Xerox Corporation (XRX)

Updated July 5th, 2018 by Josh Arnold

Key Metrics

Current Price:	$24	**5 Year CAGR Estimate:**	16.5%	**Volatility Percentile:**	70.6%
Fair Value Price:	$40	**5 Year Growth Estimate:**	2.0%	**Momentum Percentile:**	13.5%
% Fair Value:	61%	**5 Year Valuation Multiple Estimate:**	10.4%	**Valuation Percentile:**	98.5%
Dividend Yield:	4.1%	**5 Year Price Target**	$44	**Total Return Percentile:**	94.2%

Overview & Current Events

Xerox Corporation traces its lineage back to 1906 when The Haloid Photographic Company began manufacturing photographic paper and equipment. Through a series of mergers and spinoffs, the Xerox we know today was formed. Xerox spun off its business processing unit last year and today, focuses on design, development and sales of document management systems. The company produces $10B in annual revenue and has a market cap of $6.2B.

The company's recently reported Q1 earnings were somewhat weak, but certainly overshadowed by a pending merger agreement with Fujifilm. Q1 revenue was down 0.8% on a reported basis but 4.6% on a currency-neutral basis, although operating income grew 5% as margins were higher. These results are about on par with Xerox' recent reports as it struggles to maintain its revenue base, but benefits from a weaker dollar and higher margins.

The Fujifilm merger agreement, which Xerox wants to terminate, has taken center stage. Xerox already has a noncontrolling interest in a joint venture with Fujifilm that is losing money. Xerox and Fujifilm agreed to a deal to combine the entities, with Fujifilm shareholders owning 50.1% of the combined company. Xerox shareholders, however, say the deal undervalues the company and are seeking a higher price – $40 per share has been mentioned by major shareholders – or a termination of the agreement entirely. Fujifilm wants to move forward with the deal and it is currently being litigated. Fujifilm wants a breakup fee should the merger agreement terminate, up to $1B.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$4.40	$2.40	$3.16	$3.60	$3.76	$3.92	$3.84	$3.20	$2.32	$3.48	***$3.45***	***$3.80***
DPS	$0.68	$0.68	$0.68	$0.68	$0.68	$0.92	$0.98	$1.09	$1.25	$1.00	***$1.00***	***$1.00***

Xerox' earnings-per-share haven't moved around much in the past decade despite the volatile environment the company has operated in during that time. Xerox has had a difficult time growing revenue and profits and we do not see that changing moving forward. Indeed, we are forecasting just 2% earnings-per-share growth for the next five years.

Xerox has a significant overhang from the Fujifilm merger so pending what happens there, we may see estimates change. For now, we see growth coming from roughly flat revenue, but continued margin expansion as Xerox improves its operating efficiency by controlling costs. The Fujifilm joint venture is also a wildcard given that it produced tens of millions of dollars for Xerox in last year's Q1 but lost money this Q1. Xerox on its own should be able to produce low single digit earnings-per-share growth but there are certainly some large items that could cause volatility in earnings.

The dividend is $1 per share today and we do not see any increases coming anytime soon. The dividend was cut after the Conduent spinoff in 2017 and given the above, we don't see management taking the risk of a higher dividend.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	11.3	11.9	12.5	10.5	8.0	9.7	13.0	14.3	16.8	8.5	***7.0***	***11.5***
Avg. Yld.	1.4%	2.4%	1.7%	1.8%	2.3%	2.4%	2.0%	2.4%	3.2%	3.4%	***4.1%***	***2.3%***

Xerox' average price-to-earnings ratio in the past decade has been 11.5 and we see that as fair value. That is much higher than the 7 times earnings the stock trades for today, implying a 10.4% tailwind to annual total returns should the valuation normalize. While we see 11.5 times earnings as fair value, it may take years to reach it if Xerox ends up in a long court battle over the merger. In addition, if Fujifilm wins the judgment it is seeking for Xerox calling off the merger, that could negatively impact the valuation as well. There is no doubt the stock is cheap but uncertainty is a powerful force that can keep it that way for long periods of time. Xerox, therefore, is only for investors with a long time horizon.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	34.4%	35.0%	32.5%	29.6%	27.6%	28.0%	26.2%	25.2%	39.6%	39.6%	***39.5%***	***40.0%***
Debt/A	72%	70%	60%	60%	61%	56%	61%	64%	74%	67%	***70%***	***70%***
Int. Cov.	-6.7	1.2	1.4	2.7	2.8	3.0	5.4	5.4	4.3	5.3	***5.3***	***5.5***
Payout	15%	28%	22%	19%	18%	23%	26%	34%	54%	29%	***29%***	***26%***
Std. Dev.	49%	58%	34%	30%	25%	17%	20%	17%	29%	24%	***35%***	***30%***

Xerox' quality metrics have generally improved in the past decade, which is partially the product of the Conduent spinoff. Margins have increased and interest coverage has improved dramatically despite higher debt totals. We think Xerox will be able to continue these positive trends in the coming years as its business remains stable.

Xerox will suffer during the next recession as it serves a global customer base, some of which will also suffer during a downturn. Its competitive advantage is in its pure-play focus on document management systems and its very long history in the industry. In addition, it has a highly diversified, global customer base.

Final Thoughts & Recommendation

In total, we see Xerox producing 16.5% annual total returns in the coming years, although there may be significant volatility in achieving those returns. The yield will contribute 4.1% and earnings-per-share growth should add 2%. However, we see the vast majority of total returns - 10.4% - coming from a rising price-to-earnings ratio. While Xerox' total return projections are strong, keep in mind it may take years to achieve the result and much depends upon what happens with the Fujifilm merger. Therefore, while we see Xerox as trading significantly under fair value, this is certainly not a low-risk situation. The yield is safe and the stock is undervalued but value realization may only result from resolution with Fujifilm.

Total Return Breakdown by Year