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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the Unisys Corporation Third Quarter 2020 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Courtney Holben, Vice President of Investor Relations. Please go ahead.

Courtney Holben

Vice President-Investor Relation, Unisys Corp.

Thank you, operator. Good morning, everyone. This is Courtney Holben, Vice President of Investor Relations. Thank you for joining us. Yesterday afternoon, Unisys released its third quarter 2020 financial results. I'm joined this morning to discuss those results by Peter Altabef, our Chairman and CEO, and Mike Thomson, our CFO.

Before we begin, I'd like to cover a few details. First, today's conference call and the Q&A session are being webcast via the Unisys investor website. Second, you can find the earnings press release and the presentation slides that we will be using this morning to guide our discussion as well as other information related to our third quarter performance on our investor website, which we encourage you to visit. Third, today's presentation, which is complementary to the earnings press release, includes some non-GAAP financial measures. The non-GAAP measures have been reconciled with the related GAAP measures, and we've provided reconciliations within the presentation.

Although appropriate under Generally Accepted Accounting Principles, the company's results reflect charges that the company believes are not indicative of its ongoing operation and that can make its profitability and liquidity results difficult to compare to prior periods, anticipated future periods, or to its competitors' results. These items consist of pension, debt exchange, and debt extinguishment, cost reduction, and other expense.

Management believes each of these items can distort the visibility of trends associated with the company's ongoing performance. Management also believes that the evaluation of the company's financial performance can be enhanced by use of supplemental presentation of its results that exclude the impact of these items in order to enhance consistency and comparativeness with prior or future period results.

The following measures are often provided and utilized by the company's management, analysts, and investors to enhance comparability of year-over-year results, as well as to compare results to other companies in our industry, non-GAAP operating profit, non-GAAP diluted earnings per share, free cash flow and adjusted free cash flow, EBITDA and adjusted EBITDA, and constant currency.

In addition, this quarter, we will be continuing to report non-GAAP adjusted revenue and related measures as a result of certain revenue relating to reimbursements from the company's check-processing JV partners for restructuring expenses included as part of the company's restructuring program. For more information regarding these adjustments, please see our earnings release and our Form 10-Q.

From time to time, Unisys may provide specific guidance or color regarding its expected future financial performance. Such information is effective only on the date given. Unisys generally will not update, reaffirm or otherwise comment on any such information, except as Unisys deems necessary and then only in a manner that complies with Regulation FD.

And, finally, I'd like to remind you that all forward-looking statements made during this conference call are subject to various risks and uncertainties that could cause the actual results to differ materially from our expectations. These factors are discussed more fully in the earnings release and in the company's SEC filings. Copies of those SEC reports are available from the SEC and along with the other materials I mentioned earlier on the Unisys' investor website.

And now, I'd like to turn the call over to Peter.

Peter A. Altabef

President, Chief Executive Officer & Chairman, Unisys Corp.

Thank you, Courtney. Good morning, and thank you for joining us to discuss our third quarter financial results. We continue to hope that you, your families, and friends are safe and healthy. Our financial results improved significantly versus the second quarter, and we took meaningful steps to improve our pension structure. While keeping a sharp focus on near-term goals, we have also been enhancing the productivity of our operations and focusing on higher margin, higher growth segments of the market to drive the business going forward.

In addition to our overall operational productivity enhancements, we were pleased to see that the recovery from COVID-related impacts continued in the third quarter. The combination of these factors helped drive significant sequential improvement in our key financial metrics and year-over-year non-GAAP operating profit margin expansion, which Mike will go through in more detail.

One element of the financial results that I will highlight is that our Services non-GAAP adjusted operating profit margin increased 520 basis points sequentially and has increased 830 basis points since the end of the first quarter this year. This has largely been driven by effectively removing negative synergies following the sale of our U.S. Federal business and has also been helped by our ongoing efforts around workforce planning.

We are utilizing predictive analytics and near real-time data to optimize the efficiency of our workforce, including through improved labor supply and demand management and skill gap resolution. While these efforts are in early stages, we are pleased to see the improvement to-date with the total Services cost of labor as a percentage of Services revenue down 320 basis points year-over-year in the third quarter and down 250 basis points sequentially.

Moving to revenue in the quarter, factors contributing to our sequential revenue improvement include the increase in monthly tickets in our Field Services business from approximately 70% of their pre-COVID levels in June to approximately 80% in September. Volumes on the two large BPO contracts that we referenced last quarter increased from 38% and 80% of their pre-COVID monthly levels in June to 57% and 91% respectively in September. Within Travel and Transportation, our global average daily waybill count increased from 51% of its pre-COVID monthly volumes in June to 68% in September.

We also saw an increase in sales with Services total contract value signings increasing 4.3% sequentially in the quarter. We have taken significant steps to improve our pension structure and liquidity since the second quarter, including with the notes offering we just priced. Mike will provide more detail on this, but the progress enhances both our financial and operational flexibility.

We have been making improvements to the business to drive efficiencies over time including the workforce management efforts I noted, as well as increasing the implementation of automation and artificial intelligence, and enhancing collaboration tools to increase associated productivity.

We also saw sales momentum with our pipeline increasing over 20% sequentially as a result of increased unsolicited bids to help clients solve their business challenges. This is also a higher quality pipeline as we have been more rigorous in prequalifying opportunities, and we have enhanced sales training efforts through the implementation of boot camps and investment in more sophisticated training platforms to aid our new digital selling approach. As a result, our year-to-date win rate was up significantly relative to win rates in the last two years.

Within digital workplace services, as we discussed last quarter, we are shifting our focus to higher growth, higher margin segments of the market such as end-user experience. InteliServe, which is our artificial intelligence and advanced analytics powered platform, helped differentiate us within digital workplace services. InteliServe uses cloud-based, mobile-centric solutions to improve end-user experience and productivity, while supporting workforce optimization and reducing IT costs.

As an example of how InteliServe can help clients transform their digital workplace strategy, during the third quarter, we signed a contract with DJO Global, Inc., a provider of intelligent medical devices and services. InteliServe will enable omni-channeled service desk support to help provide a more affordable and effective experience for DJO's customers.

Within cloud and infrastructure, we are prioritizing our cloud efforts enhanced by CloudForte, which offers a comprehensive set of cloud services across applications and infrastructure with embedded governance and security to accelerate digital transformation for our clients. During the quarter, we signed a new scope contract with the State of North Dakota. As part of this contract, Unisys will be providing CloudForte services related to the Microsoft Azure GovCloud to support that state's unemployment insurance agency.

With respect to ClearPath Forward, while we report license revenue in our Technology segment and ClearPath Forward's services revenue and our Services segment, we think about this business as a franchise with the services inherently linked to the technology. We continue to innovate this platform and enhance our offerings.

During the quarter, we announced the general availability of ClearPath Forward from Microsoft Azure. This offering provides our clients with the ability to utilize secure high-intensity computing in a public cloud environment. This solution creates the opportunity for clients to increase volumes processed by ClearPath Forward systems and to increase their usage of related Unisys services and solutions such as Unisys CloudForte hybrid and multi-cloud services, Stealth and Stealth services.

The new work with the State of North Dakota is an example of the power of leveraging ClearPath Forward for Azure with other Unisys services such as CloudForte. ClearPath Forward services represents an ongoing opportunity for growth, including application development, modernization, and managed services. We believe all these initiatives will help us maintain our very high ClearPath Forward client retention rate.

I have spoken in recent quarters about our ongoing commitment to diversity, equity, and inclusion. This quarter, I want to highlight our focus on ESG matters. While environmental, social and governance activities have been important to us for years, during the third quarter, we published our first sustainability report, which is available on our website. Among the targets and accomplishments highlighted in the report, we note that in 2006, we announced a goal of a 75% reduction in our absolute greenhouse gas emissions from Scope 1 and Scope 2 sources by 2026. We're currently 96% of the way to achieving this goal, and we'll do so years ahead of schedule.

We've achieved a 99% reduction of our hazardous waste generation over the last 20 years, with zero hazardous waste generated across our U.S. operations in 2019. We also recognize the need to expand the impact of our ESG efforts. So, we have announced a target of having 75% of our key suppliers disclose their ESG targets and committed actions.

Before turning the next section of the call over to Mike, I would like to thank all of our associates for coming together to support each other and our clients this year. As examples, our field services technicians put themselves on the frontline even during the height of the initial wave of COVID-19 to serve our clients, and our sales executives have quickly adapted strategies to achieve success in a more virtual world.

We are truly grateful for our associates' commitment to Unisys, our clients, and our investors. I am proud of our progress since our last call, and we look forward to continuing to execute in the fourth quarter. Mike, over to you.

Michael M. Thomson

Senior Vice President & Chief Financial Officer, Unisys Corp.

Thank you, Peter. Good morning, everyone. My discussions today will refer to both GAAP and non-GAAP results. As a reminder, reconciliations of those metrics are available on our earnings material. Likewise, information related to discontinued operations is available on our website.

As Peter has already highlighted, our financial results improved significantly on a sequential basis relative to the second quarter, including being free cash flow positive for the quarter. We also took steps to significantly improve the pension structure, and our full-year expectations for revenue and profitability are unchanged. We were able to accomplish this while also streamlining operations to enhance our margin profile and focusing on higher margin, higher growth market segments.

I'll begin by noting that we were ahead of consensus on all major financial metrics for the quarter. Our non-GAAP adjusted revenue increased 12.8% sequentially relative to the second quarter to $495.1 million. This was driven by both improvements in Services and Technology revenue.

Services non-GAAP adjusted revenue increased 7.6% sequentially to $425.9 million. This improvement was driven by increased volumes in the businesses that were most impacted by COVID as well as growth in our cloud business, which was particularly strong in the public sector.

Services backlog ended the quarter at $3.3 billion. We expect the sequential improvement in Services TCV that Peter mentioned to continue into the fourth quarter and expect backlog to be higher in the fourth quarter as a result.

Technology revenue was also significantly higher sequentially and ahead of internal expectations, up 61.7% versus the second quarter to $69.2 million. The two ClearPath Forward contracts that were delayed from Q2 were signed in the third quarter, which contributed to the sequential improvement in revenue, though Technology revenue would have been up sequentially even excluding these contracts.

Last quarter, we noted that we expected Technology revenue to be split approximately 30% and 70% between the third and fourth quarter. Given that Technology revenue was slightly stronger than expected in Q3, this split is now more likely to be approximately 40% and 60%.

Moving to profitability, non-GAAP operating profit margin expanded 50 basis points year-over-year and 830 basis points sequentially to 8.5%, again driven by improvements in both Services and Technology margins.

Services non-GAAP adjusted gross margin increased to 200 basis points year-over-year and 350 basis points sequentially to 19%. And the Services non-GAAP adjusted operating profit margin increased to 250 basis points year-over-year and 520 basis points sequentially to 4.8%. These improvements were driven by the flow-through of higher revenue as well as additional savings from effectively removing negative synergies earlier in the year, following the U.S. Federal sale and the workforce management efforts that Peter outlined.

Technology margins were up significantly on a sequential basis with Technology gross margin up 17.7 points sequentially, and Technology operating profit margins up 30.9 points sequentially. Adjusted EBITDA margin expanded 350 basis points sequentially to 14.9%, driven by many of the factors I've already noted with respect to revenue and operating profit.

We continue to be pleased with our associate productivity in our remote work environment and as Peter noted, we're proud of the work our associates did during the quarter to drive progress. Despite the significant sequential improvement in non-GAAP-adjusted revenue, it was still down year-over-year but consistent with our previously discussed expectations.

The year-over-year decline was driven largely by lower volumes in both field services and our check-processing JV within BPO. As a reminder, we noted coming into the year that our ClearPath Forward renewal schedule was expected to be lighter in 2020, and that also contributed to the year-over-year decline in non-GAAP-adjusted revenue.

Technology margins were down year-over-year because of the flow-through impact of the lighter renewal schedule on revenue against a relatively fixed cost base. Our full-year expectations for revenue and non-GAAP operating profit margins remain unchanged relative to the end of the second quarter. Our models continue to indicate a 10% year-over-year revenue decline and 5.2% to 6.7% range for non-GAAP operating profit margin for the full-year 2020.

All of these forward-looking indicators are based on our current visibility and should spikes in the virus result in material negative economic consequences, our actual results may differ from our expectations.

We had previously discussed a one-time non-cash charge of $20 million related to our EMEA optimization plan, which we now expect to incur in the fourth quarter instead of in the third quarter. Our previously mentioned facility rationalization is also on track and we anticipate a fourth quarter charge of $5 million to $10 million. The resulting run rate savings from the charges taken in the third quarter and the fourth quarter is expected to be between $20 million and $30 million exiting 2021.

Moving now to pension and liquidity. We're very pleased with the progress we were able to make on both of these fronts since our last call. Our recent notes offering will allow us to significantly reduce the pension deficit and our remaining required pension cash contributions. Pro forma for contributing the net proceeds from the notes as well as up to $285 million from cash on the balance sheet, we will have effectively prefunded substantially all the expected future contributions to the U.S. pension plan.

Given that we upsized the recent notes offerings and based on the current calculations for future payment, we may not need to contribute the full remaining $285 million I've just highlighted as we do not want to be in a position where we have funded more than our required contributions. Pro forma for the contribution of the note proceeds, we will have contributed just under $800 million to the U.S. pension plan in 2020, thereby dramatically reducing the debt.

The notes offerings was a roughly leverage-neutral transactions, given that the net proceeds were used to reduce the pension deficit. As a result, pro forma net leverage is 3 times LTM adjusted EBITDA as of September 30.

Also with respect to pension, I'd like to update you on our pension liability reduction strategy. As a reminder, I mentioned on the second quarter earnings call that we were planning to remove approximately $1 billion in gross pension liabilities by the end of the first quarter 2021. This program is on track, and during the third quarter, we notified a group of plan participants of our offer to make bulk lump-sum payments.

We expect this bulk lump-sum offer to remove between $200 million and $350 million of gross pension liabilities from our U.S. pension obligation, and we anticipate this process to be completed by the end of the fourth quarter.

U.S. GAAP requires that proportional settlement change accompany the removal of significant pension liabilities. The charge represents unrecognized actuarial gains and losses currently sitting in accumulated other comprehensive income or AOCI in the equity section of our balance sheet. To that end, we anticipate $150 million one-time non-cash settlement charge to be associated with this portion of our liability reduction to be recognized in the fourth quarter.

In the first quarter of 2021, we expect to remove an additional $750 million in gross pension liabilities, with approximately $250 million coming from the U.S. pension and approximately $500 million coming from foreign pensions. This corresponding one-time non-cash settlement charge associated with the liability removal of these plans is expected to be approximately $250 million and would be recognized in the first quarter of 2021. Both of these charges are equity-neutral and will reduce future pension expense.

With respect to liquidity, our cash flow this quarter was strong. Cash from operations increased $48.6 million year-over-year and $80.5 million sequentially, to a total of $66.3 million. We were also free cash flow positive for the third quarter, with $34.3 million of free cash flow, an increase of $48.6 million year-over-year and $83.9 million sequentially. Adjusted free cash flow increased $38.5 million year-over-year and $89.5 million sequentially, to $52.4 million.

As a result, we ended the third quarter with a strong liquidity position. We paid down the $59 million previously outstanding on the revolver with cash from operations. And after doing so, we had an ending cash balance for the quarter of $774 million, down less than $10 million versus the end of the second quarter.

Given the issuance of the notes and contributions toward the pension, we have limited near-term cash requirements outside of normal operational funding. In conjunction with the recent notes offering, we've also obtained commitments to renew and extend our asset-backed lending facility or ABL at the size of $145 million with a new maturity date of 2025.

As in the second quarter, we had no negative impact on cash collections due to COVID-19 and continue to be in line with historic norm. CapEx was roughly flat year-over-year at $32 million. And we're reducing our overall CapEx target for 2020 to $140 million, down from $150 million.

Overall, we're very pleased with the progress we've made during the third quarter and we remain focused on continuing our strong execution in the fourth quarter to achieve our full-year goals.

With that, I'll turn the call back over to Peter.

Peter A. Altabef

President, Chief Executive Officer & Chairman, Unisys Corp.

Thank you, Mike. Operator, we're now ready to take comments and questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] The first question today comes from Jon Tanwanteng of CJS Securities. Please go ahead.

Jon E Tanwanteng
Analyst, CJS Securities, Inc.

Q

Hi. Good morning, and thank you for taking my questions. Very nice quarter, guys. It's clear you've done a lot of good work here. I wanted to ask about the sequential margin uptick specifically in Technology. You got some pretty good operating margins there on only $70 million in revenue. As we look into Q4 where you have more renewals coming, can we see much of that drop to the bottom line the same way it did in Q3? Or how should we think of the incremental as those renewals come in? And I have a follow-up after that. Thank you.

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Hey, Jon. Mike here.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Mike, if you want to speak specifically to that. Jon, thanks for the question. I would say that you know in general, the Technology revenue that comes in is all customized, due to specific clients with specific contracts. And so, there are allocation issues that apply throughout. But there's a lot of very specific facts about each of these contracts. So, it makes generalization about the profitability of specific contracts a little more difficult. But over to you, Mike.

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Yes. Hey, Jon. How are you? Yes, Jon, as you know, the bulk of that is ClearPath Forward technology revenue. It's a relatively fixed base. And so, we would expect the margin pull-through to be consistent with the third quarter, again with the cost basis being relatively fixed and flat, the expectation on margin. The one variable that comes into play and probably not indigenous to what's coming through in the fourth quarter is the amount of third-party hardware that might end up being included in any given scenario. But in this case, I think the expectation is consistent with what happened in Q3.

Jon E Tanwanteng
Analyst, CJS Securities, Inc.

Q

Got it. That's helpful. And again, as we look to the fourth quarter, and I know you have your full-year guidance out there, but with COVID ramping and hitting new highs in many regions of the world, how are you preparing for that especially as it comes to the ability to visit sites and do your processing and call center work? Are you going to be impacted similar to the way you were impacted in Q2, or are you going to be able mitigate that in some way?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Well, I'd say we're smarter than we were in Q2. I think the thing we did, and many of the companies in that sector did, really effectively in Q2 was to be able to move people out of contact centers, out of main facilities where they were all working together doing development work and have them work remotely. That dramatically decreased the spread of the virus within our team.

What was harder to do in Q2 was really to stand up from a workforce planning standpoint exactly how you would support all of your clients, exactly how you would do remote field service effectively. And so, that did take a while to get a handle on. I would tell you we now have that much more in hand, so I would expect more efficiencies if we get a strong second wave, if that's what you want to call it, for what we experienced in the second quarter.

The other thing to keep in mind about us as a company is the real strength of our diversity. So, the U.S. accounts for about 40% – U.S. and Canada is about 41% of our revenue. EMEA is about 32%, Asia-Pacific and Latin America together about 37%.

So, from a standpoint of client demand, different countries are going to be affected in different ways, and I think we have a strength of diversity, in the same way we have a strength of delivery because our people are spread so far around the world. So, that's not going to make it perfect, but I do believe we're in a better position than we were in the second quarter.

Jon E Tanwanteng
Analyst, CJS Securities, Inc.

Q

Understood. Thank you. And I'm sorry to squeeze one more in. Just as it relates to pension reform and stimulus, if that passes, is there a provision to pay the senior secured notes back?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

The senior secured notes, Jon, are a no call three- and a seven-year term. So, certainly not immediately, that would not happen.

Jon E Tanwanteng
Analyst, CJS Securities, Inc.

Q

Got it. Thank you very much.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Thank you, Jon.

Operator: The next question today comes from Joseph Vafi with Canaccord. Please go ahead.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

Hey, guys. Good morning. Nice to see the rebound in the business. So, I know, Peter, you mentioned some workforce efficiency metrics here upfront in some of your comments and it sounds like there may be more progress there in terms of efficient staffing and optimization. Do you have a feel for kind of best practices or benchmarks out there relative to perhaps where you are and how much more opportunity may be in front of you here?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Yes, Joe, it's, A, a great question and, B, thank you for waking up so early this morning. We stood up what was effectively a brand-new reimagined workforce management system in January, a new team leading it, new processes. So, that team has had to get up and running and on the go during most of the COVID situation.

So, as I say, when we look at the savings that we were able to pull-through this calendar year in some of our operations, it's really two buckets. One is getting rid of the negative synergies, if you will, from downsizing with the sale of the U.S. Federal group. That is effectively done on a run rate basis. There's a about less than 20% more to go in the fourth quarter, and it has all been identified.

So, the second part of that productivity is through workforce planning. That has been the smaller part in 2020. We actually expect that to accelerate in 2021. So, we think the bigger savings with respect to that are ahead of us and not behind us. And workforce planning is actually only one of three what I would call big internal housekeeping jobs we have done during COVID-19.

So, obviously, we've put in place that workforce planning system. That involves not only advanced training, but matching of skills and labor and costs. It means not going through a turnstile of how do you hire people for specific jobs, and then what happens if you don't need them anymore. But really taking that workforce and retraining that workforce, so you get out of this endless cycle of people moving in and out of the company. We think that's very productive for them and very productive for us.

But in addition to workforce planning, we have two other what I would call inside baseball initiatives going on of substance. One of them is a brand-new ERP system which doesn't sound exciting, but is exciting. Ours is about 20 years old. I can talk about it. We actually have two systems running concurrently, and everybody on this call knows the benefit of a real effective ERP system. In particular, we expect that to increase our net cash flow, and Mike can get into more detail on that.

And finally, over the course of this year, we have been standing up a very significant brand-new digital sales platform, which I alluded to in my comments. And that is dramatically accelerating our ability for the sales team to work with clients and prospects. And as you've seen from my remarks, that is just beginning. But it's already having an effect with a really dramatic increase in our win rate.

So, more to come on all three of those initiatives next year. We expect them to be more powerful next year than this year. But we like what we're seeing in all three. Mike, do you want to speak to the ERP system and the effects of that for a minute?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Sure. Hey, Joe, how are you? Really, I'd like to [ph] tie to (34:08) first, Peter, into your comment about workforce management. Joe, when we look at our total cost of labor, we're seeing that come down dramatically across the board, right? So, it's not only managing our internal workforce and the flow of resources, but it's managing any outsource component of that that we have.

So, our total cost of labor is really being helped by that. And as you know, with a geographical footprint that we have and being diverse, we want to be nimble and we want to ensure that we've got the right people in the right place, and that's been really helpful to us. And to Peter's point, we expect 2021 to continue that momentum and continue to drive that internal cost of labor down.

Maybe specifically to the ERP, and as you can imagine, it's a vast project that encompasses many aspects of our business. But one thing in particular and specifically as we talk about working capital improvements within ERP would be the new billing system component of that.

The allowance for on-demand and real time billing in a Web-based environment is going to help significantly, and we'd be looking for significant DSO reductions out of that, which by in turn would obviously reduce our working capital profile, because we're now aligning on the AR side of the coin consistent with the AP side of the coin.

And our goal here is to get to a point that we're using minimum working capital in the context of our free cash flow. So, a lot of good things in the pipeline from an operational perspective, and we feel pretty good about the direction and where we're going right now.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

That's great. Thanks for that extra color, both of you. Maybe we just kind of focus again on that last point Peter mentioned as well on the digital initiatives. I mean, if you kind of look across the enterprise and software sales and the macro and the digital transformation efforts underway are just really kind of amazing pace that they're going right now, it does sound like you're tapping into that with this kind of non-solicited bid opportunity.

Can you kind of expand on that relative to the offerings that you're seeing in these situations? And do you think the product set needs to expand to kind of exploit what you're seeing across enterprise customers?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

So, Joe, that's a great question. It's not a simple question, but it's a great question. So, I'll try to start with three, kind of, subsets and then let Mike continue on top of it.

Let me start with the last of your statements about the product set. So, I have referred to in the last two calls, both this call and the prior call, about us evolving into higher margin and higher growth areas. So, specifically, when you think about some of our lines of business, they are more stable with growth opportunities and other lines of business are – have even higher growth opportunities.

So, what I would categorize as the more stable lines would be our ClearPath Forward family of solutions. There's opportunities to grow that vis-à-vis particular services on top of ClearPath Forward or related to, things like CloudForte.

The new Microsoft Azure general applicability for the MCP version of CloudForte is a big deal. So, there are opportunities and we're spending a great deal of time and focus making sure that core franchise remains viable and has opportunities to grow.

The BPO business of ours has been kind of a very specific set of clients and capabilities and remains a specific set of clients and capabilities. So, that leaves really our two other large areas of revenue. One is what we call digital workplace services. The other is cloud and infrastructure.

So, within digital workplace services, we have sat down really since April with McKinsey and really kind of planned out what is the future of digital workplace services for us. Same thing, we sat down and worked through with McKinsey what is the future for us in cloud and infrastructure.

And in both cases, I think we pretty much knew the direction of the answer and some of the specifics. But it is a much more fulsome, fleshed-out kind of approach than we had in April. So we expect the digital workplace services, that evolution of going from really an end-user services to end-user experience, is going to increase the size of the market we can approach.

It's going to increase the value of our services to our clients, and that should result in increased margin to us. We are very committed to the digital workplace services environment. It's a major area of focus for us.

And I would just point out it's a major area of focus for us, while it is less of a focus for some of our competitors. And it's interesting because that is an area that is growing, that is getting more profitable, and you might say, why are a bunch of people leaving that market? Well, they're leaving because they find another market even more attractive. But for us, we find that a very attractive market, especially given our position in that market as one of the leaders of that market.

The second market where we are really expanding our capabilities is in the world of cloud and infrastructure. There, the focus is on cloud and that is the market that everybody is going to. You've seen that with announcements from a number of other companies in our space really over the last year and over the last month. And so, it is a big market, it is growing quickly, it is a profitable market. So, everybody is there. And so, our approach is not like everybody's.

Again, working with McKinsey, we've taken a very specific approach to that cloud market. And we have very specific, very capable assets in our CloudForte approach that have been well received. And when we – but when we look at that big market, the question is, where are you differentiated, and why will you succeed? And so, we have really looked at specific parts of that market.

I'll talk about one of them, which is the public sector, state and local in the U.S., and then governments around the world. As Mike alluded to in his remarks, we have been very successful in the public sector. We expect to be more successful in the public sector. So, that is an area where we really expect to double down and make a lot of growth and much progress in a larger market where there's a lot of other things going on.

But we really like that public sector and we think we like it for very good reasons. We are very well-known in that sector, and we have very good capabilities that speak to that sector. In particular, every one of our cloud initiatives focuses on saving money. Yes, it increases capability. Yes, it increases security. Yes, it increases the ability to be flexible in moving workload. But every one of them saves money. And when you look at governments around the world, that's just an absolute requirement, and we fit that requirement.

So, Mike, from a solution standpoint, those are kind of the areas where we're probably changing our solutions the most. And then when you talk about the non-solicited bids, that's something we have been talking about. We think it's really important. I will say that when we look – when we work with TPAs, the pipeline we are getting from TPAs has actually increased very dramatically.

The win rate related to TPA work is the win rate. I mean, you're going to win a certain percentage of those. You're not going to win all of them. The win rate related to non-solicited bids is much higher. You know the clients better and you know what the client needs and you're specifically addressing that.

So, as we look at our overall win rate, I think we're getting a little better on the TPA bids just because we simply got our act together more, but those unsolicited bids have a much higher win rate and that is coming through with our numbers.

Mike, anything to add to that?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Yes. So, Joe, maybe – and Peter, obviously very fulsome answer, so I think Joe probably got most of what he needed out of that. But I would say that the new business, from our perspective, is up year-on-year.

Peter talked about the pipeline increase. We're seeing that up typically from a deal count perspective, and we're attributing a lot of that to the non-solicited bids, to Peter's point, when you're walking the hallways and able to pick up that incremental work without going through the RFP process. And typically, that's a little higher margin work as well.

So, from that perspective, I think, Joe, all of those things are things again that we feel pretty good about. We're seeing pipeline continue to pick up. I mentioned in my comment that our expectation is backlog will increase in Q4 and close higher than we closed Q3. And a lot of that is new business, new logo, and new scope type work.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

And Joe, just to give you a number, our new business Services TCV, which is new scope or new client, was up 71% year-on-year. Now, we need our signings to continue to increase, but that's a very good number for us.

Operator: The next question comes from Rod Bourgeois of DeepDive Equity Research. Please go ahead.

Rod Bourgeois
Analyst, DeepDive Equity Research

Q

Hey, guys. So, I want to ask a little more about the improved win rate. Clearly, your new digital sales platform is part of the improved win rate story. Can you talk specifically or just give us some examples of how the digital sales platform is helping the win rate? And are there factors, besides the new digital sales platform, that are also helping on the win rate front?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Yes, Rod, thanks for the question. I think one of the requirements that clients are going to expect in the future, and we are just trying to stand in front of that and get a little ahead of that with our digital sales platform is transparency. I mean, most clients at this point are doing most of their research on the Web well before they talk to any of our salespeople or marketing people. They know more about us than we do on a good day. And they want that same ability when it comes to pricing.

So, one of the things that our digital sales platform does is it gives them access to pricing information that we have never even thought to provide before. And, frankly, we haven't been able to provide it before because it moves from being everything is being kind of a custom, large model to something that is much more available from a P&Q standpoint. So, that's what we've done.

And then, beyond what is even available from a website, from a digital sales standpoint, the modeling itself has become so much cleaner that we can be very, very responsive as to pricing. It doesn't have to be this big black box that's all that complicated.

And as you move more to SaaS services, as you move more to service on demand, you have to have that approach. So, as we have evolved into that approach, we find that clients like it. They not only like the fact that the pricing is perhaps more competitive, but they like the speed with which we can respond to them as well as the transparency of it.

So, it's a big deal for us. And I would say, if we look at the win rates so far in 2020, that digital sales platform is contributing to the win rate. But in addition to that, it is this higher mix of unsolicited opportunities, which is also contributing to the win rates. And I talked about that in response to Joe's question. We simply know more about those opportunities.

One of the advantages of our company is the depth of our relationships with our clients, our top 10 clients we've been with for an average of more than 22 years. And that includes clients that we have had only for the last three to five years. So for some of those clients, we go back even further. So we have a very, very in-depth understanding of their needs. And we can use that in-depth understanding to create unsolicited bids that we think are compelling. And more and more, they are compelling, and that's why the win rate is going up.

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Hey, Rod. It's Mike. I'll maybe just add two points to that. We've talked about in the last couple of quarters the continued work we're doing to qualify the pipeline. And I think the more qualified that pipeline, the better your conversion of that pipeline tends to be.

And then the other thing just to touch on a point that Peter made in his opening remarks, we spend a lot of time just retooling our sales in a go-to-motion or go-to-market motion, training internally.

So during the pandemic, we've really taken an opportunity to deepen, I think, the understanding of the salesforce about our platforms and what we've got to offer. So the non-solicited bids, the enhanced training and depth of the team, and the selling motion, the qualified pipeline and, to Peter's point, our significantly higher NPS scores with happy clients, we think, are all contributing factors to that increased win rate.

Rod Bourgeois
Analyst, DeepDive Equity Research

Q

Great. And then the follow-up is I'm very glad to hear about efforts to shift your mix into these higher-margin segments. It also seems that that's another effort that can help the win rate as you are very deliberate about the segments that are being targeted. As you pursue those efforts to shift the mix, to what extent might you see low-margin revenues as you make that shift?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Help me out a little bit, Rod, seed low margin revenues in terms...

Rod Bourgeois
Analyst, DeepDive Equity Research

Q

Yes, I meant to use the word seed. In other words, like would you move away from certain contracts that are at a very low margin in order to focus your efforts on higher-margin segments, or do you plan to kind of keep the core low-margin work and then just add kind of higher-margin work on top of it? Is there a bit of an effort to sort of give up on low-margin contracts to make this shift to the higher-margin segments?

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Yes. So, that's a great question, Rod. We have actually been moving away from lower-margin contracts for really a few years, and I see that movement accelerating over the next couple of years.

So, basically, what you're seeing from us, I would say, really over the past almost two years is, as we approach renewals, we very rarely – I can't think of an example where we walk away from a client. That's just not what we do. But in the context of renewals, we are absolutely looking at the business that we have and say, how does this fit into the current portfolio and are we really fairly pricing this business with our clients?

And we have and will continue to go those clients where we think we have not fairly priced the work and where the work is not advantageous to us from a target margin standpoint and go to that client at the renewal opportunity or even before renewal opportunity in the context of an extension and say, look here's the deal, we're very open book about this, here's the value we're providing, but this is why this is problematic for us.

And some clients have approached that with a view of, I got it, I've got a really good deal and I understand that this pricing isn't going to be acceptable going forward. Some clients are going to say, I've gotten used to this pricing, and I'm not going to take anything but this pricing. And either is a legitimate response, but we are not going to be inclined to accept that level of pricing going forward.

So, I think there will be an element of our revenue as we make this shift to higher margin that just isn't compatible and therefore, we'll leave it. It's not because of the nature of the work. It's really because of those specific contract terms.

As we look at the kind of work we're doing for clients today, we can make it all work inside our profit targets. So, we don't have to abandon things because we're doing the wrong kind of work, but we still have some contracts that are simply not structured. That makes sense for us. And if it doesn't make sense for us, we don't think it makes sense for our clients.

Mike, anything further to add on that?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

No, Peter. I think that's right, Rod. As you know, we've been looking at pruning that portfolio for many years. We do have contracts in that space that are three to seven years in duration. And so, there are a couple of those still lingering around.

But to Peter's point, as they come up for natural renewal is when we're having those discussions. And at least for a good chunk of what we've seen to-date, clients have been willing to work with us and actually increase that margin profile a bit to make it advantageous for both parties. So, we'll continue that approach.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Thank you, Rod.

Operator: Thank you. The next question comes from Frank Jarman of Goldman Sachs. Please go ahead.

Frank Jarman
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Great. Thanks for taking my questions. I guess one for Mike. As you look at your full-year guidance for 2020, revenue and operating margins and an update on CapEx, and then just given the nice improvement that we saw in free cash flow in the third quarter, could you just talk to sort of what that implies for free cash flow in the fourth quarter just in the broader context given the guidance you provided for revenues and operating margins? Thank you.

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Sure. Thanks, Frank. Yes, actually, I said at the end of the second quarter earnings call that I expected the back half to be free cash flow positive. So, the fact that Q3 was free cash flow positive and, to your point, the expectation is CapEx should be about $10 million lower, that also supports that.

And just the weight of the Technology revenue and profit that is coming in in the fourth quarter, I mentioned a shift there and we're at 40/60 now for third quarter, fourth quarter. So, all of those elements tend to support a continuing free cash flow positivity.

And I would expect, Frank, that Q4 to be stronger than Q3 from a free cash flow positivity for those reasons. Now, obviously, we don't guide to that particular value. But I think if you take the increased Technology revenue and the commentary about the profitability coming through and the $10 million of savings as it pertains to CapEx coming through to free cash flow gives you a good sense of where we expect the fourth quarter to come in as well as the full year. So, again, feel pretty good about that story and are hopeful that we'll continue along that path.

Frank Jarman
Analyst, Goldman Sachs & Co. LLC

Q

Great. And maybe just as a follow-up, as we roll into 2021, you've obviously made a lot of progress on the liability side. And as I think about the progress you've made with the pension, as I think about the interest costs associated with the new debt, and as you think about CapEx, working capital, some of those factors, how should we be thinking about some of those factors that build into free cash flow for 2021, if you have any early thoughts?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

Yes. Well, look, as part of the road show when we did the offering, we had some color on that and I'll point you to some slides in that materials as well. But I think in general, one of the comments that I've made during that is our expectation was, if not for the voluntary pension contributions that we'd be making in 2021, we would – we're calling free cash flow positivity for the year, right?

And as you know for following the story here, that free cash flow positive, [ph] not (57:09) adjusted free cash flow positive. So, really, very significant milestone from our perspective and it really is going to largely depend on, when you talk about adjusted free cash flow, what those pension contributions might look like.

But as you know, we've continually been driving down our CapEx number. I think maybe a couple years back, we were maybe $215-ish million. You can see now closing the year at $140 million. We think that's probably a good metric for modeling purposes for 2021, but continued work efforts on minimizing some of the CapEx dollars spent for software capitalization, as we continue to advance our public sector business and using more capital-light strategy there. We think that's driving down the outsourcing asset component as well. So, still think there's some goodness out of CapEx.

Typically, what we tell folks is 3% to 5% is a good barometer for international revenues, 3% to 5% of international revenues is a good bogey for tax purposes to use from a modeling perspective.

I guess the other component, you've got the interest expense component that you just mentioned on the new debt. So, the only other real component there is working capital. And from a working capital perspective, I mentioned in some of my opening comments here and then on one of the questions was related to the DSO favorability that we expect to start to achieve Q1 of next year as we roll out the ERP through the year.

So, we think that working capital positivity will flow through as well into free cash flow. So, all of those components, again, are favorable to our current position as we get a little closer to year-end and we talk about next year's guidance at the fourth quarter call, we'll be able to give some more specificity on to those numbers. But, hopefully, that gives you a pretty good sense of how your modeling ought to look.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

And, Frank, if I would just follow-up on Mike's comments, which I think are very responsive to – I hope are responsive to your question about 2021. But then you go a little bit beyond the 2021 timeframe, when we look or when I look at the perspective of this calendar year and what we have done about our capital structure, obviously the sale of the federal unit required us to sell or pre-close out our $440 million in terms of that long-term debt, but dramatically reduced our need to contribute to the pension in the U.S. over the course of time because of the contributions we've made.

With the offering that we have now priced, which is expected to close subject to terms and conditions this Thursday, we will effectively have replaced the $440 million with a second level of debt that is lower in cost and allows us to, again, kind of put the nail in the coffin of our expected U.S. pension contributions over time. There's still some limited amount out there, but it becomes de minimis at some point.

And so, as somebody who's been at the company for the last five years, and Mike has been here for the five years, the thought that we would now get to a place where, from a contribution standpoint, we had now a really minimal amount of U.S. pension contributions expected over the entirety of the time to come is quite a statement. And we are no longer subject to the whims of interest rates. We're no longer subject to the whims of other variables that came with that expected contribution and the fluctuations of those expected contributions.

So, this is a big deal for us, and I do want to congratulate our financial team and our legal team for making this happen. From an operational standpoint, we don't have to go to bed at night thinking about how do we fund the U.S. pension contribution. Our operators are going to bed at night and saying how do we use our assets to build the business. That's a pretty big difference.

Operator: The next question comes from Doug Thomas of JET Equity Partners. Please go ahead.

Doug Thomas
Analyst, JET Equity Partners, LP

Q

Good morning, Peter.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

Good morning. Thanks for the call.

Doug Thomas
Analyst, JET Equity Partners, LP

Q

I actually was just going to offer you a hearty – and your team a hearty congratulations for the tremendous work that you've done and point out, yes, that you're right. I mean, it's a – it was a distraction for five years, and it ought to allow you guys now to focus on growing the company. So, all those things you said are correct.

I'm just – I'm curious to – the company's performance has improved steadily as the pension issue has become less of a factor. And I'm wondering if companies, customers, potential customers are also feeling better about your current situation and whether or not that ought to help you continue to grow the top line over the near future.

Peter A. Altabef
President, Chief Executive Officer & Chairman, Unisys Corp.

A

I think what we have done over the past couple – first of all, Doug, thanks for the question – I think what we have done over the past several years has really taken the issue about our capital structure off the table. It was an issue, and I go back three to four years ago. It was an issue before the things we have done in the last three to four years. It's simply not an issue anymore.

And so, to your point, from a client standpoint, from a prospect standpoint, we've gone from a company with a relatively high debt equity ratio to a company with one of the lowest ratios in the business. And that financial strengthening is something that people pay attention to and it has been a really important part of this process as well. So, yes, I'd say we have turned that from a liability to a strength, and it also strengthens our ability to invest in the business in terms of new solutions and to drive that business forward. Mike, other thoughts?

Michael M. Thomson
Senior Vice President & Chief Financial Officer, Unisys Corp.

A

No, I think that's exactly right, Peter. And I guess, certainly it will be a lot harder for our competitors in an RFP process to kind of point to our liquidity and say, hey look, are you sure about this, right? I mean, we've taken that aspect of it completely off the table, net leverage ratio, below industry averages, cash contributions behind us. Really puts us in a much stronger balance sheet position. And that can only help, Doug, in the context of dialogs externally.

And I will say to you, part of the reason for our minimum capital requirements around the world is really about strengthening the equity in certain jurisdictions where we do public sector work. You need to have a certain ratio in certain countries to really bid on that work.

So, we think from that perspective and from our ability to have cash to support outsourcing arrangements and go after some bigger public sector work that, frankly, we may have shied away from just because of the amount of cash that would have been required to put out on the up-front side of that work effort. Both of those constraints are lifted from us. So, again, I think we feel pretty strongly that we're all in on driving top line and continuing to drive profitability.

Operator: Thank you. This concludes our question-and-answer session. I would like to turn the conference back over to Peter Altabef for any closing remarks.

Peter A. Altabef

President, Chief Executive Officer & Chairman, Unisys Corp.

Thank you, Elisa. And I do want to thank everyone for participating in the call this morning. As Mike mentioned, we are in the process of really standing up an almost continual dialog with both our buy and sell side analysts. And we think an important part of that will be a virtual analyst event, which we are calendaring for January 12 of next year, where we expect to take everyone through in more detail some of the things we have at store, as well as kind of medium and long-term projections.

So, I do hope that everyone joins us on January 12. Our IR team led by Courtney will reach out to all of the people on this call, make sure you have information about it as it becomes available. We'll also have continuing updates about that event from an information standpoint on our IR website.

So, with that, this may be the last one – this is expected to be the last one of these calls in this calendar year, so I look forward to rejoining with each of you on January 12. And in the meantime, Courtney, Matt, and our IR function, Mike, myself, and the rest of our leadership team are always available to have conversations with you, and we look forward to those as well. On behalf of Mike, Courtney and the team, thank you very much.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.