DXC Technology

NYSE: DXC

January 17, 2019

(All values as of market close on January 11, 2019)

Recommendation

BUY at Market (~$61.08)

Target Price: $80.00

31% Upside Potential

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BACKGROUND

With **$25B in annual revenues**, DXC Technology is the world's leading independent, end-to-end IT services and solutions company, providing a range of services including analytics, consulting, cloud applications, and security

6,000+ clients

133,000+ employees

70 countries

Serves a variety of industries including:

- Insurance
- Healthcare
- Transportation
- Banking/Capital Markets
- Manufacturing
- Consumer Packaged Goods
- Retail
- Public Sector
- Energy
- Technology, Media, Telecommunications

77% Market Share

OUTLOOK

Margin Expansion

Targeting to improve efficiencies in its policy alignment, supply chain, facilities and workforce to increase EBIT margins 7-8% by 2020

Revenue Growth

Expecting modest revenue growth from commoditizing legacy services against increase in next generation services

Announced Acquisition of Luxoft for ~$2bn

June 2019 pending Regulatory Approval

LUXOFT

$911M in Revenue
Strong double digit CAGR

World Class Talent
~13,000 Workforce

Strong Digital Capabilities
Differentiated Services

3-year CAGR revised to 4-6% from 2-4%

Expected 300-400M in synergies by 2022

INVESTMENT THESIS

DXC has lower margins than industry peers – these are expected to expand as DXC scales its business

DXC ranks as the lowest H1-B visa dependent IT service employer → lower risk to nationalism and immigration reform

Recent Luxoft deal promises to accelerate digital scale given little overlap across respective businesses

Leads to a compelling valuation, especially with the increase in earnings from expanding margins

Strong management team (with experience executing successful M&A deals) and lower risks implies less downside risk with extreme upside

RISKS AND CATALYSTS

Investment Risks

Idiosyncratic Risks

- Departure of CEO/CFO (I1)
- Tight digital labour market (I2)
- Messy Luxoft merger execution (I3)
- Inability to attain margin expansion (I4)

Systematic Risks

- Immigration reform and trade tensions (S1)
- General economic downturns (S2)
- Unfavourable USD/CAD FX rate movement (S3)

Trade Catalysts

Opportunity to buy at a discount
- Trading at a level not seen in the past 2 years
- Recovered from it's 52-week low and there is no indication of a major decline forthcoming

Expanding into Digital Space
- Luxoft deal promises expansion into digital space as Luxoft's business has little overlap with DXC's current operations
- Luxoft deal has positive shareholder sentiment

Favourable valuation and healthy financials
- Favourable valuation driven by margin expansion potential
- Healthy financial and steady client relationships leave no indication of future trouble

VALUATION

10% Discount rate

Target Price
$80 - $85

Terminal 10x EV/FCF

1% FCF terminal growth

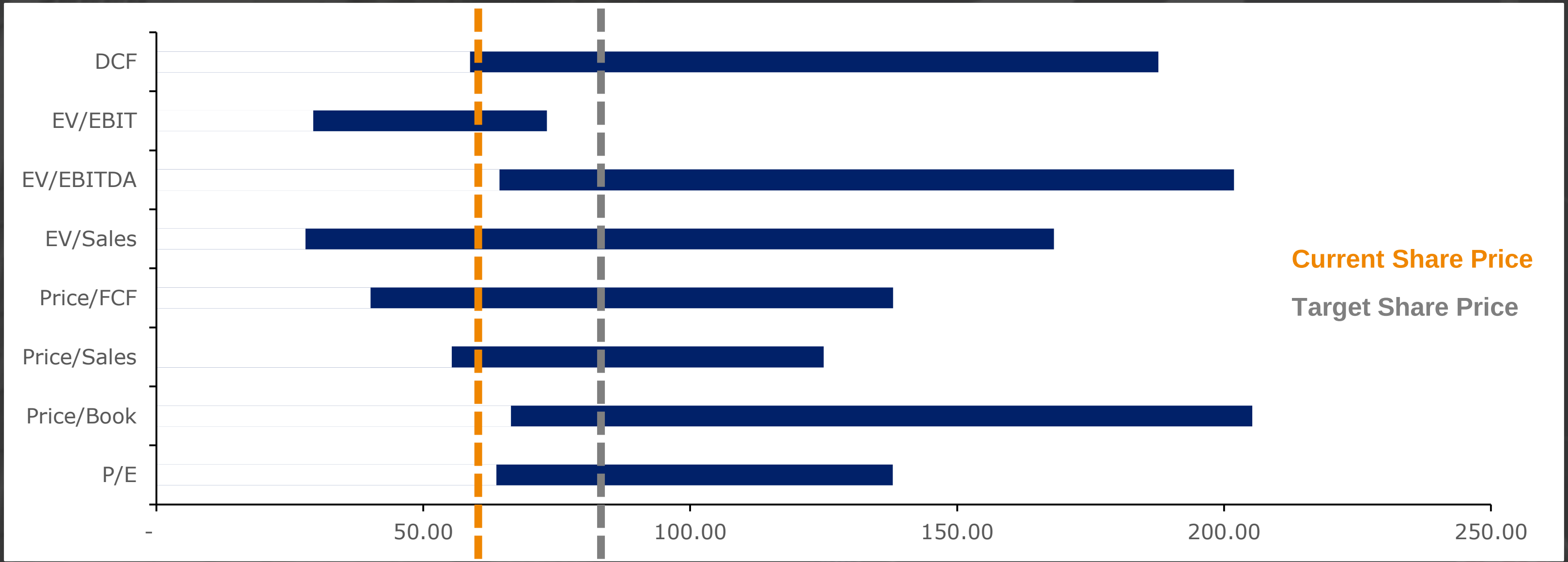
	DXC	Industry	Sector
Beta	1.37	0.87	1.11
P/E	9.50	22.12	9.66
P/Sales	2.15	3.26	2.67
P/B	1.48	4.39	1.74
P/FCF	4.28	17.03	12.46
Dividend Yield	1.25%	1.47%	2.90%
Payout Ratio	11.54	28.59	21.38

Current Share Price **$61.08** - *~25% Discount*

- Does not appear to be pricing in future margin expansion or possibility of multiples improvement
- Limited downside risk, with possibility of large upside due to additional catalysts like acquisitions

RECOMMENDATION SUMMARY

Valuation Summary – Football Field



Investment Thesis Summary

EBIT margins expected to increase significantly by 2020

Lowest risk to nationalism and immigration reform

Luxoft deal promises to expand revenue growth

Appendices

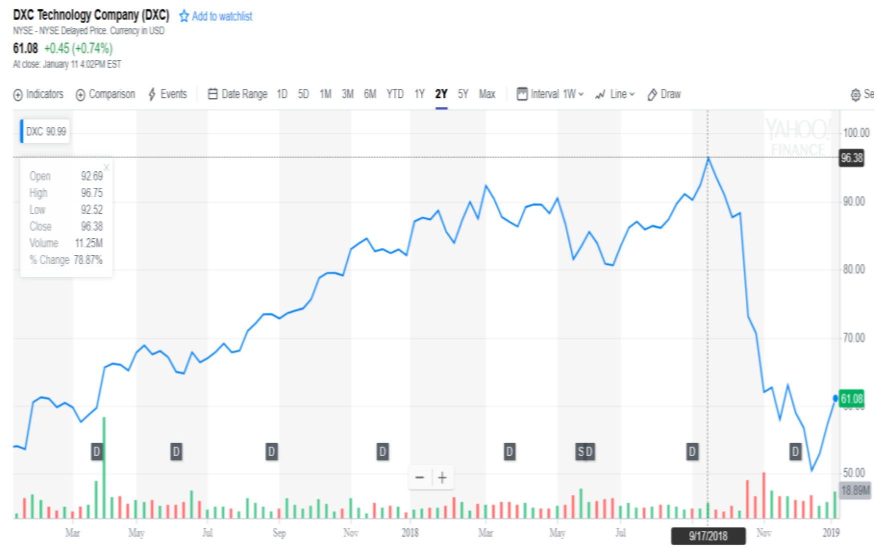
I. Company Overview
II. Business Overview
III. Recent News and Future Outlook
IV. Investment Risks
V. Key Financials
VI. DCF Analysis
VII. Public Comparables

I. Company Overview

Background

- DXC Technology is the world's leading independent, end-to-end IT services and solutions company
- Provides a range of IT services and solutions including analytics, applications, business process services, cloud, consulting, enterprise and cloud applications, security, workplace and mobility
  - **Analytics** – provide applications to enable real-time analytics
  - **Applications** – help company's develop, manage and modernize their applications
  - **Business Process Services** – provides integration between front and back offices
  - **Cloud** – maximizes legacy infrastructure and cloud services to help manage hybrid environment
  - **Consulting** – guides companies from strategy to implementation of IT services
  - **Enterprise and Cloud Applications** – helps clients build and scale new digital capabilities
  - **Security** – provides tools to help predict attacks and respond to threats
  - **Workplace and Mobility** – helps transform company's to digital workplaces
- Serve a variety of industries including Insurance, Healthcare, Transportation, Banking/Capital Markets, Manufacturing, Consumer Packaged Goods, Retail, Public Sector, Energy, TMT

2 Year Share Price Review



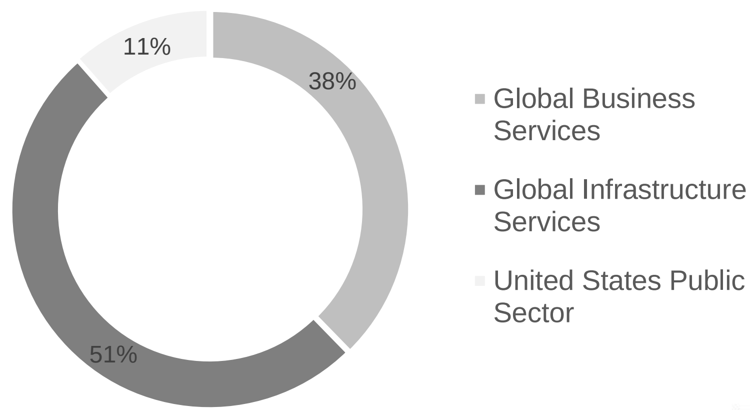
Management Team

Mike Lawrie
Chairman, President and Chief Executive Officer

Paul Saleh
Executive Vice President and Chief Financial Officer

Erich Windmuller
Senior Vice President and Chief Information Officer

Fiscal 2018 Revenues by Segment



II. Business Overview

Key Statistics

- More than **6,000** private and public-sector clients in **70 countries**
- More than **133,000** employees worldwide
- Established more than 250 industry leading Partner Network relationships including 15 strategic partners: AWS, AT&T, Dell EMC, HCL, Hitachi Vantara, HP, HPE, IBM, Lenovo, Micro Focus, Microsoft, Oracle, PwC, SAP and ServiceNow
- Around $25B in annual revenues makes it the world’s leading independent, end-to-end IT services company

Key Products

CLOUD & PLATFORM SERVICES
310,000+ VMs

WORKPLACE & MOBILITY
45M+ managed mailboxes

SECURITY
10+ Intelligent SOCs

APPLICATION SERVICES
1M+ managed apps

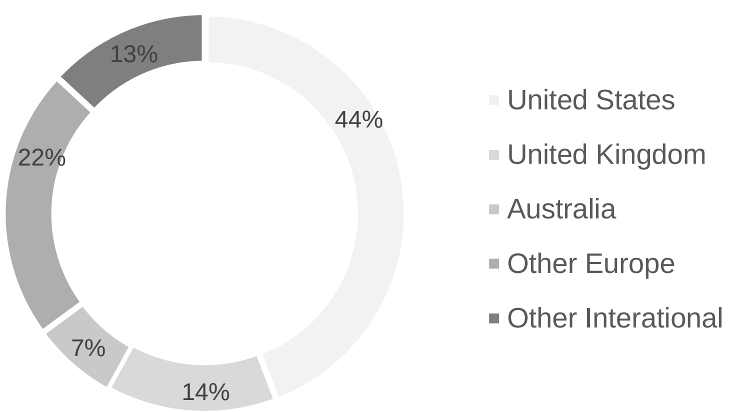
ENTERPRISE & CLOUD APPS
15,000+ agile specialists

ANALYTICS
6 of top 10 banks served

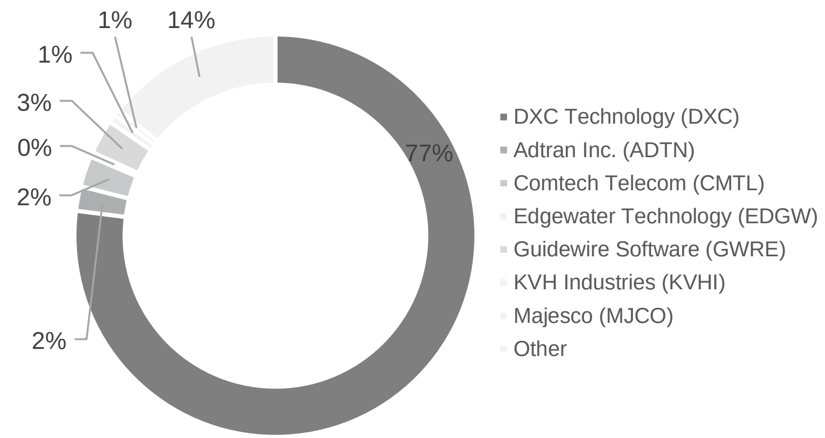
BUSINESS PROCESS SERVICES
500M+ interactions daily

INDUSTRY SOFTWARE & SOLUTIONS
#1 core insurance solutions provider

2018 Revenue Sources by Geography



Market Share (Computer Processing and Cloud Services Industry)

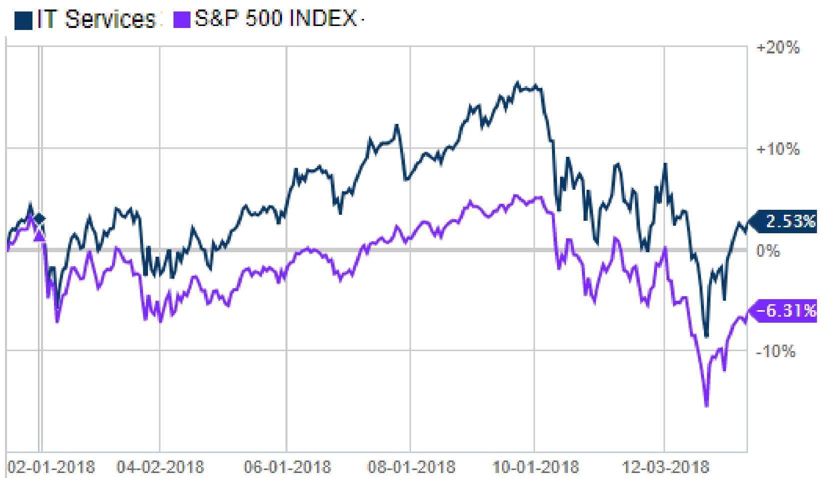


III. Recent News and Future Outlook

Company News

- Will be acquiring digital service provider **Luxoft** for $2B (closing in June 2019 pending regulatory approval)
- Acquisition focuses on improvement of revenue growth; bringing significant digital capabilities, top-notch talent, and expertise in automotive, healthcare, travel and financial services sectors
- Luxoft will be run as separate unit (~5% of total DXC revenue) under designation “A DXC Technology Company”

Industry News



Company Outlook

- Prior to acquisition forward looking guidance for 3-yr revenue growth was 2-4%, revised now to 4-6%. Main focus of company is on cost-reductions and margin improvements
- On its own Luxoft is expected to grow at 15%+ before any synergies. With DXC addressing both it’s concentration and sales distribution concerns, management expects $300M-$400M in synergies by 2022

Industry Outlook

- IT consulting and services industry has been out of favour, but if/when economic uncertainty clears; expect any previously-delayed IT projects to resume and increased spending
- According to IDC, spending on IT and business services worldwide is expected to increase at CAGR of 4.2% (from 2019 to 2022). Digitized workflows is a key component with an expected growth of 20%+
- Expect to see companies looking to supplement growth through both partnerships and acquisitions

IV. Investment Risks

Idiosyncratic Risks

- Departure of the CEO or CFO can be a major blow to stock sentiment → lack of management drama leave little indication to believe this is a serious threat
- Tight labour market in high-growth digital areas (which is a key focus for DXC going forward as indicated by their recent Luxoft deal) → valuation is based primarily on increased earning power from unlocking margin potential and does not assume any significant synergies from the Luxoft deal
- Merger execution can get messy, leading to revenue dis-synergies that could shrink legacy revenue. Legacy revenue shrinkage, along with slow revenue growth from the digital business could be extremely determinantal for DXC and hence, it's share price → strong management team has executed a similar turnaround before, and hence, we believe it can do it again
- Inability to attain margin expansion → valuation uses conservative estimates: $80 target price implies a less than 9x multiple to DXC's CY20E EPS; DXC is currently trading at 7x their CY19E EPS while competitors (with lower market share) are trading at 14x. As such, we believe our valuation assumptions are extremely conservative and have a strong sentiment that DXC will be able to attain margin expansion as they have strong client relationships, especially with the US Public Sector (more than 11% of their revenues come from government contracts)

Systematic Risks

- Increased tensions with international trade and immigration reform → DXC has lowest H1-B visa dependence among industry peers and global presence
- General economic downturns (especially with the technology/IT sector) → DXC services clients across all sectors. With cloud and security IT coming under great scrutiny of late, DXC should have some relief against major market swings

FX Risks

End of Investment Horizon USD/CAD Rate	1.50	1.45	1.40	1.35	1.30	1.25	1.20	1.15	1.10
Realization of Target	39.37	35.37	31.37	27.37	23.37	19.37	15.37	11.37	7.37
Stagnent Price Action	10.99	7.94	4.89	1.83	-1.22	-4.28	-7.33	-10.38	-13.44
Realization of Stop-Loss Limit	-5.63	-8.13	-10.63	-13.13	-15.63	-18.13	-20.63	-23.13	-25.63

Target Price = $80.00 Stop-Loss Limit = $50.00

Current Price = 61.08 Current USD/CAD Rate = 1.32

V. Key Financials

Valuation Ratios and Dividends

Metric	DXC	Industry	Sector
Beta	1.37	0.87	1.11
P/E (TTM)	9.50	22.12	9.66
P/Sales (TTM)	2.15	3.26	2.67
P/B (MRQ)	1.48	4.39	1.74
P/FCF (TTM)	4.28	17.03	12.46
Dividend Yield	1.25%	1.47%	2.90%
Payout Ratio (TTM)	11.54	28.59	21.38

Conclusion: DXC trading at a relative discount based on P/E, P/Sales, P/B and P/FCF multiples.

Growth Rates

Metric	DXC	Industry	Sector
Sales vs 1 Yr. Ago (TTM)	57.12%	8.01%	12.35%
CapEx – 5 Yr Growth	2.57%	3.57%	11.85%
EPS vs Qtr. 1 Yr. Ago (MRQ)	35.32%	13.19%	19.71%

Conclusion: DXC seemed to experience better than average growth, despite lower than average capital spending.

Financial Strength

Metric	DXC	Industry	Sector
Current Ratio (MRQ)	1.04	2.82	2.31
Long-Term Debt to Equity (MRQ)	47.03	13.85	7.63
Total Debt to Equity (MRQ)	61.10	19.70	16.72
Interest Coverage (TTM)	7.31	27.00	10.74

Conclusion: DXC is highly leveraged, posing a higher than average credit risk. Despite the high leverage, DXC seems to have fairly healthy Current and Interest Coverage Ratios, but the possibility of not being able to re-finance long term liabilities still exists.

Profitability Ratios

Metric	DXC	Industry	Sector
Gross Margin (TTM)	28.74	32.18	43.56
Operating Margin (TTM)	8.76	12.15	22.41
Pre-tax Margin (TTM)	7.86	13.79	23.98
Net Profit Margin (TTM)	8.15	10.01	17.48
Effective Tax Rate (TTM)	-3.69	27.10	25.74

Conclusion: Slightly lower margins than industry and sector (expected due to the nature of the business). Negative effective tax rate represents compensations for periods of loss in the past.

Source: Reuters (accurate as of market close on Friday, January 11th, 2019)

VI. DCF Analysis

Free Cash Flow Projections

	2018(A)	2019(E)	2020(E)	2021(E)	2022(E)	2023(E)
Free Cash Flow	2480	1907	2601	2814	2898	2995

WACC Calculation

	DXC
Risk-free rate	2.50%
Market rate	7.00%
Beta	1.37
Cost of Equity	8.67%
Cost of Debt	5.00%
Total Equity	16,416
Total Debt	8,379
WACC	**7.07%**

Company Details

	DXC
Current Share Price	$61.08
Shares Outstanding	280.11M
Market Capitalization	$17.12B

DCF Valuation Results

Gordon Growth Method

Assumptions**:** *FCF growth = 1%, Discount rate = 10%*

Implied Share Price: **$87**

Implied EV: $31.47B

TV% of EV: 66%

Current Discount: 32%

Terminal Multiple Method

Assumptions**:** *2023 EV/FCF = 10x*, *Discount rate = 10%*

Implied Share Price: **$79**

Implied EV: $29.21B

TV% of EV: 63%

Current Discount: 24%

Average implied share price: **$85** *(28% Discount)*

VI. DCF Analysis *continued*

Sensitivity Analysis

		Discount Rate						
		7%	8%	9%	10%	11%	12%	13%
Growth Rate	0.5%	$ 131.07	$ 110.40	$ 94.82	$ 82.70	$ 73.06	$ 65.22	$ 58.76
	1.0%	$ 141.69	$ 118.00	$ 100.47	$ 87.04	$ 76.46	$ 67.95	$ 60.98
	1.5%	$ 154.24	$ 126.77	$ 106.88	$ 91.88	$ 80.22	$ 70.94	$ 63.40
	2.0%	$ 169.30	$ 137.00	$ 114.21	$ 97.34	$ 84.41	$ 74.22	$ 66.03
	2.5%	$ 187.70	$ 149.09	$ 122.66	$ 103.52	$ 89.08	$ 77.85	$ 68.91

		Discount Rate						
		7%	8%	9%	10%	11%	12%	13%
Terminal EV/FCF Multiple	7.00x	$ 65.57	$ 63.11	$ 60.78	$ 58.57	$ 56.49	$ 54.51	$ 52.63
	8.00x	$ 73.31	$ 70.50	$ 67.84	$ 65.32	$ 62.93	$ 60.67	$ 58.53
	9.00x	$ 81.05	$ 77.89	$ 74.89	$ 72.06	$ 69.37	$ 66.83	$ 64.42
	10.00x	$ 88.79	$ 85.28	$ 81.95	$ 78.80	$ 75.82	$ 72.99	$ 70.31
	11.00x	$ 96.53	$ 92.67	$ 89.00	$ 85.54	$ 82.26	$ 79.15	$ 76.21
	12.00x	$ 104.28	$ 100.05	$ 96.06	$ 92.28	$ 88.70	$ 85.31	$ 82.10

Key Model Assumptions

- Conservative assumptions of no significant multiple expansion over the projection period and margin improvements slightly below companies estimates
- Projections based primarily on combination of analysts estimates, erring on the side of conservatism. Basing projections of historical results is difficult due to mergers, acquisitions and spinoffs that affect the stability of financials

VII. Public Comparables

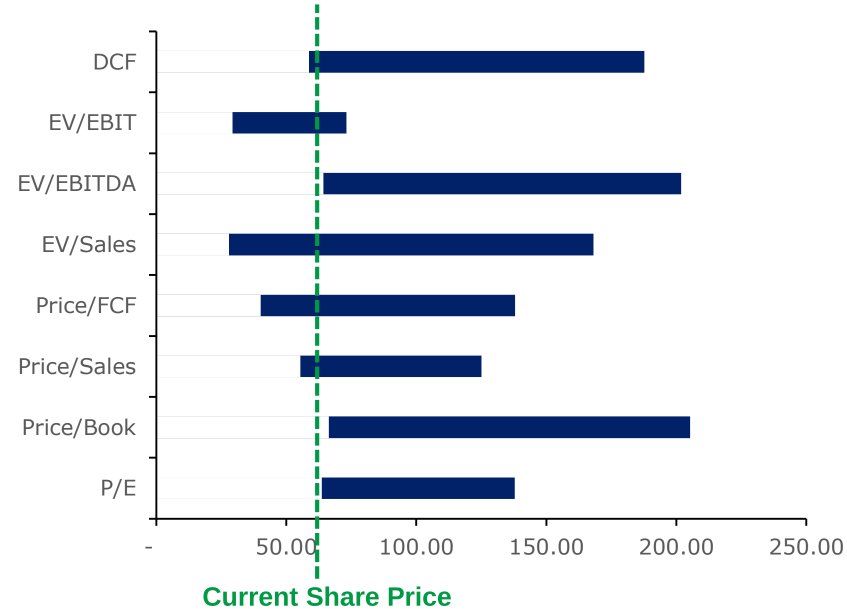
Competitors' Ratios

Metric	ACN	IBM	CTSH	CAP
EV/EBIT (TTM)	15.8	12.0	12.6	15.2
EV/EBITDA (TTM)	13.7	8.7	10.7	12.2
EV/Sales (TTM)	2.2	1.8	2.2	1.4
P/FCF (TTM)	8.4	7.3	7.8	15.3
P/Sales (TTM)	0.7	1.4	3.1	1.4
P/B (MRQ)	8.2	1.5	4.1	2.8
P/E (TTM)	21.7	10.0	18.9	11.9

Current DXC Statistics

Metric	DXC
EV/EBIT (TTM)	10.09
EV/EBITDA (TTM)	5.08
EV/Sales (TTM)	0.95
P/FCF (TTM)	4.28
P/Sales (TTM)	2.15
P/B (MRQ)	1.48
P/E (TTM)	9.50

Football Field Chart



Implied Share Price

Average Implied price: $100 (~ *40% discount*)

- Public comparables imply share prices ranging from $30 to $200; heavily skewed towards the upside. Current multiples indicate potential for significant share appreciation in the case of ratios' improvements to industry averages