sweeney, Vice President of Investor Relations, you may begin your conference.

John Sweeney
Vice President-Investor Relations, DXC Technology Co.

Thank you and good afternoon, everybody. I'm pleased that you're joining us for DXC Technology's third quarter 2022 earnings call. Our speakers on the call today will be Mike Salvino, our President and CEO; and Ken Sharp, our EVP and CFO. This call is being webcast at dxc.com Investor Relations and the webcast includes slides that will accompany this discussion today.

Today's presentation includes certain non-GAAP financial measures, which we believe provide useful information to our investors. In accordance with SEC rules, we provide 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 and in the webcast slides.

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Certain comments we make on the call will be forward-looking. These statements are subject to known and uncertain 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'd now 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 with that, I'd like to introduce DXC Technology's President and CEO, Mike Salvino. Mike?

Michael J. Salvino

President, Chief Executive Officer & Director, DXC Technology Co.

Thanks, John, and I appreciate everyone joining the call today and I hope you and your families are doing well. Today's agenda will begin with an update on Q3, which was another strong quarter of operational execution for DXC. Next, I will cover how we are consistently delivering on our transformation journey.

As a result of this execution, organic revenue, margin and EPS, all continue to improve. In addition, you will see the outstanding results for book-to-bill and free cash flow. The best part about this performance is we expect it to be sustainable.

Then, I will hand the call over to Ken to share our Q3 results, along with our Q4 and full year guidance. Finally, I will add some closing remarks before opening the call up for questions.

Regarding our Q3 performance, our revenues were $4.09 billion compared to $4.03 billion in Q2. Organic revenue continues to improve as we progressed from minus 2.4% in Q2 to minus 1.4% in Q3. I see this as significant improvement, as only a year ago our organic revenues were minus 9.7%.

I was also very pleased to see the organic revenue growth in GBS accelerate from positive 3.4% in Q2 to positive 7% in Q3. Our strategy to grow DXC relies on GBS consistently growing and we are clearly delivering against this piece of our growth strategy.

Our adjusted EBIT margin was 8.7%, up 170 basis points as compared to last year, driven by our operational work that we are doing to optimize our business. Our non-GAAP diluted EPS was $0.92 in the quarter, which is up 10% as compared to $0.84 last year.

While the quarter was strong across the board, the two strongest financial results were book-to-bill and free cash flow generation. We delivered $5 billion in bookings for a book-to-bill of 1.23x. This gets us to a book-to-bill of 1.08x on a trailing 12-month basis. And in Q3, we delivered $550 million in free cash flow.

Now, let me turn to the progress we are making on our transformation journey. The first step of the journey is to inspire and take care of our colleagues. Hiring was a major focus of ours and we ramped up hiring engine to meet the high level of demand and to activate more project work. In the quarter, we increased our head count by 3% and increased project work by 13%.

We continue to see our people-first strategy and our virtual-first model is resonating in the market and helping us in our recruiting efforts. We recently hired Kristie Grinnell as our new CIO, and she specifically called out our virtual-first model as one of the key items that drew her to DXC. In addition, I am pleased with how we continue to deliver for our people through the COVID pandemic. It is due to all these points that our attrition at DXC has stabilized and it remains below industry average.

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Focus on the customer is the next step of our transformation journey and continues to be the primary driver of our success in improving organic revenue. A key metric that we measure is our Net Promoter Score, and I'm happy to report that we continue to see improvement. Currently, our 12-month rolling NPS score is at the upper end of the industry best practice range of 20 to 30.

Another piece of our growth strategy is to run our customers' mission-critical systems, which mainly make up our GIS business; and ultimately, have these customers award us new work. Running these mission-critical systems builds trust with our customers. This strategy is being successful because we are winning more work from our customers in both GIS and GBS, and our revenues are clearly not going backwards.

A great example of this strategy working is the new agreement with Lloyd's. When I started at DXC a little over two years ago, Lloyd's was contemplating a significant reorganization without DXC, which would have caused a negative impact to our revenue. Running Lloyd's mission-critical systems well has built trust that enabled us to be chosen to build the future at Lloyd's, which will be the most advanced insurance marketplace in the world.

DXC will re-architect and develop a cloud-native platform running on AWS to replace their legacy mainframe platform. Simply put, leveraging the trust we have built with our customers by running their mission-critical systems is how we are stabilizing our revenues and setting ourselves up for growth.

Now, let me turn to our cost optimization program. We continue to make progress in optimizing our cost and delivering for our customers without disruption. Managing our cost includes executing portfolio-shaping initiatives.

We have identified businesses with roughly $500 million in revenues that are not strategic and will not help us grow. Selling these businesses will improve our organic revenue growth and our overall margin. We expect the sale of these businesses to result in an additional $500 million in proceeds within the next 12 months.

At the same time, we are focused on prudently investing in assets that will enable us to grow. A great example of this is our recently announced relationship with ServiceNow . Here, we are leveraging our proprietary technology called Platform X, which is a data-driven intelligent automation platform that helps us detect, prevent and address issues before they happen within our customers' cloud and on-prem IT estates.

NelsonHall named DXC's Platform X as a Leader in Cognitive & Self-Healing IT Infrastructure Management reflecting DXC's ability to deliver immediate results through automation. We believe that the ServiceNow relationship will help us execute on a unique opportunity to drive growth in the enterprise service management market due to our capabilities with Platform X.

Next, seize the market is where we're focused on cross-selling to our existing customers and winning new work. We had a strong quarter of bookings totaling $5 billion and a book-to-bill of 1.23x. 58% of the bookings were new work and 42% were renewals.

We are winning in the ITO market, and this is helping us with our organic revenue growth, significantly limiting the declines from double digit to low-single digit negative declines. Modern Workplace is following a very similar path. Our strong 12-month book-to-bill of 1.1x gives us confidence that like ITO, we can take this business from double digit to low-single digit decline in the next 12 months.

Analytics and Engineering is a great story as we are converting our strong book-to-bill of 1.29x on a 12-month basis and growing this business 18.7% in Q3, which is helping us consistently grow our GBS business.

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We are seeing increased opportunities in the market. We have shown the ability to win and the investment we have made in execution is paying off with good deals turning into good revenue, as you can see in ITO and Analytics and Engineering.

Now, let me turn the call over to Ken.

Kenneth P. Sharp

Chief Financial Officer & Executive Vice President, DXC Technology Co.

Thank you, Mike. Turning to slide 11, our transformation journey remains on track with strong progress across all four key metrics. Organic revenue improved 100 basis points from Q2 to a decline of 1.4%. Adjusted EBIT margin is up to 8.7%. Year-over-year, our adjusted EBIT margin expanded a 170 basis points, while we substantially reduced our Restructuring and TSI expense.

Q3 book-to-bill was 1.23x and 1.08x on a trailing four quarters. From our perspective, looking at book-to-bill over a trailing four quarters is more meaningful than looking at one quarter in isolation. Non-GAAP diluted earnings per share was $0.92, up $0.08 compared to the prior year. Our earnings per share expanded despite $0.23 of headwinds from taxes. The tax rate headwinds were more than offset by increased margins and lower interest expense.

Moving to our segment results on slide 12, GBS continues its strong performance, accelerating organic revenue growth to 7%, our third consecutive quarter of organic revenue growth. GBS is benefiting as we leverage our relationships with our Platinum customers. Our GBS business has higher margins and lower capital intensity, so as we grow this business, it has a disproportionately positive impact on margins and cash flow. Our GBS profit margin was 16.2%, up 200 basis points compared to the prior year.

GIS organic revenue declined 8.3%. GIS profit margin was 4.8%, an improvement of 110 basis points compared to prior year. Our focus with GIS heretofore has been on improving delivery, to deliver for our customers while stabilizing the margins. As we set up for next year, we are putting in place a program to drive cost out of GIS to move the margins forward.

Turning to our Enterprise Technology Stack, Analytics and Engineering revenue was $545 million and organic revenue was up 18.7%. We continue to see high demand in this area. Of note is the success we are seeing with our Platinum customer channel. Applications organic revenue increased 4.8%, also accelerating.

BPS, our smallest layer of the Enterprise Technology Stack, generated $116 million of revenue and organic revenue was down 8.3%. We expect the declines in this business to moderate as we move forward and put our new strategy in place.

For our GBS layers of our Technology Stack, our book-to-bill was 1.28x and 1.17x on a trailing 12-month basis. Cloud and Security revenue was $471 million and organic revenue was down 12.2%. IT Outsourcing revenue was $1.11 billion and organic revenue was down 1.9%.

Let me remind you that this business declined 19% in Q3 FY 2021. This is a significant improvement that we indicated last quarter. We expect IT Outsourcing to continue to decline in low-single digit, ideally 5% or better.

Lastly Modern Workplace revenue was $561 million and organic revenue was down 16% as compared to prior year. We remain positive about our prospects and our strong book-to-bill of 1.11x over the trailing 12-month is expected to stabilize Modern Workplace as we move through FY 2023.

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For our GIS layers of the Technology Stack, our book-to-bill was 1.18x and 1.01x on a trailing 12-month basis. As you think about organic revenue growth prospects for GIS, our focus on improving the quality of revenue by expanding margins, reducing capital intensity and driving cash flow may create headwinds for organic revenue growth.

For example, using our capital to buy laptops, bearing the risk and, ultimately, recovering our cash over three to four years with relatively low returns does not feel like a great economic model. At the end of the day, we will prefer to provide our offerings and services and forgo the revenue associated with buying the assets to improve the underlying economics.

Next up, let me touch on our efforts to build our financial foundation. This quarter, we made particularly strong progress with cash generation and continued reduction of Restructuring and TSI expense. With regard to financial discipline, remediating our material weakness is a top priority. We are in the late stage of our efforts to remediate the material weakness and we have fully implemented our 11-point remediation plan. As a result, we expect to remediate our material weakness in Q4.

I should note, as it relates to the material weakness and governance more holistically, we are clear-eyed on how we think about governance. We do not find our current governance score to be acceptable. We are working hard to ensure we improve its trajectory. Like many things at DXC, we are finishing the unfinished homework, creating a sustainable business brick by brick.

In addition to our material weakness remediation, we are committed to improving our pay practices. As part of good governance, our board members and management are continuing to engage with our shareholders to proactively take their feedback, as we work together to design and set our short-term and long-term incentive structure.

Our focus is to set metrics and targets that are highly aligned to what our shareholders want, all the while incentivizing management to improve the company's performance, creating and enduring in sustainable business.

The execution of the transformation journey has made measurable improvement, allowing us to put the business on a firmer financial foundation, expanding margins and generating and keeping more cash.

Slide 15 shows the results of the structural improvements we have made. We've reduced our debt from $12 billion to $4.9 billion and are now below our targeted debt level. We have reduced our quarterly net interest expense to $23 million, a $31 million reduction as compared to prior year.

As you recall, we were able to term out a significant portion of our debt last quarter with principally all of our outstanding borrowings at fixed rates. We expect to continue the lower interest expense at approximately $25 million per quarter.

We also continue to make progress on reducing Restructuring and TSI expense. This reduction contributed $195 million to cash flow during the quarter as compared to the prior year. Further, this also achieves one of our goals of narrowing the difference between GAAP and non-GAAP earnings.

I should note that while we have been reducing Restructuring and TSI expense, we have also been able to expand margins. Lastly, as you can see, we have also reduced operating lease cash payments from $156 million in the third quarter of the prior year to $117 million in the third quarter of FY 2022.

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Moving to chart 16, let's talk about the focus we've brought to capital expenditures, including capital leases. Our capital expenditures were reduced from $219 million Q3 FY 2021 to $146 million Q3 FY 2022. We are closely managing our capital lease origination, which ultimately means our capital lease debt and associated payments continue to decline.

In FY 2020, we had $270 million quarterly run rate for originations, while our last two quarters averaged less than $60 million. We made $207 million of capital lease payments in Q3 last year, which is now down to $184 million in the current quarter. For Q4, we expect a further reduction of capital lease payments to approximately $140 million.

A metric we like to look at to gauge capital efficiency is capital expenditures and capital lease originations as a percentage of revenue. We are now tracking at 5.2% for two consecutive quarters, down from roughly 10% in FY 2020.

Clearly, our focus has been on improving our cash flow. Specific to new business, we have been focused on structuring our transactions to have lower capital intensity, potentially trading off revenue in favor of cash flow.

As you can see from my prior comments, our focus on driving structural changes has improved our ability to generate and hold on to more cash. Cash flow from operations totaled an inflow of $696 million. Free cash flow for the quarter was $550 million, an increase of $956 million as compared to prior year, and moves our year-to-date free cash flow to $650 million or $150 million above our full year guidance.

Further, cash in the quarter was negatively impacted by two previously disclosed payments totaling approximately $130 million. These payments were offset by much stronger performance due to improvements in the business and benefits from timing on payments and receipts in the quarter. We expect this timing to create some headwinds in Q4 cash flow.

Slide18 shows our trended cash flow profile. Our progress in Q2 and Q3 gives us confidence as we work towards delivering our longer-term FY 2024 guidance of $1.5 billion in free cash flow.

Moving to slide 19, let's revisit our relatively simple capital allocation formula. We are targeting a debt level of approximately $5 billion and a cash level of $2.5 billion. With debt at our target debt level, cash over $2.5 billion is excess cash, which we expect to deploy. Based on this formula, we expect to self-fund stock repurchases of $1 billion over the next 12 months. The $1 billion in repurchases will be funded from a combination of cash generated from operating our business as well as proceeds from our portfolio-shaping efforts.

We recently executed a number of sale agreements and expect to divest businesses and assets with approximately $500 million of revenue and will generate $500 million of proceeds in the next 12 months. These businesses are not synergistic and cannot be leveraged more broadly in our Platinum channel.

As you will see in our 10-Q, we entered into an agreement to sell our German financial service subsidiary that includes both of our banks for approximately $340 million. As noted in the liquidity section of our previously filed financials, the German financial services business has cash held on deposit for the bank's customers. The current cash balance related to these deposits is $670 million.

We also announced an agreement for the sale of our Israeli business for $65 million. The valuation for these assets are accretive to our valuation. Further, we do not expect these divestitures to create headwinds related to

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achieving our FY 2024 longer-term guidance for organic revenue growth, adjusted EBIT margin and free cash flow. We continue to assess our portfolio to ensure we have businesses that are aligned to our strategy and not a distraction for our management team.

Now, let me cover our progress on share repurchases. In Q3, we repurchased $213 million of common stock, bringing our FY 2022 year-to-date repurchases to $363 million or 10.6 million shares. Our share repurchases are self-funded. As noted, we expect to repurchase $1 billion of our common stock over the next 12 months as we firmly believe our stock is undervalued.

Turning to the fourth quarter guidance, revenues between $4.11 billion and $4.15 billion. If exchange rates were at the same level as when we gave guidance last quarter, our fourth quarter revenue guidance range would be $20 million higher.

Organic revenue declines minus 1.2% to minus 1.7%; adjusted EBIT margin in the range of 8.7% to 9%; non-GAAP diluted earnings per share of $0.98 to $1.03 per share. For Q4, we expect the tax rate of approximately 26%.

As we look to the end of FY 2022, I would like to update our current fiscal year guidance. Based on the strengthening US dollar, our revenues are expected to be negatively impacted by approximately $40 million. We now expect to come in at approximately $16.4 billion.

Organic revenue growth range of minus 2.2% to minus 2.3%, which is slightly lower than our previous range. Adjusted EBIT margin, 8.5% to 8.6%. We continue to expand margins while significantly lowering Restructuring and TSI expense and are now guiding to $400 million for FY 2022.

To put this all in context, we expect to spend $500 million less on Restructuring and TSI expense than last year, while expanding margins by over 200 basis points. Our focus is to embed these types of expenses over time into the normal performance of the business, and believe we have taken significant strides in doing so. Non-GAAP diluted earnings per share of $3.64 to $3.69.

Lastly, we are increasing free cash flow guidance to over $650 million, $150 million improvement to our prior FY 2022 guidance. Fourth quarter cash flow is expected to be impacted by timing, which boosted Q3 cash flow; and in addition, $100 million payment in Q4 to terminate a financial structure put in place a number of years ago.

We are reaffirming our guidance for FY 2024. This reflects our strong execution in driving forward on our transformation journey. Overall, we are making great progress driving efficiency in the business and generating strong free cash flow. We are utilizing those cash flows to drive significant value for our shareholders through our stock repurchase program.

With that, I will now turn the call back to Mike for his closing remarks.

Michael J. Salvino

President, Chief Executive Officer & Director, DXC Technology Co.

Thanks, Ken. Let me leave you now with a few key takeaways. As I think about finishing out FY 2022, we are making great progress. During our June Investor Day, we committed to making progress on all nine of these points, and let me quickly give you an update on each.

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Win in the market and a book-to-bill of greater than 1x, our trailing 12-month average is now 1.08x. Sequential revenue stability. This year, we produced relatively stable revenues in Q2, Q3, and we expect this to continue in Q4.

Strengthening the balance sheet. Our debt is now at $4.9 billion and our refinancing has significantly lowered our interest expense. Achieve organic revenue growth of minus 1% to minus 2% in FY 2022. This is where we're coming up a little short anticipating negative 2.2% to negative 2.3% organic revenue growth.

Remediate material weakness and improve governance score. As Ken indicated, we will remediate the material weakness in Q4 and we have plans to continue to improve our governance score. Reduce Restructuring and TSI. We have taken it from over $900 million to roughly $400 million in FY 2022.

Continue margin expansion. We have expanded margins every quarter throughout FY 2022. Improve free cash flow. We exceeded the $500 million guidance for FY 2022. And finally, resume capital deployment to shareholders. We have repurchased $363 million and plan to do another $1 billion over the next 12 months.

In addition to this progress, we're also committed to portfolio shaping. What this means is we're making the right bets in investments, like what we are doing with Platform X and ServiceNow, and divesting assets that are not core to our strategy and will not help us grow. Our portfolio shaping is anticipated to drive $500 million in excess cash in the next year.

In closing, I am confident that by staying focused on our transformation journey, we will continue to deliver on our commitments both in the short term and the long term.

And with that, operator, please open the call up for questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Ashwin Shirvaikar with Citi.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.
Q

Good evening.

Operator: Please go ahead, your line...

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.
Q

Hey, Mike, Ken, John.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Hey, Ashwin. It's Mike.

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.
A

Hi, Ashwin.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.
Q

Hey. Congratulations. I guess, my first question is, the last four quarters, it's been quite a turn in your cash flow. And I get the points you made in your prepared comments. Could you comment on what investors should expect as it relates to sort of a good net income to free cash flow conversion ratio? And then in terms of use of cash, if you don't mind revisiting what you said on slide 19, are you saying no acquisitions at all? Or could you kind of just clarify that point?

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Okay. So, look, I'll start and then I'll hand it over to Ken. And then, Ken, you hand it back to me on the acquisition. So, look, in terms of the last four quarters, Ashwin, what you're seeing – and this is the thing that we talk about all the time, is the operational execution. And what that operational execution is, is doing across the board, is literally starting now to drive the free cash flow.

And what was interesting is when we were in Q1 and we went minus $300 million, I know that was a little hard to believe. But what we could see was that the business was starting to turn, both in terms of what we were doing in terms of driving good revenue, along with good margin, along with just stopping certain things and putting in the operational rigor that we needed to do.

Ken, do you want to comment on the other piece, and then I'll go to the acquisition stuff?

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Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.

A

Yeah. Sure, Mike. So, Ashwin, look, we've been working pretty hard, the finance team, Mike's team, kind of down in the [ph] bowels (00:32:50) of the organization, making sure that we're executing in pretty disciplined fashion, right. And I think if you look at the kind of quarter-over-quarter, there's some pretty good structural improvements around bringing down the Restructuring and TSI costs to about $195 million. Dealing with the interest that we dealt with last quarter when refinanced our debt, that's about $70 million or so. Capital expenditures and capital leases, so just being more disciplined managing the contracts, managing our performance. And the great news is when you have happy customers, they tend to pay you and things work so much better. And that's what Mike and his team have really brought forward.

So, what I would say, just kind of maybe looking back, right, because it is a little hard. Your first two quarters in as CFO, you print some negative cash, maybe it's my first three quarters, but it's nice to see the almost $1 billion in cash generation since then. And now, we're year-to-date at $650 million. So as you think about cash conversion, I think it's a great question. Certainly, it's something that's on our mind. We'd certainly like to see that correlation between earnings and cash flow – GAAP earnings and cash flow to get really close. And that's something we certainly guided to when you think about FY 2024, that should give you a pretty good perspective of where we think we'll be.

But we'll certainly kind of keep you updated on that. And as far as percentages, I think you probably maybe let us work through that next quarter as we guide for 2023 and 2024, we can be a little clearer on that. But we think we're absolutely in a better place, for sure.

With that, I'll turn it back to Mike on the acquisition piece.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Ashwin, so look, on acquisitions and what's on slide 19, we talk about building the strong foundation, and we still got work to do, right. I mean, sometimes our team makes this look easy and there's still a lot of work that we need to do, as it relates to, for instance, the Platinum channel and, for instance, still what I'd like to see happen with some of our offerings.

The other key thing is, I believe, we've got enough to grow. And when I think about our growth equation around GBS consistently growing and then GIS driving to a negative low-single digit, we've got what we need to get there, all right. So, I look at the next 12 months and say the best use of that cash is to return it to the shareholders. And we never say never. So, we're not – I know there's a big red X on that slide, but we look at stuff all the time, and if we think it's the right thing to do that we can absolutely create it – bring it in as part of our growth agenda, then absolutely, we'll do it.

Ashwin, did you have a second question?

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.

Q

I did have a second question. Thank you for that response and also thank you for the cash flow performance. The question on bookings, as you deliver on your bookings presumably, I would think industry reputation goes up, you're attracting talent, are you seeing the top of your funnel grow in size as well? And is there a way to quantify that or comment on that?

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Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Well, look, I mean the bookings – are we seeing the top of the funnel increase? I would tell you we are seeing an increase in a better number of qualified deals. Okay? And that's what I'm looking at in terms of quality. Because when you produce a $5 billion quarter, which is a big quarter for us, that means the quality that was sitting there was something that we really could convert. And I understand that the Q2 number wasn't where we needed to be. But we've got a team that can convert the pipeline into good deals. And that's what I said.

I mean, Ashwin, the market right now, we see there's a lot of opportunities. Here's the good news. We are winning. And with the execution that we're investing in, we're turning those good deals into good revenue. And that's what I would highlight that what we're doing. And for instance, the two that I called out, both Analytics and Engineering, there is no question. And that's more of a project-based business.

And then, when you look at an outsourcing-based business, look what we've done with ITO. I mean, that's converting good deals to good revenue. Otherwise, there's no way you can take the business from minus 17.7% to minus 1.9%, when most people kept telling me when I joined that we had secular issues with that, and I kept saying no, we have customer delivery issues and that's what we're going to go fix. And I think we've done a pretty good job with that.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.

Q

Understood. Thank you.

Operator: Okay. Next, we'll go to Bryan Keane with Deutsche Bank.

Bryan C. Keane
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, guys. Just want to ask about the GIS segment profit margin. It slipped a little bit sequentially to 4.8%. Just thinking about some of the factors there and what might be the outlook in that segment, because obviously there is some room for improvement there going forward in the out-years.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Bryan, so let me give you a little color there, that you'll see – what is it, on slide 12? Slide 12. You'll see that what we did originally is we put together a plan to take out a chunk of costs in that business, which we successfully did, and then make sure that we focused on no customer disruptions. So, we let that bed down. As Ken mentioned, our next step now is we're into 2023 planning and we're putting together our next program. And our next program – that's why I had Ken highlight those four areas. Meaning, we're still going to be focused on contractor reduction.

Now, we're including our data centers in our colocation leases, Bryan, which I think we can take a nice chunk of costs out of that. Scaling our GIDCs is important. And then to try to tie a few things together, automation will be the last. That deal that we cut with ServiceNow around Platform X that was literally the automation that I've been talking about for a while, that we can monitor cloud and on-prem estates and now to have ServiceNow validate that and say they want to go out in the market with us to go to the enterprise service management market and, hopefully, dominate it, that's a good win.

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So, what we'll do is, we will take the next chunk out of that. I think we can. But again, we're going to be very focused on making sure we're delivering for our customers, too.

Bryan C. Keane
Analyst, Deutsche Bank Securities, Inc.
Q

Got it. And then, as a follow-up, just thinking about the portfolio pruning, I think you mentioned it was about $500 million in revenue which will generate about the equal amount in proceeds. Just trying to figure out how fast or how much of a decline that piece of business was in and what maybe the margin impact was there? Just trying to get to an EPS impact versus the proceeds. Thanks.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Bryan, so we call it portfolio shaping, not pruning. That's a better word, don't you think? So, what we are doing is – look, let's be clear. If I think something is a distraction for our team, then – it is not where it needs to be, then that's what we're looking at. And you've seen over the course of my two-plus years that if I think that's happening, we're going to [ph] exit (00:40:44) it. So, those businesses, which Ken literally has said, they will be accretive. They will not impact our FY 2024 numbers and they will be accretive to our organic revenue and margin. Look, I'm not going to give you the details, but safe to say they weren't performing where they need to be.

The second thing is strategically, I mean, Bryan, if I came to you and said, why don't you put your assets in our bank, you'd scratch your head, okay, because that's not a Platinum account offering, and there is a number of things that look like that. And to me, that's a distraction. And what we need to do is do the hard work, much like I said when answered Ashwin's question, because there is still stuff that we can go do to make DXC a much better place.

So, Bryan, thanks for that question. Next question?

Bryan C. Keane
Analyst, Deutsche Bank Securities, Inc.
Q

Thanks.

Operator: Anything further Mr. Keane.

Bryan C. Keane
Analyst, Deutsche Bank Securities, Inc.
Q

No, that's it. Thanks so much.

Operator: Okay. Thank you. We'll take our next question from...

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Thanks, Bryan.

Operator: ...Lisa Ellis with MoffettNathanson.

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Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Terrific. Thanks, guys. I was looking back at my notes from when DXC bought Luxoft, and it looked like about half of Luxoft's head count was in the Russia and in the Ukraine at the time. Can you just comment on whether or not – I mean, they are the foundation of Analytics and Engineering that's performing fantastically well. So, I'm just – are you seeing or do you anticipate any disruption to that business given the conflict in the region, or how should we be thinking about that?

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Okay. So, Lisa, first of all, it's half of Analytics and Engineering. Remember, we still had – before we bought Luxoft, we had DXC capability in that space. But look, when I look at that situation, again, this is what we do. This is what we do for living. We run customers' mission-critical systems. So, we've had business continuity plans in that region for a while. We've also operated in the Ukraine for 15 years and Russia for 20 years and we've managed through events like this. And we've done a nice job supporting both our customers and our colleagues and that's our focus.

So, look, if need be, we're ready to support a movement of our folks to Poland. And when I say that, we've outfitted all of our folks with technologies, so think computers, cell phones, network connections. We've also secured lodging. We've also had multiple town halls communicating with them and getting their buy-in that that's a good plan.

Now, in terms of stats, the stats are we have 4,000 colleagues in the Ukraine out of our 130,000-plus and they're across three main cities. These folks drive roughly about $250 million in annual revenues and 70% of those revenues come from 20 customers. And we obviously have been communicating with those customers and are coordinated around what to do there if we need to.

So, I think, Lisa, we've got a very good plan and we'll continue to execute.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

[ph] Okay. Good. Again – (00:44:14) and thanks for the clarification on the size of that business. A follow-on one, again, I'm just looking at the growth of that business. I like this concept of the Platinum channel that you're describing on the call. Is that an area where you're focused on cross-selling in that digital engineering business? I would imagine because a portion of it came from Luxoft, the customer base might still be a bit different. Is that part of what's driving that growth? Or is that kind of – is that an example of sort of this cross-selling into the Platinum channel?

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Exactly. So, one of the things when I talk about doing the hard work, before I got here, we didn't have any Platinum accounts. So now, our team in the various businesses are laser focused on those customers to make sure that we deliver, we're proactive and we listen. So taking an offering like Luxoft into those Platinum accounts is huge. Now, the only way we can do that is you heard me talk about running mission-critical systems. What happens is we run these mission-critical systems, when we do the GIS business, we build that trust, which gives us more, just call it, plate appearances, using a baseball analogy.

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Those plate appearances allow us to introduce new offerings like Luxoft, like the Analytics and Engineering, because, Lisa, quite frankly, DXC was never known for that work. So, a lot of times, we'll show up at our clients and they will be surprised at a lot of the examples we have, for instance, in the banking space or in the automotive space.

So, what we're doing is, we're planting a lot of seeds in those areas. And you know that business is, you start it with delivering 5 or 10 people. 5 or 10 people grows into 50 people very quickly when you deliver. So, that's exactly our strategy, and I appreciate you asking the question.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Thank you. [ph] Good to go (00:46:27).

Operator: Okay. Next, we'll go to Bryan Bergin with Cowen.

Zack Ajzenman
Analyst, Cowen and Company

Q

Hi. Thanks. This is Zack Ajzenman on for Bryan. First question, we're looking to dig a bit more into the moving pieces within GIS. ITO trends notably better, but kind of surprised by the weakness in Cloud and Security, particularly against something like the more well-known industry tailwinds in those areas. So, could you help us better understand the current dynamics that's weighing on that stack layer?

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Okay. So, when we look at GIS, let's take a step back again, because when I look at what we were focused on doing in FY 2022 is to stabilize the revenue, and I think we're done that. If you look at page 11, when you look at what we've done year-over-year, we've gone from minus 9.7% to minus 1.4%. And then, I look at it also as quarter-over-quarter, and we've increased our revenue Q2, Q3 and we're guiding towards increased revenue in Q4.

So when I look at the equation to grow DXC, the first thing we got to do is consistently grow GBS, and we just printed our third quarter of growth at 7%. Then the second thing we got to do is we got to get GIS, all right, into negative single digits. And right now, we're sitting roughly at about minus 8%.

So then, if you look at page 13, the real piece that we've got to focus on is Modern Workplace. The cloud business has been lumpy for us. We've had some good quarters and we've had some bad quarters. What I can tell you is that we're building the right team and it looks like we've got some decent momentum in that business having a book-to-bill of 1.23x.

When I look at the GIS weakness and the revenue weakness, it literally has come, for the most part, from Modern Workplace. Meaning, when you put a business up into strategic alternatives, which, quite frankly, it seems to have – the market right now, there seems to be a lot of that going on. And I'm happy that we're through that.

So when we put that business up for strategic alternatives, we thought that there would be revenue declines. And what we saw in 2022, they were a little bit deeper than we thought. The good news is the UPtime solution, which is our new solution that we use at DXC, is really taking shape in the market.

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Now, why do I tell you all that, because that business is sitting at minus 16%, and I think it's going to follow the exact same track as ITO. So, look, what we've done with ITO, minus 17.7% now to minus 1.9%. So if we do anything close to that, we will end up getting GIS right where we want it and DXC will ultimately grow. So, hopefully, that gives you enough color on your question.

Zack Ajzenman
Analyst, Cowen and Company

Q

It does. Thanks for the bridge there. And just our follow-up is on cost savings. I think back at the Analyst Day, one of the levers you guys focused on as it relates to improved margins was reducing the contractor mix, which stood at 17% last year. Any update on the mix today and any context on how challenging it might be to move away from contractors with attrition expected to kind of remain in elevated levels. I know I heard you guys say you're below industry average, but sounds like attrition is kind of here to stay on an elevated basis over the upcoming quarters.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Okay. Well, thanks for that question. So, let me talk a little bit about attrition. And the first thing is, when you think about what we're doing, first, our people-first strategy is resonating. So, you'll see that we are changing the culture. And I appreciate what the women and men of DXC are doing to do that.

The second is our virtual-first model, meaning people love it. And UPtime, which is the Modern Workplace solution, is totally supporting us to be able to do that in a very effective manner. And then, last thing is, I think, we're doing a very good job taking care of our colleagues during the COVID situation. So, all that boils into stabilizing our attrition and stand well below the industry average.

So, look, when I think about the employee base as a whole, I think we're doing a very good job.

Zack Ajzenman
Analyst, Cowen and Company

Q

Thank you.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

What's the next question, David?

Operator: Sorry about that. We have Tien-Tsin Huang with JPMorgan.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Hey. Thanks so much. Good to connect with all of you guys. Couple of questions, I guess, first, just on the quality of the backlog in the pipeline, just curious about the mix of larger deals versus some of the short-cycle work and just new logo versus renewals, et cetera. I know you've talked about last quarter, Mike, that you saw a little bit of a push-out, and it sounds like you signed some of those bigger deals. Just curious how things are looking now so far in this calendar year.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

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Okay. Well, look, one of the things that we have done with book-to-bill now is we think the 12 month – the rolling 12-month average is the best way to look at it. We said we're 1.08x and I expect to keep that number over 1x. Quite frankly, I expect to be over 1x in Q4, too. When you look at new logos or what I say new work versus renewals, that's 58%-42% is a very good mix still. I think that's our third quarter with us driving that kind of new work. And the reason why that's so important is, if you go back to 11 and you see the organic revenue, I mean, that's the stuff that we're driving through to take us from minus 9.7% to minus 1.4%.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC
Q

Yeah. No, that makes sense. I get it. So, just on the free cash flow and the cash generation, good work there. So, the $1 billion in share repurchase, should we expect that to be a programmatic or opportunistic sort of idea? Or is there some other structure you might put in place to enact that? Just curious about the execution on that. Thanks.

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.
A

Yeah. And we've been doing, right, share repurchases. We're pretty programmatic as far as timing and we stay pretty disciplined with it. It's important for us to stay self-funding around it. So, we look at where our cash is and where we expect to have cash and work with the banks, of course, and buy back the shares kind of on a periodic basis. So, we'll continue to do that. Our expectation is we'll be in the market and that's kind of how it works.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC
Q

Okay. Makes sense. Thanks for the time.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Thanks for the questions.

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.
A

Thank you.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

David, next question.

Operator: Okay. Next, we'll go to James Faucette with Morgan Stanley.

Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC
Q

Hey, guys. This is Jonathan on for James. Thanks for taking our questions. I want to build on some of the questions that we've had earlier. Can you talk through the progress of the Luxoft penetration into your Platinum accounts? Are you seeing any pricing power in Analytics and Engineering there? And are you – like, what are you seeing from a runway perspective?

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Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

So, in terms of pricing power, we've definitely been able to increase our prices in that segment of our business. In terms of runway, I would tell you it's still very early innings. And there is a lot of juice still left in that tank. Okay?

But again, I continue to look at Analytics and Engineering business as – remember, it's a combined business. And when I think Analytics and Engineering, it's not just the stuff we do in banking and automotive, but it's also things like data cleansing, because the way we've tackled that market is we do a lot of what I call the hard work. And when you cleanse the data and you're the person bringing all those data lakes and so forth together, then it just goes to show you that, look, we'd be the right person to then do the analytics on that data because we know the data the best. And that's what DXC had before we built Luxoft. And bringing the two together is pretty phenomenal, as you can see with us getting to 18.7% in that segment.

Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC
Q

That's good color. Thanks for that. And a follow-up, if I may.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

James (sic) [Jonathan], did you have another question?

Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC
Q

Yeah. Look, I appreciate the commentary on...

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

Yeah. Go ahead.

Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC
Q

...attrition stabilizing. Can you talk through some of the attrition you're seeing at the top of the tech stack, particularly in the Analytics and Engineering?

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.
A

We're not – look, in terms of the top, that's not the issue. The issue is how quickly can we hire. And that's what I said on the last call. Like, we need to rev up our hiring engine, and because I thought we fell short in Q2, and I think I was very clear on that. So, what I was pleased to see is that the hiring engine allowed us to increase our head count by 3%.

When you look at our margins, we also built a little bit of a bench, right, that I was okay with us eating into our longer-term margins a bit to do that. Because in the market right now, not only do you have to show up with the capabilities and the skills, but if you've got the deep relationship, James (sic) [Jonathan], first one to the door is usually going to get the work. And that's what we've seen. So, that's basically what we're doing.

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Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC

Q

Good color.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Fair enough, James (sic) [Jonathan]?

Jonathan Y. Lee
Analyst, Morgan Stanley & Co. LLC

Q

All right.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

David, next question.

Operator: All right. Next, we'll go to James Friedman with Susquehanna.

James E. Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Really good work here, guys. I got a couple. Ken, in your prepared remarks about BPS, talking about moderating the declines, you alluded to, but I don't think you elaborated on a potential new strategy, that was your language. So, what's – could you elaborate on that one?

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.

A

Yeah. Sure. We've got some businesses. And as we've been working through our portfolio, that really align well with the BPS and the insurance business. So, I think from our perspective, longer term, right, is how we leverage that customer base, bring them together and do more with it. And that's kind of where we're working through now on what's that strategy to tackle the market.

James E. Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Mike, your prior answer about driving costs out of GIS in 2023, it was a great answer, I heard you say before. But could you just – sorry, could you just repeat it, because there's a lot of moving parts there? So taking costs out of GIS starting in 2023.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Okay. So, it's basically the exact same equation we did to begin with. Okay? Except now the new entrant is data centers and colocations, which Ken loves, okay, because we've got a huge opportunity there, too. But the levers are these. First one is the contractors, which – that's already been discussed on this call and what we'll do is continue to drive those down. And look, our focus is to make sure we're delivering as much of the work as we can at DXC with our own people. And it's really hard in my mind to motivate and change a culture when you've got contractors in. So, it's kind of personal, all right, is what I would tell you.

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The second thing is scaling our GIDCs. What that means is if we do have attrition and we are hiring new people, let's hire them in the right spots and let's make sure we're filling up the centers that we want in terms of where we can get the best talent for our skill set. Third is automation, and that's why I couldn't be more pleased about Platform X. I mean, that's something that we built internally and now to be able to take that to market with somebody like ServiceNow is huge.

And then, the last one is data centers. So, we've got not only these data centers that we've owned, but we also have these colocation leases. And if you look at what Ken and the finance team has done in the real estate area in the last 12 months, we're going to be able to take another chunk out of that, because the data centers are not filled at 100% capacity. And then, these colocations, to be quite blunt with you, I've never seen before. So, we're going to clean that stuff up.

James E. Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Are you allowed to...

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Hopefully, that gives you the color.

James E. Friedman
Analyst, Susquehanna Financial Group LLLP

Q

Yeah. That was great, Mike. Thank you. It seems consistent, a little more elaborate. And then, if I could just ask, are you allowed to say about the share repurchase? Like, what are you thinking about the time? Do you want the proceeds first from the sale, the self-funded share repurchase timing?

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.

A

Yeah. We probably wouldn't get too far in the timing on that. But look, we think our stock is undervalued. Clearly, last quarter, we went into the market and bought some stock back. We would expect to do the same thing based on our formula. So, we've got – certainly, our formula is $2.5 billion in cash, and we're sitting with excess cash today. So, we feel good about where we are.

And Mike said earlier, our debt's sitting at $4.9 billion. So, clearly, we've done what we needed to do on the debt, and we actually have some more payments that continue to come due on these capital leases as we've been bringing it down. So, expect our debt to continue to come down a bit, and we've got excess cash. So, we think we're in a great spot.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

So, look, thanks for that question. David, we'll take one more question and then I'll close the call, because we're right at the top of the hour right now.

Operator: All right. Next, we'll go to Rod Bourgeois with DeepDive.

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Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

Hey, guys. Hey, thanks for fitting me in here. Very nice to see the increased free cash flow outlook. So, I just want to ask, I mean, you've talked about the margin levers, that's very helpful. Besides the mix shift that's happening, which is clearly positive in the business, what are the main levers remaining to reduce capital intensity? And I'd especially like a view on whether you have a path to make free cash flow smoother or less lumpy and less seasonal. If you can give us an update on the capital intensity outlook, that would be really helpful.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

Rod, you want it all. I mean, are you serious? I mean, the free cash flow, all right, I mean, make it less lumpy, I'd love to have that, all right? And what I can commit to you is that we're working really hard, all right, around it. But you can see the levers, right? You can see some of the capital levers that I've mentioned. And those are real, and we've got to get after those to be able to drive more free cash flow.

But I'll let Ken go through it, and then I may have a few more comments after that.

Kenneth P. Sharp
Chief Financial Officer & Executive Vice President, DXC Technology Co.

A

Yeah, Rod. I just think you'll see a greater and greater focus over time as we look at, specifically, the GIS layers of the stack and making sure we're being thoughtful with the kind of the CapEx upfront, the returns that we expect and the timing of cash flow. And that dialogue has really been in process for a couple of quarters at the longest. And I think Mike and his team are really working through how to engage with the customers, get something done that doesn't have us be a bank where we're buying capital, putting on our books. I mean, certainly some cases, you're going to do that. But there's assets that you immediately deliver to a customer and then you have them on your books. Those are really not appealing, right?

So, how to work that balance and strike that balance is important to us on the CapEx side. So, we think we can kind of work that and I think we've seen some kind of early-day wins on that. I would also add, like when you look at our structural cash improvements, the Restructuring and TSI, certainly a big piece. The interest is done. Everything is termed out. For the most part, the capital leases will continue to come down. But I think we have [ph] goodness (01:03:38) there. Capital expenditures, you have to, for me, put capital lease originations in there. And right now, we're doing more debt paydown on the capital lease side. So when you think about our payments sitting at $180 million this quarter, going down to $140 million next quarter, I think that's just more cash we're going to keep at the end of the day.

I know a geography that shows up below the cash flow free line. But I think that's important and it's a bit of the untold story, candidly, because when we gave the $1.5 billion FY 2024 guidance, we had $900 million of capital lease payments that went out. And I think it was actually you that we were talking to offline, and you made the astute point of, hey, that means you really only have $600 million in cash flow. So, the mere fact we're tackling the stuff underneath and holding on to more cash, I'm actually surprised we don't get more accolades around that and all these great write-ups that you guys all do, because I think we've all done, collectively, a phenomenal job getting the business in a better place from a capital structure, capital usage standpoint.

So I'm pretty excited about it. I do think we have some things to kind of work through, certainly, going forward. Cash taxes right now is a bit elevated for me. I don't like it. I like to pay less tax, like every other person. So, we've sold a lot of businesses, had some gains. And hopefully, that will normalize over time. And you'll see that come

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down as well. But I do think we're in a lot better shape now than we were, I think, when you asked me that question about the $900 million. So, I feel pretty good about where we are.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

A

So Rod, it's Mike. Do you have a follow-up question?

Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

No, this is exactly what I was looking for. I mean, I think this is the key to the valuation. It's always been the struggle in this business is the free cash flow generation, making it steadier and on the rise. And so, this detail is super helpful.

Michael J. Salvino
President, Chief Executive Officer & Director, DXC Technology Co.

Rod, thanks so much. And look, before I close the call, what I wanted to do is thank all the women and men of DXC for their hard work in continuing to change our culture and clearly make DXC a better place for our customers, our colleagues and our shareholders.

And with that, operator, please close the call.

Operator: And this does conclude today's conference. You may now disconnect.

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