



# Xerox Corporation (XRX)

Updated February 4<sup>th</sup>, 2019 by Josh Arnold

## Key Metrics

|                             |      |  |       |                                 |       |
|-----------------------------|------|--|-------|---------------------------------|-------|
| <b>Current Price:</b>       | \$29 | <b>5 Year CAGR Estimate:</b>               | 13.7% | <b>Volatility Percentile:</b>   | 82.6% |
| <b>Fair Value Price:</b>    | \$41 | <b>5 Year Growth Estimate:</b>             | 2.5%  | <b>Momentum Percentile:</b>     | 39.9% |
| <b>% Fair Value:</b>        | 69%  | <b>5 Year Valuation Multiple Estimate:</b> | 7.7%  | <b>Growth Percentile:</b>       | 9.5%  |
| <b>Dividend Yield:</b>      | 3.5% | <b>5 Year Price Target</b>                 | \$47  | <b>Valuation Percentile:</b>    | 92.9% |
| <b>Dividend Risk Score:</b> | D    | <b>Retirement Suitability Score:</b>       | C     | <b>Total Return Percentile:</b> | 78.8% |

## 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 (now called Conduent) and today, focuses on design, development and sales of document management systems. The company produces \$9.5 billion in annual revenue and has a market cap of \$6.5 billion.

Xerox reported Q4 earnings 1/29/19 and results were in line with expectations. Earnings-per-share rose 10.6% year-over-year as total revenue fell 7.8% on a reported basis. Constant currency comparable revenue fell 6.1%, sending full-year revenue down 4.9% on a constant currency basis. Revenue suffered for both new sales as well as service, maintenance and rental revenue. While the latter was weak for all of 2018, the decline in new sales revenue was a bit of a surprise. In total, Xerox' Q4 top line performance was weaker than expected.

Gross margins were roughly flat year-over-year, but prudent expense management led SG&A costs 13% lower during the quarter. That helped salvage operating margins, which rose 180bps to 16.1% of revenue.

Free cash flow continues to improve as Xerox produced \$398 million in Q4, an increase of 34% year-over-year. That capped a year of very strong cash generation that crested \$1 billion in 2018, a nearly 20% improvement over 2017.

Strong cash generation affords Xerox the ability to return capital to shareholders, including the dividend and buybacks. Xerox bought back almost 10% of the float in 2018 thanks to robust buyback spending, and strong free cash flow should keep that tailwind going, albeit at what is likely to be lower rates than 2018.

Management guided for a decline of 5% on the top line for this year, but a 100bps to 150bps increase in operating margins as its efficiency efforts continue to play out. We are out with an initial estimate of \$3.75 in earnings-per-share for 2019, the midpoint of management's freshly-released guidance.

## Growth on a Per-Share Basis

| Year          | 2009   | 2010   | 2011   | 2012   | 2013   | 2014   | 2015   | 2016   | 2017   | 2018   | 2019          | 2024          |
|---------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------------|---------------|
| <b>EPS</b>    | \$2.40 | \$3.16 | \$3.60 | \$3.76 | \$3.92 | \$3.84 | \$3.20 | \$2.32 | \$3.48 | \$3.46 | <b>\$3.75</b> | <b>\$4.24</b> |
| <b>DPS</b>    | \$0.68 | \$0.68 | \$0.68 | \$0.68 | \$0.92 | \$0.98 | \$1.09 | \$1.25 | \$1.00 | \$1.00 | <b>\$1.00</b> | <b>\$1.00</b> |
| <b>Shares</b> | 217    | 349    | 334    | 306    | 297    | 279    | 253    | 254    | 255    | 230    | <b>225</b>    | <b>210</b>    |

Xerox' earnings-per-share have not 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 2.5% earnings-per-share growth for the next five years despite what looks to be a better performance in 2019.

We see growth coming from roughly flat revenue, but continued margin expansion as Xerox improves its operating efficiency by controlling costs. Indeed, the last three quarterly reports have seen revenue fall in the low single digits while operating margins have risen. Xerox should be able to produce low single digit earnings-per-share growth, but revenue growth is a significant wildcard. Most of our earnings-per-share growth projection comes from the buyback

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program as revenue losses and margin gains largely offset each other. In other words, actual earnings growth will likely be tough to come by; we are counting on a meaningful share reduction for the modest growth we've projected.

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 do not see management taking the risk of a higher dividend.

## Valuation Analysis

| Year      | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Now  | 2024 |
|-----------|------|------|------|------|------|------|------|------|------|------|------|------|
| Avg. P/E  | 11.9 | 12.5 | 10.5 | 8.0  | 9.7  | 13.0 | 14.3 | 16.8 | 8.5  | 8.0  | 7.6  | 11.0 |
| Avg. Yld. | 2.4% | 1.7% | 1.8% | 2.3% | 2.4% | 2.0% | 2.4% | 3.2% | 3.4% | 3.6% | 3.5% | 2.1% |

Xerox' average price-to-earnings ratio in the past decade has been 11 and we see that as fair value. That is much higher than the 7.6 times earnings the stock trades for today, implying a 7.7% tailwind to annual total returns should the valuation normalize over the next 5 years. Xerox is certainly cheap today, but a recent string of relatively weak earnings reports has investors on edge when it comes to buying this stock. Guidance for 2019 is strong, but Xerox has to deliver.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year   | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|--------|------|------|------|------|------|------|------|------|------|------|------|------|
| Payout | 28%  | 22%  | 19%  | 18%  | 23%  | 26%  | 34%  | 54%  | 29%  | 29%  | 27%  | 24%  |

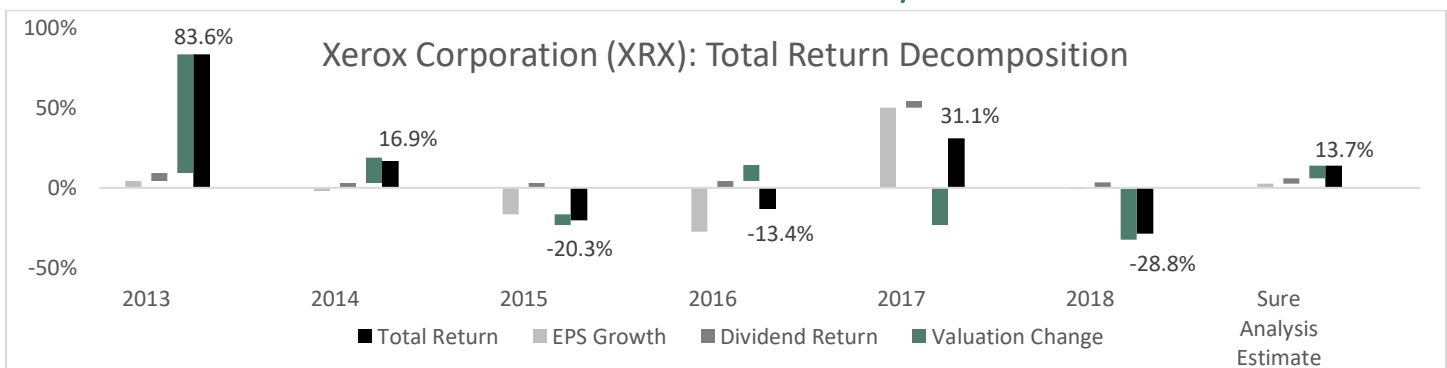
Xerox' quality metrics have generally improved in the past decade, which is partially the product of the Conduent spinoff. Margins have increased and interest coverage has improved dramatically despite higher debt totals. We think Xerox will be able to continue these positive trends in the coming years 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 13.7% annual total returns in the coming years, although there may be significant volatility in achieving those returns. The yield will contribute 3.5% and earnings-per-share growth should add 2.5%. However, we see more than half of total returns – 7.7% - 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 as recent earnings reports have been less than stellar. Therefore, while we see Xerox as trading significantly under fair value, this is certainly not a low-risk situation. We rate the stock a hold despite its high projected returns due to this uncertainty surrounding the earnings outlook. The yield is strong and the stock is cheap, but there is not a lot of clarity in terms of the path to higher earnings.

## Total Return Breakdown by Year



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## Income Statement Metrics

| Year             | 2009  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  |
|------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Revenue          | 14466 | 21633 | 21900 | 20421 | 20006 | 12679 | 11465 | 10771 | 10265 | 9830  |
| Gross Profit     | 5312  | 7697  | 7324  | 6787  | 6485  | 5110  | 4582  | 4261  | 4061  | 3927  |
| Gross Margin     | 36.7% | 35.6% | 33.4% | 33.2% | 32.4% | 40.3% | 40.0% | 39.6% | 39.6% | 39.9% |
| SG&A Exp.        | 4149  | 4594  | 4421  | 4141  | 4073  | 3133  | 2865  | 2695  | 2631  | 2458  |
| D&A Exp.         | 698   | 1097  | 1251  | 1301  | 1358  | 639   | 590   | 563   | 527   | 526   |
| Operating Profit | 263   | 2010  | 1786  | 1690  | 1504  | 1381  | 1146  | 1032  | 931   | 1024  |
| Op. Margin       | 1.8%  | 9.3%  | 8.2%  | 8.3%  | 7.5%  | 10.9% | 10.0% | 9.6%  | 9.1%  | 10.4% |
| Net Profit       | 485   | 606   | 1295  | 1195  | 1159  | 1013  | 448   | -471  | 195   | 361   |
| Net Margin       | 3.4%  | 2.8%  | 5.9%  | 5.9%  | 5.8%  | 8.0%  | 3.9%  | -4.4% | 1.9%  | 3.7%  |
| Free Cash Flow   | 2015  | 2207  | 1460  | 2067  | 1948  | 1887  | 1463  | 957   | -71   | 1050  |
| Income Tax       | 152   | 256   | 377   | 256   | 253   | 198   | 193   | 62    | 481   | 257   |

## Balance Sheet Metrics

| Year               | 2009  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  |
|--------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Total Assets       | 24032 | 30600 | 30116 | 30015 | 29036 | 27658 | 25541 | 18051 | 15946 | 14874 |
| Cash & Equivalents | 3799  | 1211  | 902   | 1246  | 1764  | 1411  | 1228  | 2223  | 1293  | 1084  |
| Acc. Receivable    | 1850  | 2826  | 2307  | 2639  | 2651  | 2421  | 741   | 651   | 1048  | 1276  |
| Inventories        | 900   | 991   | 1021  | 1011  | 998   | 934   | 901   | 841   | 915   | 818   |
| Goodwill & Int.    | 4384  | 12020 | 12940 | 13122 | 12956 | 11804 | 4291  | 4077  | 4198  | 4087  |
| Total Liabilities  | 16841 | 18441 | 17742 | 18002 | 16268 | 16556 | 16075 | 13090 | 10439 | 9621  |
| Accounts Payable   | 1451  | 1968  | 2016  | 1913  | 1626  | 1584  | 1342  | 1126  | 1108  | 1091  |
| Long-Term Debt     | 9264  | 8607  | 8633  | 8489  | 8021  | 7741  | 7279  | 6316  | 5517  | 5230  |
| Total Equity       | 7050  | 12006 | 11876 | 11521 | 12300 | 10678 | 9074  | 4709  | 5256  | 5005  |
| D/E Ratio          | 1.31  | 0.72  | 0.71  | 0.72  | 0.63  | 0.70  | 0.77  | 1.28  | 1.01  | 1.00  |

## Profitability & Per Share Metrics

| Year             | 2009  | 2010  | 2011  | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  |
|------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Return on Assets | 2.1%  | 2.2%  | 4.3%  | 4.0%  | 3.9%  | 3.6%  | 1.7%  | -2.2% | 1.1%  | 2.3%  |
| Return on Equity | 7.3%  | 6.4%  | 10.8% | 10.2% | 9.7%  | 8.8%  | 4.5%  | -6.8% | 3.9%  | 7.0%  |
| ROIC             | 3.1%  | 3.3%  | 6.2%  | 5.8%  | 5.6%  | 5.1%  | 2.5%  | -3.4% | 1.7%  | 3.4%  |
| Shares Out.      | 217   | 349   | 334   | 306   | 297   | 279   | 253   | 254   | 255   | 230   |
| Revenue/Share    | 65.79 | 64.06 | 60.67 | 61.45 | 62.84 | 43.29 | 42.61 | 42.08 | 40.01 | 39.06 |
| FCF/Share        | 9.16  | 6.54  | 4.05  | 6.22  | 6.12  | 6.44  | 5.44  | 3.74  | -0.28 | 4.17  |

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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