

Dear fellow shareholders:

It will come as no surprise to you that Xerox shareholders have been negatively impacted by the economic crisis that has ricocheted around the world in recent months. Through three quarters of 2008, we were on the path to another year of solid performance. That trajectory changed dramatically in the fourth quarter.

One example will make the point. Our developing markets organization was on track to deliver another year of double-digit revenue growth. Through the first three quarters of 2008, revenue was up 17 percent. Starting in mid-November, the bottom fell out with breathtaking speed, resulting in a fourth-quarter revenue decline of 14 percent in our developing markets.

“Although we are hardly immune from the recessionary turmoil, we are better positioned than most to navigate through it.”

Some of the sudden shift was due to a rapid decline in the Russian and Eastern European economies. But 11 points of the 14-point decline was due to major – some would say wild – shifts in currency in several developing markets.

Typically, we manage changes in currency through pricing, but this currency decline was so swift and so significant that pricing couldn't catch up. I point this out not as an excuse, but as an illustration of the roller-coaster nature of this economy.

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Although we are hardly immune from the recessionary turmoil, we are better positioned than most to navigate through it. Our value proposition is supported by the strength of our financial position and the resiliency of our recurring revenue stream that is driven by installs of Xerox technology and multi-year contracts for Xerox services. More than 70 percent of our revenue and 80 percent of our cash flow is generated from our annuity-based business model, making for a solid and reliable asset, especially in tough economies. Last year, our annuity delivered \$12.9 billion in revenue – up 4 percent from 2007 – and helped us generate more than \$1.7 billion in adjusted cash from core operations* – or \$1.36 per share in adjusted free cash flow.*

* See Page 7 for the reconciliation of the difference between this financial measure that is not in compliance with Generally Accepted Accounting Principles (GAAP) and the most directly comparable financial measure calculated in accordance with GAAP.



Given our cash flow, healthy cash balance – \$1.2 billion at the end of 2008 – and a \$2 billion credit facility, we remain quite confident in our financial position and have no need to access the capital markets in the foreseeable future. It's certainly an advantaged position in this economy.

Although we are keenly aware that there is much we cannot control, the wonderful people I am privileged to lead at Xerox are focused with passion and grit on those things we can control. This attitude and focus helped us turn in credible performance in a very difficult year:

- Total revenue for 2008 was \$17.6 billion – that's an increase of \$380 million, or 2 percent, over 2007.
- Full-year net income was \$230 million including a litigation charge. Excluding this and certain other charges, adjusted net income was \$985 million.*
- We generated \$939 million of operating cash flow. Adjusted cash from core operations for the year was \$1.7 billion.*
- Through the 5 percent of our revenue invested in innovation, we continued to expand our portfolio of document management technology and services – already the broadest in the industry and in our history.
- And we continued to expand distribution, bringing the Xerox brand to more businesses of any size all around the world.

The proof points are everywhere. The highly respected Gartner organization lists us as a "Magic Quadrant" market leader in managed print services, as well as for printers and multifunction systems that print, copy, fax and scan all in one device. Our new offerings last year garnered some 230 awards from industry groups and media around the world. I could go on, but you get the point. Third parties are validating our progress and our leadership in virtually every aspect of our business.

That's all looking in the rear-view mirror. I don't have to be a psychic to know that you have little patience for that – especially in these turbulent times. Neither do I. I've met with many investors in recent months and I keep hearing three questions asked over and over:

- What are you doing to confront the recession right now?
- What are you doing to make sure you come out of this crisis with a full head of steam?
- Why should I continue to invest in Xerox?

Fair enough. Let me answer each of those questions as candidly and succinctly as I can.

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Actions to Minimize Impact of the Recession

We are doing everything possible to reduce cost – everything that doesn't mortgage our future. We took a \$349 million restructuring charge in the fourth quarter of 2008 that has resulted in the elimination of about 3,400 jobs. We expect that the restructuring will deliver \$200 million in savings this year.

2008 bonuses have been scaled back substantially and people on bonus plans will receive no salary increases this year. Expenses like training and travel have been significantly cut back. External hiring has to be approved by me personally.

We've accelerated the consolidation of manufacturing facilities around the world, stopped the production of products made in very low volume, and consolidated operations wherever we can. We've realigned our support operations – including human resources, training, finance and marketing – to achieve better synergy at lower cost. We've streamlined product development and engineering by combining two product development organizations into one.

So we are taking a long list of actions aimed at getting our expenses aligned with the realities of faltering economies in just about every corner of the globe. Our investments over the years in Lean Six Sigma have given us a set of tools and processes that simplify and reduce the cost of managing our global operations. For us, it's not an event, but a way of life.

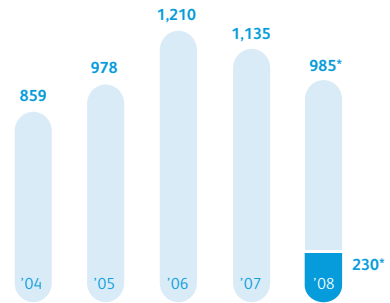
The management team I'm privileged to lead is a seasoned group that knows all about belt-tightening and is eager to deliver the best possible shareholder value that conditions allow. You place a lot of trust in us. It's something we take very seriously.

Emerging with a Full Head of Steam

At the same time, we are not mortgaging our future. We are continuing to invest for growth and we are continuing to stick to the fundamentals – starting with listening to our customers. One of the things I'm proudest of is the customer-centric culture we've developed at Xerox. We have a proven track record that demonstrates that our customers increasingly see us not as a vendor, but as a partner.

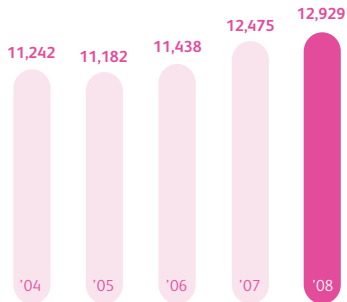
Net income

(millions)



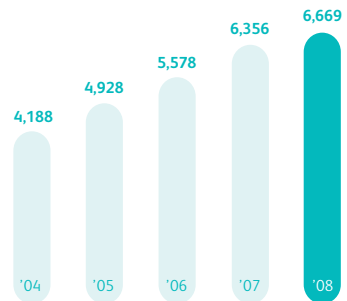
Post-sale revenue

(included in total revenue – millions)



Color revenue

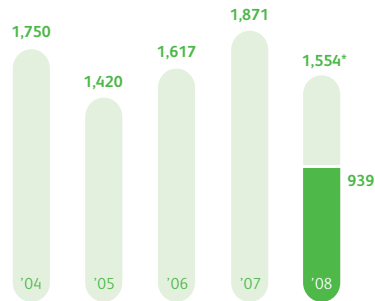
(included in total revenue – millions)



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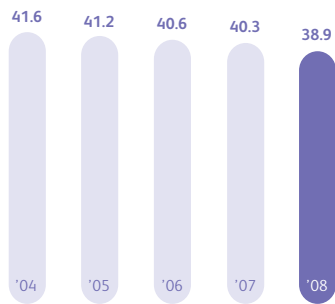
Net cash from operating activities

(millions)



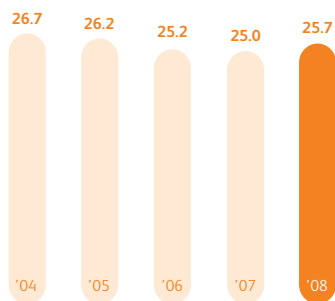
Gross margins

(percent)



Selling, administrative and general costs

(percent of revenue)



Our combination of document services, affordable and innovative color technology, and broader distribution to businesses of any size positions us exceptionally well to attack a \$132 billion market. Here's how:

We provide document services that help businesses work faster and smarter with lower costs. Today businesses rely on us to help reduce their infrastructure costs by optimizing how they manage their document technology and handle enterprise-wide printing needs. Also core to our document services offerings is our expertise in converting paper to digital and helping customers seamlessly track, edit, share and save documents in any form.

In a world where 15.2 trillion pages are printed each year and \$650 billion in productivity is lost each year due to the overload of information, our ability to simplify the way work gets done helps customers save up to 30 percent on their document management costs. That's a figure that is getting more and more attention as we speak to our customers these days, many of whom are looking for ways to contain cost and reduce paper. That may seem counter-intuitive coming from a company known for putting marks on pages, but it's actually a sweet spot for us, especially in what we call "document-intensive" industries like legal, healthcare, financial services and education.

Increasingly we're partnering with IT services companies like CSC and HCL Technologies to integrate our strength in document management with their capabilities in managing enterprise-wide IT systems. And, we are the preferred global imaging partner for IBM Managed Business Process Services, a unit of IBM Global Technology Services. Under our worldwide agreement, we're scanning and imaging millions of documents for IBM and their customers.

We provide affordable color printing systems that cut through the clutter with high-impact communications. Xerox continues to benefit from making color printing affordable for businesses of any size. Revenue from color now represents more than 41 percent of our total revenue.

The billions of pages printed on Xerox color systems grew 24 percent last year, and total significantly more than any of our competitors. In fact, according to estimates by InfoTrends, a leading independent research firm, Xerox's DocuColor®, iGen3® and iGen4™ presses accounted for approximately one-half of the total worldwide color pages printed by high-speed digital systems.

With the broadest portfolio of color printing systems on the market, we continue to create new business opportunities in production printing through color technology and systems such as the Xerox iGen4™ Press and Xerox 700, both of which launched in 2008.

This year we'll shake up the industry even more with the introduction of a color multifunction system that breaks down the cost barrier of color printing in the office through exclusive solid ink technology, which not only lessens the impact on a business' bottom line but also on the environment.

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We have more distribution channels to bring Xerox's technology and services to more businesses of any size, anywhere around the world. For decades, we've had the largest and best direct sales force in our industry. Currently it's over 7,500 strong – one of our crown jewels and an asset that gives us a competitive advantage. That's backed up by Global Imaging Systems, our wholly-owned and growing network of U.S. dealers, as well as an equally impressive partnership with agents, concessionaires, resellers and more – giving Xerox the largest, broadest and most professional distribution network in our industry.

By acquiring nine office technology dealers in the last two years and launching 19 products in 2008 designed for small and mid-size businesses (SMB), we have significantly increased our penetration in the SMB marketplace. In fact, the number of installs for our desktop printers and multifunction systems grew 10 percent last year, largely due to more channels selling the Xerox brand.

“Our recurring revenue stream represents more than 70 percent of our total revenue. That gives us some cushion in challenging economic times and helps fuel the \$1.7 billion in cash that we expect to generate this year from core operations.”

Bottom line: yes, we are feeling the impact of the recession; yes, we are moving aggressively to reduce costs, generate cash and weather the storm; but no, we are neither giving up on 2009 nor mortgaging our future by compromising on investments that will give us momentum as we come out of the economic downturn.

The Case for Xerox as an Investment

We firmly believe that we will navigate through this set of challenges and emerge stronger than ever. I say that for several reasons.

We continue to enhance our leadership position in document technology. Last year, Xerox inventors earned more than 600 U.S. utility patents. We currently hold more than 8,900 active patents in the U.S. and, together with our research partner Fuji Xerox, we have received over 55,000 worldwide patents in our history.

Our research leadership yields the best and broadest set of offerings in our industry. Over the past three years, we have launched more than 80 products – including 29 new products last year with about the same number expected this year.

Our distribution and services capacity is also the best and broadest in our industry. Through our vast and growing network of direct sales, agents, resellers, Global Imaging partners and distributors, we do business in over 160 countries. This is a huge competitive advantage, as customers depend on us for global account management and increasingly want to move documents around the world with speed, ease and security.

Our strategic bets in the marketplace are paying off in areas like color and document services. Color pages now represent 18 percent of total pages printed on Xerox technology, up from 12 percent in 2007. We lead the industry in the number of color pages printed. In services, we generated \$3.5 billion in annuity revenue last year, a year-over-year increase of 3 percent.

Our recurring revenue stream represents more than 70 percent of our total revenue. That gives us some cushion in challenging economic times and helps fuel the \$1.7 billion in cash that we expect to generate this year from core operations.

Our leadership team is battle-tested and results-driven. They are an unusual mix of Xerox veterans, new leaders who have recently emerged from the ranks and people who joined us from other leading companies. They are all driven by one goal – the success of Xerox measured by the value we deliver to our shareholders.

Last but hardly least is the quality and dedication of our workforce. Together with our technology and our distribution, they provide the knowledge and the passion to bring value to our customers. When I visit customers, it's our people they want to talk about. Customers sing the praises of Xerox people and want to talk about their focus on solving problems, their can-do attitude, and their desire to do whatever it takes to get the job done. At the end of the day, Xerox people spell the difference between failure and success.

So we are feeling good about where we are. There is a fair amount of disruption in our industry – some of it brought on by the economy but much of it brought on by Xerox. Over the past few years, we have upped the ante considerably on the technology we have brought to market. We have both built and acquired new document services offerings. And we have expanded our distribution.

We are proud of but not content with the competitive advantage we have created in our industry. We know it's a never-ending battle but it's one we're eager to wage. We feel the same way about corporate responsibility. Even in the worst of times, we continue to make appropriate investments in the communities in which we work and live. We continue to be a leader in diversity in all its forms. We continue to fight for a sustainable world and a greener planet.

We don't have our heads in the sand about the challenges we face, yet we believe we are better positioned than most to meet the obstacles that 2009 will certainly bring our way. There are likely to be winners and losers when the dust finally settles. We feel confident we will be a winner.



Anne M. Mulcahy
Chairman and Chief Executive Officer

Note: Color results exclude Global Imaging Systems performance.

Non-GAAP Reconciliation

Adjusted Net Income/EPS (in millions, except per share amounts)	Full-year 2008	
	Net Income	EPS
Net Income – As Reported	\$ 230	0.26
Adjustments:		
Q4 2008 Restructuring and asset impairment charges	240	0.27
Q4 2008 Equipment write-off	24	0.03
Q1 2008 Provision for litigation matters	491	0.54
Net Income – As Adjusted	\$ 985	1.10

**Adjusted Net Cash from Operating Activities/
Cash from Core Operations**

(in millions)	Full-year 2008	Full-year 2007
Operating Cash – As Reported	\$ 939	\$ 1,871
Payments for securities litigation	615	—
Operating Cash – As Adjusted	\$ 1,554	\$ 1,871
Increase (decrease) in finance receivables	(164)	(119)
Increase in equipment on operating leases	331	331
Cash from Core Operations – As Adjusted	\$ 1,721	\$ 2,083

Adjusted Free Cash Flow/Free Cash Flow Per Share

(in millions, except per-share data, shares in thousands)	Full-year 2008
Operating Cash Flow – As Reported	\$ 939
Payments for securities litigation, net	615
Capital expenditures	(206)
Internal-use software	(129)
Adjusted Free Cash Flow (FCF)	\$ 1,219
Adjusted Weighted Average Shares Outstanding	895,542
Adjusted Free Cash Flow Per Share	\$ 1.36