Niels Christensen, IRO

Thank you, Operator. Good afternoon everyone, and thank you for joining us.

Earlier today, Unisys released its second quarter 2014 financial results. With us this afternoon to discuss our results are Ed Coleman, our CEO, and Janet Haugen, our CFO.

Before we begin, I want 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 afternoon to guide our discussion on our investor website.

Third, today’s presentation, which is complementary to the earnings press release, includes some non-GAAP financial measures. These have been provided in an effort to give investors additional information. The non-GAAP measures have been reconciled to the related GAAP measures and we have provided reconciliations within the presentation.

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 actual results to differ materially from expectations. These factors are discussed more fully in the earnings release and in the company’s SEC filings. Copies of these SEC reports are available from the SEC and from the Unisys investor website.

Now I’d like to turn the call over to Ed.

Ed Coleman, CEO

Thanks, Niels. Hello, everyone, and thank you for joining us today to discuss our second-quarter 2014 financial results.

Please turn to Slide 4 for an overview of the quarter.

Our second-quarter 2014 results were impacted by lower sales of Technology products and less revenue from systems integration. The lower revenue volume, particularly in Technology, impacted our bottom-line results and resulted in a net loss in the quarter.

We were profitable at the pre-tax line and saw sequentially improved results from the first quarter of 2014.

We were pleased to see growth in our IT outsourcing revenue in the quarter and substantial growth in Services orders driven by a significant outsourcing contract award from the Commonwealth of Pennsylvania. I’ll talk more about this groundbreaking project in a few minutes.

Moving to Slide 5 … while this has been a challenging first six months of the year for us, we expect a strong second half of 2014.

In our Technology business, we believe the soft first half has been a matter of timing around deal closings in our flagship ClearPath family of enterprise software and servers.

As you know, ClearPath sales can vary significantly from quarter to quarter depending on the timing of client decisions, which is why we measure this business on an annual basis.

We have a sizeable pipeline of ClearPath opportunities in the queue and expect a strong second half of the year in sales.

While we see the opportunities to reach our $500 million 2014 Technology revenue goal, given the pattern of timing delays we’ve experienced over the last year, we think it is prudent to reflect this execution risk in a revised outlook for about $470 - $500 million in 2014 Technology revenue. This range represents growth from 2013.

Revenue from our newer Stealth and Forward! product lines will be incremental to this.
Within our ClearPath business, we are excited about a new generation of systems that we announced in June. Our ClearPath models now use standard x86 Intel processors from the low end to the high end, culminating a decade-long shift away from proprietary CMOS chip technology.

Clients have reacted very favorably to this new generation of systems and we look forward to rolling out the new systems to them.

The new models make use of an advanced software-based architecture that allows ClearPath systems and workloads to run on the same fabric-based Intel platform we announced last fall as Forward! by Unisys to support Linux and Windows.

This has been a remarkable engineering achievement in that the evolution to all-Intel based systems has been done without impacting our customers and their decades of investments in ClearPath applications.

In addition to ClearPath, we also expect increased market traction in the second half of 2014 for our newer Stealth and Forward! products.

With Stealth and Forward!, we have two innovative products that we feel are well positioned and have significant growth potential. On the marketing side, we’ve been investing in increasing market awareness of these products – and we are excited by the recognition we’ve been seeing.

Recently, Stealth won the prestigious 2014 American Technology Award for cybersecurity from the TechAmerica Foundation, which recognizes the best technology products in the U.S. Stealth has also been named a finalist for the 2014 American Business Awards in the category of new software security product of the year.

Market interest in Stealth and first-time buys and proof-of-concept implementations continue to grow. We look for ongoing traction in the second half of the year.

We are also seeing increased market interest and recognition of the previously mentioned Forward! line of fabric-based Intel servers.

Forward! uses Unisys secure partitioning technology to run Windows and Linux applications with mission-critical levels of performance, security, and availability on an Intel platform. We are targeting Forward! for such growing markets as server consolidation, Unix-to-Linux migration, SAP and other ERP applications, cloud and big data workloads, and running mission-critical applications that have not yet been virtualized.

In the second quarter we brought out a new version of Forward! with enhanced power and functionality. We also released third-party benchmarking results that show Forward! providing significant performance advantages over industry-standard virtualization technologies.

We were excited to see Forward! recently positioned in Gartner’s first-ever Magic Quadrant for Integrated Systems. This came after Forward! has been out in the market for only six months. Forward! was also recently named by Computer Reseller News as one of its “10 Coolest Servers” of 2014.

We have a growing pipeline of opportunities for Forward! and look for increased traction in this product as well in the second half.

With the combination of our new ClearPath systems, Forward! and Stealth, along with our Choreographer provisioning and orchestration software, we have laid the foundation for clients to build a software-defined data center that gives them far greater power, flexibility and security for their mission-critical applications.

Turning to Slide 6, in our Services business we continue to make adjustments to our portfolio, our go-to-market approach, and our cost structure in light of changing market conditions.

Our biggest challenge in Services, from a revenue perspective, is in our project-based systems integration business. Like others in the industry, we are seeing a shift in client buying patterns away from traditional large, multi-year, customized systems integration projects toward shorter-term, packaged projects that can be implemented quickly with less risk and with a rapid return on investment.

Organizations are also looking to reduce their capital investments and operating expenses by moving to cloud-based solutions delivered on demand via as-a-service delivery models.

This shift is also changing the requirements for resources and people skills. Today’s IT consultants and service specialists must be adept in applying disruptive technologies such as mobility, the cloud, social computing and big data within subscription-based Software-as-a-Service delivery models where clients are increasingly interested in purchasing computing power on an as-needed basis.

We feel that we are well along in making this transition in our outsourcing and managed Services business. For example, the Commonwealth of Pennsylvania recently chose Unisys for a groundbreaking solution to create and operate what is expected to be one of the largest secure, cloud-based IT implementations by a U.S. state government.
Building on our previous data center transformation work with the Commonwealth, Unisys will consolidate seven separate data centers into a secure hybrid cloud environment that will allow state agencies to procure computing services on demand. The contract is valued about $681 million over its initial seven-year term and has three additional one-year options.

By enabling agencies to access and use IT services on an as-needed basis, the Commonwealth will be able to reduce operating costs while enhancing its flexibility and service delivery.

As another example of how we are transitioning to new models in our managed services business, we continue to grow our client base for our cloud-based Edge IT service management solution, which uses advanced automation and predictive analytics to deliver cost-efficient, personalized IT support services to an organization’s end users.

Because it is cloud- and standards-based, Edge can be implemented in as few as 45 days compared to the six months or more that other ITSM deployments typically require. We were excited to see Unisys recently named as a “Leader” in the 2014 Forrester Research Wave Report for North American ITSM Implementation Providers, where our solution was the only one to receive a perfect score in the category of value proposition.

Edge is now being used by more than 160 clients globally – including in emerging markets. In Africa, IT services provider Bytes Technology Group recently chose our Edge ITSM solution to provide IT services to 41 business units. Bytes will also use Edge to provide standardized IT support services to new customers across the region. This follows the selection of Edge by 21Vianet as its standard ITSM platform for delivering IT support services to its customers in China.

While we’ve made good progress in transitioning our managed services business to new delivery models, we have more work to do in our project-based systems integration business, where we’ve been experiencing revenue declines. This impacts our ability to reach our 2014 goal of flat services revenue. Combining this ongoing challenge with our first half services revenue performance, we anticipate low single digit percentage declines in year over year 2014 services revenue for the full year.

Given that systems integration has traditionally been a higher-margin services area for us, these declines have impacted our ability to achieve our long-term goal of a consistent 8 to 10 percent Services operating profit margin.

We are taking a number of actions to drive improved trends in our systems integration business.

First, given the increasing commonality of skill sets across services sub-segments, we have combined our non-U.S. Federal services businesses into one organization, with common resource management across both managed services and shorter-term project work. We feel this will help us better leverage critical skills in client projects while increasing our efficiency and utilization, which already showed encouraging improvement in the second quarter.

Second, we are rationalizing our services and solution portfolio and shifting more of our offerings to cloud-based and software-as-a-service delivery models – with the goal of improving cost efficiency while putting greater sales and delivery focus behind those solutions with the greatest growth prospects.

Third, we plan to increase the percentage of our workforce in lower-cost delivery organizations. That percentage has been flat in recent months at about 35 percent of our global workforce. We want to increase that by at least five percentage points over the next 12 months to improve our overall cost competitiveness.

And, finally, we have had a few underperforming contracts that have impacted our Services revenue and margins in the first half. We believe these issues are mostly behind us now and we look for improvement in our Services results in the second half of the year.

So in summary, moving to Slide 7 … while we are disappointed with the results in the first half of 2014, we are looking forward to a strong second half of the year.

The IT industry is going through major transitions, driven by the disruptive trends of cloud, mobility, big data, social computing, and increasing cybersecurity threats.

These transitions include the shift from labor-based services to software-based and enabled services; from on-premise computing to hybrid clouds; from heterogenous technology platforms to standardizing on common platforms like Intel Xeon; from human to machine interactions to sensor-based machine to machine interactions in support of critical infrastructure and other mission-critical applications.

As a leader in providing mission-critical products, services and solutions, Unisys, too, is making important changes to its business. We are creating innovative new products and services to incorporate these disruptive trends and support these necessary transitions to deliver what we refer to as “modern mission critical” IT.

We believe we are well positioned to take advantage of these market shifts to drive profitable growth and achieve our 2014 to 2016 financial goals. As a reminder, those goals are:

To grow our Technology business by leveraging our investments in new technology products such as Stealth and Forward!, while continuing to invest in ClearPath as the foundation of our Technology business.
Second, to continue building our reseller channel to reach new customers and grow revenue coming from the channel;

And, third, to reach our goal of consistently achieving an 8 to 10 percent operating profit margin in our Services business by growing our higher-margin services, simplifying our operations, and providing services more cost efficiently.

To drive toward these growth goals, we continue to enhance our sales team and go-to-market model to improve our selling execution. And we continue to invest in marketing and awareness activities to increase the visibility of Unisys and our offerings in the market.

Thanks again for joining us today. Now, I’d like to ask Janet to take you through our results in more detail, and then we will be happy to take your questions.

Janet Haugen, CFO

Thanks, Ed. Hello, everyone.

This was clearly a difficult quarter and a challenging first half across both our Technology and Services businesses.

While the second quarter of 2014 represented improved sequential performance compared to the first quarter and included significant year-over-year order growth, solid cash management, and stable Services operating margins, our results were below those of the second quarter of 2013.

Please turn to Slide 9 for a discussion of our second quarter 2014 financial results.

We reported revenue of $806 million in the quarter, which was down 6 percent year-over-year; down 7 percent on a constant currency basis.

Technology revenue in the second quarter of 2014 was down compared to the year ago period principally reflecting lower sales of our ClearPath systems which can vary significantly from quarter to quarter.

The Technology performance continues to be best measured on an annual basis. Our goal for the base Technology business is for year-over-year growth in revenue for 2014. This requires a strong second half performance and we have a pipeline of opportunities that support this outcome. Our Stealth and Forward! product offerings represent the opportunity for additional growth.

Our second quarter 2014 results were also adversely affected by lower Systems Integration and Infrastructure Services revenue.

In the second quarter 2014, our Systems Integration business was impacted by execution issues on a few Systems Integration projects. While in-quarter project revenue as a percentage of total services returned to the low end of the historical range we would expect, lower revenue associated with the projects I mentioned earlier impacted both the top line and profitability of our Systems Integration business.

Currency had a 1 percentage point positive impact on our revenue in the quarter.

Based on today's rates, we anticipate currency to have a 2 percentage point favorable impact on revenue in the third quarter of 2014 compared to the third quarter of 2013.

Our gross profit margin declined from 23.4 percent in the second quarter of 2013 to 20.5 percent in the second quarter of 2014 primarily due to lower year-over-year revenue in the Technology business.

Operating expenses declined by approximately 8 percent year over-year in the second quarter of 2014. This reduction was achieved despite the incremental investments we continued to make in growth programs like Stealth, Forward!, our reseller channel initiatives, and our cloud-based solutions. During the second quarter of 2014 the incremental spending on these growth programs was approximately $7 million. While this was more than offset by lower operating expenses elsewhere during the second quarter of 2014, we continue to expect an increase in year-over-year operating expenses for the full year 2014.

Second quarter 2014 pension expense was $18 million compared to $23 million in the second quarter of 2013. Pension expense is not included in the segment results. We expect approximately $75 million of pension expense in 2014, compared with pension expense of about $94 million in 2013.

Other expense for the second quarter of 2014 was $3 million which was primarily attributable to foreign exchange losses. Other income of $14 million in the year ago quarter reflected foreign exchange gains.

At the tax line, we had a $20 million tax provision in the quarter on $11 million in pre-tax income compared with a $23 million tax provision in the year-ago quarter on pre-tax income of $50 million. As I have said previously, our effective tax rate varies significantly quarter to quarter based on the geographic distribution of our income.
We reported a net loss of $12 million in the quarter, versus net income of $20 million in the year ago quarter. Excluding the impact of pension expense in both years, we reported non-GAAP net income of $6 million for the second quarter 2014 compared to non-GAAP net income of $46 million in the prior year.

In the second quarter of 2014 we reported a loss per diluted share of 24 cents compared to earnings per diluted share of 46 cents in the year-ago quarter. Excluding the impact of pension expense in both quarters, we reported non-GAAP earnings per diluted share of 11 cents for the second quarter 2014 compared to 91 cents in the prior year period.

Moving to discuss our second-quarter revenue in more detail, please turn to Slide 10. As noted earlier, Services revenue, which represented 88 percent of our revenue in the second quarter of 2014, declined 4 percent year-over-year.

Technology revenue, which accounted for 12 percent of our total revenue, declined 21 percent year-over-year.

On Slide 11, you can see Services revenue and margins.

We were pleased to see growth in our IT Outsourcing, Business Process Outsourcing and Core Maintenance businesses. This was offset by declines in our Systems Integration and Infrastructure Services businesses which were down by 8 and 16 percent, respectively, and drove the overall decline in Services business.

Ed and I spoke to our challenges in Systems Integration earlier. As we have mentioned before, our Infrastructure Services business is not a strategic growth area and the decline in that business reflects lower volumes on some existing contracts and the conclusion of other contracts that we did not renew.

Services gross profit margin decreased 140 basis points year-over-year to 16.8 percent from 18.2 percent in the second quarter of 2013. This decline was due to lower volume in our Systems Integration and Infrastructure Services businesses and the project execution issues I highlighted previously. This decline in gross margin was offset by lower operating expenses. As a result, Services operating margin of 4.0 percent in the second quarter of 2014 was flat year-over-year.

Moving on to Technology revenue and margins on Slide 12, Enterprise Class Software and Server revenue declined 19 percent year-over-year due to lower ClearPath volume while sales of Other Technology, all of which is third party product, decreased by $4 million to $3 million.

Lower ClearPath volume in the second quarter of 2014 drove the decline in Technology gross profit margins from 59.4 percent a year ago to 50.2 percent. As we have mentioned before, the profitability of the ClearPath business is sensitive to revenue volumes because of the relatively high proportion of fixed costs associated with this business. Our Technology operating margin declined from 23.9 percent in the second quarter of 2013 to 1.9 percent in the second quarter of 2014.

Slide 13 shows our second-quarter revenue by geography and industry.

Our North America revenue which represented 40 percent of our revenue in the second quarter 2014 declined 10 percent with lower Technology revenue and softness in Systems Integration driving the decline. Revenue from the U.S. Federal government represented 14 percent of total Unisys revenue in the second quarter and was down 3 percent year-over-year.

International revenue declined 3 percent in the quarter and was down 4 percent on a constant currency basis.

Revenue in our European region was up 8 percent in the second quarter on an as reported basis and up 1 percent in constant currency.

The Asia Pacific Region revenue decreased by 24 percent as reported and 21 percent on a constant currency basis. This decline was primarily attributable to lower Technology revenue.

In Latin America, currency had a major impact on year-over-year comparisons. Revenue declined 6 percent from the second quarter of 2013 but was up 1 percent on a constant currency basis.

From an industry perspective, Public Sector, which reported a 6 percent year-over-year decline in revenue, remained our largest industry revenue source, representing 40 percent of our total revenue.

Revenue from Commercial industry customers represented 34 percent of our second quarter revenue while the Financial Sector accounted for 26 percent of revenue. Commercial revenue declined 11 percent in the quarter while revenue from the Financial sector rose 2 percent.

Slide 14 provides more detail on our U.S. Federal government revenue over the past six quarters.

While flat sequentially, our U.S. Federal revenue of $116 million declined approximately 3 percent when compared to the year-ago quarter.
In the second quarter of 2014, revenue from Civilian agencies represented about 44 percent of our overall U.S. Federal government revenue while Homeland Security agencies and Defense and Intelligence agencies represented about 30 percent and 26 percent of our revenue respectively.

We ended the second quarter of 2014 with about $270 million of U.S. Federal services backlog, which was up 4 percent versus the second quarter of 2013.

We previously discussed the July 2013 award to Unisys of the Border Enforcement and Management Systems contract by Customs and Border Protection last year during our second quarter earnings release. This contract award, which was valued at that time to be worth up to $460 million over five years, was delayed due to a protest by the incumbent contractor and a reevaluation effort followed by Customs and Border Protection. We expect the reevaluation of the award to be completed this quarter.

For some comments on Services orders, please turn to Slide 15.

In the second quarter, our Services orders rose year-over-year and sequentially, driven by a large order from the Commonwealth of Pennsylvania that extends and enhances the services that Unisys provides to this long-standing IT Outsourcing client.

We ended the second quarter with $4.7 billion in Services backlog down from about $4.8 billion at June 30, 2013.

Of the $4.7 billion in Services backlog at June 30, 2014, approximately $630 million is anticipated to convert into third quarter 2014 Services revenue. During the past several years, the amount of revenue in backlog at the start of the quarter has typically ranged between 85 and 90 percent of our quarterly Services revenue for the full quarter and the sell-and-bill revenue has accounted for the remainder.

Moving to cash, please turn to Slide 16 for an overview of our cash flow performance in the quarter.

We generated $3 million of cash from operations in the second quarter of 2014 compared to $16 million in the year-ago quarter.

Capital expenditures were $45 million in the second quarter of 2014, versus $38 million in the second quarter of 2013. The increase in capital expenditures largely reflected continued investments in our new products. We expect full year capital expenditures of approximately $200 million.

We contributed $48 million in cash to our defined benefit pension plans in the second quarter of 2014 versus $35 million in the second quarter of 2013. For the full year 2014, we expect to contribute approximately $235 million.

We continue to monitor possible legislative changes in the U.S. which, depending on timing, might have some positive effect on the 2014 contribution requirements, and could have a favorable impact on required contribution levels over the next four to five years.

We had free cash flow usage of $42 million in the second quarter of 2014 versus free cash flow usage of $22 million in the same period last year. In the second quarter of 2014, we had year-over-year increases of $13 million in required pension contributions and $7 million in capital expenditures. Our free cash flow generation before the pension cash contributions was $6 million for the second quarter of 2014 versus $13 million in the second quarter of 2013.

I would like to take this opportunity to remind everyone that we expect free cash flow in 2014 will continue to be impacted by higher operating expenses, higher capital expenditures associated with new deals and investments, and by an approximate $85 million increase in pension contributions that we expect to make in 2014 versus 2013.

Depreciation and amortization was $41 million in the quarter, up slightly from the second quarter of 2013.

Excluding the impact of pension expense, Unisys generated adjusted EBITDA of $69 million in the second quarter of 2014 versus $113 million in the prior year period.

Our debt balance was $210 million at June 30, 2014, unchanged from a year ago.

Our cash balance of $574 million at June 30, 2014 was consistent with the prior year level and remained roughly 3 times our debt.

As we have discussed previously, in December 2012 our Board of Directors authorized the purchase of up to $50 million of the Company’s common or preferred stock through December 2014. During the second quarter of 2014, Unisys returned approximately $13 million to shareholders through the repurchase of common shares under this authorization.

Since June 30, 2014, we have purchased about 97,000 shares of common stock for approximately $2.4 million.

Through July 22, 2014, approximately $22 million remains available under the Board authorization for further repurchases during the remainder of 2014.
Let me conclude by acknowledging that the first half of 2014 was challenging. As we move through the second half of 2014 we remain focused on strengthening the business and supporting our new and innovative products in the marketplace to position the company for success during the second half of 2014 and beyond.

As Ed mentioned, we are taking a number of actions to improve our Services businesses – improving our efficiency and utilization, rationalizing our portfolio with a focus on cloud-based and software-as-a-service solutions, increasing the percentage of our workforce that is based offshore, and addressing underperforming contracts.

In the Technology business, we are focused on delivering a strong second half of the year by capitalizing on our new ClearPath offerings and continuing the momentum in bringing our new innovative Stealth solutions suite and Forward! servers to market.

Additionally, we expect to continue our strong cost control and cash management activities throughout the balance of the year.

Thank you for your time.