FINAL TRANSCRIPT

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XRX - Q3 2008 Xerox Corporation Earnings Conference Call

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PRESENTATION

Operator

Good morning and welcome to the Xerox Corporation third-quarter 2008 earnings release conference call hosted by Anne Mulcahy, Chairman and Chief Executive Officer. She is joined the Ursula Burns, President, and Larry Zimmerman, Executive Vice President and Chief Financial Officer. During this call, Xerox executives will refer to slides that are available on the web at www.xerox.com/investor.

At the request of the Xerox Corporation, today's conference call is being tape recorded. Other tapings and/or rebroadcasting of this call are prohibited without express permission of Xerox. After the presentation, there will be a question-and-answer session. (Operator Instructions)

During this conference call, Xerox executives will make comments that are forward-looking statements which by their nature address matters that are in the future and are uncertain. Actual future financial results may be materially different from those expressed herein.

At this time, I would like to turn the meeting over to Mrs. Mulcahy. Mrs. Mulcahy, you may begin.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Thank you. And good morning and thanks to all of you joining us today. During our call today, we will focus on what we know is top of mind for you, the strength of financial position, the resiliency of our business model, how the economy is impacting our business today, and how we are positioned to weather economic challenges ahead while strengthening our competitive leadership.

So if you will turn to slide four, we will review the current dynamics of our business. From our perspective the economic challenges are primarily impacting our business with large enterprises especially in the United States and to some extent in the United Kingdom. We are seeing a good deal of this pressure on sales of our high-volume production systems. Continued strong demand for our products for small and midsized businesses is helping to offset this economic impact. We are generating a solid return on our investments through our developing markets and global imaging operations. And we continue to benefit from demand for our outsourcing and document services.

Certainly a broad worldwide presence helps us in today's environment. So does the business model that is annuity-based. More than 70% of our revenue is recurring providing stability in tough economic conditions. This annuity is a primary source of our operating cash and we are consistently generating solid cash flow with modest capital investments. To date, operating cash flow is $754 million including $260 million in the third quarter.

We recognize that the changes in our revenue mix both from geographic and productline perspectives require us to reduce our cost base so we can maintain growth investments and increase earnings. We are focusing on operational improvement through additional restructuring that will improve operating margins.

As in past years, we expect the fourth quarter to be our strongest for cash flow. So as we look ahead, we remain confident in the strength of our financial position. We are not immune to economic issues and the unpredictability of these coming months will likely make for a challenging environment. But we are better positioned than most and believe we have the flexibility to manage our business successfully through today's challenges as well as serving the long-term value of our shareholders.

So let me take a moment now and review our Q3 results. Larry then will share more detail about our financial results; I will discuss our Q4 expectations and then Larry, Ursula and I would be pleased to take your questions.

So if you turn to slide five, we will summarize our third-quarter performance. We are reporting earnings of $0.29 per share for the third quarter. That includes a $0.04 benefit from tax settlements partially offset by $0.01 of restructuring. Revenue has remained stable over the past few quarters even as economic pressures have increased. Total revenue of $4.4 billion was up 2% and flat at constant currency.

Despite seeing pressure on page volume and large enterprises post sell revenue growth stayed steady and was up 3% with a 1 point currency benefits. Again, where we are experiencing the most impact from the economy is in production equipment sales which led to a decline in equipment revenue of 4% at constant currency, a slight sequential improvement from Q2 as we begin to see the benefit of new products that started shipping in September.

I'll show you in a moment install activity was relatively healthy in key areas like office color and that's an important indicator of our future success. More installs of Xerox technology helped to fuel our profitable post-sell revenue. But as you know, install activity and post sell are very closely linked and flow through to annuity for the long-term.

Gross margin was 39.2% of revenue consistent with the prior quarter but down about 1 point from last year. And selling, administrative and general expenses were 26% of revenue, up a bit more than 0.5 point. The price and mix dynamic continues. [Strength] in developing markets and services put pressure on gross margins but also resulted in a favorable adjusted tax rate from the geographic shift in revenues.

At the same time, we maintained our marketing and sales coverage investment so we can build on our industry leadership. However, to better align our operations with the changing dynamics in our business, we will continue to reduce costs across the board. These activities will accelerate in the fourth quarter helping us build more flexibility in our business so we can improve operating margins and earnings while maintaining investments to drive growth. As a result, we will take a restructuring charge of about $400 million in the fourth quarter. Larry will talk more about this in a moment. And as I mentioned, we are managing the balance sheet well generating $260 million in cash from operations this quarter.

So if you will turn to slide six, we will further review our revenue. Here is a more detailed view our revenue results for Q3 where you will see the direct impact of the economy on our production revenue and the list from our expanded SMB coverage in office. In production, revenue was down 1% in the quarter including a 2% benefit from currency. The challenges in production were primarily US-based but the beginning of some pressure in the UK on our sales to large enterprises. The biggest impact is in production monochrome with 11% install activity decline.

During the quarter, we had only a few weeks of benefit from the launch of Xerox iGen4 production press and the Xerox 700 entry color press both of which just became available worldwide in September. We are encouraged by early signs of demand for these products. In fact, activity was particularly strong in Europe and we expect additional momentum from these launches on a global basis during Q4 and into 2009.

In the office, Q3 revenue was up 3% with a 2 point currency benefits and that was led by strong growth in global imaging systems in our developing markets. Expanded sales coverage to the SMB market through global imaging and resellers and agents and concessionaires contributed a 15% increase in activity for black-and-white multi-function device. And as we continued to drive demand for color in the office with installs of color multifunction systems, up 23%.

Color revenue grew 5% in the third quarter; color pages were up 27% and now represent 17% of total pages printed on Xerox technology. These results exclude the benefits from global imaging systems. As mentioned earlier, growth in our developing markets is providing positive leverage to our overall business with DMO revenue up 15% in the quarter from positive performance in all regions.

Equally important is the continued growth of our document management services. Through Xerox Global Services, we are providing clients with more cost effective ways to manage their document technology, convert paper to digital and simplify document intensive work processes especially in industries like legal, healthcare, education and insurance.

Through Q3, annuity from our multi-year global service contract is up 6%. We are scaling the business not only through industry focused efforts such as our Xerox litigation services for eDiscovery in the legal space but also through key partnerships with leading IT companies. In fact, Xerox recently signed a worldwide agreement with IBM that will leverage our document management expertise to support back-office functions.

Xerox Imaging Services will give IBM and its customers digital access to better manage and use information currently stored in millions of paper [based] documents, performing similar alliances around the world that play to our industry-leading strength in end-to-end document management.

So now, I'll turn it over to Larry for a deeper dive on our financials and then I will return to discuss Q4 expectations. Larry?

Larry Zimmerman - *Xerox Corporation - CFO*

Thank you, Anne, and good morning. In the third quarter, we delivered EPS of $0.29 and $260 million cash flow from operations. While cash flow continues its positive performance in trend with a $754 million year-to-date (technical difficulty) earnings per share, we are helped by the positive effect of prior year tax settlements.

The challenging areas of our business that put pressure on results (technical difficulty) significant slow down in US large enterprise accounts as well as continued mix pressure on gross profit margin as growth came from lower margin parts of our business, geographies, products, and services.

We believe that given this continued environment and trend, it is appropriate to accelerate cost and expense reductions and announce an approximate $400 million restructuring charge for the fourth quarter. Work is in progress to identify the specifics but the size of the charge and the required savings going forward are clear.

In addition, I believe it's important to also focus on some of the positive aspects of the quarter. Our annuity model yielded 2% constant currency recurring revenue growth which drove good cash performance, excellent growth in developing markets and global imaging. Solid performance in Europe, good overall office performance continued growth in our services business. These positive results coupled with our restructuring cost and expense actions will protect us on the downside and give us an opportunity on the upside going forward.

So let's go through a few slides that I hope will add some clarity. I will start with cash flow, talk a little bit about liquidity and receivables given the current environment and then go to the P&L and end with the annuity recurring revenue scorecard.

Slide eight. We are pleased with third-quarter results of $242 million core cash flow and $260 million total cash from operations with year-to-date core cash flow at almost $700 million. We are on track to meet our full-year guidance of $1.1 billion core cash flow allowing for the litigation we talked about in Q1.

As of October 1, all of the Carlson settlement cash is in escrow. Settlement cash will run through cash from operations in the fourth quarter. Cash flow is driven by earnings and includes $205 million of pension payments. Inventory and accounts receivable are on track and will significantly contribute to fourth-quarter cash flow.

Capital and internal software was $85 million in the third quarter and $244 million year-to-date and consistent with $350 million for full year. Cash from investing also includes the litigation cash moving to escrow. Cash from financing includes share repurchase of $91 million and dividend of $37 million and our cash balance is $873 million. So as we talk about good cash performance, I thought I would spend a slide on two questions I get asked.

Slide nine. The first question is what are the debt maturities for unsecured notes supporting our financing business? And second, what is the trend of receivable write-offs? Let's start with two points.

First, we have consistently delivered significant cash flow from operations and cash balances. It is the strength of our annuity recurring revenue model. You can see on the top left box, $1.4 billion to $1.9 billion cash from operations over the last three years. And we will do it again this year factoring in the impact of securities litigation.

Second bottom left, our debt maturities are spread evenly over the next 10 years and are in line with cash flow. 2009 is made up of $934 million of notes due January 15, 2009; $150 million of notes due December 2009; and $448 million in private placements with the final maturity of 2022 which is included because there was a put option in third-quarter 2009.

If we move to the bottom right, you can see that in addition to our $1.4 billion to $1.9 billion of operating cash flow every year, we have a $2 billion revolving credit facility through 2012 with only $248 million drawn at September 30, 2008. We also have a significant secured credit line commitment that we have not used in almost three years that goes through the end of 2010.

The $1.4 billion and $250 million private placement talk to the access we have had in credit markets in the last five months. So given the 10-year spread of our debt, our strong cash generating capabilities particularly in the fourth quarter, our access to capital markets as well as over $2.5 billion of available borrowing, I think it is clear that our debt is well supported and that we approach it in the same way going forward.

Lastly top right, our receivable write-offs and reserves are consistently below 1% of revenue and the dollar growth is largely associated with revenue growth. We inspect these reserves along with write-off experience every quarter on a conservative basis and have not seen a material change in trend or aging.

Now I would like to move to the P&L, slide 10. Revenue for the quarter was flat at constant currency with 2% growth and post sale revenue and a 4% decline in equipment revenue also at constant currency. Given the US enterprise environment, the revenue performance was driven by developing markets, global imaging, office, and services. These growth areas offset US challenges as our investments in them paid off and kept our revenue on trend. This did however keep pressure on gross profit margin as it declined 9/10 of a point. We believe our cost reduction efforts will help improve this over time.

R, D&E continues on a consistent basis and will also benefit from efficiency improvement. SAG grew $47 million with $18 million of the increase due to selling and $10 million due to currency. We believe these selling investments are yielding and are an investment in our future. Bad that provision also impacted SAG but as discussed, is within our historical range as a percent of revenue.

Other net increase reflects the year-over-year impact from gains or losses on currency of $17 million. We had $14 million of restructuring in the quarter and a 6% tax rate driven by the conclusion of prior years as well as a higher content of non-US profit at a lower effective tax rate. This lower tax rate will have a positive cash affect in that future. The tax rate net of restructuring helped $0.03 in the quarter and would have been 24% without it. Our EPS was $0.29.

Slide 11. As mentioned earlier, we are accelerating our restructuring efforts and will implement approximately $400 million charge in the fourth quarter. Significant work is underway to identify the specifics. The focus is to improve efficiency and effectiveness of our operations from our support infrastructure, delivery of our product and service fees as well as development and engineering. These actions will have significant savings in 2009 of $200 million and [netting] the savings against the charge will have about an $80 million incremental use of cash in '09.

These are aggressive actions in challenging times but also will play out to well as opportunities present themselves in the future.

Slide 12. In spite of the challenges from the economic environment, our recurring revenue business model continues to improve and point favorably to the future. As Anne mentioned earlier, page volumes particularly in the US enterprise have been a bit pressured but this has had only a marginal effect on post-sale revenue. Post-sale revenue growth at constant currency was 2% in the third quarter and year-to-date, post sale constancy currency growth is 3% adjusted for global imaging.

The leading indicators for our annuity remain solid. As we go through this scorecard, keep in mind that machines in the field as well as page data do not include printers, developing market countries, and global imaging and all revenue measures exclude global imaging; including these items would improve the results.

As we discussed during last quarter, we incorporated a new metric for total pages to provide an estimate of what our page growth is if DMO printers and global imaging are included. Looking first at the top left box, digital revenue in the quarter was up 6%; machines in the field was up 6%; and digital pages were down 1% or up 2% including DMO, global imaging and printers.

Color continues to drive digital growth with 14% revenue, 34% machines in the field and 28% page growth. Although color equipment revenue growth was not as robust in this environment, the post sale annuity revenue in pages had excellent growth. In addition, the positive impact of color on price per page will continue to be an opportunity as color represents only 22% of machines in the field and 16% of pages.

Black-and-white digital pages and MIF are stable with declines in pages being driven in part by the transition of pages onto color and color capable devices. Black-and-white machines in the field, stability along with color growth, and the solid install performance Anne reviewed earlier, are all positive indicators for future annuity.

We also continue to see good growth in services. Services annuity is up 6% year-to-date and we see this growth continuing as more and more customers look to Xerox to help them reduce their costs by optimizing and simplifying document infrastructure. With over 70% of our revenues coming from post sale, these positive indicators support the resiliency of our business model and stability of our revenues. This stability of recurring revenue coupled with our actions to manage cost and expense will yield earnings expansion and cash generation going forward.

Now I will give it back to Anne.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Thanks, Larry. So wrapping up, as we look at Q4, we are assuming continued economic challenges resulting in pressure on margins due to the shift in our revenue mix as well as currency headwinds. The restructuring we took earlier this year will help to offset some of this pressure. Again, the fourth quarter is seasonally our strongest for operating cash.

We also expect and are already seeing some benefit in Q4 from our new production systems as well as more demand for the broader line of competitively priced office printers and MFPs we launched this year. So we expect to deliver fourth-quarter earnings per share in the range of $0.03 to $0.05. That includes $0.31 of restructuring. Excluding restructuring, Q4 earnings expectations are $0.34 to $0.36 per share. And we believe the $200 million in savings from restructuring that we will realize in 2009 will increase operational profits and margin positioning us well to deliver double-digit earnings growth in 2009.

We will share more detail with you are about 2009 expectations at our investor conference next month.

So if you'll turn to the last slide, we can't reiterate enough that our annuity-based business is a true asset in tough economic times. It delivers recurring revenue for multi-year contracts and generates strong operating cash flow. As Larry mentioned, we expect to have another strong year in cash from operations.

Key to boosting our post sale is increasing install activity of Xerox products. Our investments in the SMB channels through coverage and a broad portfolio of service and technology are paying off and helping to offset the challenges we are facing in large enterprises. That is why with the strong growth from developing markets, revenue has remained stable this year.

We are managing the balance sheet with a close eye on the bottom line. The restructuring actions this year position us well for 2009 reducing our cost base and giving us greater flexibility in our model to operate even more efficiently and effectively in any economic environment.

So let me end where I started, we remain confident in the strength of our financial position and our ability to manage the business successfully through today's challenges and for the long-term value of our shareholders.

So thank you again for joining us today. Now Larry, Ursula and I will open the line to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Carol Sabbagha, Barclays Capital.

Carol Sabbagha - *Barclays Capital - Analyst*

Thank you very much. Just a couple of questions, Anne. First on '09 guidance, not going into great detail because I am sure you are going to give that in November. But sort of when you look out, is it just the restructuring that is giving you confidence in saying you can achieve double-digit growth?

Second, what are you assuming the economic backdrop is for '09 in that forecast?

Third, how much of the $200 million in savings from the restructuring would you expect to drop to the bottom line? And what is your thought process around FX going into that year?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

I would start, Carol, by saying we are certainly not depending on any economic recovery in 2009 to guide us in terms of our ability to deliver earnings growth. We are assuming more of the same if not quite frankly some hedge on deterioration in economic environment. Clearly we have some opportunities based upon the strength of the product portfolio and another strong year of product introductions and the momentum we have been services. But the reality is we intend to take the full $200 million in savings to the bottom line plus.

So this really is an opportunity to ensure despite very, very tough economic circumstances, we are expecting continued pressure as it relates to currency in 2009 and that is really why we are being so aggressive in terms of the cost reduction so that we can be assured of delivering the earnings growth that we would expect in 2009.

Carol Sabbagha - *Barclays Capital - Analyst*

Okay, and one other question. You did buy back some stock this quarter. Just looking out over the next 12 months given the credit environment we are in, what is your approach going to be to stock buybacks?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, I think obviously we had indicated to you that we slowed down the buybacks. That was really due to the litigation settlement in the second half of this year. And I think we will continue to monitor and be conservative as we go into 2009. Obviously we look at a very low stock price that is an opportunity. But we are going to be cautious and ensure that like always, we are conservative with our uses of cash and to the extent that it makes sense to repurchase, we will.

Carol Sabbagha - *Barclays Capital - Analyst*

Thank you very much.

Operator

Richard Gardner, Citigroup.

Richard Gardner - *Citigroup - Analyst*

Great. Thank you very much. Anne, I was a little surprised to hear you say that Europe is relatively stable. I was wondering if you could provide any more detail there? And specifically, do you think that any of the strength you are seeing in Europe is due to pent up demand coming out of Drupa that may not last here as we go into Q4 and the first half of '09? Thank you.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Yes, thanks. Our comment on Europe's stability was specifically with regard to Q3. I think we have started to see weakening certainly in the UK and clearly are not anticipating continued stability in Europe. So we have comprehended a weakening environment -- by the way, currency plays a big role in that because as you look at both the euro and the yen, it has a significant impact.

So we built in quite frankly a fairly I think realistic outlook of what we can expect from Europe next year and it's certainly not reflective of the stability that we saw in Q3.

Richard Gardner - *Citigroup - Analyst*

Okay. And one follow up if I could. I was hoping you might be able to help us figure out how to think about the impact of recent currency movements on your margins. And what type of remediation actions you can take and how quickly to maintain margins in the face of adverse currency movements here? Thanks.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Okay, I think I'm going to start and maybe Larry will want to jump in here. But as we look at the euro, the impact on revenue if we looked at for example today's spot rates on what we expect for Q4 is about a 5% negative impact on revenue for Q4. Obviously it had some positive implications as it relates to cost as well and we comprehend those in as we look at the outlook. But there is clearly a negative with regard to the impact of the euro on our revenue flow through.

But we are always -- live in the world of constant currency and we will continue to report that way so you will always get a sense for the underlying strength of the activity. Probably the bigger issue for us is the dramatic turn in the yen. And as we look at the yen, we hedged the balance sheet in terms of activity that we can currently identify if you will in the pipeline. But going forward on forward purchases, it is really impossible to hedge that activity.

So if I look at, for example, Q3, we lost probably about $20 million so I think that was an unexpected impact on our earnings. If we looked at the biggest single disappointment that we didn't anticipate in Q3, it was really the impact on the cost base which obviously got reflected in gross margin for Q3. We are expecting that going forward to continue.

So when you ask about -- we will do what we can on the hedging side but it is not sufficient to offset the impacts. So our plan is to restructure. And we are going to live in the real world. We are going to comprehend the flow-through of that and we are going to actually restructure our cost base so that the kind of continuing negative pressures that we've seen continue and we can still improve our results to deliver double-digit earnings.

Richard Gardner - *Citigroup - Analyst*

Okay. Would you be willing to give us some sense of the impact of recent yen movements on gross margins for the fourth quarter? And then I will cede the floor. Thank you.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Okay, I think what we saw in the third quarter was probably 2/10 or 3/10 of gross margin impact. That was in the third quarter. That will accelerate going forward. Probably two or three times that when we look at, quite frantic, the yen impact as it relates to the total cost base that -- now obviously all of our competitors are in the same place as well so this is not something that disadvantages us. We all get our supply from Asia. So this is kind of a level playing ground.

But having said that, we definitely expect it to get worse going forward and that is why we have really quite frankly done the due diligence on what kind of cost base restructuring needs to happen so that we can offset that and more to deliver better bottom-line earnings.

Operator

Chris Whitmore, Deutsche Bank.

Chris Whitmore - *Deutsche Bank - Analyst*

Thanks very much. To follow up on that last question, how are competitors responding to the weaker environment? Have you seen any change in the pricing environment in both the production and the office side?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, I think we would say that pricing is somewhat stabilized and actually it's improved a little bit from what we were seeing. So we are giving you a 5% to 10% range on price discounting that is pretty consistent for us. We had seen a little bit of a spike earlier in the year that has moderated.

So pricing itself is not a significant additional pressure, if you will. I think what we are seeing from competitors is competitors taking prices up, particularly supplies pricing. We've seen almost all of our competitors take supplies pricing up. Obviously, we are doing that opportunistically as well.

I think we are just starting to see that happen, so we are obviously intending to stay competitive and make sure that we win in the marketplace. But I think we are seeing more, quite frankly, uplift in price, particularly in the post-sales side than we've seen in quite a while.

Chris Whitmore - *Deutsche Bank - Analyst*

And last cycle was characterized particularly in the production segment with excess capacity amongst the commercial printers. What is your sense in terms of the amount of capacity out there? Do you expect to see a capacity overhang in that commercial printing segment as we roll forward here, given the weakness in pages?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, I think we would characterize it that there is probably -- I'm not sure if I would call it excess capacity in black and white, but sufficient capacity without having to reinvest, if you will, in new technology. Where we see the opportunity for growth is in digital and color. And that is where all the growth is happening in the commercial print marketplace. Obviously, the excess capacity is in the analog world, in the offset world, and that is a big problem. And I think that we find that the commercial print world is prioritizing their investments for growth.

So we are seeing color number one on the list, and then digital in general being the only place an investment is made, being made, in the commercial print marketplace. So you are right, we are seeing some pressure on pages, but I do think that those who want to survive and grow in this particular economy are going to have to get into the value-based part of the market which is all about color digital printing. So we are optimistic that that actually will come back favorably in terms of the graphic communications marketplace.

Chris Whitmore - *Deutsche Bank - Analyst*

Last question around strength in DMO and SMB. How sustainable is the strength in those segments given the global economy? What gives you confidence that SMB, in particular, won't soften going forward? Thanks.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, for us global imaging is a great barometer for SMB growth, and quite frankly, they have been extraordinarily resilient in terms of the ability to deliver great results. So that has been a great kind of bellwether for us, that their ability to perform in what we would view as a weak economy all this year is fabulous.

I think we are clearly moderating our expectations for DMO. That is already comprehended in our outlook, both from a currency perspective as well as some potential weakening of the DMO economy. I would characterize that as saying still growing but perhaps not at the rate of growth that we have seen which has been extraordinary, obviously, over the last few years.

One of the reasons we invested in SMB is because we have such a low share there. So from our expectation, we have more to gain than we have to lose as we go after the SMB. Those that are obviously very heavily vested already, particularly in the black-and-white side of the SMB marketplace, have a lot to lose. We have relatively nothing there. So we tend to benefit from the upside there versus quite frankly the downside risk.

Operator

Mark Moskowitz, JPMorgan.

Mark Moskowitz - *JPMorgan - Analyst*

Thank you, good morning. A couple of questions if I could just following up on Chris's question. With the SMB market and the vulnerability of that segment to macro duress and in tightening credit, are you trying to flex your financing arm a little more to help out those folks or are you status quo right now?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

We really don't do a lot of financing in the SMB market. Most of our financing takes place in the large enterprise area. What we do offer, which is very attractive to the SMB market, is leasing, operating leases which allows them to invest in the technology without having to do a capital outlay. So it's one of the reasons that it puts pressure on equipment sale margins for us but we think it is a really great offering in tough economic times to have operating leases.

So it basically extends the ability to acquire the technology without taking quite frankly the balance sheet risk as it relates to the capital investment. And so far so good. We are seeing that really as an attractive option for the SMB market.

Larry Zimmerman - *Xerox Corporation - CFO*

Just so we are clear too, we are not taking additional credit risk.

Mark Moskowitz - *JPMorgan - Analyst*

Okay.

Larry Zimmerman - *Xerox Corporation - CFO*

If you were asking that.

Mark Moskowitz - *JPMorgan - Analyst*

That was going to be my second point if you were flexible to taking on extra risk to maybe inspire greater demand generation within the SMB segment?

Larry Zimmerman - *Xerox Corporation - CFO*

No.

Mark Moskowitz - *JPMorgan - Analyst*

Okay and then as far as global imaging, any change in the margin structure? I know it's been a pretty attractive margin profile for you. Has there been any change in that structure in this type of environment?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

We've seen the margin improve because they are selling more Xerox products and that gives them or gives us quite frankly the manufacturing flow through on that. So nothing but good news from global imaging.

Mark Moskowitz - *JPMorgan - Analyst*

Okay. And then just lastly maybe bigger picture, Anne. Can you maybe just give us some context around what you are seeing from your large customers this time versus the '01, '02 downturn? Are they doing anything differently? Are they slamming on the brakes on some projects, all projects? What kind of sense are you getting from your major customers?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

I think we do see a big difference. I think we do see both time to revenue, time to contract all -- I guess I would kind put the anxiety factor around the large enterprise business that feels a lot stronger right now than previously. So that it is not as much that we have seen a downsizing of activity. It's just a lack of new activity coming out of commercial enterprise -- the big enterprises than we've seen historically in the past.

Mark Moskowitz - *JPMorgan - Analyst*

Okay so there hasn't been any major deferrals then. Just a lack of new generation?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Yes. I think it is just -- and by the way, that is where fortunately our services businesses has been well positioned. I think we are looking at -- we are doing big services contracts with financial services and weaker parts of the industry so that they can reduce the cost of their infrastructure. So this is where the services business is really well-positioned in terms of the economic downturn.

Mark Moskowitz - *JPMorgan - Analyst*

Okay, thank you.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Just a question in terms of market share and competitive positioning what you are seeing out there? It seems as if this is more of a market issue as opposed to Xerox losing share but I'm just kind of curious as to what you are seeing?

And then sort of how we should think about some of the consolidation that has gone on in the industry with for example of Ricoh purchase of IKON.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, I will begin and then maybe Ursula can talk a little bit about the implications of the IKON Ricoh purges. But I mean there is no question that I think we are faring well in terms of the market indicators. For example although it's a little bit of a lagging indicator, market share literally, I mean we regained our color revenue leadership, we are number one in revenue leadership across the board all segments. We gained share in every segment except one which was production color and that is really where the 700 and the iGen4 are going to have a dramatic impact.

Our installs as we look at just install increases in the quarter were up across the board with the exception of mono production which quite frankly isn't really a lot different in terms of what we're reporting from the past. So every market indicator would say that we are holding our own and potentially will gain share in tough times which for us is the strategy because that is the annuity of the future.

Ursula, the IKON Ricoh peace.

Ursula Burns - *Xerox Corporation - President*

We expect -- it hasn't closed yet but we expect as it closes for this to go fairly well that IKON and Ricoh will manage their business going forward. But we are prepared to take advantage of any fallout that happens there for sure in a delayed or confused buying decision by their customers. More importantly though, I think the biggest impact that that combination will have will be on Canon. It is clearly an advantage for Xerox Corporation. So if you look at Canon's business, global imaging and now IKON Ricoh has tightened up Canon's go-to-market abilities pretty significantly. But we see no -- we do not think it will be a negative for Xerox.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

As a matter of fact, I might add that we are actually seeing wins in the Canon install population due to the fact that those all become decisionable now with this particular IKON Canon install -- installation. So we are a little bit bullish about this.

Shannon Cross - *Cross Research - Analyst*

Okay, great. Larry, can you talk a bit about cash flow? Obviously it's so important in fourth quarter given all of the -- everything that is going on. Can you just walk us through the biggest drivers of cash flow in the fourth quarter and what we should keep in mind and how -- what leaves you at your comfort level with this $1 billion approximately you're going to be expecting?

Larry Zimmerman - *Xerox Corporation - CFO*

I think if you look at what we've consistently done in the fourth quarter, working capital has dramatic changes in the fourth quarter. So inventory and accounts receivable improved significantly and I am confident that we will do that again. We also have our highest earnings of the year. So the combination of that and improvements in working capital makes me confident that that will happen in the (technical difficulty)

Shannon Cross - *Cross Research - Analyst*

Okay and then one last question. With regard to the debt that will be coming due in the first quarter, how do we think about the interest cost on that debt relative to ways that you are going to be able move into the credit facility or whatever? Should that be a net positive? How should we think about it from an interest cost standpoint?

Larry Zimmerman - *Xerox Corporation - CFO*

Right now I would say that you ought to consider a neutral point of view because you don't know what the market rates are. But if you think of us using cash flow which will build up cash on hand in the fourth quarter, if you think of the revolver which has lower rates, you could build a case here where we are going to save money because those are at 9.75. So assuming you don't go to capital markets and aren't crazy I think with cash on a hand and a revolver, we certainly have more than adequate funds and it will be a lower rate.

Shannon Cross - *Cross Research - Analyst*

Great, thank you very much.

Operator

Ananda Baruah, Banc of America.

Ananda Baruah - *Banc of America Securities - Analyst*

Thanks for taking the question. Anne, can you at least anecdotally maybe give us a sense for if you hadn't done the restructuring with the $200 million cost savings, what we might have expected from baseline, OpEx in '09? And I guess the reason I'm asking is because in '07 and '08 you grew OpEx maybe mid single digits, '08 to date which is a bit higher than you traditionally have. And you had some things going on in the last couple of years in terms of product build out, distribution buildout, things of that nature that we might have expected to taper off a little bit in '09 which might have set the '09 baseline OpEx spend -- maybe -- I don't know if it is back to traditional levels but maybe a little bit lower on a year-over-year growth level than they were the last couple of years.

Then you have the $200 million on top of that. So I guess I just wanted to see if you could maybe give us a sense of where we might actually see -- have seen things above and beyond the $200 million cost savings?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

I think it's a really hard question because there's just so many variables that we are dealing with right now. I would look at it and say if we hadn't quite frankly run into the tough economy, if we hadn't run into the currency impacts of quite frankly to the cost base particularly, then clearly there was little or no need to take a $400 million restructuring. Having said that, we are always working the issues. And we would have taken these over time anyway. These are all when optimization of technology enabled productivity, remote diagnostics, all sorts of opportunities for us to quite frankly be more efficient and more productive which we have tried to take over time and comprehend within our earnings.

I think the whole reason for accelerating this and doing it in the fourth quarter is to prepare for the fact that we do believe that 2009 will be a very tough year from an economy perspective, from a currency perspective. And we want to set expectations for earnings growth that we can count on quite frankly restructuring to deliver.

It certainly gets our business more fit which is not a bad thing and should conditions turn better, I think it's all upside for us. I mean one of the things that clearly haven't yielded in total yet is we've been making coverage investments and we've stayed the course on our marketing and coverage investments because we know we've got the portfolio and the capability to deliver more with coverage. And clearly that is a little dampened in a weakened economy in that investment is staged to deliver as the economy turns as well. So I guess that doesn't really answer your question but it is probably as good as we can do.

Ananda Baruah - *Banc of America Securities - Analyst*

No, that is a fair enough. And just wondering what your thoughts are around your graphic arts business and your mom and pop commercial printer business. Because at their heart many of those folks are actually small-medium businesses and we continue to hear from other large companies their concerns about the small-medium business either customers or distributors getting access to financing and things like that.

So can you give us -- let us know what you are seeing they are? And what your thinking is around those folks and how concerned you are if you are concerned about them getting financing?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Let me begin by saying I think we are trying to enable the graphic arts industry with operating leases so this really once again has an impact on equipment sell revenue but it enables quite frankly our graphics arts customers to do what they have to do but to be successful which is bring in digital technology and get into the value-based printing business without uptick in the balance sheet risk quite frankly on capital investment on their part.

So we think that is a good strategy. Having said that, there is no question that we've seen some weakness more so in pages I would say than just installs in the -- our production color installs grew 4% in the quarter which certainly isn't at the rate that we have had in the past but it grew.

Ursula Burns - *Xerox Corporation - President*

And the uptick of the two new products are good.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Color pages, Ursula, grew at like 27 --

Ursula Burns - *Xerox Corporation - President*

27 -- 27%.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

27%. So I do think that we are doing -- we are optimizing the graphic arts industry by helping the healthy graphic arts players have access to digital technology by ensuring that quite frankly these operating leases enable that and making sure that they are well positioned to deliver the value-based printing capabilities that will be absolutely crucial to their survival and success going forward.

Ananda Baruah - *Banc of America Securities - Analyst*

Thanks. And I guess the last one from me. Clearly you guys are pointing to the numbers bear it out -- I guess production being the most significant area of weakness this quarter and its production enterprise. You had I guess you had the iGen4 and then the 700 color for only a few weeks this quarter in North America. It sounds like you guys feel relatively comfortable with the shipment trends you saw the first couple of weeks from those guys.

So I guess where was the relative area of weakness compared to what you guys are expecting in production for both mono and color? Was it really more on the mono side that you guys were surprised a little bit?

Ursula Burns - *Xerox Corporation - President*

I think Anne said in her talk earlier that the activity declines that we saw and the biggest weakness was clearly in production mono. We did have the 700 and the iGen4 for a couple of weeks only particularly in North America, iGen4 worldwide only for a couple of weeks, 700 in a couple of weeks. The shipment trends are very, very strong. So I believe that we will continue to actually perform well in the color production side and we will continue to see weakness in production mono.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

I mean the color press 700 by the way is a great play for an economically sensitive world because it is great value for what you deliver. Okay.

Ananda Baruah - *Banc of America Securities - Analyst*

Thanks.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *Bank of Montreal - Analyst*

Thanks. I had two. First one for you Larry. On a broader scale when you think about what you have to roll over next year during the course of all of calendar year '09, how do you think about the puts and takes? What I mean specifically if you have $1.6 billion that you want to refinance, how do you think about the use of cash -- how much would you anticipate from the cash flow side versus using some of that as you mentioned on the term debt side?

How should we be thinking about that but I assume also that that term loan comes due so at some point I would think when the market settled down, you will have to go back and tap the public markets. What I am really trying to understand is as Shannon indicated, how should we think about the cost of funds not just in the first quarter but during the course of '09 versus what you might do on the share buyback side?

Larry Zimmerman - *Xerox Corporation - CFO*

The key word there was have to go to capital markets and we are in a position where we don't have to go to capital (multiple speakers)

Keith Bachman - *Bank of Montreal - Analyst*

But Larry, when does the term come due?

Larry Zimmerman - *Xerox Corporation - CFO*

The first payment is in January 15.

Keith Bachman - *Bank of Montreal - Analyst*

No, I'm sorry -- when does the term -- you can always substitute the term loan. You can use some of your term debt to pay down (multiple speakers)

Larry Zimmerman - *Xerox Corporation - CFO*

You talking about a revolver?

Keith Bachman - *Bank of Montreal - Analyst*

Yes the revolver.

Larry Zimmerman - *Xerox Corporation - CFO*

That is a different term. Yes, it is 2012.

Keith Bachman - *Bank of Montreal - Analyst*

Okay. So you could keep that in place for the balance -- you could access that and keep in place for the balance of '09?

Larry Zimmerman - *Xerox Corporation - CFO*

We intend to keep that in place through 2012 and we would never think of not having a revolver (multiple speakers)

Keith Bachman - *Bank of Montreal - Analyst*

No, no Larry, Larry, sorry. Perhaps I'm not being clear. But you could substitute that financing and you could use that for the duration of '09 to pay down what is due in January and thereafter.

Larry Zimmerman - *Xerox Corporation - CFO*

Yes.

Keith Bachman - *Bank of Montreal - Analyst*

Okay.

Larry Zimmerman - *Xerox Corporation - CFO*

Definitely. Between cash flow and the revolver, we do not have to go to capital markets.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

By a wide margin.

Larry Zimmerman - *Xerox Corporation - CFO*

By a wide margin.

Keith Bachman - *Bank of Montreal - Analyst*

Sorry, I understand that. What I'm trying to ask is if you think about what you have due versus what you anticipate in cash flow, should we think about the share buyback keeping -- what levels of share buyback should we anticipate next year? In other words, would you anticipate using the whole revolver and then using your cash flow to then go ahead and buy back your stock at these price levels?

Larry Zimmerman - *Xerox Corporation - CFO*

No, you should think of the fact that we are going to treat cash as a scarce asset. We are going to be careful on everything we do with cash in this environment.

Keith Bachman - *Bank of Montreal - Analyst*

Okay.

Larry Zimmerman - *Xerox Corporation - CFO*

If the environment changes, we will do it differently.

Keith Bachman - *Bank of Montreal - Analyst*

Okay. Second question. Anne, just the office margins were actually pretty good given the backdrop, the production environment, the operating margins were down certainly on a year-over-year basis. I assume that is driven by the volume variance and also the mix issue. Should we think about if this given the backdrop that we have the production operating margins will stay at these levels in the mid 6's?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

No, I think there is a couple of things going on here. One is on the office margins, they are strong because everything was strong. Activity was strong, clearly it was by the way probably the most lucrative area for us is color multifunction was up 23%. So office was just actually performed very, very well.

On the production side, clearly our -- the issue for us was actually even though we grew production color installs, it was not at the same rate that we normally grow it and with the iGen4 and the color press 700, color will have an much more positive impact on the operating margins in the production world going forward.

By the way, we are not necessarily expecting to grow the business at the rate we might have because of the weakening economy but we think the mix toward production color will actually improve based upon the 700 and iGen4 availability, both Q4 and 2009.

Keith Bachman - *Bank of Montreal - Analyst*

Okay, thank you.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

I think we have time for one more question.

Operator

Jay Vleeschhouwer, Merrill Lynch.

Jay Vleeschhouwer - *Merrill Lynch - Analyst*

Thanks, good morning. Follow-up on the questions regarding the restructuring, Anne. Could you say to what degree it will affect production versus office? Have you thought through the relative impact on those two parts of the business? And a follow-up.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

You know, Jay, I think as we look at it right now, it is hard for me to give you the definitive. We've got it broken out pretty well in terms of area of the business. And I might ask Ursula just to spend a minute talking about it. I would say that some of the development and engineering compensation that we have will probably have a bigger impact on production than office just because we do that in house. So some of the manufacturing optimization and the development optimization will have a disproportionately positive impact on production.

But there is going to be enough of a general infrastructure that it's going to be pretty significant for office too. So, Ursula, just -- I think it's important to characterize some of the things that we are doing because I think they are pretty well thought out and they really position us well for the future.

Ursula Burns - *Xerox Corporation - President*

Just three areas I will focus on, Jay. The first is on the point that Anne -- which is on the development and engineering resources and how we are planning to optimize there. You know that we've been on the platform strategy for awhile in the hardware space. We are bringing that from office and production to focus on the team products so that we can actually be more consistent across office and production.

We are also focusing on software platforms across the groups as well. A marred large amount of our R&D is spent on software development so we are coming to focus on that to more of a platform perspective than versus office and production. That's our first area.

The second is trying to gain efficiencies because we are now a digital business and a lot more of our products are connected, a lot more of our business is services based. So we should be able to use more of the infrastructure that already exists to drive efficiencies through our system.

So things like remote diagnostics, things like managing (inaudible) -- delivering tools to managing our managed service business significantly better. Those areas will drive efficiencies through our business. Supply chain, we are significantly more of a -- focusing more on small and medium businesses across the world around the world so doing significantly more point to point delivery versus many different touches in the supply chain and streamlining our manufacturing infrastructure as well.

And then in the last area is on the basic infrastructure of marketing, finance, HR training areas like that. We are trying to go to a shared service infrastructure to leverage the fact that we actually are significantly more mature business. Everywhere that you can look as Anne said, we are moving it up one level and taking it quickly, taking it now.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

And the good news is that we come to this prepared because we have been doing quite frankly these have been the source of our Lean Six Sigma Black Belt effort in terms of process change for a long time now and so they are in a position where we can actually execute and do them without quite frankly disrupting the business.

Jay Vleeschhouwer - *Merrill Lynch - Analyst*

Are you prepared to say whether or not you are adhering to the 40% to 41% long-term gross margin nominal range or is that perhaps in some flux given what is going on?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, I think we are actually preparing for delivering double-digit earnings with gross margin below 40% Jay. I think that is fair to say. The context that we have here is not counting quite frankly on margin improvement and saying maybe that is the real world for the foreseeable future, let's deal with it. Let's get our cost base and our economics in line so that is not a detractor from our ability to deliver the kind of growth in both operating margin and earnings that we expect.

Jay Vleeschhouwer - *Merrill Lynch - Analyst*

All right. And maybe just to wrap up. Do you foresee having to curtail in some way your investments in market coverage particularly given the breadth of markets you address like GA and TransPromo, financial services, news specialty, (inaudible) photo printing and all the rest. Are you going to have to maybe pull back in any of those kinds of investments or coverage capabilities?

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

We are staying the course. We chose our words carefully by saying we are maintaining our marketing and coverage investments. So we made a lot of investments. We are going to maintain it. We are going to get yield from it because we really haven't seen the payback on a lot of that yet. But as we look at the year-over-year, you will see those increased investments going forward because we've done them, they are sunk investments and now it's all about getting returns. And as you know when you are investing in coverage, it's a lagging return because you've got to bring people up to speed particularly in areas like continuous feed and production environments.

So that really -- that return is in front of us versus seeing it currently. So we are going to stay the course and maintain those investments and get real tough in other area of the business so that we can maintain those investments and grow for the future.

Jay Vleeschhouwer - *Merrill Lynch - Analyst*

Could I squeeze in just one more? Did you see in terms of your Drupa or at show quarter book or your immediate post-show order book any cancellations in the last few months or has everything held in your order book and you are now just having to deliver?

Ursula Burns - *Xerox Corporation - President*

We have seen no cancellations in the order book, Europe or North America.

Jay Vleeschhouwer - *Merrill Lynch - Analyst*

Okay, great. Thanks very much.

Anne Mulcahy - *Xerox Corporation - Chairman and CEO*

Well, thank you everybody. We appreciate your time today and we look forward to sharing more detail with you as we look forward to 2009 at our investor conference on November 24. Thank you again.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect.
