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# Cognizant Technology Solutions Corp.

(CTSH)

Q3 2019 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Ladies and gentlemen, welcome to the Cognizant Technology Solutions Third Quarter 2019 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there'll be a question-and-answer session. [Operator Instructions] Thank you.

And I would now like to turn the conference over to Katie Royce, Global Head of Investor Relations. Please go ahead, Katie.

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**Katie Royce**

*Global Head-Investor Relations, Cognizant Technology Solutions Corp.*

Thank you, Rob, and good afternoon, everyone. By now, you should have received a copy of the earnings release for the company's third quarter 2019 results. If you have not, a copy is available on our website, [cognizant.com](http://cognizant.com). The speakers we have on today's call are Brian Humphries, Chief Executive Officer; and Karen McLoughlin, Chief Financial Officer.

Before we begin, I would like to remind you that some of the comments made on today's call and some of the responses to your questions may contain forward-looking statements. These statements are subject to the risks and uncertainties as described in the company's earnings release and other filings with the SEC.

Additionally, during our call today, we will reference certain non-GAAP financial measures that we believe provide useful information for our investors. Reconciliations of non-GAAP financial measures, where appropriate, to the corresponding GAAP measures can be found in the company's earnings release and other filings with the SEC.

With that, I'd now like to turn the call over to Brian Humphries. Please go ahead, Brian.

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## Brian J. Humphries

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

Well, thank you, Katie. And good afternoon, everybody, and thanks for joining us on today's call.

Over the past few months, we've initiated what we expect will be a multi-year evolution of our business, aimed at returning our company to historical levels of performance. We view this as a systematic process of revitalizing the company, and one we're pursuing with rigor and urgency.

Today, I want to clarify where we are in this project and where we're headed by briefly covering our Q3 performance and then reviewing how we've begun to operationalize the conclusions of the transformation office, including our refined strategic posture which aligns to our clients' digital imperatives and our plan for resetting our cost base to facilitate investments in growth.

Let's begin with our third quarter earnings. Q3 revenue grew 5.1% year-over-year in constant currency to \$4.25 billion, and non-GAAP EPS was \$1.08. In an uncertain economic climate, our year-over-year performance in North America improved modestly in the third quarter. As we've discussed in prior calls, our ability to accelerate the company's top line growth depends on revitalizing our North America performance, and in particular, our Banking and Financial Services and Healthcare businesses, both of which were under new leadership. While we have more work to do, we now have highly engaged strategic leaders running these businesses to bring a fresh perspective and huge client centricity. Arguably, even more important than the modest year-over-year growth improvement we've seen is the new energy we have in our North America leadership team, and our clients are noticing this.

At a global level, in Q3, Banking and Financial Services was up 3% year-over-year in constant currency, and Healthcare was down 90 basis points year-over-year in constant currency. In Banking and Financial Services, against the backdrop of growing demand for DevOps and some in-sourcing of skills, we see cost pressure in the traditional business, with growth opportunities in Digital with particular interest in cloud, digital engineering, AI and analytics and interactive. Similar dynamics exist in Healthcare, but here revenue growth also continues to be impacted by rate reductions and volume discounts from clients in the midst of merger integration.

Our momentum continued in our other two business segments, Products and Resources and Communications, Media and Technology. Both posted double-digit revenue growth in constant currency year-over-year.

Later in our call, Karen will take you through the details of the quarter, including the business segment and markets commentary.

Let's turn to my second topic, operationalizing the conclusions of the transformation office. As a reminder, upon joining Cognizant in April, we established a transformation office to identify, prioritize and put into action key initiatives aimed at accelerating our revenue growth and unlocking the full potential of Cognizant. Following six months of engagement by 250 of our leaders, we have now identified, amongst other things, our strategic focus, operating and commercial models, global delivery structure, and our cost base and processes and tools required to enable us to be fit for growth.

As a result, we are now in execution mode, putting into action key initiatives aimed at facilitating investments in growth, going to market with a sharper strategic focus, working more closely with our clients, continuing to evolve our skill sets, and creating a leaner and simpler operating model.

Let's start with our strategy. I continue to allocate significant time to face-to-face meetings with the C-suite of our clients. I find these meetings essential because they allow me to gain insights into the key trends by industry, customer pain points, and desired business outcomes. Clients across all industries are confronted with the risk of being disrupted by next-generation, nimble, digital-native competitors. So, they are redirecting their focus and investment to digital and embracing DevOps and technologies like cloud, digital engineering, analytics, AI, and automation.

We spent the past few months sharpening our strategic posture to align directly with clients' needs to become modern, data-enabled, customer-centric and differentiated businesses. Our strategy had two parts. First, protecting and optimizing our core portfolio, which includes efficiency, tooling and automation, delivery optimization, protection of renewals, strengthening our industry alignment, and scaling our international footprint. And second, winning in four key digital battlegrounds; data, digital engineering, cloud and IoT. These four areas enable clients to put their data at the core of their operations, improving the experience they offer their customers, tapping into new revenue streams, defending against disruptors, and reducing costs.

The two parts of our strategy reinforce each other. It's our core portfolio that has built our strength in the market; for instance, our deep relationship with clients who lead their industries, our reputation for responsive and reliable delivery, and our historical strength of the application there mean that we know how to help clients transition from managing their current legacy state to enabling their digital future. We are investing aggressively and are determined to win in these four digital battlegrounds. And as we do so, we expect to accelerate our revenue growth.

I want to offer a bit more context about these four areas starting with data, which is the heart of our strategy because it's at the core of our clients' competitiveness. No matter their industry, clients must quickly get better at storing, managing, reporting, analyzing and reusing their data. Clients need to leverage enormous amounts of data to fuel AI-based platforms that can transform customer experiences, drive automation, and provide management insight. This is causing a shift from legacy to next-generation data services like data modernization, AI and machine learning.

We're helping our clients make the leap from systems of record to systems of insight and engagement. It starts with data engineering, including basic things like customer and product hierarchies.

Turning to digital engineering. To compete effectively, clients need to become software-driven enterprises. And to do so, they are replacing traditional application development with digital engineering to build leading edge, consumer-grade experiences, and infuse software into their product services and customer experiences.

Cloud, our third digital battleground, is just as critical to clients' digital journeys, given that an estimated 50% of our workload sit on public and private clouds today, a figure set to rise to 80% in a couple of years. Our clients need help migrating their workloads, as well as the entire spectrum of client management including monitoring, notification, provisioning and orchestration, governance, and security. We aim to significantly enhance our partnership with leading scale companies, hyperscale companies, and SaaS vendors.

Our fourth battleground is IoT, an exciting space given that 75% of businesses are expected to increase their IoT spending in the next five years and 40 billion-plus devices are expected to be IoT connected by 2025. The adoption of IoT enabled by 5 generation technology is sparking an explosion in distributed and edge computing. A vast array of sensors and industrial IoT devices and solutions would proliferate across businesses, cities and environments of all kinds, significantly changing use cases and accelerating adoption. For clients, IoT offers the ability to instrument everything, for constant insight.

If you look back at our recent acquisitions such as Softvision, which expanded our digital engineering capabilities, and Zenith Technologies, which expanded our IoT portfolio and our Life Sciences domain expertise, we've been methodically deepening our expertise in areas that we believe will provide the greatest value to clients while generating the best return for Cognizant.

Our latest step along that path is our agreement to acquire Contino, a leading consultancy that specializes in helping global 2000 clients speed their digital transformations by leveraging enterprise DevOps methodologies and advanced data platforms. Cognizant's approach to cloud migration, core modernization, and cloud security is reshaping how enterprises build their infrastructures. And these cloud capabilities will enable us to offer transformative cloud-based solutions to our clients. We expect this transaction to close later this quarter.

The refinement of our strategic posture also highlights a subset of our portfolio that is not in line with our strategic vision for the company, and therefore an area to exit. Within Digital Operations, we have a content operations business that offers a wide range of business process services to clients across all industries. Some of these projects involve ensuring proper brand and business experiences, such as integrating our healthcare patients or determining whether online maps are accurate. But within one subset of the content operations business, our work is largely focused on determining whether certain content violates client standards and can involve objectionable materials. We've determined that this subset of work is not in line with our strategic vision for the company.

While we intend to exit this work, we recognize that cleansing the web of objectionable content is a worthy cause and one of which companies have a role to play. For this reason, we have decided to allocate \$5 million to fund research aimed at increasing the level of sophistication of algorithms and automation, thereby reducing users' exposure to objectionable content.

Over the coming quarters, we intend to comply with our contractual obligations and determine the best path forward with affected clients. Exiting this subset will impact our financial performance in the coming year and also affect approximately 6,000 roles. In the months ahead, we expect to work with our partners to explore ways to transition roles to alternative vendors, thereby reducing the impact to our valued associates. As a reminder, other Cognizant Digital Operations content work will continue.

In recent quarters, I've discussed the importance of simplifying our organizational model to enhance role clarity, empowerment and accountability, whilst ensuring we further increase our client centricity and optimize our cost structure. Over the last few months, the transformation office and the client feedback have identified a series of measures to help us progress against these goals. And today, I want to give you an update on some of the decisions we have taken.

These actions include returning to our simpler two-in-a-box model of client partner and delivery partner for a more seamless client experience and greater agility in front of the customer; our previously announced consolidation of the delivery organization under one delivery leader reporting to me; significantly increasing investments in automation and tooling to enable more streamlined and efficient processes, higher productivity, and lower delivery

costs; combining Cognizant digital engineering capabilities with Cognizant Softvision, thereby creating a powerful team focused on software product development and application modernization; extending our global brand, developing greater thought leadership by industry vertical, and better positioning Cognizant in the market as a leader in digital by uniting all marketing under a recently hired CMO reporting to me; strengthening Cognizant consulting capabilities in select geographies and verticals, whilst complementing our targeted capabilities with greater partnerships, with a leader again reporting to me; aligning our specialist sales capabilities to the service lines albeit with an industry intersection point to ensure the highest competencies and capabilities are available to our client partners. And lastly, in our commercial teams, the implementation of more leveraged sales compensation programs, and the development and deployment of a RAD model or retention, acquisition, development, to optimally segment our clients and future clients, thereby allowing us to better hunt and farm. These changes, for the most part, will become effective January 1, 2020.

Against this strategic backdrop and a set of organizational decisions aimed at ensuring strategy execution, today we are also announcing a cost reduction program. In any people-intensive business, cost reduction always involves difficult choices. [indiscernible] (00:15:17) their skill sets and freeing up capacity to invest in growth, we've made the decision to remove approximately 10,000 to 12,000 mid to senior level associates from their current roles in the coming quarters. This gross reduction is expected to lead to a net reduction of approximately 5,000 to 7,000 roles as we aim to reskill approximately 5,000 associates, thereby lessening the impact on our associates and allowing us to reduce lateral hiring.

These numbers exclude the approximately 6,000 roles impacted by our decision to exit a subset of our content operations business. But as previously stated, we expect to work with our partners to explore ways to transition these roles to alternative vendors, thereby reducing the impact on our associates and also reducing any associated charge.

Establishing a healthcare cost structure is but a means to an end, and that's to drive revenue growth. We free up costs. We've identified a series of investments that require funding, including the previously announced hiring of approximately 500 revenue-generating associates over the coming year, a combination of customer-facing and sales support professionals who will help us expand existing accounts and generate new ones. Significant investments in Cognizant Academy, our internal learning center; and in technical skills, as we aim to reskill and redeploy our talent towards digital imperatives; accelerated investments in tooling and automation; and increased investments in marketing and branding, as we aim to strengthen our international operations and, indeed, our digital brand.

Karen will provide more detail on our 2020 Fit for Growth Plan, including the expected completion date and run rate savings, along with the charges we expect to incur. We will take great care to treat our associates with the dignity and respect they deserve and to minimize any internal distractions caused by our actions, as we get the company back to achieving its full potential.

I've been in the CEO role now for a full seven months, which has given me the opportunity to considerably deepen my knowledge of our operations, our market opportunity, and our clients. And three things are resoundingly clear to me. First, we built an enviable position in a large and attractive market that's expected to continue growing at a steady rate. Most of our clients we serve are still in the early stages of their transformation. They need our expertise in a distinct set of digital technologies, coupled with our intimate knowledge of their technology environments, to fully digitize their businesses.

Second, the significant time I've been able to spend with our top accounts convinces me that our clients love working with us and actually want us to succeed. In fact, they want us to step up and do even more for them. It's

my observation that Cognizant is one of those rare B2B organizations that is a so-called loved brand. The reservoir of client trust we've built over the years is one of our most distinctive assets.

And third, the company is brimming with talented and engaged associates around the world. Our associates are driven to grow and develop new capabilities [ph] and these are skilled (00:18:36) in our portfolio of solutions and in how to apply them to help our clients thrive in a digital economy.

In summary, the leadership team and I are fully aware that we have a multi-year project ahead of us. My optimism about Cognizant's future is pragmatic and it comes from the winning spirit of our associates around the world, who are passionate about contributing to the long-term success of our clients.

Notwithstanding a backdrop of macro demand uncertainty that gives us calls for prudence, I'm convinced that much of what we need to do to increase Cognizant's competitiveness is within our own control. Our relentless focus on growth has defined Cognizant's performance since its founding a quarter century ago, and that determination and focus are as strong as ever.

We're determined to unlock the organization's growth potential and return Cognizant to its historical position of being the bellwether in the IT services industry.

And with that, it's my pleasure to turn the call over to Karen who will give you an update both on our operational and financial performance as well as a view as to how we will see the fourth quarter. Karen?

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## Karen McLoughlin

*Chief Financial Officer, Cognizant Technology Solutions Corp.*

Thank you, Brian, and good afternoon, everyone. Third quarter revenue of \$4.25 billion was above the high end of our guided range and represented growth of 4.2% year-over-year or 5.1% in constant currency. Digital revenue growth was in the mid-20% range and represented over 35% of total revenue.

Moving to the industry verticals, where overall company performance continues to be impacted by Financial Services and Healthcare. Financial Services growth was up 3% in constant currency, driven by the ramp-up of several projects in insurance and banking performance which was consistent with last quarter.

Within banking, our performance continues to be impacted by a few of our largest customers. Consistent with the last quarter, two of our top five accounts continue to grow while three remain under pressure, a trend we expect to continue through the remainder of the year.

As we had expected when we did our last earnings call, insurance in Q3 benefited from a ramp-up in project-based work. However, in Q4, we anticipate a continuation of trends seen over the course of this year where executive transitions underway at several of our clients is showing – slowing the decision-making process, particularly around larger deals in the pipeline.

Moving on to Healthcare, which declined 0.9% year-over-year in constant currency. Within our Healthcare vertical, performance continues to be primarily impacted by large clients involved in mergers, the continued shift of work to a captive at a large client and the continued year-over-year impact from the completed ramp down of an account in which we were the subcontractor to a third party.

Additionally, in the quarter, we were impacted by a charge related to an ongoing contract dispute with a large client. This charge impacted both revenue and margins.

Life Sciences again grew double digits year-over-year, benefiting from continued demand within digital operations, large enterprise transformation deals, migrating from on-premise to cloud-based environments, and momentum within our industry-specific platform solutions such as our Shared Investigator Platform and SmartTrials.

Zenith also contributed to growth in the quarter, and we are pleased with the early success we have seen with this acquisition. We expect similar year-over-year trends in Healthcare in the fourth quarter.

Products and Resources grew 13.4% year-over-year in constant currency. This is the seventh consecutive quarter of double-digit constant currency growth. Growth was broad-based across verticals as results continued to benefit from strong growth within our digital business and demand for digital engineering, cloud infrastructure, IoT and analytics solutions.

We do expect to see slower growth on a year-over-year basis in the Products and Resources segment in the fourth quarter as we lap the ramp-up of work with new logos and the contribution of acquisitions made in Q4 2018.

Our Communications, Media and Technology segment grew 10.6% year-over-year in constant currency. In Technology, growth was driven by revenue from recent acquisitions and demand for our digital engineering services, partly offset by slowing demand for content services.

As Brian mentioned, we have decided to exit certain types of content work within our digital operations practice that is not in line with our long-term strategic vision for the company. I will provide some more color on the impact of this to our Communications, Media and Tech practice as well as the overall company in a few minutes.

Turning to geos. Europe grew 8.8% year-over-year in constant currency, reflecting weakness in the UK from macroeconomic uncertainty. In Continental Europe, we saw strength in life sciences, driven in part by our Zenith acquisition. While a few of our larger banking relationships in Europe remained under pressure, we did see good growth in several of our newer logos, including the partnership with three Finnish financial institutions.

The Rest of World grew 11.1% year-over-year in constant currency, driven by strong growth in Products and Resources, insurance and CMT, that was partially offset by softness in banking driven by the weakness with several of our large clients.

Over the coming years, there is significant opportunity to gain further market share within Europe as well as the Rest of World, and we intend to increase investments in these markets in the coming quarters.

Turning to margins. Our GAAP operating margin and diluted EPS were 15.7% and \$0.90, respectively. Adjusted operating margin, which excludes realignment charges, was 17.3% and our adjusted diluted EPS was \$1.08 in the third quarter. While up by 120 basis points from Q2, our adjusted operating margin was down 120 basis points year-over-year, below our expectations primarily due to employee compensation and benefit costs outpacing revenue growth and the ongoing dispute with a large healthcare client, which negatively impacted operating margins by 40 basis points.

These headwinds were partially offset by the impact of lower incentive-based compensation and cost savings realized as a result of the targeted actions at the senior levels of our pyramid to simplify our org structure that we



took in Q2 and Q3. The cumulative savings from actions taken in Q2 and Q3 are now expected to result in annualized savings of over \$100 million, with approximately \$50 million realized in 2019.

However, we have more work to do to rightsize our cost structure and are not satisfied with the amount of cost reduction achieved in the quarter as we did not achieve our full potential around pricing levers, aligning bill rates with promotions and pyramid optimization.

Also, we experienced a longer than previously anticipated timeline to align revenue and head count growth as we continue to hire and reskill our workforce to be better positioned to capture digital demand in the market.

Attracting and retaining our talent is a key factor to our long-term success. While reduction of our attrition rate, currently running at 24% annualized, remains a long-term goal, we do expect this rate to remain elevated for the next few quarters as we undergo this transformation.

Turning to our balance sheet. Our cash and short-term investment balance as of September 30 stood at \$3.1 billion, up approximately \$75 million from June 30 but down \$1.4 billion from December 31, reflecting the over \$2 billion of share repurchases completed year-to-date and approximately \$380 million deployed on acquisitions.

As a reminder, our short-term investment balance includes restricted short-term investments of \$419 million related to the ongoing dispute with the India income tax department. We generated \$620 million of free cash flow in the quarter. DSO of 78 days was down slightly sequentially, but up two days year-over-year, which negatively impacted free cash flow by approximately \$100 million. This was primarily due to the customer dispute I referenced earlier. Our outstanding debt balance was \$747 million at the end of the quarter and there was no outstanding balance on the revolver.

During the third quarter, we opportunistically repurchased approximately 3.6 million shares for approximately \$219 million, and our diluted share count decreased to 551 million shares for the quarter. On a year-to-date basis, we have repurchased over 31 million shares for approximately \$2 billion.

As of September 30, we had \$519 million remaining under our existing share repurchase authorization. Through our cash generated from operations, remaining cash on the balance sheet and our revolving credit facility, we continue to have access to plenty of liquidity to fund both our existing capital return program as well as future acquisitions.

Before I turn to guidance, let me provide an update on the outcomes of our transformation office, including the 2020 Fit for Growth Plan that we announced this afternoon as well as the content work that we intend to exit. As Brian highlighted, we are moving rapidly to implement the key initiatives identified by the transformation office aimed at accelerating our revenue growth.

Our 2020 Fit for Growth Plan is expected to run for two years. This program is designed to simplify the way we work, reduce our cost structure and fund investments in the business, which will enable growth. As part of this plan, we expect to remove 10,000 to 12,000 mid- to senior-level associates from their current roles.

We will make every effort to identify productive roles based on client demand and our model assumes that approximately 5,000 associates will have the opportunity to reskill for new sales or delivery roles within the company. We expect the remaining 5,000 to 7,000 associates to exit the company by mid-2020 either through attrition or role elimination.

As Brian said, any time we make decisions that impact our employees, we take it very seriously. We believe these actions are critical for the long-term health and competitiveness of the company. We expect the charges will also include charges related to optimizing our real estate portfolio. These actions are expected to be substantially complete by the end of 2020 and will result in annualized gross run rate savings of \$500 million to \$550 million in year 2021.

While we will begin the execution of the plan in Q4, we do not expect a material savings impact in the fourth quarter. These cost reduction activities will be occurring at the same time that we accelerate investments in sales resources, branding, talent, reskilling and lean and automation enhancements across the company, and further investments in our four key digital battlegrounds, including M&A.

These actions are an important step to building a strong foundation to support our future growth ambitions and success in our chosen digital battlegrounds. Our commitment to all associates during this time of transition is to ensure that we preserve the qualities, value and culture that make Cognizant a great company for employees and clients alike.

Additionally, as Brian mentioned, we have determined that certain content work within our digital operations practice is not in line with our long-term strategic vision for the company and we intend to exit this work over the course of the next one to two years. This transition is expected to impact approximately 6,000 associates around the world.

In addition to continuing to meet our contractual obligations during this period, we will ensure that our associates are treated fairly and with the respect that they deserve. In the months ahead, we will work with our partners to explore ways to transition the work and role to alternative vendors and we'll provide impacted associates with a number of transition assistance programs, including retention bonuses, severance packages and the opportunity to participate in various reskilling programs.

While the exact timing for the completion of this transition is uncertain, we do expect there to be a small impact to revenue within the CMT practice in the fourth quarter. And as a result of this decision, we estimate that we may lose revenues of between \$240 million to \$270 million on an annualized basis within our Communications, Media and Technology segment.

We anticipate revenues will ramp down over the next one to two years. And therefore, the impact on 2020 revenues may be lower than the expected annualized run rate. This is expected to be modestly dilutive to our adjusted operating margin, subject to the timing of the ramp down and other factors.

We expect to incur a wind-down charge related to the transition of these associates and any related assets such as real estate and equipment. The total expected charges associated with this Fit for Growth cost transformation plan, including the wind down of certain content work, is expected to be in the range of approximately \$150 million to \$200 million. We will provide a more detailed update regarding the phasing of the impact when we provide our 2020 guidance on our Q4 call.

I would now like to comment on our outlook for Q4 and the full year 2019. For the full year 2019, we expect revenue to grow in the range of 4.6% to 4.9% year-over-year to \$16.75 billion to \$16.9 billion in constant currency. Based on current exchange rates, this translates to growth within the range of 3.5% to 3.8% to \$16.7 billion to \$16.74 billion on a reported basis, reflecting our assumption of a negative 110 basis points for foreign exchange for the full year.

This guidance continues to reflect the muted outlook for banking and Healthcare. This implies fourth quarter revenue growth in the range of 2.1% to 3.1% year-over-year to \$4.21 billion to \$4.25 billion in constant currency. Based on current exchange rates, this translates to growth in the range of 1.7% to 2.7% year-over-year to \$4.2 billion to \$4.24 billion on a reported basis, reflecting our assumption of a negative 40 basis points for foreign exchange in the fourth quarter.

This outlook reflects our expectation for slower organic revenue growth in Q4 as a result of a more cautious macro outlook in the UK and continued headwinds in Financial Services and Healthcare and the impact of exiting certain content work.

For the full year 2019, we now expect adjusted operating margins to be between 16.5% and 17%, reflecting Q3 actuals and the longer than previously anticipated timeline to normalize the revenue growth and head count trajectory and additional costs from recent acquisitions.

We expect to deliver adjusted diluted EPS in the range of \$3.95 to \$3.98. This guidance anticipates a full year share count of approximately 560 million shares and a tax rate in the range of 24% to 26%.

Guidance provided for adjusted diluted EPS excludes realignment charges; charges under our 2020 Fit for Growth Plan and other unusual items, if any; net non-operating foreign currency exchange gains and losses; clarification, if any, by the Indian government as to the application of the Supreme Court ruling related to the India defined contribution obligation; and the tax effects of the above adjustments.

In the context of the Fit for Growth Plan we announced today, we are targeting adjusted operating margins in 2020 to be in the range of 16% to 17%. While the cost program outlined today, coupled with annualized savings in Q2 and Q3, will increase margin rates. This increase is being mitigated in the near future by two major things. First, our full year fiscal 2019 margin rate reflects lower incentive compensation payouts given our underperformance versus target. Our goal in 2020 is to perform at plan and, therefore, have target payouts to be a normalized part of our cost structure in line with company performance. This is a margin rate headwind of 120 basis points year-over-year that we plan to absorb.

We are investing meaningfully in a number of areas, including revenue-generating resources, Cognizant Academy, tooling and automation, and marketing and branding. These important investments will help us accelerate growth rates. However, in the short term, they negatively impact margins by approximately 150 basis points.

With that, we can open the call for questions. Operator?

## QUESTION AND ANSWER SECTION

**Operator:** Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Thank you. And our first question comes from the line of Lisa Ellis with MoffettNathanson.

Lisa Ellis

*Analyst, MoffettNathanson LLC*

Q

Hi. Good afternoon and thanks for going through all this, it's fantastic. Brian, I'd like to double-click on one of the investment areas in sales and marketing, clearly, one of the most critical areas to reaccelerating top line growth. You mentioned a few things, the 500 new salespeople, the return to the Two-in-a-Box model. Can you provide maybe a more holistic view of the major changes you're planning to make to Cognizant's sales strategy and sales coverage and overall go-to-market model? Thank you.

Brian J. Humphries

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

A

Yeah. Hi, Lisa. So I'll give you four examples. First of all, it's important to clarify the role of the client partner and returning to Two-in-a-Box I think really simplifies Cognizant's go-to-market team in front of a customer. So we traditionally used to have a Two-in-a-Box of a client partner and delivery partner. A few years ago, we moved to Three-in-a-Box, and we're returning to what we traditionally have had with greater clarity of roles and responsibilities, therefore, between the client partner and the new role that we will term an engagement delivery partner.

Second point, we will actually add more head count in sales or the commercial function than before. I've referenced this in our prior call. We were adding approximately 500 headcounts. Not all of those are quota carrying, but some, for instance, will be business finance people or indeed commercial lawyers, but it's all with a view to helping us show up to more clients and have greater agility in front of the clients and greater responsiveness.

The third major thing relates to how we want to compensate our commercial teams. As of January 1, we will move to a more leveraged sales compensation plan with at least 70% of the base fixed or at most and then 30% variable. And within the variable portion of their compensation, there will be strict parameters in terms of what they are required to sell. That will enable us to ensure that people do not follow the path of least resistance, which is what they sold yesterday, but more readily embrace the things that we need them to sell, which is part of our digital strategy.

And then the fourth thing, we will deploy something we spent a lot of time working on the last four months, what I'd call a RAD model. That is a term to address how you think about sales segmentation in the purest form, how you tier customers, Tier 1, 2 and 3, based not just on what you sell them today, but more readily on what you have the potential to sell them on. So potential versus current. And then you tier customers between an existing customer or – that you want to retain or potentially develop, subject to your share of wallet, or a customer that you want to acquire. And according to where a customer sits in that [ph] \$9, (00:39:28) then the degree of sales coverage that they get or visits from somebody like myself changes.

So those are four examples of what we're doing to try to ramp our commercial momentum. Obviously, in addition to that, I've talked previously about greater alignment with strategic partners. I referenced in today's script the notion of going to market more readily with hyperscale players. But we have some tremendous partners in

industry verticals like Temenos, Guidewire, Adobe and the like that we want to embrace further and make sure we go-to-market with together.

**Operator:** Thank you. The next question comes from the line of Edward Caso with Wells Fargo.

**Edward S. Caso**

*Analyst, Wells Fargo Securities LLC*

Q

Hi, good evening. Thank you for all the detail. Could you flesh out a little bit more of the commentary around – or it sounded like an inability to get pricing, and it is – is that going to take time for the sales organization to get going and the workforce to be re-sort of-calibrated here? I mean, sort of when do you think you can get those start to get some of the pricing for the value that you're hoping to give?

**Brian J. Humphries**

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

A

That's inherently a complex topic because we have a series of activities that we have from time and material staff augmentation through to managed services or more fixed-price-type bids. But let me decompose your question down, and, Karen, perhaps you can comment as well on this. With regards to the sales teams, their ability to ramp, ultimately, also depends on where they've come from before and if they know the client itself or if they know the industry.

Our intent is, of course, to hire people who are able to sell business outcomes, who have the gravitas and the wherewithal to speak with the C-suites, understand the industry pain points and sell a business outcome. So you need to expect, nonetheless, however, as we deploy these salespeople and for the clients, they build relationships, subsequently build the pipeline. That pipeline is ultimately progressed and eventually turns into TCV, which later turns into revenue. It's for that reason that we've spoken previously around the impact of these 500 head count that we've agreed to hire.

It's more a negative impact in terms of our cost structure in the short term. However, I don't view it as a cost, I view it as an investment that will have an appropriate return over time in the form of sales force gearing, so OpEx to gross margin dollars or, indeed, OpEx to revenue dollars. And we're anticipating the revenue return from that to really kick in more in Q4 next year or, indeed, the first half of FY 2021.

Look, the pricing dynamics are important. Karen can comment on those. I just wanted to add one point. If the client partner is the quarterback on a deal, they need to be surrounded with world-class experts that are aligned to key practices and have competencies in those areas, whether that is artificial intelligence or analytics or digital engineering or cloud or otherwise. We spent a great deal of time in recent months honing in on a model that we think will give us greater competency and greater technical capability to support a [ph] general (00:42:30) client partner in front of the client. We do want to allocate more pricing power back to the client partner, but they will have to operate within certain bands or parameters as they deal their pricing on a quarterly basis, we will review those. So there will be some notion of checks and balances.

**Karen McLoughlin**

*Chief Financial Officer, Cognizant Technology Solutions Corp.*

A

Sure. And so, Ed, let me talk about a couple of things in pricing. One is what I would call market bill rates and pricing for new deals and renewals and so forth. As we look at the digital business, pricing continues to be very strong there. Obviously, you have a high demand in that business and a short supply of talent. So, by definition, bill rates continued to be strong there.

Where you do continue to see pressure on deals and particularly with renewals and vendor consolidations and so forth is in the core part of the business, the heritage application, maintenance, et cetera, part of the business, where we do continue to see pricing pressure on those transactions.

The other piece which we were referring to in the script is also around what I would call contract hygiene. So the ability to get COLA increases, to get [ph] role (00:43:37) changes when we promote people. As you know, for several years, that was something that just was not commonly done in the industry and is something that many firms have started to reinstate into their portfolio over the last few years.

We've made some progress this year where we have automated COLA adjustments and so forth. But I think we still have a lot of opportunity to continue to get better at that and enforcing contract terms and, in particular, when we promote people to either rotate them into new opportunities that are appropriate for their new level or to get rate adjustments within their existing clients. So, both of those are opportunities that we continue to see as we move forward.

**Operator:** Thank you. The next question is from Tien Huang with JPMorgan.

Tien-Tsin Huang

*Analyst, JPMorgan Securities LLC*

Q

Hi. Thanks so much and appreciate all the detail here. I just wanted to get your thoughts on the cost, the soft cost, the hard cost to attain the \$500 million to \$550 million in savings from Fit for Growth, how much disruption might there be on both culture and then also on the revenues, aside from the \$250 million that you called out from getting out of the content work.

Brian J. Humphries

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

A

I would say the majority of the people we're targeting through this exercise are senior to mid-level executives. They tend to be not the client partners or in front of clients, but some degree of middle management that has crept into the system over the years. Of course, we're spending a huge amount of time bringing our team through these changes and making sure that they are contextualized and that people know we're investing in growth.

To be honest, Tien, I feel as though there's a degree of swagger coming back in Cognizant these days. Client partners, in my opinion, will be delighted with the news today that we're returning to a Two-in-a-Box model. And they do appreciate the fact that we're spending hundreds of millions of dollars to reinvest back into the business, including more coverage and giving the sales folks an opportunity to earn more than ever before via having a more leveraged sales compensation plan.

Of course, that is not for everybody and there will be some degree of disruption, but we aim to mitigate that as best we can. And as I said, not only are we adding more people in deploying segmentation, but we're also honing in on optimization of skills via a competency model that will be measured on a more thorough basis going forward. So, look, it's very hard to control this. It's a people business. We're spending a huge amount of time communicating, contextualizing, but we feel it's the right thing to do.

**Operator:** Thank you. The next question is coming from the line of Keith Bachman. [ph] Mr. Bachman, (00:46:13) please proceed with your question.

Keith Bachman

*Analyst, BMO Capital Markets (United States)*



Hi. Thanks very much. I wanted to ask a clarification on the question. Karen, the clarification, just to be clear on the content ops, is whatever we think the normalized run rate for Cognizant in 2020, we should go ahead and take an additional amount out from our revenue expectations of – I don't know – \$150 million or something as we assume that content ops gets at least partially taken out next year.

And then my question is directed to Brian. Brian, you talked about swagger in the last comment. And on the last conference call, I think you said win rates had gone up, but I was hoping you could just talk a little bit about what you see as the economic backdrop. A number of companies, the IT services side have called out some incremental weakness, but juxtapose that against what you've seen in your time there, I think, frankly, putting a lot more initiative into the sales side. If you could talk about a little bit at your win rates and how those might balance out. Thanks very much.

Karen McLoughlin

*Chief Financial Officer, Cognizant Technology Solutions Corp.*



So, Keith, it's Karen. Let me just cover off on the content situation first. You're right. As you think about the model for next year, it is appropriate to take some portion of our estimate of the \$240 million to \$270 million. As we said, it will not – we don't expect it at this point to all go away at the beginning of the year, we think that will phase in throughout the year. Although I would say it would be more heavily weighted to the first part of the year.

Also, the other thing I would also like to point out with that range is that it does assume that, in certain of the client situations, that they may exit more than just the specific digital operations work that they may choose to transition more work. So this is our best estimate at this time of what we think the annualized impact would be. And obviously, we'll provide as much color as we can as we understand further the transition plans.

Brian J. Humphries

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*



And, Keith, with regards to the second question, yes, it of course didn't go unnoticed with us as well. But we're delighted to have beaten consensus and indeed our guidance for this quarter. But bear in mind we had to set guidance prudently. And we're also walking into the coming quarter having read the dynamics in the industry. So we remain somewhat, I would say, prudent going into this quarter as well. The backdrop is uncertain.

However, I would say, if I look at the micro element within Cognizant, first of all, growth is permeating the company. We're going back to our roots, it's back to basics. And I think people are actually delighted with that. We found appreciation of focusing on growth as opposed to margin rate.

We have very deliberately insisted on a significant uptick in executive presence with customers. I'm leading by example myself, and that permeates the organization as well. And then, of course, Karen and I have been working on what we announced today for a number of months now. And so, we've been trying to start looking at deals, not with today's cost structure, but envisaging the economic value of deals over time with tomorrow's cost structure which, as you know, we're aiming to reduce.

And we know in Cognizant that once we get our foot in the door with clients, because we have confidence in our teams and confidence in our delivery, we tend to land and expand. And hence, that's also the reason we're deploying the RAD model going forward, to make sure we accelerate new logos and cross-sell and up-sell. So, those are the positives. But again, the backdrop is uncertain. Certainly, in the UK, it's uncertain.

I would say, in North America, what we found is there is continued compression in legacy businesses, and pricing pressure on renewals continues at a steady rate. But the digital imperatives remain key. I've been pleasantly surprised, as I've dealt with C-suite executives throughout the world, that digital is certainly not viewed as a cost center expense. It is very much viewed as a critical enabler, both on the defense as well as on the offense for these companies, to disrupt or indeed to avoid being disrupted by more nimble next-generation companies. And that is an area where, on the contrary, I do not see demand constraints. I see more supply constraints, given the nature of the teams we need to fulfill those demands.

**Operator:** Our next question comes from the line of Ashwin Shirvaikar with Citigroup.

Ashwin Vassant Shirvaikar

*Analyst, Citigroup Global Markets, Inc.*

Q

Hi, Brian. Hi, Karen. It's good to see the velocity on Fit for Growth initiatives. I want to start by asking if you could provide maybe a framework for how investors should think of the trajectory of growth over the next couple of years as these initiatives unfold. I mean, will we see perhaps a flattish-type pace before higher growth kicks in? And that's, I guess, including the impact of the CMT, the content ops. And then, in the meantime, what are your thoughts on providing metrics to the investor community that help us if you are on the right track?

Karen McLoughlin

*Chief Financial Officer, Cognizant Technology Solutions Corp.*

A

So, Ashwin, in terms of growth, I think, obviously, it's early to give guidance for next year, although certainly we would expect that we will start to see some acceleration over versus constant currency organic growth this year. Q4 is obviously a little bit light, and Q1 does tend to be a slower quarter for us. So, when we give guidance in February, we'll have a little bit more color on how we see the rest of the year playing out.

In terms of incremental revenue from the sales hires and so forth, I think, as we had talked about this before, we do not anticipate any significant revenue next year from that investment. It really takes about 12 months for the sales teams to ramp up and actually generate revenue that becomes incremental to us. So, I think that would be more back-ended and certainly into 2021. And now all of that, obviously, excludes the impact of the content work in the Digital Operations practice. But excluding that, that's how we would expect it to play out.

**Operator:** Thank you. And our next question is from the line of Bryan Keane with Deutsche Bank.

Bryan C. Keane

*Analyst, Deutsche Bank Securities, Inc.*

Q

Thanks. On the \$500 million to \$550 million of gross annualized savings, what's the net savings there? Because it sounds like there's a drag from investments and adjusted operating margins in fiscal year 2020. But can we expect a positive impact to margins thereafter in fiscal year 2021? I'm just wondering if there might be some one-time investments in fiscal year 2020 that go away, so that fiscal 2021 and beyond we'll see some net drop to the bottom line. Thanks.

Karen McLoughlin

*Chief Financial Officer, Cognizant Technology Solutions Corp.*

A

Yeah. So, I think, obviously, Bryan, as you said, and as you heard on the call, that we're assuming a target range of 16% to 17% next year, roughly in line with 2019. And as we talked about on call, there is about 120 basis



points that we had to make up given the lower incentive base compensation this year, and then on top of that the investments in sales and training and so forth.

I think it's premature, obviously, to give guidance beyond 2020. But certainly, we think the investments we'll make in sales will start to pay off in 2021. I would anticipate that, certainly, the investments that we're making in branding and training and reskilling [indiscernible] (00:53:51) will continue on for quite some time. We think that perhaps those are areas that we've underinvested in recently, and so those will become part of the core of the organization going forward. But certainly, as you know, this is still a relatively linear business. So, as we look to accelerate revenue growth in the future, that should certainly help to stabilize and provide some margin opportunity depending year-to-year on the investments that we want to make in the business.

**Operator:** Our next question is from the line of Rod Bourgeois with DeepDive Equity.

**Rod Bourgeois**

*Analyst, DeepDive Equity Research*

Q

Hey, guys. Hey, a lot of work done here in seven months. If I go back over Cognizant's history, it's had a distinctive ability to mine its large clients for additional revenues. Clearly, that client mining performance has slowed in recent years. And so, my question here is, whether you're seeing ways to rejuvenate Cognizant's client mining ability, are there corrective measures being made or new initiatives specifically on the front for client mining? The RAD model makes a kind of sense here, but I'm also wondering if there are practical changes beyond the RAD model to better connect with the large clients.

**Brian J. Humphries**

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

A

Yeah. So, hi, Rod. It's a good question. And look, if I look back over the last four years, and the data will tell you that we have been growing new logos, but not really accelerating new logo revenue, and really the pipeline [ph] in the TCV (00:55:25) in the last 18 months or so stopped this year performing where we needed it to be. But the bigger issue was, to your point, the installed base accounts. And we had stopped mining or upselling it on the contrary because of pricing erosion at the time of renewals, that became a little bit of a drag on the business.

So, very much at the core of the RAD model is, of course, tiering customers, based on potential, not based on where we are today. And, of course, segmenting customers then between acquisition customers versus a customer that you already exist in that you want to develop or where you already exist that you're simply trying to retain. And so, the RAD model is key to achieving this.

Sales compensation is also key because, in our existing accounts, what we want to do is get much more leverage in the sales compensation program and put parameters in a portion of people's compensation such that they are not just enticed, but they're also obligated, from an earnings point of view, to cross-sell the portfolio into digital and beyond as opposed to simply selling what they sold yesterday, which has traditionally been a path of least resistance.

And then the third thing, of course, as we are thinking about upselling and cross-selling, a lot of that leads to different decision-makers. It's more project-based. It's more pod cultures in digital engineering. It's line of service. So, distinctively changing out some client partners. We've done a good job on that in some of the clients I've seen, for instance, in the last few months. These are client partners that joined Cognizant in the last year or so or 18 months, a different background, a different compensation model. But again, I don't think about the salary of a

salesperson as a cost, I think about it as an investment. And therefore, I think about it in terms of sales gearing, both on a gross margin level versus OpEx or, indeed, on revenue basis versus OpEx.

And then last, but not least, we're really trying to segment our own capabilities into a four-box, great sellers who understand the industry and understand the technology is in the top right-hand quadrant. You also have a bunch of people who are very confident with technology, but not really sellers. Some of those you can migrate across to more commercial skills, some of them will simply remain presales-oriented people. Some people are frankly great sellers, but don't really understand the industry well enough or the customer pain points. We obviously have to educate them. And then the people in the bottom left that are the worst of both worlds, not particularly good commercial skills in terms of getting a PO signed, but certainly not technical either. Those are the people that most likely you will see exit the company going forward, particularly in a sales comp plan where, with a higher variable portion of compensation, they will not be earning as much as they have previously.

And then, one of the final actions we've taken to ensure cross-selling is to put all of the so-called CSEs. These are our more specialist salespeople, aligned into the practice and service lines to ensure a great deal of focus on competency assessments, certifications; and indeed, alignment with our partners that intersect nonetheless with verticals to make sure we have the right skill sets and indeed the right go-to-market partnerships to do QBRs with more of our partners, and make sure we end up with asymmetrical accounts where our partners can bring us into their accounts and, vice versa, we can bring them into ours, and leverage the best of both worlds.

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**Operator:** Thank you. Our next question is from the line of Bryan Bergin with Cowen and Company.

**Bryan C. Bergin**

*Analyst, Cowen and Company, LLC*

Q

Hi. Thank you. First, I just wanted to clarify on the content ops, is there an opportunity to sell this practice or is this more so a wind-down and transfer? And then, within Banking and Healthcare, can you just give us a sense on these large clients, how close you may be to seeing any inflection in the trajectory there or at what point are they just not among the top clients?

**Brian J. Humphries**

*Chief Executive Officer & Director, Cognizant Technology Solutions Corp.*

A

So, I think, in Banking and Healthcare, we have some tremendous examples actually, and I've seen some of these myself, of accounts that we have really turned around in the last few years through different account teams, much more focused on digital. But that's a blueprint or a qualification that we need to bring more broadly across the company.

You will see some inflection points, particularly in Healthcare, as we get into FY 2020 because we will be rounding the tougher compares. As you know, many of our Healthcare clients [indiscernible] (00:59:48) merged into two and ended up with a very different rate dynamic for Cognizant, and we will be running that once we get to Q1 next year.

In Banking, it's less obvious in the sense that there wasn't a single inflection point or ongoing trends. Some captives, some in-sourcing, particularly in the world of DevOps. But as I said earlier, while the legacy business or traditional areas of the business have been under some pressure of price renewals, I do see opportunity for us to better participate in the digital spend that these banks have at their disposal and have been prioritizing. And that's what we're setting out to achieve in the coming years, of course.

So, no major inflection point, but I will say I am pleased with the revised energy I'm seeing in the North America team now, in particular. And the new Banking leader and the new Healthcare leader, they seem to be [ph] going down (01:00:38) well with clients, and that's always a good positive leading indicator.

With regards to the content moderation business, that's something we're working with our partners on right now, to understand how to best transition to work. Whether it is one of the options we referenced or another, we will determine that in the coming periods. For now, we've taken a restructuring charge against it, but our intention is to work very aggressively with partners to make sure that we can transition our employees with minimal disruption. And, of course, financial consequence of that is, of course, minimal charges as well.

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## Katie Royce

*Global Head-Investor Relations, Cognizant Technology Solutions Corp.*

Okay. And this is Katie. I think with that, that will end today's call. Thank you all for your questions, and we look forward to speaking with you next quarter.

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**Operator:** Thank you. This concludes today's Cognizant Technology Solutions third quarter 2019 earnings conference call. You may now disconnect.

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