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Unisys Corp. (UIS)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the Unisys Corporation Second Quarter 2023 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference call over to Ms. Michaela Pewarski, Vice President of Investor Relations. Ms. Pewarski, the floor is yours, ma'am.

Michaela M. Pewarski

Vice President-Investor Relations, Unisys Corp.

Thank you, operator. Good morning, everyone. This is Michaela Pewarski, Vice President of Investor Relations. Thank you for joining us. Yesterday afternoon, Unisys released its second quarter financial results. I'm joined this morning to discuss those results by Peter Altabef, our Chair and CEO; Deb McCann, our CFO; and Mike Thomson, our President and COO, who will participate in the Q&A session.

Certain statements in today's conference call contain estimates and other forward-looking statements within the meaning of the securities laws. We wish to caution listeners of this call that the current expectations, assumptions and beliefs forming the basis for our forward-looking statements include many factors that are beyond our ability to control or estimate precisely. This could cause results to materially differ from our expectations. These items can also be found in the Forward-Looking Statements section of today's earnings release furnished on Form 8-K and in our most recent Forms 10-K and 10-Q as filed with the SEC. We do not, by including this statement, assume any obligation to review or revise any particular forward-looking statement referenced herein in light of future events.

We will also be referring to certain non-GAAP financial measures such as non-GAAP operating profit or adjusted EBITDA that excludes certain items such as postretirement expense and cost reduction activities and other expenses the company believes are not indicative of its ongoing operations as they may be unusual or non-recurring. We believe these measures provide a more complete understanding of our financial performance. However, these non-GAAP measures are not intended to be a substitute for GAAP. The non-GAAP measures have been reconciled to the related GAAP measures. We have provided these reconciliations within the presentation. The slides accompanying today's presentation are available on our website and were furnished on our Form 8-K filed this morning.

With that, I'd like to turn the call over to Peter.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Thank you, Michaela. Good morning and thank you for joining us to discuss Unisys' second quarter 2023 results. We had another quarter of better-than-expected revenue and profit, positioning us well as we enter into the second half of the year. Excluding our License and Support Solutions, which fluctuate based on renewal timing inside a year and between years, we experienced year-over-year revenue growth and margin expansion.

Revenue and pipeline continue to expand in our Next-Generation Solutions, which includes Modern Workplace, Digital Platforms & Applications or DP&A, Specialized Services & Next-Gen Compute or SS&C, and certain Micro-Market Solutions. Second quarter revenue in these higher growth and margin solutions grew approximately 14% year-over-year. Our Next-Gen pipeline is 55% larger than a year ago, providing a strong foundation for future growth.

We're seeing a growing number of opportunities and proof-of-concepts involving generative AI. Hyperscalers and enterprise software companies are continuing to release new tools and technologies, which our teams are adopting to enhance our next-generation AI solutions development. Looking more closely at the second quarter performance, total company revenue was \$477 million, a decline of 7.4% as reported and 6.3% in constant currency.

The decline, which was expected, was driven by lower L&S revenue within our Enterprise Computing Solutions or ECS segment due to the timing of ClearPath Forward license renewals. This was partially offset by better-than-expected performance in the rest of the business, which we call our Ex-L&S Solutions and includes our Digital Workplace Solutions segment or DWS; our Cloud, Application (sic) [Applications] (00:04:58) & Infrastructure segment or CA&I, as well as the SS&C portion of ECS and our business process solutions.

Second quarter Ex-L&S revenue was \$396 million, a strong year-over-year increase of 6.5% in constant currency. We achieved year-over-year constant currency revenue growth of 7.7% in DWS and 2.6% in CA&I, with both segments benefiting from increased levels of project-based work in the quarter. SS&C grew 14.5% year-over-year in constant currency. SS&C solutions are our Next-Generation Solutions within ECS and generate revenue streams from specialized services, application expansion and monetization.

Contract signings in the first two months of the quarter felt much like a continuation of the first quarter. Financial services clients remain cautious and commercial clients are slow to make decisions on new investments due to lingering concerns around inflation and macroeconomic conditions, which was a headwind to new logo signings. However, general activity levels with clients picked up in June. Our trailing 12-month Ex-L&S book-to-bill was 1.0 times, unchanged from last quarter.

Excluding L&S, second quarter total contract value or TCV was down 2% sequentially and declined by 4% year-over-year. The year-over-year declines were due to lower signings with new logos and the fact that this quarter was a lighter renewal quarter due to timing, which was expected. A significant portion of our anticipated TCV for the remainder of the year is renewals. New and expanded scopes within existing clients remain strong, growing TCV 14% versus the second quarter of last year.

We had several sizable signings within CA&I that incorporated new or expanded DP&A solutions. For instance, we signed a four-year cloud security innovation agreement with California State University, the largest higher education system in the United States and a Unisys client for more than 15 years. The contract includes a renewal of services for cloud transformation and cloud security modernization of their ERP system, which supports the institution's 23 campuses. And Unisys will now undertake multiple additional projects to better protect student data, enhance cyber security and integrate data across CSU. CSU's benefits from this new agreement will include operational and administrative efficiencies, cloud savings, reduced technology costs and the reduction of technical debt.

We also expanded our DP&A footprint with a large financial services institution in the US after receiving their supplier of the year recognition for two years running. Unisys will support additional aspects of the client's cloud migration and maintenance across their business lines. In DWS, we expanded our work with a large Canadian telecom company to support a communications technology integration for one of their financial services clients that recently acquired 530 regional bank branches. As part of this project, Unisys will manage more than a dozen technology vendors, standardize technology services and upgrade devices.

In ECS, we expanded our relationship with a leading global telco company to include a cloud migration for our client's voicemail services. We also signed several new managed services contracts, including work to support ClearPath Forward technology refreshes and strengthening relationships with important L&S clients, including one of our largest financial services clients. We also launched collaborative DWS client innovation sessions in EMEA, which has led to several Modern Workplace engagements, and are expanding this initiative to other geographies in the third quarter.

Our Ex-L&S pipeline also accelerated as the quarter progressed, growing 15% sequentially and 22% year-over-year. Growth was strongest in the new logo pipeline, up 47% sequentially and 97% versus a year ago. We've added approximately \$1 billion in net new logo opportunities. We expect the new logo pipeline being built today to contribute to bookings in 6 to 12 months as those opportunities move through the funnel.

We're increasing the speed and agility of our review and proposal process, and our sales teams are aligned around point of spear solutions targeting prospective clients where we see long-term growth opportunity. This is the most evident through our Next-Gen pipeline growth, which was 25% on a sequential basis and 55% versus the prior year period. Next-Gen new logo pipeline grew more than 50% sequentially and more than doubled year-over-year.

Modern Workplace pipeline was driven by interest in our Unified Experience Management solution, which we refer to as experience-as-a-service. This offering leverages our PowerSuite software and is based on experience-level agreements or XLAs. We also added several sizable opportunities related to device subscription services or DSS and device asset management. Our DP&A pipeline saw a notable uptick in opportunities across a range of offerings, including detection and response, digital identity management, security advisory consulting and DevSecOps.

We also saw numerous new DP&A opportunities in application managed services and development. Across our business units, we are also seeing growing client interest in solutions incorporating advanced data and artificial intelligence. Within ECS, we unveiled our Unisys Logistics solution and are actively working on pilots with existing Cargo Portal clients. Unisys Logistics is a proprietary SaaS application that delivers complex real-time logistics optimization and leverages quantum computing, data, AI and transportation industry expertise.

We believe generative AI represents a significant market opportunity for the IT services industry. Our portfolio of solutions, engineering capabilities, data expertise and our partner ecosystem position us well in this area of growing demand. In DWS, we're working with clients on chatbot automation solutions that incorporate generative AI to deliver more humanlike interactions. Our footprint and diverse client base within DWS, combined with our experience in chatbot design, gives us an advantage in providing generative AI innovation in DWS.

In CA&I, we're having client discussions related to our core AI capabilities, which include strategy, design, infrastructure and development services to support both cognitive and generative AI workloads. We also have strong data engineering capabilities that are helping clients deploy data lakes, data fabric and purpose-built vector databases for AI, which position us well for future services related to generative AI. Across the company, we're using or have initiated access to generative AI platforms being built by our partners such as Microsoft 365 Copilot, Google PaLM and Vertex Studio, as well as services from AWS, Snowflake, Salesforce, ServiceNow and Adobe.

We featured a number of our data and AI solutions at our June Analyst and Advisor Event, which was attended by more than 100 industry analysts and advisors from 31 different firms. Turnout was more than double that of last year's event and attendees included prominent firms such as Avasant, Deloitte, E&Y, Everest, Forrester, Gartner, HFS, IDC, ISG and NelsonHall. Connecting with influential analysts and advisors is important for our business, because when decision-makers evaluate technology industry service providers, they often look to this group for insights and recommendations. During the event, we were able to make connections and meet one-on-one and educate these key influencers about our strategy and solutions.

Turning to profitability, our second quarter Ex-L&S gross margin expanded to 16% from 10.4% in Q2 of 2022. The margin improvement was broad-based across DWS, CA&I and SSC (sic) [SS&C] (00:14:33). We continue to improve our labor efficiencies, which was down 440 basis points year-over-year and 350 basis points from the first quarter. At the overall company level, we are leveraging advanced technology tools to rapidly match talent to demand, further bolstering our ability to meet client expectations and fill roles quickly.

Our [ph] workplace transformation team (00:14:59) has developed efficiency plans to include elements such as role redesign, account rotations and additional moves to low-cost geographies. Excluding field services, 61% of head count is now in low-cost markets, up from 58% in the prior quarter. 75% of all Q2 hires were in low-cost countries, a 12% increase over the same quarter last year. Our trailing 12-month voluntary attrition was 14.4% in the second quarter, down from 19.2% in the second quarter of 2022.

Voluntary attrition in the month of June was 12% annualized, the lowest monthly rate we've had since December of 2020. While voluntary attrition levels have reduced across our industry, in part due to easing of the labor market, we believe our investments in the associate experience are having a meaningful impact on retaining talent. We have implemented enhanced new leader training, onboarding processes and channels for associates to recognize one another's successes.

We have also invested in diversity, equity and inclusion or DEI, both in talent acquisition and retention, and our metrics continue to improve as a result. Excluding field services, women now make up 36.9% of our global associate population, up from 35.4% a year ago, and underrepresented ethnic groups are now 31.5% of our US

associate population, up from 29.5% last year. We were recently recognized as a Best Employer for Women by Forbes, and for the third consecutive year, a Best Place to Work for Disability Inclusion by the Disability Equality Index.

With that, I'll hand it off to Deb to discuss our financial results in more detail.

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

Thank you, Peter, and good morning, everyone. My discussion today will include certain non-GAAP financial metrics. As a reminder, reconciliations of those metrics are available in our supplemental earnings materials posted on our Investor Relations site. Unless otherwise stated, all figures are as reported, except for segment revenue growth, which we discuss in constant currency. I will also provide information both including and excluding L&S Solutions to allow investors to isolate the portion of ECS, which includes uneven revenue based on the timing of license renewals, to evaluate the progress we are making in the business outside of this area.

As Peter highlighted, it was another quarter of results that exceeded our expectations. We are continuing to advance our Next-Gen Solutions, improve Ex-L&S revenue and margins, and build awareness for our generative AI capabilities. The solutions, innovation and go-to-market initiatives we showcased at our June [ph] Investor and Analysts/Advisors Days (00:17:57) are also building momentum in our pipeline, which is a positive sign for our future growth.

For the second quarter, company revenue totaled \$477 million, a decline of 7.4% year-over-year or a 6.3% decline in constant currency. This was driven by license renewals in our ECS segment, as expected, and the variability of those renewals inside a year and from year-to-year. Year-to-date revenue totaled \$993 million, a 3.3% year-over-year increase or a 5.3% increase in constant currency, driven by improving performance in our Ex-L&S Solutions and the weighting of L&S renewals in the first quarter. Excluding L&S, second quarter revenue grew 4.9% and 6.5% in constant currency, while year-to-date revenue grew 3.3% and 5.6% in constant currency.

I will now provide second quarter detail by segment. Please note that as I speak about segments, I'll discuss revenue growth rates in constant currency terms. DWS segment revenue grew 7.7% year-over-year in the quarter. Growth was driven primarily by expanded or new scope engagements with our existing commercial and public sector clients that we signed in recent quarters.

CA&I segment revenue increased 2.6% year-over-year in the quarter. Like the first quarter, we continued to see some caution with certain financial services clients, which account for 18% of CA&I segment revenue. Revenue with financial clients declined modestly versus a year ago. However, this was more than offset by growth with CA&I commercial sector clients with strength in our next-generation DP&A solutions.

ECS segment revenue, which includes Licenses and Support and Specialized Services & Next-Gen Compute, declined 27% year-over-year, driven by anticipated License and Support renewal timing, though the SS&C portion of the segment grew 14.5%. Second quarter L&S revenue was \$81 million in the quarter, down 41.2% year-over-year due to the timing of license renewals. However, this decline was better than expected due to small variations in timing, terms and volumes relative to our original assumptions. Our expectation for L&S revenue for the year is unchanged.

Notable ClearPath Forward renewals during the quarter were signed with life sciences, public sector and financial services clients, among others. Strength in SS&C, which comprises the rest of our ECS segment, partially offset lower year-over-year L&S revenue. The 14.5% growth in SS&C was driven by revenue from first quarter wins and

price increases negotiated on renewals in prior quarters to offset rising labor costs. As a reminder, we expect slower SS&C growth in the back half as we begin to lap some of these benefits.

Second quarter backlog was \$2.7 billion versus \$2.8 billion at the end of the first quarter. This decline was driven by the timing of renewals within our Ex-L&S Solutions, specifically within DWS and our business process solutions, where two large BPS contracts are expected to be signed by the end of the year. This timing dynamic is not indicative of a decline in renewal rates, which were above 95% in the quarter.

Looking ahead, we are pleased with our year-to-date performance and are reaffirming our full year guidance range for total company revenue of negative 3% to negative 7%. We continue to expect Ex-L&S revenue in the range of negative 1% to positive 4%. Based on our results year-to-date, we see a pathway to achieve revenue above the midpoints of these ranges. We continue to expect approximately \$350 million in full year L&S revenue. As we mentioned at our June Investor Day, we expect average annual L&S revenue of \$360 million from 2024 through 2028.

As a reminder, most of our L&S revenue comes from the licensing and maintenance services related to our ClearPath Forward operating system, on which many of our ECS clients run core operations and have built complex application layers over decades. Given the complexity of these application ecosystems and the security and performance of ClearPath Forward, our L&S revenue is sticky and we have good visibility into our clients' renewal plans. However, renewal timing can be difficult to predict with precision and can shift between quarters or even years as clients can renew early based on their budgeting processes or when reaching consumption limits.

Moving on to gross margins, our second quarter gross margin was 24.3% versus 28.8% in the second quarter of 2022. The decline was driven by the timing of high-margin L&S renewals. Excluding L&S, our gross margin was 16%, up from 10.4% in the prior year period, reflecting the results of our ongoing initiatives related to labor costs, delivery efficiencies and COLA pricing. Touching briefly on segment level gross margins, DWS gross margin was 13.6%, a 60 basis point expansion year-over-year, driven by labor efficiencies and contracting improvements. This also represents 170 basis points of sequential improvement due to better labor utilization relative to the first quarter of 2023, which had been impacted by staffing in advance of revenue.

CA&I gross margin expanded to 16.9% from 5.5% or an improvement of 1,140 basis points. Improvement included labor efficiencies in our CA&I delivery organization and prior year included elevated costs associated with certain contracts. We are seeing good results in DWS and CA&I from our focus on the labor pyramid, increased use of automation and optimization of contingent labor, and we continue to expect more than 250 basis points of aggregate gross margin improvement in our DWS and CA&I segments. ECS gross margin was 54.1%, down from 66.2% a year ago due to lower L&S revenue.

Moving on to total company profitability, our non-GAAP operating margin was 3.4%, down from 9% in the prior year quarter, due primarily to lower levels of L&S renewals during both the quarter and the year. Our year-to-date non-GAAP operating margin was 7.7% versus 3.4% last year. Second quarter adjusted EBITDA was \$50 million or 10.5% of revenue versus \$90 million or 17.6% of revenue in second quarter 2022. Second quarter declines were due to lower L&S revenue, as operating expenses were relatively consistent year-over-year. Year-to-date adjusted EBITDA was \$149 million or 15% of revenue compared to \$125 million or 13% of revenue for the first half of 2022.

Second quarter GAAP net loss was \$40 million compared to a loss of \$17 million a year ago. Excluding \$11 million of retirement expense and \$23 million of cost reduction and other expenses, net of tax, our non-GAAP net loss was \$6 million or a loss of \$0.09 per share. This compares to second quarter 2022 non-GAAP net income of

\$16 million or earnings per share of \$0.24. We are on track to achieve our full year profitability guidance for non-GAAP operating margin of 2% to 4% and adjusted EBITDA margin of 9.5% to 11.5%. Like our revenue guidance, we have a pathway to achieve results above the midpoint of these ranges.

Capital expenditures were \$18 million in the quarter, down from \$25 million in the prior year period. We generated \$25 million and \$17 million of free cash flow in the second quarter and year-to-date respectively. This compares to negative \$59 million and negative \$111 million in the prior year quarter and year-to-date periods. The year-over-year variance was largely driven by the timing of technology collections. We continue to expect full year free cash flow to be in line with 2022 at approximately negative \$75 million. Pre-pension free cash flow, which we define as free cash flow prior to postretirement contributions, was \$39 million in the second quarter and \$48 million year-to-date.

Cash balances were \$423 million as of June 30, up from \$392 million at the end of 2022. Our net leverage ratio, including all defined benefit plans, was 1.8 times as of the quarter-end. Our balance sheet and liquidity positions are strong. Our 6.875% senior secured notes with a \$485 million face value do not mature until November 2027 and our \$145 million ABL facility is undrawn.

Looking ahead to the third quarter, due to the cadence of L&S revenue during the year caused by renewal timing, we expect overall company revenue to decline in the low to mid single-digits year-over-year, with third quarter L&S revenue expected to be approximately \$50 million, which is the lightest L&S quarter of the year. We expect a modest third quarter non-GAAP operating loss of approximately \$10 million to \$15 million, driven by the timing of L&S renewals. The third quarter outlook gives us a pathway to achieve results above the midpoint of our full year guidance for both revenue and margins.

Lastly, I will briefly touch on our expected cash contributions to our US qualified defined benefit plans. As a reminder, once a year at year-end, we provide detailed projections for 10-year cash contributions, which change based on financial market conditions, funding regulations and actuarial assumptions. Based upon market conditions as of June 30, we estimate that our 10-year contribution would be \$600 million to \$620 million. This compares to \$650 million estimate as of the year-end 2022 and is modestly higher than our first quarter estimate of \$570 million to \$590 million. Cash contributions to our US qualified defined benefit plans are still expected to begin in 2025 and continue through 2032.

I will now turn it over to Peter for some closing comments before opening the line for questions.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Thank you, Deb. Before we open up for Q&A, I wanted to share that over the past few months, as our leadership team has been meeting with and having conversations with clients, our positive momentum has never been more evident. Our clients are exhibiting more openness to expanding their relationships with Unisys and are eager to discuss how we are innovating across our portfolio.

With that, operator, please open up the line for questions.

QUESTION AND ANSWER SECTION

Operator: Hey. Thank you, sir. We will now begin the question-and-answer session. [Operator Instructions] And the first question we have will come from Rod Bourgeois of DeepDive Equity Research. Please go ahead.

Rod Bourgeois

Analyst, DeepDive Equity Research LLC

Q

Yes. All right, guys. Hey. So, at the June Analyst Day, you shared some helpful updates on the business and laid out some longer term financial projections. Based on your latest results and the prospects that you're seeing at this point, I wanted to ask if there are any changes in how you're thinking about your longer term financial projections.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Hey, Rod. This is Peter. Thanks very much for the question. And I sympathize, your last name and my last name both can be challenging. But it's actually a trickier question than it appears for a different reason. So – and the reason is because it's really hard for companies to have long-term numbers out there and then put the burden on them to update them over time. And we have always maintained a position that we don't update those numbers over time.

That said, we just had the Investor Day in June, and I can tell you, we don't have any changes since that number. Those were really set as long-term numbers and long-term estimates, and they haven't changed. As I said in my remarks, as we look at the quarter, the first two months of the quarter were kind of similar to the beginning of the year. But we did see some pick-up in activity, in conferences, in dialogue or just across the board with our clients. That activity has really kind of continued in July. But none of that changes our long-term perspectives. So, I hope that's helpful.

Rod Bourgeois

Analyst, DeepDive Equity Research LLC

Q

Yeah, definitely helpful. And I want to ask a question on your last point though about the pick-up in activity. And you did mention earlier that the new logo activity, I think, picked up in June after it had earlier been impacted by the macro obstacles. I just wanted to see if you could expand on that pick-up in activity, more color or some dimensioning to how much pick-up is occurring and whether that's a – maybe a little bit of a green shoot on the macro front.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Yeah. I'll cover that and then hand it over to Mike for kind of a more detailed answer. I think some of that is us, some of that is the industry, and some of that is really kind of the way we're kind of organized internally. So, let's take each of those separately. So, on us, I think that we benefit from the fact that we have a long tenure at many of our clients. I mentioned in my discussion the California State University has been a client for 15 years. That puts it in the junior category of clients among our top 50, because our tenure is longer than an average of 15 years.

That trust and that relationship, when you have a period like we're having now, a real dramatic change in the way people are thinking about technology, and here I'm referring to AI and specifically generative AI, we don't necessarily have the right to win any particular deal and we certainly don't take that for granted. The relationships we have with our clients get an audience, and we have kind of earned an audience. So, I think that's a big advantage for us. So, it allows us to put our best foot forward, make sure we have put our best foot forward. But in a time of change, that's an advantage.

With respect to the industry as a whole, a lot of change going on, hesitancy in some areas, especially around willingness to enter into long-term contracts. You see some – the TCV numbers slightly down at negative 2% and negative 4%, but that is related more than anything else for us to the renewal cycle of some of our larger deals. But when it comes to our organization and how we're approaching business, I'll really turn that over to Mike, because under his leadership and the sales teams, both new clients and existing clients, I think we made some pretty big changes that I think are going to position us well, and you see it in the pipeline. Adding \$1 billion of pipeline for us is a big deal. That's a big number for us, and we've done that in the last quarter. And so, Mike, if you could talk about some of the things we're doing and some of the things we're seeing.

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

A

Yeah. Great. Thanks, Peter. And Rod, thanks for the question. Good to talk to you. Look, I think Peter nailed it in his last comment there. Really looking at the increase in pipeline, over \$1 billion in a quarter is a big deal for us. The bulk of that is all in our Next-Gen Solutions, right. So, I think, Rod, from our perspective, the go-to-market activities have been very strong, the interest has been strong. We talked about the Analyst & Advisor Day and the feedback from that analyst/advisor community about inviting Unisys to more and more opportunities. I think the awareness take-up has been strong as well.

As you know, we really just launched that branding initiative at the tail-end of Q4 last year in November, and a lot of these contracts take 6 to 12 months in their cycle. And so, I think what you're really seeing now is just that activity starting to come through from that increased pipeline. As you know, that qualified pipeline is [ph] vetted (00:36:03), right. So, we feel pretty good about not only the growth in the pipeline, but the fact that that pipeline has some level of analysis to it, right, before it gets in the pipeline. And we expect that we'll continue to see enhanced win rates.

Our Next-Gen Solutions are certainly resonating in the market and the activity continues to pick up. So, I feel like it's kind of the evolution of what we started maybe 6 to 12 months ago, and we're starting to get into that cycle where we're seeing the benefit of that come through. You're also seeing the impact of deals we won in the back half of last year, where we're kind of getting to know those clients in a better way and they're expanding their relationship with us. So, I think it's really just the proof point, Rod, that the strategy is starting to take hold.

Rod Bourgeois

Analyst, DeepDive Equity Research LLC

Q

Nice. And if I can ask one more on labor productivity, in your year-end 2022 earnings report, I think you noted labor costs had declined by 50 basis points. But you're now citing much bigger labor productivity increases sequentially and year-to-year. And so, can you share more on the main cause in the labor productivity jump that you've experienced and how much room is now left on that front? Thank you.

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

A

Sure.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Yeah. Rod, I'll let Mike do that one as well. I will say that that's a major area of emphasis [ph] for us (00:37:39). You heard me talk about our HR statistics. And getting the attrition rate down helps productivity, because you don't have to retrain as many new people come in the door. But beyond really getting attrition rate down, the work that Mike and our teams have done around labor is ongoing. So, you're seeing that in the middle of the cycle. There are ups and downs from quarter-to-quarter, but it is a long-term effort to take where we are and continue to improve it. Mike?

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

A

Yeah. Thanks, Peter. Again, Rod, thanks for the question. So, look, I'll say it from the point of view is we've talked about the kind of talent marketplace and the talent mobility platforms that we've put in place over the course of the, again, last 6 to 12 months. And you noted and Peter noted in his commentary, there was about a 4.4 points of improvement in that labor number and 3.5 points sequentially, right. So, there is a whole host of things that make that up. Peter mentioned the hiring and the attrition, and that's a big part of it. But look, the other aspects of that have to do with continual automation, continual kind of right-shoring, continual reskilling.

And you're right, they're very significant movements. And I don't think that we're at the end of the aspect of that, right. I know 4.5 points is a pretty big jump year-over-year. But there's still opportunity there. It's ongoing. It will be continually part of our DNA. And I think Deb mentioned that we're still calling for about 2.5 points of improvement overall from a company perspective in relation to the full year numbers. So, still opportunity to go, still working through that and embedding that in our DNA. But we've seen some significant marked improvement, and then the key is obviously maintaining that run rate and continuing to enhance that gross margin profile.

Rod Bourgeois

Analyst, DeepDive Equity Research LLC

Q

Thank you.

Operator: Thank you, sir. The next question we have will come from Joseph Vafi of Canaccord.

Joseph Vafi

Analyst, Canaccord Genuity LLC

Q

Hey, guys. Good morning. Nice to see that Ex-L&S constant currency growth in the quarter. Let me just – could you just remind us again on, if you look at your Next-Gen portfolio broadly, the margin – the gross margin profile on the Next-Gen portfolio versus the traditional portfolio? And then, I have a couple follow-ups.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Yeah. I...

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

A

Sure, Joe. This is Deb. Or Peter, did you want to take it?

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

No, I was going to hand it over to you, Deb.

A

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

Okay. Yeah. So, the Next-Gen margins are higher, and that's why it's a big focus for us. So, we haven't been talking as much about [indiscernible] (00:40:48) we did lay out at the Investor Day and it's still – that we're targeting for those Next-Gen margins in that 25% range is what we're looking for. And to get to that, expanding – we had said about 50 basis points of expansion a year to get to that by 2026.

A

Joseph Vafi

Analyst, Canaccord Genuity LLC

Got it. Thanks, Deb. And then, what about the capital intensity of that Next-Gen portfolio versus some of the others?

Q

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

Yeah. So, we don't necessarily expect – we still expect around about 5% of – for CapEx as a percentage of revenue. A big focus on kind of a CapEx-light strategy that we've been having for the past few years to try to reduce the amount of capital related to clients and just being extra cautious with our capital while still ensuring that we're investing in the business. So, we don't see that changing with the Next-Gen Solutions.

A

Joseph Vafi

Analyst, Canaccord Genuity LLC

Got it. And then, just maybe one more in terms of – on the renewals, the macro does add a little bit of extra – it doesn't help obviously on the renewal cycle. But are we – if you look at some of the renewals that are – that may be out there – I know a couple of years ago, there were some renewals that you just decided weren't worth renewing for a variety of reasons. Is there any of that out there at this point in terms of renewals that just may not economically work at this point? And that's my last question. Thanks.

Q

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

Hey, Deb, I'll take that one if you'd like. Hey, Joe. Thanks for the question. The short answer is no, there are no renewals out there like that that – you're talking about some of the contracts that we walked away from in some of our legacy business just based on their margin profile. I would say what's left in the portfolio is quality work either on the traditional side, et cetera, where we're happy with the work effort that's going on. We see it as a gateway to Next-Gen. The margin profile on those contracts is fine. And I think I mentioned on our last call that we've been very successful from a pricing point of view in renegotiation where we had concerns about the margin profile.

A

So, just a tidbit on the renewals as well. I mean, the back half of this year just happens to have more renewals in it than the back half of last year. Or said differently, the front half was a little higher this year. And Deb mentioned in her prepared remarks that we still have over a 95% renewal rate. So, A, we're happy with what's out there; B, we think it's a gateway to the future; C, we're having good pricing power in regards to those renewals; and D, the back half of the year has a larger set of those renewals coming into play, which should help our TCV and then ultimately help our backlog and book-to-bill as well.

Joseph Vafi

Analyst, Canaccord Genuity LLC

Sure. Great. Thanks for that color, Mike. Thanks, everybody.

Q

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Thank you, Joe.

A

Operator: And next, we have Anja Soderstrom of Sidoti.

Anja Soderstrom

Analyst, Sidoti & Co. LLC

Hi. Thank you for taking my questions. Most of them have been addressed already. But how should we think about the timing of technology collections in regards to forecasting the free cash flow?

Q

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

Hi, Anja. Good morning. Thank you. As far as the free cash flow, as you know, this quarter, it was positive \$25 million, first quarter negative \$7.5 million. And so, year-to-date, it's \$17 million, our free cash flow. And as we mentioned, we're still holding to that – the full year, what we're saying is that free cash flow will be similar to 2022, which was negative. So, as far as specifics exactly on technology collections, that's – a lot of that is driven by the timing of technology collections. And so, as you can foresee, right, in order to get to that negative that we're expecting to be similar to 2022, those [ph] timing (00:45:20) collections are really what has skewed the timing of where we're going to see free cash flow in the next quarters.

A

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

And Anja, this is Peter.

A

Anja Soderstrom

Analyst, Sidoti & Co. LLC

Okay.

Q

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

I would add to that if I could. As you know from the June Investor Day, we're very focused on free cash flow, and we're very focused on building free cash flow into a healthy positive number as we extend multiple years, especially in light of the pension obligations in the future. So, I would tell you that is a major effort and focus of us. Joe Vafi's question mentioned CapEx. And I think that Deb's answer obviously is right that we don't expect an increase in CapEx cost because of the focus on Next-Gen Solutions. To some extent, we expect it to decrease, because when you think about what's not in Next-Gen Solutions, it is the traditional L&S business and it is the traditional infrastructure business, both of which, even though we kind of have a lower capital version of those, can still be higher CapEx than Next-Generation Solutions. So, we're really focused quite intently on cash flow. And so, you can expect, as we discussed in June, to see us working long-term on improving that.

A

Anja Soderstrom

Analyst, Sidoti & Co. LLC

Q

Okay. Thank you. And did I hear you right when you said that the activity that picked up towards the end of the quarter has continued into the third quarter?

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Yes. Again, activity is a broad word. We obviously do not have July numbers and we're not suggesting we have July results. But in terms of the level of dialogue and in terms of, I would say, the interest in our clients and our prospects to have really good discussions with us, and obviously, you're seeing – the pipeline grew last quarter. And now, the question for us is how do we take that pipeline through the funnel and work the pipeline to get closure? So, I would say that we feel good about what we're seeing in June, and that is continuing.

Anja Soderstrom

Analyst, Sidoti & Co. LLC

Q

Okay. Thank you. That was all for me.

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Thanks.

Operator: The next question we have will come from Arun Seshadri of BNP Paribas.

Arun Seshadri

Analyst, BNP Paribas

Q

Yes. Hi. Thanks for taking my questions. Just maybe one clarification for Deb. For free cash flow guidance, I think that you reiterated the – your free cash flow guidance. And I notice you didn't exactly say there was a path for upside like you saw on the revenue and EBITDA line. Any sort of additional commentary you can provide on that?

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

A

Yeah, not so much. So, I think we – there's lots of puts and takes within that number, but pretty similar to what we've laid out typically that makes up that free cash flow number. So, I think – and I think it's a little more – the precision of the free cash flow is a little more challenging to predict versus the revenue and margin. So, although we're able to say that on the revenue and margin, it's a little more challenging on the free cash flow, given the timing of some of these collections and not being able to completely anticipate when they're going to come in.

But you're right. We are seeing momentum on the revenue and margin side. And the goal is that eventually that will drive the improvement in the free cash flow with the success we're having in our Next-Gen Solutions, which are higher margin and create higher free cash flow. That is the ultimate – the goal that we've laid out at Investor Day and that we're pushing for from a long-term perspective. As Peter laid out, free cash flow is a very big priority for us.

Arun Seshadri

Analyst, BNP Paribas

Q

Got it. Thank you for that, Deb. And then, broadly on Ex-L&S gross margin, very nice jump this quarter. Just wanted to understand, was there anything at all sort of that you consider one-time or non-recurring in that sort of gross margin jump? And sort of how do you – how should we expect to see the Ex-L&S gross margin trend for the balance of the year?

Debra McCann

Executive Vice President & Chief Financial Officer, Unisys Corp.

A

Right. So, yeah, as we did mention in the commentary, there were some elevated expenses due to some troubled contracts that we had last second quarter that led to some of the higher basis point increase. But we do – that number of the Ex-L&S gross margin of the 16%, it should be similar to what we're seeing. I think it's not necessarily always sequential, right. It's not huge numbers we're talking about, right. So, \$1 million here and there can really shift that number. So, I'm not necessarily saying it's going to be fully linear.

But I think we are making a lot of those efficiency improvements, looking at price and our improvement in contracting and the improvement in more Next-Gen Solutions, which are improving those margins. And all of that combined is where we're leading. But like I said, it doesn't mean each quarter is going to be up. Sometimes, there can be some puts and takes. But I think the goal is still that total company operating margin that we laid out is where you can look at and see kind of where we're going.

Arun Seshadri

Analyst, BNP Paribas

Q

Got it. Thank you for that. And then, lastly for me, the Ex-L&S TCV, just wanted to make sure I understood the mechanics of that decline. It sounds like there's just – there was just less traditional business renewing in the quarter. Is that the main takeaway there?

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

A

Yeah. This is Peter. Again, the number is not huge, right. So, the Ex-L&S TCV was up 4% if you look at that year-on-year and 2% quarter-on-quarter. So, not a huge number, not really statistically significant, although I'm not using that in the technical term. And again, I think that's somewhat based on renewal cycle and when you look at the kinds of deals that we got last year. And it's somewhat based on – I think as we have said, there has been some hesitancy in the industry, I think, across the board around signings. But again, for us, it's really a relatively modest [indiscernible] (00:52:23).

Arun Seshadri

Analyst, BNP Paribas

Q

Got it. Thank you very much.

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

A

Yeah, Peter. If I could just add to that too, Arun, so I think your comment is pretty much spot on. The front half of the year from a renewal perspective had about 12% more TCV in it, and we're expecting that to be in the back half of this year just based on those renewal cycles. So, again, the renewal rate is excess or north of 95%, and it's just heavier in the back half of this year.

Arun Seshadri

Analyst, BNP Paribas

Got it. Thank you both, Peter and Mike.

Q

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Thank you.

A

Operator: And next, we have a question from Matthew Galinko of Maxim Group.

Matthew Galinko

Analyst, Maxim Group LLC

Hey. Good morning. Thanks for taking my question. Just wanted – I think you mentioned managed services wins in ClearPath Forward. So, I just wanted to ask for a little more color on those. Were they competitive takeaways? How – just anything you could add to those wins that you referenced.

Q

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Yeah. And again, I'll defer to Mike for a little more specifics on that. But managed services around ClearPath Forward, much of that is in our SS&C line of ECS. And so, it has been actually a focus for several years now to make sure that not only are we providing the software to – and support, which tends to be through a license section, but that we're also looking really hard at how do we provide a more broad-based managed services around our applications. And that is one of the areas of emphasis in SS&C. So, we have seen some progress on that, and we expect that to grow. Mike?

A

Michael M. Thomson

President & Chief Operating Officer, Unisys Corp.

Hey, Matt. It's Mike. Thanks for the question. I think when Peter was talking about managed services growth in ECS, it was really due to some of our industry solutions, not necessarily driven by ClearPath Forward. And some of that growth can be kind of expanding those relationships, right. So, I don't want to give you the impression that there was a takeaway of a managed service component within ECS, if that's what you heard from that. I don't believe that's what the intention was, that it was the managed services related to industry solutions, which I think you're aware we have both in travel and transportation and financial services and some other areas where we have deep industry experience, as well as some kind of volume-based things on the CPF side. So, hopefully, it answers your question.

A

Matthew Galinko

Analyst, Maxim Group LLC

All right. Thanks for clarifying.

Q

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Yeah. And Matt, just to be clear, those industry solutions can be sit on top of ClearPath Forward or they can be independent of ClearPath Forward. The ECS team is not only focused on ClearPath Forward. But the ECS team really specializes in our solutions, and if you will, proprietary things that we lead with as opposed to the CA&I

A

team, which is more about creating solutions on behalf of our clients. And that's one way to think about those two different teams. There are managed services opportunities on both sides, so CA&I as well as ECS. The ECS managed services opportunities tend to be around our solutions, whether those'd be more generic ClearPath Forward which deals with many industries or the specific industry solutions that we have some on top of ClearPath Forward and some independent.

Operator: [Operator Instructions] It appears that we have no further questions at this time. We will go ahead and conclude our question-and-answer session. At this time, I would like to turn the conference call back over to Mr. Peter Altabef for any closing remarks. Sir?

Peter A. Altabef

Chair & Chief Executive Officer, Unisys Corp.

Yes. Thanks, Mike, very much. I'd like to thank everybody for participating on this call. And many of you also participated in our June Analyst Day call, and I really want to thank you for your involvement in that. We mentioned the industry analysts call in my remarks, and of course, as you all know, we also had an investor analyst call. Like the industry analyst call, the investor analyst call was very well attended, and both the questions and the level of engagement, we really, really appreciate. So, we continue to be available to each of you and really appreciate the dialogue that we have and continue to develop. So, thank you very much on behalf of our team.

Operator: And we thank you, sir, for your time also and the rest of the management team. The conference call has now concluded. At this time, you may disconnect your lines. Thank you again, everyone. Take care and have a wonderful day.

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