Analyst Corner

By: Barton Hooper, CFA · October 2018

An Introduction to DXC Technology (DXC)

DXC Technology ("DXC") is an information technology ("IT") outsourcing firm created on April 1, 2017, from the merger of Computer Sciences Corporation ("CSC") and Hewlett Packard Enterprise Services ("HPS").

Both firms had long and infamous legacies as pioneers of outsourced IT services for corporations and governments. Outsourced IT services run the gamut from operating datacenters, to writing and maintaining applications, down to providing help desk personnel, who get workplace laptops to recognize the company Wi-Fi network. Historically, these engagements involved large, bespoke and intricate contracts for various activities, and often involved the re-badging of clients' employees to those of the IT outsourcer.

To diversify their product lines, many IT outsourcers expanded into business process outsourcing ("BPO") and consulting services, but for firms such as CSC and HPS, IT outsourcing remained the core. The offering mix contrasts with long-term Weitz portfolio holding Accenture, for example, which has a significant consulting business that complements its IT and BPO services, allowing for higher sales growth and margins.

Customers chose to outsource their IT and back office functions using BPO because operating environments were becoming increasingly complex and expensive. The hope was that an outsourcer could create scale across multiple customers while delivering better performance at a lower cost. While lower costs were realized by customers in the form of low pricing, IT and business complexity only grew as new technology was layered on top of legacy systems. Any savings created through purchasing or learning curves were typically given back to the customer at contract renewals. These developments meant that IT outsourcing and BPO firms became businesses with a lack of standardization, high labor intensity and low profit margins. IT outsourcing and BPO became, in the words of DXC CEO Mike Lawrie, "Your mess for less."

During the 1990s and 2000s, CSC and HPS predecessor firms HPE and EDS faced additional pressure from India-based firms, who were able to offer many services, such as network and application management, to customers for a much lower price due to the labor arbitrage available from using programmers from their home country. The India-based firms proved equally capable of performing BPO services at a much lower cost.

With numerous complex contracts, poor service levels and pressure from Indian firms, CSC found itself near bankruptcy by 2012. Mike Lawrie was hired at this time as CEO of CSC. Immediately, Mr. Lawrie began to rationalize CSC's business by renegotiating or exiting unprofitable contracts, cutting out multiple layers of management created to oversee the overly complex contracts, and investing in lower-cost IT outsourcing facilities in India and the U.S. while also modernizing CSC's underlying technology infrastructure. During Mr. Lawrie's term as CEO of stand-alone CSC, until the merger with HPS, margins increased from zero to approximately 8 percent, while its 2,000 customized offerings were reduced to 230 standardized services. Further value was created by spinning off CSC's federal government business.

Following the merger, DXC has focused on rationalizing its cost structure, aligning go-to-market and delivery operations, and further simplifying service offerings. In the fall of 2017, DXC announced the spin-merger of the legacy HPS federal government services business (representing 10 percent of revenue) into a new company called Perspecta, which began trading on June 1, 2018. DXC is now focused on serving global businesses and state and local governments.

Today the company continues to focus on reducing costs. For example, only 54 percent of its outsourcing workforce is based in low-cost locations, but the goal is to increase it to 70 percent in the next few years. Additionally, the company is ahead of its goal to achieve the $2.1 billion of cost savings (adjusted for the Perspecta spin) it projected at the time of the merger with HPS.

Looking ahead, Mr. Lawrie and his team are in the process of repositioning the overall business to take advantage of new technologies and business opportunities. The emergence of new technologies and processes, such as cloud, artificial intelligence and robotic process automation, has allowed DXC (and others) to realize true scaling impacts, as previously labor-intensive activities are replaced by software and algorithms, many of which include proprietary DXC intellectual property. The company has been applying these helpful technologies to standardize processes across the customer base, reduce labor and management oversight while providing more consistent levels of service, all at a lower cost.

DXC's customers are using the savings from basic services to purchase higher-margin digital transformation capabilities such as cloud, mobile and analytics. The company has also expanded and fortified its industry-specific practices in healthcare, travel and financial services to create a differentiated BPO business. These specialized practices help customers using DXC developed software, processes and services, which drive higher revenue and margins while increasing customer "stickiness." DXC expects the combination of its digital transformation and industry-specific services to eventually generate half of total revenues as these practices grow and it actively shrinks traditional IT outsourcing services.

While on the surface the legacy businesses of DXC looked severely challenged, Mr. Lawrie's excellent track record at CSC, and the similarities between CSC's challenges then and DXC's now, gives us confidence that DXC's future should be much improved. To date, DXC appears on track with our investment thesis that good management, significant cost savings and a change in business mix will eventually result in the stock price approximating our business value of around $115.

Barton Hooper, CFA, *research analyst, joined Weitz Investments in 2007. Prior to joining the Firm, he was a research analyst at Oak Value Capital Management and Trilogy Capital Management. Prior to his investment management experience, Barton worked at George K. Baum & Company and Deloitte & Touche LLC as a certified public accountant. Barton has a bachelor's in accounting from the University of Missouri and an MBA from Washington University in Saint Louis.*

As of September 30, 2018, each of the following portfolio companies constituted a portion of the net assets of Value Fund, Partners Value Fund, Partners III Opportunity Fund, Hickory Fund, and Balanced Fund as follows: Accenture plc-Class A: 1.9%, 0%, 0%, 0%, and 1.1%. DXC Technology Co.: 1.5%, 2.9%, 2.8%, 0%, and 0%. Perspecta Inc.: 0%, 0%, 1.2%, 0.9%, and 0%. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

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