Off Wall Street

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New Rec: Conduent (CNDT: $16.16) January 7, 2018

Position: Buy **Upside potential: 40%**

$Mil	Q317	Q417e	2017e	2018e	2019e
Revs	1,480	1,470	6,004	5,649	5,710
EPS$*	0.22	0.25	0.79	1.04	1.22
Y/Y	-8%	-10%	-5%	31%	17%
PE	n/a	n/a	20.3	15.5	13.2
FCF$	n/a	n/a	0.85	1.09	1.37
PSR	n/a	n/a	0.8	0.9	0.9
Consensus.*	n/a	n/a	n/a	0.99	1.18

*Adjusted EPS

Shares Out: 210M **Market Cap: $3.4B** **FYE: December**

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Concept:

1. Spin-off from XRX creates opportunity and incentive to improve the profitability of the company, which was mismanaged under XRX.
2. A new CEO with a proven track record is renegotiating or exiting uneconomic legacy contracts and signing new contracts that are profitable and sustainable.
3. CNDT is executing a major cost transformation program that should result in cumulative net annual savings of ~$415M in 2017-2018
4. FCF should increase markedly in 2018-2020 timeframe. Excess cash could be reinvested into improved systems, enhanced sales capability, debt reduction and acquisitions.
5. Improved margins and reduced financial leverage should result in a multiple re-rating and significant share price improvement. A streamlined CNDT could present an attractive acquisition target for a larger entity.

Summary: CNDT provides business process outsourcing (BPO) services in transaction-intensive processing, analytics and automated solutions. The business is relatively defensive with most revenue derived from clients' core processes. CNDT services front and back office processes across 18 industries, for a diverse, high quality client base (including 76 of the Fortune 100 and government agencies in all 50 states). CNDT is the largest servicer of US municipal parking and automated toll processing. It manages 40% of US child support payments and 50% of workers compensation, and services the top 20 managed healthcare plans. CNDT was spun off from Xerox on 1/3/17 and addresses a $200B+ market that is growing at ~5%. The company seems well positioned to capitalize on key trends, such as increased demand for productivity, automation and urbanization.

The separation from XRX creates an opportunity to improve performance and move fully to a service-based culture. As a standalone entity with a proven (and well incentivized) new management team, CNDT can fully align its investments, operating model and capital structure with its business strategy. CNDT is driving a mix shift to contracts with higher-margins, higher-growth potential and better sustainable profitability. It is exiting or renegotiating unprofitable legacy contracts and divesting non-core and low-margin businesses. Importantly, we think the issues restraining near-term performance are addressable (not systemic) and are concentrated within a few specific areas. CNDT is also executing a strategic cost transformation program to drive margin expansion. Management's goal is to remake CNDT into a more predictable and sustainable business with strong FCF, and a focus on core profitability and growth.

CNDT is a self-help story for patient investors. In 2016, it embarked on a three-year cost transformation program that targets $700M annual gross cost savings/synergies by the end of 2018. The savings are largely driven by controllable corporate restructuring activities (G&A, facility consolidation, procurement, IT). We expect ~75% of the projected savings will be reinvested into the company (salesforce, automation, etc.) to drive growth in the near term. However, reinvestment needs should diminish in 2019 resulting in a greater % of net savings accruing to the bottom line. The business was mismanaged under XRX as evidenced by a collection of unprofitable legacy contracts and a 2016 EBITDA margin of 9.8% compared to 15%+ for industry peers.

Management is focused on improving the sales function by increasing the headcount and hiring sales managers with industry specific experience. A key objective is to increase the average number of services per client and to bundle more services onto a single platform. CNDT is also investing in analytics to surround its existing technology platforms and in automation to reduce total headcount. Starting in 2018, CNDT will pursue strategic M&A (it has not completed an acquisition since Q315), which could be funded by divestiture proceeds and FCF. Management sees an opportunity to consolidate subscale competitors and could target higher-margin, higher-growth situations and specific technologies.

CNDT has developed unique technology platforms that provide competitive barriers to entry and client stickiness. Its VECTOR transportation platform is used across the US to support automated tolling collection and has proprietary technology related to license plate and vehicle recognition for violation enforcement. Its MIDAS platform is used by more than 2,200 US hospitals to improve patient case management. BenefitWallet is a small but rapidly growing platform that consolidates Health Savings Accounts (HSAs) for employers. A publicly-traded peer trades at 27x FTM EBITDA. Importantly, 80% of CNDT's workload is transaction-based processing, where reliability and technical expertise are critical variables. Most peers rely more on cost-plus (labor-driven) models.

A large % of CNDT revenue is derived from multi-year contracts with high recurring revenue and ~90% renewal rates. The business is cash generative with low capital intensity. However, in the near term, FCF is being impacted by cash restructuring charges, settlement payments, separation costs and increased interest expense related to the spin-off debt. CNDT has successfully refinanced a portion of the debt and it plans to reduce debt with proceeds from divestitures and excess FCF. Current net leverage is 2.6x and should move below 2x over the next 12-18 months. In 2019, cash restructuring charges should be minimal, and capex should remain modest. Thus, as the cost program progresses, interest expense declines and working capital management improves, FCF should increase markedly, enabling CNDT to invest more aggressively in acquisitions and share repurchase.

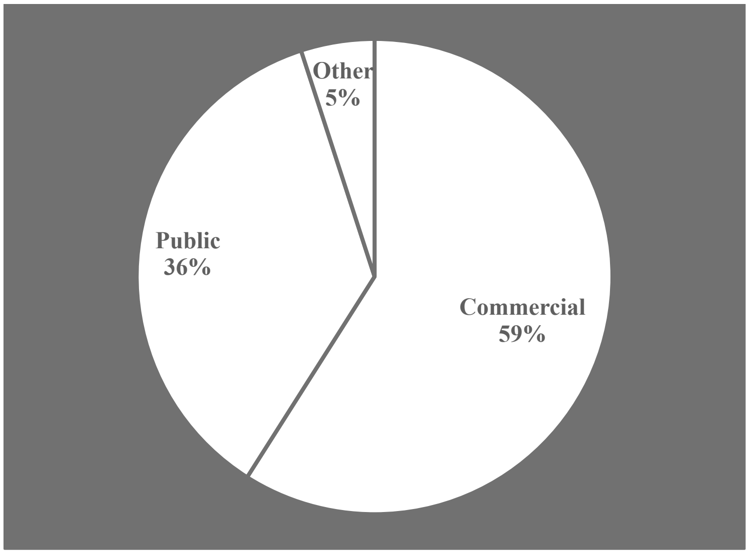
CNDT is progressing through a multi-year operational transformation. Although there have been tangible signs of progress, we do not expect the path to be smooth. Not surprisingly, sentiment remains poor as investors wait for revenue stabilization before committing to CNDT shares. However, the share price appears to be unusually inexpensive at 6.7x and 6.2x 2018e and 2019e EBITDA respectively, well below an industry peer average (~7-11x EV to FTM EBITDA). We think the valuation fails to reflect the various high-quality businesses within the CNDT portfolio. We project a 3.5% organic revenue decline in 2018 followed by 1% organic growth in 2019. Although the 2019 revenue base will be lower, it should represent higher quality, high-margin business with meaningful embedded growth potential. Investors willing to withstand some near-term volatility should be amply rewarded over time.

In our view, CNDT presents good risk-reward for patient investors. As management progresses through the remediation of unfavorable contracts and divests non-core operations, sentiment should improve, and the multiple should re-rate upward, especially as net leverage is reduced. This, combined with increasing EBITDA and a reduction in net debt, should result in meaningful shareholder return. At a conservative 7.75x our 2019e EBITDA, CNDT would trade at $22.76, which implies a return of 41% over 12-18 months. We think downside should be moderate (~15%). Longer term, CNDT shares could appreciate further based on a higher multiple, increased FCF, reduced leverage, accretive M&A and potential share buybacks. There should also be a moderate benefit from recent tax reform. Finally, a streamlined CNDT could be attractive to a larger acquirer. We note that Carl Icahn has a 10% position in CNDT with several board seats, while the ACS founder holds 6% of the shares and a preferred issue ($100M convertible at $22.84). Moreover, the new CNDT CEO turned around and sold his previous company (iGate) for 14x EBITDA (pre-synergy) and 3x revenue.

Background:

Conduent (CNDT) is a global business process outsourcing (BPO) provider specializing in transaction-intensive processing, analytics and automated solutions. The company was formerly known as Affiliated Computer Services (ACS) and was acquired by Xerox in 2010 for $6.4B. At the time, ACS was the largest global diversified BPO provider with 74,000 employees.

Table 1: CNDT Revenue by Segment – 2017e



Under XRX, ACS was mismanaged and never properly integrated or standardized the various acquisitions it completed. In mid-2015, XRX sold the IT Outsourcing business of ACS for $1.05B or ~9.1x EBITDA. In November 2015, activist investor Carl Icahn acquired 8% of XRX shares and was given three board seats after which he began to push for a spinoff of ACS. In January 2016, XRX announced that it would spin off the remaining ACS business as Conduent. The spin-off was completed on January 3, 2017 and CNDT began to trade as a separate company on the NYSE. At Q317, CNDT had 89,700 employees and is projected to generate $6B in revenue for 2017. In Table 1, we provide a breakout of revenue by segment. The company is headquartered in Florham Park, NJ.

Discussion:

1. Conduent (CNDT) is a classic spin-off situation with a favorable risk-reward setup. The rationale behind the spin-off transaction is multifold. First, it was important to formally separate CNDT from the declining equipment-driven printing and document business of XRX. Next, by hiring a proven CEO from outside the company and assembling a new senior management team, CNDT could be streamlined and transformed into a predictable, higher-margin, free-cash-flow generating entity that would eventually warrant a higher public multiple.

The transformation of CNDT is likely to be a prolonged and somewhat messy process involving the remediation or exiting of poorly structured legacy contracts, specifically in commercial customer care (call centers) and state Medicaid (MMIS) administration. For contracts that are economic but non-core to the new corporate vision, CNDT has a strategic divestiture program with resulting cash proceeds allocated toward debt reduction and acquisitions. Importantly, divestitures should enable CNDT to shift from operating many disparate businesses created from prior acquisitions to a company focused on specific industries and offerings where it possesses scalable technology and leading market positions. Management has been adamant that it is unwilling to sign contracts that are uneconomic, poorly located or too long in tenure (especially given the rapidly changing nature of technology).

The combination of these actions is expected to negatively impact the volume of new business signed in the near term, and will require significant cash costs for restructuring, settlement payments, separation fees (banking fees etc.) and reinvestment. In addition, there are ongoing expenses for the operation of a new stand-alone public company.

Offsetting these near-term negative factors is an opportunity to aggressively reduce the company’s cost structure by eliminating duplicative costs, centralizing and leveraging procurement and IT expenses, and reducing the extensive global real estate footprint. There is also an opportunity to shift a larger % of CNDT’s service delivery infrastructure to low-cost locations both within and outside the US. Over time, we also expect CNDT to reduce debt and to refinance high cost debt that was undertaken at the time of the spin-off transaction.

We have been tracking CNDT for more than a year and have been impressed with the initial actions of Ashok Vemuri, the new CEO (hired in July 2016). Vemuri spent 14 years at Infosys and subsequently was hired at iGate, where he executed a two-year turnaround and very successful sale of the company. Importantly, the strategy he is implementing resulted in success at other companies with similar situations including Computer Sciences, HP Enterprises and Genpact. Vemuri appears to be a no-nonsense operator focused on remaking CNDT into a predictable business that generates consistent FCF. He and his senior management team are well incentivized to see CNDT succeed. We note that the compensation agreement includes a material change of control incentive bonus.

Nearly a year into the separation, there have been both positive and negative factors. CNDT has successfully remediated several large legacy customer care contracts and is in negotiations on several others. It also exited a large poorly structured NY State Medicaid contract. The company appears to be solidly on track with its cost savings plan and has begun to divest non-core businesses. In Q317, CNDT sold several businesses with combined EBITDA of ~$6.8M. Net proceeds of $56M demonstrate that CNDT can divest these non-core, lower-margin businesses for a good multiple (8.3x in this instance). We note that CNDT shares are currently valued at ~6.7x 2018e EBITDA. Most importantly, Q317 results provided evidence that CNDT's strategy is beginning to show progress. Although revenue declined 7% y/y (including divestitures and strategic non-renewals), EBITDA increased 5% y/y and margins increased 120bp y/y to 11.8%. The renewal rate on existing contracts was 98%.

Conversely, revenue continues to show mid-single digit y/y declines, driven by contract losses, reduced pricing upon renewals (typical in the BPO industry), strategic exits and divestitures. We estimate that ~45% of the y/y revenue decline is from strategic actions and divestitures. Moreover, total contract signings have been lower than historical measures and new business signings have been erratic from quarter to quarter. FCF has also been below par and is being impacted by the aforementioned non-recurring cash costs and new stand-alone expenses.

Investors have been focused on CNDT's top line and appear to be unwilling to commit until there are tangible signs of stabilization. There is also concern about the ability of management to remediate lingering legacy contracts (typically 3-year agreements) and about the high level of debt. Moreover, certain investors might have expected a rapid turnaround and resulting share price gain in 2017 but have been disappointed.

Considering the above factors, we are not surprised that CNDT shares remain in the penalty box, especially during a year when large technology stocks have reported strong earnings growth and substantial share price gains. However, it is the impatience of investors that has created the opportunity in CNDT. The current valuation seems unusually inexpensive. As we discuss in detail below, CNDT shares are trading at ~6.7x and 6.3x our 2018 and 2019 estimated EBITDA respectively. This compares to a group of peers trading within a range of 7-12x FTM EBITDA. We note that pure call center companies, which are inherently poor businesses, trade above the low end of this range and higher than CNDT. The low valuation appears to discount zero growth in EBITDA over the next several years and ignores the multiple highly advantaged businesses in the CNDT portfolio.

In our view, CNDT has an opportunity to expand margins (off a very low base) over the next 2 years through a combination of the following: a favorable mix shift of the services portfolio, aggressive cost reductions, increased service penetration of existing clients and strategic M&A. We are less concerned with the near-term revenue declines as CNDT prunes the portfolio. With an ample base of recurring revenue, we expect EBITDA to increase meaningfully through 2020 (even factoring in divestitures) and we expect CNDT shares to gradually re-rate as revenue stabilizes and net leverage declines.

2. CNDT's most promising near-term opportunity seems to be to improve the mix of service contracts. CNDT must remediate a number of very large "customer care" (call center) contracts within its Commercial segment. According to management, at the start of 2017 there were 9 large domestic legacy contracts (signed under XRX) that are negatively impacting profitability. These are call center contracts that are disadvantaged in one or more of the following ways: There is no minimum volume commitment; there is a requirement for CNDT to employ domestic labor despite competitors using much cheaper foreign labor; the centers are dedicated to a single client, which prevents CNDT from realizing the flexibility and efficiency that comes from a shared service center; they do not utilize advanced technology (call deflection, voice recognition, etc.) that can maximize productivity. Moreover, some of the centers are located in ultra-high cost regions (ex. Seattle, Northern NJ) where labor is very expensive.

We estimate that these contracts collectively have been losing \$40M-\$70M (EBIT) annually. With an average contract length of ~3 years, CNDT (in Q317) implied that it is about halfway through the duration of these agreements. Thus, in a worst-case scenario, the company would not renew any of the remaining contracts and be free of them by early 2019.

The new management has been proactively addressing these contracts. The best possible outcome is for the client to recognize CNDT as an important long-term partner (that is losing money) and agree to restructure the deal. For example, it could agree to more favorable pricing or to let CNDT move a meaningful portion of the labor offshore or to a shared center (substantial savings) and perhaps add more automation. An alternative is that CNDT agrees to keep existing terms for the call center contract but asks for the client to take one or more of its other BPO services. However, if a client refuses to negotiate, CNDT must wait for the contract to expire over the next 1+ years and then either renegotiate more favorable terms or simply walk away.

Based on our research, it seems unlikely that another competitor could provide the same service at a meaningfully lower cost. It is important to note that most of these contracts involve meaningful upfront investment by the provider. Thus, CNDT should be in a favorable negotiating position at the time of expiration. Over the past two quarters, CNDT has exited 3 of these contracts and remediated 2 other ones, while it is in negotiations on another. It has also been closing service centers – some as it exits business, and others that are being consolidated into existing centers (both onshore and offshore). It has closed 130 facilities YTD, which should result in meaningful savings in 2018 and beyond.

CNDT's other problem area has been its Health Enterprise Platform, which involves the administration of state Medicaid programs. The unprofitable legacy contracts have been placed into the company's "Other" segment. In early 2017, CNDT announced that it would not continue to invest in the NY contract (originally signed in 2015) and would instead seek an exit. On November 30, 2017, CNDT entered into a definitive settlement with the state of NY to formally terminate the contract as of December 15th. CNDT will pay an additional $20M as part of the settlement. In 2015 and 2016, XRX terminated similar contracts with the states of CA and Montana. Within the Other segment, the only remaining Medicaid servicing activity is with North Dakota, NH, and Alaska (profitable).

The NY contract represents a textbook example of the challenges and opportunities faced by CNDT. Under XRX, the company entered into large multi-year contracts that later proved to be uneconomic. Part of the problem was that XRX sales people were often incentivized to sign large contracts regardless of the future margin achievement. While this led to growth in signings backlog and revenue, it often entailed large upfront cash startup costs and uncertain future performance metrics, especially given the lack of sufficient contract guardrails.

In mid-2017, CNDT performed a detailed contract-by-contract review of the entire portfolio and identified a group of businesses that are targeted for divestiture. These represent contracts/relationships that it deems to be risky, overly complex or non-core to its future strategy. In Q317, CNDT divested assets representing $81M in annual revenue and ~$6.8M in EBITDA for which it received $56M in net proceeds. According to management, CNDT could divest assets that represent annual revenue of $250M-$500M during the first half of 2018. We expect CNDT to divest ~$300M (in revenue) and to use the proceeds to reduce debt and to pursue bolt-on acquisitions.

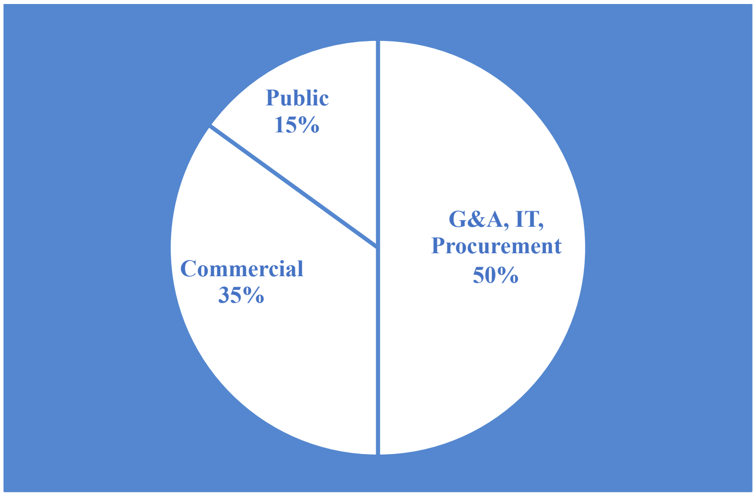
Another opportunity to improve the portfolio mix is by mining existing clients for new business. CNDT benefits from a large highly-diverse installed base of clients with minimal concentration. Management is driving service level penetration through the bundling of additional high-value (and high incremental margin) services for existing customers – packaged and priced in a way that is much more cost effective. As part of this effort, CNDT is investing in automation, and plans to increase the sales force by 25%, with a focus on industry-specific expertise. Unlike the XRX model, CNDT sales people will be compensated based on recurring revenue and overall profitability.

Finally, CNDT will target profitable new business that complements the company's overall service offering. It will also push for minimum volume commitments where applicable and pursue shorter-term engagements that require lower upfront investment with reduced risk from technological change. This will be supplemented with strategic M&A (beginning in 2018). We expect CNDT to target technology-rich bolt-on acquisitions in Healthcare, Transportation and various Public-sector businesses. CNDT might also look to acquire a federal contracting vehicle.

Management's primary objective is to become somewhat smaller but more profitable and growth oriented. Looking ahead one year to 2019, CNDT's service portfolio should be vastly improved, with most of the disadvantaged legacy contracts remediated or exited, subpar businesses divested, and new profitable business added. The result should be a portfolio with a lower revenue base but a much-improved margin structure and embedded organic growth potential.

3. In addition to improving the contract mix, CNDT is aggressively reducing the overall cost structure. In mid-2016 it established a multiyear program that targets $700M of gross cost reduction through YE 2018. Roughly half of the projected savings involves corporate functions including G&A, procurement, workforce/contractor savings, IT infrastructure, vendor consolidation and facility reductions. We detail the projected cost savings mix in Table 2.

Table 2: CNDT Projected Cost Savings Mix



Source: Company Presentation

The company is also eliminating most client services (excluding Transportation) in Asia, SA and the Middle East. It is important to note that under XRX, CNDT's cost structure became bloated and inefficient with poor integration and insufficient investment in modern systems and automation technology. Headcount increased to a peak of 104,000 at YE 2015 despite stagnant revenue. We note that headcount has been reduced to 89,700 at Q317.

On the real estate front, CNDT initially targeted $35M of savings on an annual spend of $300M. However, it is aggressively closing sites around the world and is on track to substantially exceed its original savings target. In Q317, it closed 24 sites and exited an additional 27 leases. In addition, CNDT plans to increase the % of employees in low-cost locations and is moving toward a shared services delivery model with centralization of duplicative activities.

A major cost savings target is the Commercial segment. This includes remediation of Customer Care contracts (discussed above), back-office optimization of the Transaction Processing business, and general cost reductions in the healthcare businesses. Aggressive adoption of automation combined with process standardization and modernized work models are also leading to efficiencies. In Q317, SG&A was 9.7% of rev vs. 10.3% in Q316.

In 2017-2018, CNDT will need to reinvest a substantial portion of the projected savings into the company. These investments will target various sales functions, upgrading of systems, and new platform technology. Under XRX, investment in sales and the requisite IT infrastructure was subpar and CNDT will require a catch-up period. Post spin-off, CNDT will also have ~$65M in new expenses to operate as a standalone public company. We detail the projected cost savings program in Table 3.

Finally, CNDT's "Other" segment provides a significant opportunity to improve profits. The segment lost $100M (EBIT) in 2015 and $84M in 2016. The Other segment consists of two businesses that are no longer core to the company. The Student Loan Servicing business is in runoff mode (the underlying government program was terminated) and should be able to generate a small positive EBIT in 2018. The larger Health Enterprise business consists of the previously discussed legacy state Medicaid contracts. CNDT should have minimal future exposure to Medicaid contracting and the CEO has stated that it will no longer pursue new Medicaid business. With the absence of these large loss-making agreements, CNDT expects to reach breakeven in the Other segment within the next year.

Table 3: CNDT Cost Transformation Program ($mil)

2016	220
2017	210
2018	270
Cumulative Gross Annual Savings	700
Gross savings: 2017-2018	480
Stand-alone recurring costs	(65)
Net annualized savings: 2017-2018	415
% reinvested in 2016-2018	73%
	(303)
Estimated net annual savings 2H18 run rate	112
as % of 2016 EBITDA	18%

Source: CNDT; OWS estimates

4. CNDT participates in the global business process outsourcing (BPO) industry, which has an estimated addressable market of $200B+ growing at ~5% annually. The industry is highly fragmented but has begun to consolidate. BPO is essentially the outsourcing of corporate and government back office functions to third-party providers. The use of a third-party platform reduces a client's need for in-house legacy systems/infrastructure and enables the client to maximize profitability and efficiency while concentrating on its core competencies. BPO engagements are generally operated under long-term contracts (2-6 years) with the BPO provider increasingly considered to be a strategic partner.

Within the addressable market, CNDT specializes in transaction-intensive processing, analytics and automated solutions. CNDT focuses on several attractive markets including healthcare claims, transportation, and benefits administration. More commoditized areas include finance and accounting, call centers and IT solutions. CNDT should benefit from strong secular tailwinds in outsourcing driven by an increasingly tight domestic labor market. Moreover, increased urbanization should benefit CNDT's municipal parking and public transit operations.

CNDT is also assessing the use of blockchain and distributed ledger technologies for various BPO applications. Management foresees these driving meaningful improvements in transaction efficiency, security, transparency and overall costs. Obvious areas to benefit include claims management, loan processing and CNDT's parking solutions.

One of the most attractive attributes of CNDT is that ~80% of its workload is transaction-based processing activity where reliability and technological capability are essential to its customers. Moreover, an estimated 65% of the business is platform-based and less dependent on human labor. While CNDT's software-based platforms require upfront development costs, they possess meaningful operating leverage with minimal recurring maintenance capex requirements. More importantly, CNDT's platforms are driven by specialized expertise and possess high barriers to entry, increased switching costs and a high degree of client "stickiness".

CNDT has a diverse client base spread across numerous industry verticals. Client concentration is minimal with the top customer representing 4% of revenue and the top-10 accounting for 20% of revenue. Customers include 76 of the Fortune 100 as well as 500+ government agencies. While CNDT services thousands of clients, the larger clients account for the lion's share of the business. Major clients include Apple, Verizon, P&G, Delta Airlines, Michelin, Adobe, GM and Mondelez to name a few.

5. CNDT is comprised of two core business segments – Public and Commercial. A third segment, referred to as "Other", accounts for ~5% of revenue and currently operates at a loss.

CNDT's Public segment accounts for ~36% of TTM revenue or ~$2.2B and an estimated 60% of EBIT. As the title implies, it serves Federal, State and Local government clients (municipalities, agencies) with offerings in Transportation, Healthcare, Payments, Case Management and Claims Processing. Public contracts, on average, tend to be longer in duration (~5 years) vs. CNDT's Commercial contracts (~3 years). In Table 4, we provide a breakdown of Public revenue by service offering.

CNDT's Transportation platform, VECTOR, is underpinned by its Automated Tolling business, which provides back-office processing of electronic toll collection (Ex. EZ-Pass) in the US and several foreign countries. In the US, CNDT processes $2.5B in electronic toll transactions and 50M video-based violations annually. It also provides solutions for High Occupancy Toll (HOT) Lanes. CNDT is the #2 player in the US, slightly behind TransCore (a unit of Roper Industries). The two companies have a virtual duopoly with a combined 90% of the US market (growing at 6%) and enjoy EBITDA margins of 25%+ according to the company. CNDT's Tolling platform is driven by proprietary technology that enables the management of toll processing, lane solutions, and collection of payments across state lines. Moreover, CNDT possesses intellectual property around license plate/vehicle recognition technology as well as GPS and camera technology to assist in automated traffic law enforcement. We note that Roper (ROP) shares are valued at ~17x 2018e EBITDA.

Table 4: Public Revenue Mix by Service Offering

Public Segment	% of Public Rev	% of Total Rev
State & local	23%	8.1%
Payment services	22%	7.7%
Tolling	15%	5.3%
Transit	11%	3.9%
Government healthcare	11%	3.9%
Photo & parking	11%	3.9%
Commercial vehicle	4%	1.4%
Federal	3%	1.1%
Public revenue	100%	35%

Source: CNDT Presentation

The Transportation platform also includes contracts to manage public transit fare systems (busses, trains, trams etc.) and municipal parking systems, which entails the management of on street parking in major cities like Boston and Los Angeles. CNDT is also a leader in efficiency management for commercial truck fleets (with a 40% market share).

In Payments, CNDT is the leading provider of prepaid card services to the US government. It provides servicing and processing for several key government programs including SNAP, social security, unemployment benefits and child support payments. It also manages 50% of domestic workers compensation claims and has a growing business in fraud detection that serves government benefit programs. All 50 states use CNDT services.

As a stand-alone entity, we think the Public segment would trade at a significantly higher multiple than that implied by CNDT's current valuation. This is based on the essentiality of the services provided, the strong margins and the recurring nature of the contracts. CNDT's public clients do not buy on low price, but on the best overall value, reliability and technical/service capabilities. Moreover, the Public businesses leverage CNDT's unique technology platforms as evidenced by segment revenue/employee of $220,000. This compares to an average of ~$45,000/employee in the general BPO industry. Looking at a group of comps, we think CNDT Public segment could be valued at 9x-10x EBITDA on its own.

6. CNDT's Commercial segment accounts for ~59% of TTM revenue, or ~$3.6B, and ~41% of EBIT. It provides end-to-end enterprise services to large commercial customers primarily in the US. As we detail in Table 5, the company provides a wide array of BPO offerings. It has strong market positions Healthcare, High-Technology, Industrial, Aerospace/Defense, Banking & Insurance and Communications/Media. It has also developed particular expertise in the automotive industry, marketing & customer experience, mortgage/consumer loan processing, workforce learning and digitized source-to-pay solutions. Compliance and fraud analytics is an emerging area for the company.

Clients include the top 20 US managed healthcare plans, 9 of the top 10 global pharmaceutical companies, 4 of the top 5 mobile phone manufacturers, 3 of the top 5 US life insurers, and 5 of the top 10 global banks.

Table 5: Commercial Revenue Mix by Service Offering

Commercial Segment	% of Comm Rev	% of Total Rev
Customer experience	34%	20.4%
Human resources	25%	15.0%
Industry-specific services	14%	8.4%
Learning & legal	6%	3.6%
Transaction processing	6%	3.6%
Omni-channel Comm.	5%	3.0%
Finance & accounting	5%	3.0%
Workers compensation	5%	3.0%
Commercial revenue	100%	60%

Source: CNDT Presentation

In Healthcare, CNDT has developed solutions for health insurers, providers, PBMs, employers and pharmaceutical companies. Its Midas platform is used at more than 2,200 US hospitals for patient case management (capturing and analyzing patient data). Midas uses critical metrics to measure quality of care and patient safety while also enabling hospitals to control overall costs. For health insurers, CNDT provides intelligent claims processing solutions.

CNDT's ClearSight platform for customer call centers provides automation of simple routines as well as more complex processes. The company has been investing in robotic process automation (RPA), which enables call center agents to improve focus on the end customer and critical tasks while the automated platform processes the requisite information to support the agent's ability to serve the client in a more efficient manner.

CNDT's Global HR portal solutions support communication between all employees, managers, new hires, retirees and various business operations. This includes documentation support for employee ID tracking as well as a comprehensive benefits administration platform. Its Life Connect Portal provides a custom HR solution that can be scaled as a company grows. We note that some of its HR offerings are similar to the HR BPO business of Aon, which was recently sold to Blackstone for $5B or ~10x EBITDA.

BenefitWallet (BW) is a rapidly growing platform that consolidates the administration of all health spending accounts onto a single platform. These include Health Savings Accounts, Health Reimbursement Arrangements, Flexible Spending Accounts, and Health Incentive Accounts. While CNDT does not break out results for BW, management has stated that it is very profitable. We estimate BW oversees ~$2B in assets and generates annual revenue of ~$85M with annual growth of 15%-20% going forward. The business is highly scalable and should generate rapid earnings growth over the next 3-5 years, especially given the tailwind of the continued shift of healthcare costs to employees.

BW has a publicly traded peer. HealthEquity (HQY) is the leading technology player in the space and currently trades at ~10x 2018e revenue and 28x EBITDA with EBITDA margins of 37%. This highlights the potential value of BW within the CNDT portfolio. If we assumed $112M in revenue in 2019 and applied a revenue multiple of 4x, BW would be valued at $450M or 14% of CNDT's current market valuation. Most importantly, however, BW exemplifies the type of high quality growth-enabled business (that would warrant a far higher multiple) that reside within the CNDT portfolio.

7. At the time of its separation from XRX, CNDT was allocated $2B in long-term debt, much of which carried relatively high rates. At Q117, net leverage stood at 2.9x, which is a substantial amount of leverage for a BPO business. Management's stated target is to reduce leverage to "under 2.5x" in the near term. At Q317, net leverage was 2.6x, and we expect it to reach 2.4x by the end of the year. Barring an aggressive allocation to acquisitions, we expect net leverage to decline to 1.8x at year-end 2018.

There is also an opportunity to reduce interest expense through refinancing. In the first 9 months of 2017, CNDT twice refinanced its term debt, resulting in a net savings of 250bp on $548M of principal. This should result in annual interest savings of ~$20M. In addition, CNDT has a $510M Senior Note issue with an unusually high coupon of 10.5%. Although not callable until 2020, we think CNDT could potentially repurchase some or all of the issue at a premium in 2019 with a potential annual cost saving of $22M.

Table 6: FCF 2016-2020 ($Mil)

	2016	2017	2018e	2019e	2020e
Net Income	6	62	79	99	114
D&A	613	502	490	484	491
Working capital	(387)	(160)	(120)	(98)	(92)
Restructuring costs	(155)	(95)	(65)	(25)	(11)
Deferred tax, pension, stock comp, other	20	(27)	(29)	(41)	(41)
Operating cash flow	77	281	355	419	461
Total capex	188	120	130	135	140
FCF	(111)	161	225	284	321
Net debt	1,820	1,588	1,256	1,147	977
Net debt/EBITDA	2.9	2.4	1.8	1.5	1.2

CNDT generates cash, and has strong recurring revenue and low capital intensity. FCF averaged well above 40% of EBITDA in 2014-2015. In 2016 and in 2017, however, significant restructuring expenses, settlement payments (CA, Montana, NY Medicaid terminations), and expenses related to the separation from XRX (investment banking fees etc.) have reduced FCF. Restructuring expenses are expected to be $95M in 2017 before declining to $65M and $25M in 2018 and 2019 respectively. There is also $65M in new annual expenses to operate a stand-alone public company. Additionally, upfront contract startup costs impact FCF in the near-term, but should generate increased FCF as contracts mature. CNDT expects FCF as a % of EBITDA to be between 25%-35% in 2018. After 2018, we think FCF conversion could be closer to 40%.

We expect FCF to improve markedly in 2018-2020 (as we detail in Table 6 above) and for management to deploy the increased FCF toward debt reduction, accretive acquisitions and internal investment in modern systems, automation technology and the overall corporate sales function. Moreover, we would not be surprised if CNDT instituted a share repurchase program in 2019.

9. There are a number of risks to an investment in CNDT. Near term, CNDT is expected to establish 2018 guidance in conjunction with its Q4 earnings report in February 2018. There is a risk that management uses the opportunity to re-set expectations lower. There is a risk that CNDT is unsuccessful at remediating additional Customer Experience contracts, which could impact earnings in 2018. CNDT could also fail to increase new business signings at a sufficient rate to drive

future revenue growth. It could also experience a lower than expected renewal rate on existing contracts.

10. Recent results

In the most recent quarter (Q317), total revenue declined 7.3% y/y to $1.48B. According to management, 40% of the total sales decline (~3%) was due to strategic decisions to exit contracts. CNDT also divested ~$82M of annualized revenue in the quarter. Total adjusted EBITDA increased 3% y/y (+5% excluding one-time expenses related to a hurricane) to $174M. The EBITDA margin increased 120bp y/y to 11.8%. Interest expense increased from $11M in Q316 to $35M in Q317 reflecting the new debt assumed by CNDT at the time of the spin-off. Adjusted EPS was $0.22 vs. $0.24 in Q316 (PF) but improved from $0.16 in Q217. Finally, total capex (PP&E + internal use software) was $31M in Q317 vs. $42M in the prior year. YTD, FCF improved $137M y/y.

CNDT completed the successful remediation of two large Customer Experience contracts during Q317. It also delivered robust performance on its cost transformation. SG&A as a % of sales declined to 9.7% vs. 10.3% in Q316. The salesforce experienced its first y/y growth in more than two years. At 9/30/17, cash was $468M, or $352M net of restricted cash expected to be paid out over the next year for deferred compensation; total debt was $2.06B. We estimate year-end net debt to be $1.6B, which implies a net debt/EBITDA at 2.4x.

In Q317, new business signings were $390M, a 38% decline y/y. However, CNDT noted that two large contracts worth $200M were closed early in Q4 making total new signings ~$590M vs. $625M in Q316 (-5.6%). New signings included key expansions in Transportation. The Q317 renewal rate was reported at 98%, or $657M, and included key renewals in Government Healthcare, Payment Services and Communications/Media. YTD, the renewal rate has been ~93%. CNDT also reported a rolling 12-month contract pipeline of $13B, +9% vs. Q316. Finally, the total value of all contract signings was reported at $1.05B, which excludes the $200M of signings that slipped into Q417. Including the $200M, TCV were 19% lower y/y. This should not be surprising given the volume of low quality business that CNDT is no longer pursuing.

11. Financial assumptions

For 2018, we estimate organic sales decline 3.5%, with the trend improving as the year progresses. Our forecast assumes management walks away from underperforming contracts and pursues only business that should be profitable throughout the engagement. In addition, we project that CNDT divests business representing $300M in annual revenue with blended margins that are below the corporate average. We assume the divestitures are completed by mid-year 2018. Lastly, we assume CNDT uses a portion of its FCF combined with the net proceeds from divestitures to make acquisitions. A large % of the remaining combined cash proceeds should be used to reduce debt. We estimate $150M in acquisitions in 2018 and assume 50% of the annualized revenue acquired will accrue to CNDT in 2018.

The result is 2018 revenue of $5.65B vs. $6.0B in 2017. Next, we estimate 2018 adjusted EBITDA of $703M or 12.5% of revenue. This compares with $664M of EBITDA, or 11.0% of revenue, for 2017. Interest expense should decline to $128M in 2018 from $140M in 2017 based on lower debt and a lower blended interest rate following two refinancing transactions in 2017. Next, we estimate 2018 FCF at $225M or $1.08 per share. This is equivalent to 32% of EBITDA. We estimate capex at $130M or 2.4% of revenue. At YE 2018, we estimate net debt to be $1.26B or 1.8x TTM EBITDA.

For 2019, we estimate revenue increases 1.2% to $5.71B. This results from 1% estimated organic growth, additional M&A and the residual impact from the 2018 divestitures. We estimate another $175M in acquisitions in 2019 and assume 50% of the annualized revenue acquired will accrue to CNDT in 2019, along with the 50% from the 2018 acquisitions. Next, we forecast a ramp in EBITDA margins to 13.4% that is driven by an improved contract mix and significantly reduced costs. This results in 2019 EBITDA of $768M. Interest expense should decline to $121M in 2019 from $128M in 2018 based on lower debt. Next, we estimate 2019 FCF at $284M or $1.37 per share. This is equivalent to 37% of EBITDA. We assume capex at $135M or 2.4% of revenue. Importantly, we estimate net debt to be $1.15B at YE 2019 or 1.5x TTM EBITDA.

12. Following CNDT's January 2017 spin-off from XRX, a new management team is executing on a major cost transformation while also working to improve the contract mix. These combined efforts should result in a considerable expansion of margins over the next several years. CNDT should experience increasing FCF as non-recurring restructuring, settlement and separation-related costs dissipate in 2018 and 2019 and working capital management improves. The combination of

improving revenue trends in 2H18 and reduced net leverage should drive a gradual positive re-rating of CNDT's valuation multiple.

Based on our 2019 projections, we have established an initial price target of $22.76, which we expect to be reached within 12-18 months. Our target is driven by the midpoint of our conservative range of EBITDA multiples (7.25x–8.25x), which also translates into a P/FCF multiple of 16.8x our 2019 forecast. These multiples are at a discount to a comparable peer set.

Another way to value CNDT is on a sum-of-the-parts method by separating what we view to be the most valuable parts of the company and placing a more appropriate value on the related underlying profits. We detail this analysis in Table 7. Using our 2019 EBITDA estimates, we apply a 9.2x multiple to the Public segment businesses, a 12.5x multiple for BenefitWallet, and conservative multiples of 7x and 5x respectively for the Commercial (ex-BW) and Other segments. After subtracting net debt, we arrive at a per-share valuation of $24.60 for CNDT. Longer term, CNDT shares could increase further and CNDT could become an attractive acquisition target for either a larger BPO or IT services company or private equity.

Table 7: CNDT Sum of Parts ($mil)

Segment	EBITDA - 2019e	Multiple	Valuation
Public Segment	361	9.2	3,338
Commercial Segment	368	7.0	2,575
BenefitWallet	30	12.5	381
Other	9	5.0	45
Total	768	8.2	6,339
less: net debt 2019e			(1,147)
Net equity value			5,191
Value per share			**$24.60**

Source: OWS estimates

13.Financial projections

a. Annual Projections ($Mil)	2016	2017e	2018e	2019e	2020e
Commercial	3,805	3,518	3,241	3,290	3,441
Public	2,308	2,187	2,143	2,197	2,252
Other	378	312	265	223	183
Total Revenue	6,491	6,017	5,649	5,710	5,875
Cost of service	5,498	4,987	4,641	4,681	4,792
Gross Profit	1,070	1,030	1,008	1,028	1,083
R&D expense	28	17	19	22	25
SG&A	686	608	537	514	512
EBIT	357	405	453	492	545
Other expense, net	0	0	0	0	0
Interest expense, net	44	140	128	121	115
Pretax income	312	265	325	371	430
Income tax	108	93	101	111	129
Net income - adjusted	204	164	216	252	293
Adjusted EPS	$0.97	$0.79	$1.04	$1.22	$1.42
WA shares	211	207	208	207	206
Adjusted EBITDA	635	664	703	768	822
Gross margin	16.5%	17.1%	17.8%	18.0%	18.4%
SG&A	10.6%	10.1%	9.5%	9.0%	8.7%
R&D	0.4%	0.3%	0.3%	0.4%	0.4%
Adjusted EBIT	5.5%	6.7%	8.0%	8.6%	9.3%
Adjusted EBITDA	9.8%	11.0%	12.5%	13.4%	14.0%
Interest Expense	0.7%	2.3%	2.3%	2.1%	2.0%
Pretax income	4.8%	4.4%	5.7%	6.5%	7.3%
Tax rate	34.5%	35.2%	31.0%	30.0%	30.0%
Y/Y % Chg.					
Revenue		-7.3%	-6.1%	1.1%	2.9%
Gross Profit		-3.7%	-2.2%	2.0%	5.3%
R&D expense		-39.6%	13.1%	15.8%	13.6%
SG&A		-11.3%	-11.8%	-4.3%	-0.3%
EBIT		13.6%	11.7%	8.8%	10.8%
Interest expense, net		216.0%	-8.6%	-5.5%	-5.0%
Pretax income		-15.1%	22.4%	14.5%	15.9%
Income tax		-13.5%	7.9%	10.8%	15.9%
Net income - adjusted		-19.8%	31.7%	16.7%	16.4%
Adjusted EPS		-18.4%	31.1%	17.3%	17.0%
WA shares		-1.8%	0.5%	-0.5%	-0.5%

b. Quarterly Proj. ($Mil)	Q117	Q217	Q317	Q417e	Q118e	Q218e	Q318e	Q418e
Total Revenue	1,553	1,496	1,480	1,488	1,441	1,402	1,388	1,418
Cost of service	1,292	1,253	1,220	1,223	1,194	1,155	1,136	1,156
Gross Profit	261	243	261	265	247	247	253	262
R&D expense	3	3	4	7	5	5	5	4
SG&A	169	153	144	142	140	135	130	132
EBIT	89	88	112	116	102	107	118	126
Other expense, net	0	0	0	0	0	0	0	0
Interest expense, net	36	35	35	34	34	33	32	30
Pretax income	53	53	77	82	68	74	86	97
Income tax	18	18	29	28	22	23	26	30
Net income - adjusted	33	33	46	52	44	49	58	65
Adjusted EPS	$0.16	$0.16	$0.22	$0.25	$0.21	$0.23	$0.28	$0.31
WA shares	208	207	207	207	207	208	208	208
Adjusted EBITDA	153	157	174	180	167	171	179	187
Gross margin	16.8%	16.3%	17.6%	17.8%	17.1%	17.6%	18.2%	18.5%
SG&A	10.9%	10.2%	9.8%	9.5%	9.7%	9.6%	9.4%	9.3%
R&D	0.2%	0.2%	0.3%	0.5%	0.3%	0.4%	0.4%	0.3%
Adjusted EBIT	5.7%	5.9%	7.6%	7.8%	7.1%	7.6%	8.5%	8.9%
Adjusted EBITDA	9.9%	10.5%	11.8%	12.1%	11.6%	12.2%	12.9%	13.2%
Interest Expense	2.3%	2.3%	2.4%	2.3%	2.3%	2.4%	2.3%	2.1%
Pretax income	3.4%	3.5%	5.2%	5.5%	4.7%	5.3%	6.2%	6.8%
Tax rate	34.0%	34.0%	38.0%	34.0%	32.0%	31.0%	30.5%	30.7%

(amounts in $000, except ratios)	
Current debt	2,056,000
Current Equity	3,312,000
Current tangible BV	(587,000)
Current market value	3,328,000
Current cash	468,000
Current DSO	83
Current DIO	9

FYE December	2017e	2018e	2019e
EBIT	405,159	452,504	492,427
EBITDA	663,859	703,358	767,612
Free cash flow	167,000	225,075	284,017
Surplus cash flow (NI+D&A - capex)	350,400	433,000	447,000
Capex	120,000	130,000	135,000
EV/EBITDA	7.5	6.9	6.2
EV/(EBITDA-capex)	9.1	8.5	7.6