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HPQ - Q3 2013 Hewlett-Packard Earnings Conference Call

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OVERVIEW:

HPQ reported 3Q13 total revenues of \$27.2b and non-GAAP diluted EPS of \$0.86. Expects full-year FY13 non-GAAP diluted EPS to be \$3.53-3.57 and GAAP diluted EPS to be \$2.67-2.71.



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third quarter 2013 Hewlett Packard earnings conference call. My name is Adrian and I'll be your conference moderator for today's call. At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call, Mr. Rob Binns, Vice President of Investor Relations. Please proceed.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Good afternoon. Welcome to our third quarter 2013 earnings conference call with Meg Whitman, HP's Chief Executive Officer, and Cathie Lesjak, HP's Chief Financial Officer. Before handing the call over to Meg, let me remind you that this call is being webcast. A replay of the webcast will be made available shortly after the call for approximately one year.

Some information provided during this call may include forward-looking statements that involve risks, uncertainties and assumptions. If the risks or uncertainties ever materialize or the assumptions prove incorrect, the results of HP may differ materially from those expressed or implied by such forward-looking statements. All statements, other than statements of historical fact, are statements that could be deemed forward-looking statements, including, but not limited to, any projections of revenue, margins, expenses, earnings, earnings per share, tax provisions, cash flows, share repurchases, currency exchange rates, or other financial items, any statements of the plans, strategies, and objectives of management for future operations, and any statements concerning the expected development, performance, market share or competitive performance relating to



products or services. A discussion of some of these risks, uncertainties and assumptions is set forth in more detail in HP's SEC reports, including its most recent Form 10-Q. HP assumes no obligation and does not intend to update any such forward-looking statements.

The financial information discussed in connection with this call, including any tax-related items, reflect estimates based on information available at this time and could differ materially from the amounts ultimately reported in HP's third quarter Form 10-Q. Revenue, earnings, operating margins and similar items at the Company level are sometimes expressed on a non-GAAP basis and have been adjusted to exclude certain items, including, amongst other things, amortization of purchased intangible assets, restructuring charges and acquisition-related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables and in the slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations web page, at www.HP.com. I'll now turn the call over to Meg.

Meg Whitman - Hewlett-Packard Co - CEO

Thank you, Rob, and thanks to all of you for joining us today. As we continue our fix and rebuild year, parts of the business, like Printing, Enterprise Services, Converged Storage and Software, are making progress, while others, like Industry Standard Servers and Personal Systems, have not completely turned the corner. So overall, I would say our turnaround continues. We're moving forward against our plans and I remain comfortable with where we're heading. Most importantly, we once again achieved the financial performance we said we would, delivering \$0.86 in non-GAAP diluted earnings per share, within our previously provided outlook of \$0.84 to \$0.87.

During the third quarter, we held our annual HP Discover event in Las Vegas. We brought together more than 11,000 people, including more than 120 of the world's top CIOs. These are record numbers for HP. I was encouraged by the interest I heard from our customers about technologies like HP Moonshot, StoreOnce, 3PAR, Software Defined Networking, Vertica and Autonomy. At HP Discover, we introduced some very significant new innovations. We announced Haven, a big data analytics platform that leverages our analytics software, hardware and services to allow customers to make decisions in realtime. We also expanded our converged cloud portfolio, with a common, open stack-based architecture for HP's private, managed and public cloud offering. And we announced a new partnership with Google to introduce a one-stop shop technology solution for small and medium-sized business customers. As I've said before, HP's turnaround will happen on the back of great products and services. As the benefits of our focus and investment begin to pay dividends in 2014, I expect that you will see increased innovation across HP.

From a macroeconomic standpoint, we see a continued weak enterprise spending environment. Sentiment in the US is improving, although it's not translating to our results yet, due to inconsistent execution. I would characterize Europe as challenging, and China continues to be soft. We're also seeing acceleration in trends, driving customers to the cloud and shifting to mobility.

For the third quarter, our results were driven by solid execution in Software, Printing, Converged Storage and Enterprise Services, coupled with the savings from our restructuring program and improvements in our operations. As a result of our focus on operations, we were able to bring our cash conversion cycle down to 18 days, a remarkable achievement compared to 27 days in the prior year. In the quarter, operating cash flow was \$2.7 billion. Once again, another strong performance. As a result, we lowered operating company net debt by \$1.7 billion, to \$1.2 billion. This represents our sixth consecutive quarter of reducing our operating company net debt by more than \$1 billion. Our operating company net debt is now below pre-autonomy levels and is approaching our goal of approximately zero. We also returned approximately \$283 million to shareholders, primarily in the form of dividends in the quarter.

Along with the operational improvements and the workforce restructuring, we're focused on getting the right leadership in place to lead the Company through the next phase of the turnaround. To that end, we announced several changes to our executive leadership team during the quarter. In June, Dion Wiesler took over Printing and Personal Systems. Dion is more aggressively shifting to a multi operating system, multi architecture and multi-form factor strategy.

And earlier today, we announced additional changes to our executive leadership team. Bill Veghte, currently HP's Chief Operating Officer, will become EVP and General Manager of the Enterprise Group, replacing Dave Donatelli, who will remain with HP and take on a special assignment. Bill brings a critical set of skills to the management of HP's Enterprise Group. He is a proven technology executive with a wide range of experiences leading sales, services, marketing, and engineering at scale. During his tenure at HP, he has run HP Software, held the responsibility of Chief Strategy



Officer, and for over 15 months, has served as HP's Chief Operating Officer. As COO, Bill helped create HP's blueprint for the future and deeply understands the strategic challenges and opportunities facing both the Company and its customers.

As hardware becomes more standardized, leadership solutions are increasingly differentiated by the software layer that drives the hardware. This is true for both traditional IT and cloud environments. Bill will retain his current responsibility for the Pan HP Cloud initiative; and Bill's experiences in software and in the enterprise, combined with HP's infrastructure leadership, will help HP accelerate innovation in converged infrastructure, cloud, and the emerging area of software defined data centers.

In a separate organizational move, Henry Gomez, EVP and Chief Communications Officer, will assume the additional responsibilities of Chief Marketing Officer. By combining Marketing and Communications, we will accelerate programs that will drive sales, build brand loyalty and help customers embrace the new style of IT. HP's current CMO, Morty Homlish, will become Chief Customer Experience Officer, a new role that will focus on driving more consistent and high value interactions with customers across all business units.

Now, let me turn to our business group performance in the quarter. As you would expect in the turnaround, there are areas where we're doing well and areas where we have to improve. Let me start with the parts of the business that performed well in the quarter. In Printing, we once again delivered a solid quarter. Business initiatives like Ink Advantage and new products like Office Jet Pro X continue to take hold, with strong customer adoption. As a result, we're seeing strength in our Ink in the Office program. Overall, we grew hardware unit sales for the first time since 2011, gaining 1 point of share in both ink and laser over the prior year, and 5 points of share in laser over the prior quarter. The Printing team has done a very good job executing the strategy we laid out last October. Although revenue is down, profitability is in line with our expectations and the top line is stabilizing. Printing revenue was down 3.6% over the prior year and 1.4% in constant currency, while margins were 15.6%, essentially flat over the prior year.

In Enterprise Services, the business is stabilizing, as we continue to execute well against our recovery plans. Revenue was down 8.7% over the prior year, better than the FY '13 outlook range we previously provided. We saw add-on business offset the anticipated revenue run-off from the four exceptional accounts we identified at our security analyst meeting last October. Margin in the quarter was 3.3%, bringing Enterprise Services year-to-date margins to 2.4%, at the high end of our FY '13 outlook range. We continue to see improvements in signings, but they are mostly renewals. Going forward, we're focused on strengthening our go-to-market capabilities dedicated to strategic Enterprise Service solutions in areas like cloud, big data, and apps modernization, and new account wins. As we outlined in October, this will be a multi-year journey.

Enterprise Services was able to secure some major wins in the third quarter. We announced that Enterprise Services and its partners were awarded the United States Department of the Navy's Next Generation Enterprise Network, contract value at up to \$3.4 billion over five years. The contract's being protested, but we have every confidence in the Navy's evaluation and the ultimate selection of HP.

In the Enterprise Group, we're making progress in executing our vision of converged infrastructure based on HP intellectual property and the software defined data center. We see near term revenue pressures in ISS and some parts of Storage, where we face aggressive pricing and competition. Customer interest in our revolutionary HP Moonshot product has been strong. We're working hard to ramp this product in the market. We're currently in testing and development with many key customers and expect to roll out a number of new innovations on this platform over the next few quarters.

In Storage, we're seeing the planned portfolio shift continued, with strong performance in our Converged Storage business, which was up 37% over the prior year, being offset by weakness in traditional Storage. We continue to see solid growth in our mid-range 3PAR products that were launched in the first quarter. While we were pleased with our Networking performance in China, revenue was essentially flat and we must grow this business faster. Going forward, we're focusing on new channel plays and improved go-to-market actions to accelerate growth. Enterprise Group had a number of significant customer wins in the quarter. HP was selected as the official technology partner to Oriental Dreamworks, the joint venture between the China consortium led by China Media Capital and Dreamworks Animation.

In Software, we saw good performance and improved execution. We grew revenue nearly 1% over the prior year and 4.3% sequentially. We saw continued improvement in operating leverage, as margin expanded 2.5 points over the prior year and 1.4 points over the prior quarter, and achieved an operating margin of 20.5%. Performance in Software was driven by strength in Security, which saw double digit revenue growth, strong



momentum in Vertica, which saw triple digit growth, and sequential license revenue growth in Autonomy. In addition, we saw pockets of improvement in IT Management, although we saw continued pressure from the shift to SAS coupled with a portfolio that is weighted towards Services and Support.

Now let me turn to where our performance needs to improve. Overall, the Enterprise Group's performance was very disappointing. Enterprise Group profitability was pressured by lower revenue, particularly in ISS, resulting in an operating margin of 15.2%, down 1.9 points over the prior year and 0.7 points sequentially. ISS continues to experience near-term business model challenges, impacting our competitiveness in the Hyperscale market. In addition, mainstream server weakness was driven by execution challenges, competitive pricing and a misaligned go-to-market model. This impacted our revenue and profitability. The net impact of these execution challenges is an expected loss of 5 points of market share on a revenue basis. Fixing execution across Enterprise Group will be Bill Veghte's top priority in his new role.

In our Personal Systems business, we're seeing continued PC market contraction, as HP revenue declined 11% over the prior year. On a positive note, in the third quarter we saw relative strength and market share gains in growth markets, like Asia Pacific, and in commercial PCs. According to IDC's second calendar quarter results, HP has achieved its highest ever PC share in India, with 34.1%, leading every category of the PC market. Overall margin for the quarter was 3%, down 0.2 points sequentially and down 1.7 points over the prior year. Looking forward, we're focused on driving profitable growth in Personal Systems. It's going to take time to get margins to our desired levels against the backdrop of a changing marketplace, but we're confident that our differentiated approach from competitors, including our focus on beyond-the-box innovation, will pay off over the long term.

Now let me turn to our future outlook. As you know, I stated in May that I believe that company-level revenue growth was still possible in fiscal 2014. Particularly given the challenges I just highlighted in Enterprise Group and Personal Systems, as well as the fact that 2013 revenue from key accounts in Enterprise Services is running off more slowly than anticipated, we now expect that total company year-over-year revenue growth in fiscal 2014 is unlikely. That said, I remain confident that we are making progress in our turnaround. We are already seeing significant improvement in our operations. We are successfully rebuilding our balance sheet. Our cost structure is more closely aligned with our revenue, and we have reignited innovation at HP, with a focus on the customer. So I do expect that we'll see pockets of year-over-year revenue growth across certain parts of the business in 2014. As is our normal practice, we'll give a more comprehensive outlook on 2014, including EPS, at our security analyst meeting October 9 and I look forward to seeing you all there. Now let me turn it over to Cathie for a closer look at our performance in the quarter. Cathie?

Cathie Lesjak - Hewlett-Packard Co - CFO

Thanks, Meg. Good afternoon, everyone. Total revenue for the quarter was \$27.2 billion, down 8% year-over-year and down 7% in constant currency. Overall, our results came in largely as expected, with some variance in performance among the business units. Enterprise Services came in slightly ahead of expectations, and Printing and Software were broadly in line; however, a weak PC market and increasingly competitive pricing pressured Personal Systems, and execution challenges and aggressive pricing impacted Industry Standard Server performance. I'll go into more detail on each segment shortly.

By region, EMEA remains weak, particularly in Consumer, with revenue of \$9.6 billion, down 10% year-over-year and 8% in constant currency. Revenue in the Americas, up \$12.4 billion, declined 7% year-over-year as reported and in local currency, partly driven by weakness in US public sector spending, as well as soft demand in Brazil and Canada. APJ was mixed, with strong growth in India, due in part to our recent educational PC win in the state of Uttar Pradesh partially offsetting weaker China performance. APJ revenue was \$5.2 billion, down 8% year-over-year and down 5% in constant currency.

Turning to gross margins. Improved Enterprise Services and Technology Services margins, combined with a favorable mix from Software, Printing and Personal Systems, offset a highly competitive pricing environment across most of our hardware businesses. Gross margins were flat on a year-over-year basis and down 30 basis points sequentially. Non-GAAP operating expenses were \$4.1 billion, down 4% year-over-year and 2% sequentially, driven by expense benefits from restructuring actions and lower R&D investments in Business Critical Systems. Non-GAAP operating profit of \$2.3 billion was 8.4% of revenue, down 80 basis points year-over-year. We recorded \$146 million of expense on the other income and expense line. With a 22% tax rate and roughly flat share count of 1.9 billion shares outstanding, we delivered non-GAAP diluted earnings per share

of \$0.86. Our non-GAAP EPS excludes pre-tax charges of \$356 million in amortization of purchase intangibles, \$81 million of restructuring charges, and \$4 million in acquisition-related charges.

Turning to the business groups. I'll start with Printing. We continue to execute on our strategy and the group delivered solid results in the third quarter. Revenue of \$5.8 billion was down 4% year-over-year. Total unit shipments grew 5% year-over-year, as we took advantage of the depreciating yen to place more units and partially offset other currency headwinds. Operating profit of \$908 million, or 15.6% of revenue, was down 0.2 points from last year. Commercial hardware revenue declined 3% year-over-year, while units increased 12%. We experienced strength in low end laser sales, while high end revenue declined due to mix shifts in the value segment. We saw good growth in Managed Services and Indigo sales.

Consumer Hardware revenue was flat, while units increased 2% against the prior year, driven by strong Ink in the Office and Ink Advantage sales. Supplies revenue declined 4% against prior year and made up 66% of Printing revenue. Our overall channel inventory has moved slightly above our target range. This was partly driven by supplies demand from our channel partners seeking to maintain service and reliability levels to their customers. We need to bring down channel inventory in the fourth quarter.

Personal Systems continues to face a challenging environment. Revenue was \$7.7 billion, down 11% over prior year, led by weakness in Consumer. Total unit shipments declined 8% year-over-year. We saw broad-based regional softness, led by EMEA. Consumer sales declined 22% year-over-year, while Commercial performed much better, down just 3%. Commercial unit shipments out paced the market by 8% year-over-year, and we maintained our number one market share position in this category. Continued pricing pressure and currency headwinds drove an operating profit of \$228 million, or 3% of revenue, down 1.7 points over prior year. Personal Systems contributed just 9% of HP's segment operating profit. We remain focused on improving profitability in this business over the long term.

Turning to Enterprise Group, results were weaker than expected, with revenue down 9% year-over-year, to \$6.8 billion. We continue to see positive momentum with our Converged Storage Solutions, but we face extreme competitive pricing in Industry Standard Server and Storage and continued weakness in Traditional Storage demand. We are also working to address execution challenges across IFS, and as Meg noted, we need to improve the go-to-market fundamentals across Enterprise Group. Operating profit was \$1 billion, or 15.2% of revenue, down 1.9 points from last year. Higher margins in Technology Services helped offset weakness in the other businesses, primarily ISS and Storage.

By business unit, Industry Standard Server revenue declined 11% year-over-year, to \$2.9 billion. We saw double-digit declines in Mainstream and Hyperscale. Hyperscale results partly reflected a tough compare over the prior year. Storage revenue declined 10% year-over-year, to \$833 million. We remain excited about our Converged Storage offerings, which grew 37% year-over-year. 3PAR was up double digits again, and StoreOnce continued to do well. Together, 3PAR plus XP plus EDA, a metric that adjusts for the planned product transition, outgrew the market.

Business Critical Systems revenue declined 26% year-over-year, consistent with expectations, at \$284 million. We continue to face Itanium pressures, and the overall UNIX market secular declines persisted. This more than offset solid growth in Mission Critical x86 sales. Networking sales were flat year-over-year, at \$644 million. We continued to make strides in wireless LAN, and have had strong customer interest in our new software defined networking solutions that we introduced earlier this year. That was offset by weakness in US public sector spending. Finally, in Technology Services, revenue declined 7% year-over-year, to \$2.2 billion, driven by hardware, declines particularly in BCS and Traditional Storage. We are focused on improving our attach rates on our newer products.

Turning to Enterprise Services, revenue of \$5.8 billion declined 9% year-over-year, as public sector austerity measures continued to pressure discretionary IT spending, particularly in the US and UK; but performance was still ahead of where we expected, due to incremental business offsetting expected run-off. Operating profit of \$192 million, or 3.3% of revenue, was down 0.5 points year-over-year, due to higher operating expenses on a tough year-over-year compare offsetting improvements in resource management and cost control, and our handling of underperforming contracts. By business unit, IT Outsourcing revenue was \$3.7 billion, down 7% year-over-year; and Applications and Business Services revenue was \$2.2 billion, down 11% year-over-year. Both business units were significantly impacted by contractual run-off.

Strategic Enterprise Services revenue continues to grow double digits, driven by cloud, security, application modernization and big data solutions. We are pleased with the execution progress across ES. Our signings were up double digits both year-over-year and sequentially, driven by renewals;

however, our ability to grow sales beyond traditional offerings needs to improve. Growing our bookings at SES by better embedding in our large deals and winning smaller deals remains a top area of focus.

Software had a solid quarter, with revenue up 1% year-over-year, to \$982 million. We are especially pleased with the continued performance in our strategic areas of cloud, security, and big data. Sales of our Security Solutions grew double digits, while Vertica revenue was up triple digits. At the same time, we continue to prune our Professional Services portfolio, which tempers revenue growth, but improves profitability. Operating profit for the quarter was \$201 million, or 20.5% of revenue. This was up 2.5 points year-over-year and 1.4 points sequentially, showing real signs of improved operating leverage. License revenue was flat year-over-year, while Support revenue grew 4% over the prior year.

By design, Professional Services revenue declined 11% from last year and SAS revenue was up 4% on prior year, which is below our expectations, but bookings growth was solid in the quarter. Across Software, we saw better sales execution in this quarter, with improved license conversion. But we still have work to do on building our pipeline and continuing to improve our sales execution.

HP Financial Services revenue declined 6% year-over-year, to \$879 million, due to Enterprise Services volume declines offsetting solid direct business growth. Financing volumes were down 9% year-over-year, with net portfolio assets of \$12 billion, down 4%. Operating profit was \$99 million, or 11.3% of revenue. The return on equity in HP Financial Services continues to be strong.

Moving on to our balance sheet and capital allocation for the quarter. We continue to execute our strategy of driving free cash flow and strengthening our balance sheet. Operating cash flow was \$2.7 billion in the quarter, down 6% year-over-year, and free cash flow was \$2 billion, down 2%. We continued to see improvement in working capital, with the cash conversion cycle down 9 days year-over-year, to 18 days. The year-over-year reduction was driven primarily by improvements in days payable. Sequentially, the reduction of 3 days was in line with typical seasonality for days payable and days inventory, where we were able to offset the increases from the large deals I noted last quarter with other inventory improvements. Days sales outstanding was better than normal seasonality, as a result of strong collections, as well as better usage of cash discounts.

I want to take a minute to comment on our share repurchase program. In Q3, we spent just \$3 million on repurchasing 168,000 shares in the quarter, well below our historical levels. During the quarter, we had material, non-public information that prevented us from putting in place a share buyback plan as we typically do. However, we have developed a plan for Q4 that will ramp up our spending to offset dilutions from Q3 and Q4, but will remain in line with our broader FY13 goal of rebuilding our balance sheet. We will provide an update on our capital allocation priorities for fiscal '14 at our security analyst meeting in October.

We remain committed to overall capital distribution to shareholders, and we paid out \$280 million in dividends in Q3. Gross cash at the end of the quarter was \$13.7 billion. Operating company net debt was \$1.2 billion, down another \$1.7 billion from the last quarter and down \$10.6 billion from the peak in the first quarter of fiscal 2012. I am pleased with our progress in reducing operating company net debt; and on August 1, we further reduced gross debt by paying off a \$1.1 billion maturity.

Looking ahead to the fourth quarter, we see mixed trends. At a macro level, we expect consumer demand weakness in the PC industry will likely continue to impact Personal Systems, and we expect continued pricing pressure in Printing, Personal Systems, and Industry Standard Servers. At the same time, we expect to see more favorable trends in demand for commercial PCs relative to Consumer. We expect Printing to continue to perform well, as we utilize yen tail winds to place more units. But as we mentioned, we do have a little bit more work to do to bring down supplies channel inventory. For Enterprise Services, contractual run-offs continue, but we expect the overall full year revenue decline to be in the 8% to 9% range, less than the 11% to 13% range we indicated in the Q2 earnings call.

For the year, we continue to expect margins to be at the high end of our 0% to 3% range that we provided last October. Software will have a tough Q4 compare, due to the large General Motors deal we noted last year. We still expect to see improved execution and strong customer demand across our big data, security, and cloud offerings. Finally, we anticipate 1 point of currency headwind to revenue in Q4. With that context, we expect full year fiscal 2013 non-GAAP earnings per share to be in the range of \$3.53 to \$3.57. We expect full-year fiscal 2013 GAAP earnings per share to be in the range of \$2.67 to \$2.71.



Finally, although we don't typically update our cash flow outlook quarterly, we think it makes sense to update our expectations, given our Q3 cash flow performance. We now expect free cash flow to approach \$8 billion for the full fiscal year 2013. We did better than expected in Q3, but we believe the Q3 cash conversion cycle was below what we consider to be a sustainable long-term rate, so we expect some pullback in Q4.

I know everyone wants to hear our view on Fiscal '14, but we will provide our detailed outlook at our upcoming security analyst meeting on October 9. We look forward to seeing you all then. With that, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Mark Moskowitz, JPMorgan.

Mark Moskowitz - JPMorgan Chase & Co. - Analyst

Yes, thanks. Good afternoon. Meg, the first question is for you. I was curious, regarding this commentary around execution, can you give us a little more specifics, particularly in context of today's management changes, how much is driven by technology deficiencies versus go-to-market, or both? And just want to see how we should think about that trajectory, if there's a lot more R&D required going forward?

And then I have a follow-up for Cathie, if I could, around the Services business. I hear you on the revenue decline not being as bad as expected at last October's analyst meeting. But how should we think about some of the Services slippage going forward? As these extensions with some of these four exceptional Services customers unwind, will there be any sort of operating margin hit down the road that we should prepare for?

Meg Whitman - Hewlett-Packard Co - CEO

Great. Well, let me take the first one. So we were disappointed, as I said, in EG's performance this quarter. And there are a couple of issues. This is less technology than it is a number of other areas. First is, we've got to have the right products targeted to the market segments that we choose to go after with the right cost structure. And we've got some more work to do on having a competitive cost structure around supply chain, as well as our manufacturing strategy. We also have got to simplify and make more effective our selling motion. This is a very big, very complicated sales motion, and frankly we've got to simplify it. And then we've got to see our channel programs that we put in place earlier this year, and some changes to the partner compensation program in August, have got to work. And actually, there's some bright spots there. But my view is we've got some operational excellence work that needs to be done here. So I actually am quite confident in our technology. I'm confident in our next generation Blades, in Moonshot. I think we can turn the corner on this, but we're going to have -- we have a bit more work to do.

Cathie Lesjak - Hewlett-Packard Co - CFO

And also, on the Services business question, in terms of the slippage. So I'm not sure I would call it slippage. That sounds unplanned in some way. We've been working closely with these top four accounts. And at least one of them is completely done, but the three that remain. And we're working very methodically to make sure that their transition works well. And frankly, that gives us time to come in and do a couple of things, a, get our cost structure in line for now the new run rate business, but also it's enabling us a chance to come in and sell a bit more on a sell and bill basis within the quarter. And we saw that this quarter. So this quarter, we had just had the run-off from these exceptional accounts and we hadn't been able to bring in some additional revenue, then the reduction in revenue would have been much lower. And so -- or sorry, much higher, much worse. And so I think that that's giving us time. So I think actually, letting these things take a little bit longer to transition has been good for us.



Rob Binns - *Hewlett-Packard Co - VP, IR*

Great. Thanks, Mark. Next question, please?

Operator

Tony Sacconaghi.

Toni Sacconaghi - *Sanford C. Bernstein & Company, Inc. - Analyst*

Yes, thank you. Meg, I was wondering if you could comment a little more on the management changes. In the last two months, you've changed leadership of business units that comprise more than 80% of your profits. So you outlined some of the things that you were dissatisfied with. Perhaps you can comment on what are the specific marching orders to the new executives. And can you also comment on why you are not looking to attract talent from the outside? I think in your press release, you said the imperative is to rapidly respond with fresh ideas and bold execution. Fresh ideas often come from the outside, and all the management changes that have occurred recently have included promotions solely from within. So marching orders and then recruiting outside talents, and I have a separate follow-up, please.

Meg Whitman - *Hewlett-Packard Co - CEO*

Okay, good. So this, as I've said for a long time, is a five-year turnaround, with appropriate milestones along the way. But we're entering the next phase of the turnaround, and my view is we need to accelerate into the next turn. And my job is to get the right people in the right job at the right time with the right experience and domain expertise. And as I evaluate the performance of each of these businesses, what I think is necessary, then I've got to match the right executive to the challenge at the time. And I am excited about the makeup of this new team.

And you're right, Tony. I have relied more on promote from within, because we've got a lot of very talented executives in the Company who have been in second or third level jobs, who are more than capable of stepping up. In the case of Dion Weisler, the results in APJ for PPS are really quite good. And it takes a long time to learn how HP does things and understand the business. In the case of Bill Veghte, he had been our Chief Operating Officer, had helped plot the blueprint for the future, and brings a tremendous amount of software expertise to a business that is relying more on software to differentiate the hardware than the bare metal. Also has tremendous expertise in selling, ran Microsoft North America. And one of our big weaknesses here is our selling motion and our sales go-to-market.

So it's always a balance. I have brought some new people in from the outside. But you're right. I tend to want to go with people who I think have the fresh ideas, and the energy and the enthusiasm, but also don't have to start at the beginning of the learning curve.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Great. Thanks for that, Tony. Next question, please?

Operator

Katy Huberty, Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

Yes, thank you. Cathie, can you talk a little more specifically about the cash cycle improvement in the quarter, and importantly, why you don't think that's sustainable? Were there mix or timing situations this quarter that won't continue? And then also, can you reconcile the fact that Printer



Hardware units growth was the best in a couple years, and yet Printer Supplies growth declined this quarter, which was a deterioration from last quarter. and you're sort of down ticking on the outlook around Printer Supplies, as well. Thank you.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Thanks, Katy. On the cash conversion cycle, first off, we're very pleased with the performance that we've delivered, both in Q3, as well as frankly throughout the year, around cash flow. What is showing up in the numbers is the work we did to educate everybody in the Company, help them understand how they can contribute to improving cash flow, and then frankly also embedding, in a more significant way, cash flow into the executives' bonus metrics, doesn't hurt either. And so we've seen that kind of improvement. Specifically in Q3, one of the big drivers of the year-over-year improvement was in days payable, and that really was the result of some purchasing linearity in the quarter. When we step back and we look at what is a long-term sustainable cash conversion cycle for the Company, we think it's more in the low 20s. And that's really where the pullback that we expect to see in Q4, as well. So that's on that side.

In terms of the Hardware units, again, what we did this quarter was we were able to use the yen tail winds that we have in our cost structure to really go after more units. And we saw that with units being up 5% year-over-year, in the Commercial space, up 12% year-over-year, in the Consumer space, up 2%. And so we're really pleased with having that opportunity to get those units out, for exactly the reason that you raise is that in a fairly short amount of time, that's going to drive additional Supplies consumption. In terms of the specifics around the quarter for Supplies this quarter, we do expect that Supplies will continue to be relatively volatile quarter-to-quarter. Our strategies for the long term are to really drive units out there that will ultimately use more HP-branded ink. Those strategies are things like Ink in the Office, Ink Advantage, Ink Subscriptions, multi-function printers, Managed Print Services, those are all really designed to drive more supplies per unit. And while it's still early days, the early indications are encouraging that those strategies are going to bear out.

Katy Huberty - *Morgan Stanley - Analyst*

Thank you.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Thanks for that, Katy. Next question, please?

Operator

Jim Suva, Citi Research.

Jim Suva - *Citigroup - Analyst*

Thanks very much. And Meg, a quick question. It seems like awhile ago you were talking a lot of confidence about the five-year program, especially with the revenue growth next year. It seems like now that the confidence is down shifting a little bit, and maybe I misinterpreted the tone of your voice recently or maybe that is true. And if it is true, is it mostly due to PCs, or how should we think about your confidence in outlook? And is this five-year program changing at all?

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes. So listen, I'm very confident that our turnaround is working. As you would expect in any turnaround, some businesses are performing better than you would think and some are somewhat performing not as well as you would hope. But what has changed about 2014's revenue outlook for me is a couple of things. First is Enterprise Group's performance, especially during the last quarter. I would say that weak execution has amplified



the market challenges that we know exist, and it's been a very aggressive pricing environment. The server market growth rates have come down in the last quarter. The PC market has not stabilized as much as I had anticipated it would. That stabilization is yet to occur. And then finally, Enterprise Services, which is good for this year, is running -- the revenue is running off more slowly this year, which is good for this year but creates growth challenges for next year.

So I am confident that we can address the challenges. There are some segments that will absolutely grow next year and will deliver very good performance, but I think it is unlikely, given the changes that occurred over the last quarter or so, that we're going to see growth in 2014, as I had hoped.

Jim Suva - Citigroup - Analyst

That's on the revenue side, but then also on the profitability side, it seems like cash flow is better and restructuring is progressing well. Do you think on the earnings side you could see growth, or just the top line is so much pressure?

Meg Whitman - Hewlett-Packard Co - CEO

You know, we're being very smart about this, as smart as we can in a dynamic market, which is, it's not growth at any cost. We want to manage the margin revenue trade-off here. And we'll give you a lot more insight to that in our security analyst meeting, where we're going to talk about our earnings per share projections, capital allocation, the investments we need to make, and where we think the growth is going to come from next year by market segment.

Rob Binns - Hewlett-Packard Co - VP, IR

Great. Thanks Jim.

Jim Suva - Citigroup - Analyst

Great. Thank you very much.

Rob Binns - Hewlett-Packard Co - VP, IR

Next question, please?

Operator

Ben Reitzes, Barclays.

Ben Reitzes - Barclays Capital - Analyst

Yes, hello. Can you talk a little bit about the Technology Services business. That had been pretty stable, and it kind of dipped down 7% and inflected. And I think that's your most profitable business at the whole company, even more profitable than Software.

And then just one clarification. I wanted to know, Meg, that the server business, ISS, has been declining for several quarters. I believe this is the seventh or eighth in a row, or sixth or seventh in a row, and I was wondering like, why now. Why didn't we hear about this a couple quarters ago, and what actually came to light to make the decision happen now, on this call, rather than over the last year? Thanks.



Cathie Lesjak - *Hewlett-Packard Co - CFO*

Thanks, Ben. Let me start with the Technology Services question that you have. One of the things that we are absolutely seeing in Technology Services is the need to really improve our attach rates on some of our newer products. And so as some of the older products, like Business Critical Systems, which has a very strong attach and penetration rate, as that has a long tail, but it is coming down, and hardware in general has been coming down, that's starting to impact Technology Services. And so what we're doing about that is trying to improve our attach on the newer products, and then also coming out with new innovative service offerings, like what we call Proactive Care or what we call Data Center Care, coming out with these new offerings to somewhat cushion the pressure that we're seeing, because hardware sales are declining. If you go back and you look at fiscal '11 and fiscal '12, we were able to improve the penetration rates in Storage and in Networking over 300 basis points each. In this year, we've had a little bit of a step back, particularly in this quarter we were down a little bit on pen rates, and that's really due to mix. We've got to get the attach rates up on the newer products.

Meg Whitman - *Hewlett-Packard Co - CEO*

Let me take the question on our Enterprise Group performance overall. The server business has been under pressure for some time. The pricing in the marketplace is as intense as I've seen it since I've been at HP. But the revenue share loss this quarter was bigger than we had anticipated. I had said in the script it was 5 points of share loss on a revenue basis. And we have got to move faster on our Hyperscale initiatives. We've got to -- and Moonshot will be the disruptive force there, so we've got to move that faster. And then we must see Networking grow faster. We are the upstart in this business. So a flat Networking performance is not what we need to see. And then frankly, our Storage business, the Converged Storage part is growing well, but the decline in tape and other areas, XP, we can do better than that.

So my job, as I said, is to make sure that we are positioning these businesses for the future. And what I ask of our Senior Executives, to double back to Tony's question that I didn't answer as directly as I could have, is listen, set realistic targets, deliver on your commitments, while keeping an eye on the long term. I've said for a long term, we're not here for this quarter or for this year. We are trying to set HP up for another really great run here. You've got to decide where you're going to play and how you're going to win, because this isn't all about revenue growth. This is a margin revenue trade-off business, and we have to be very clear about where we want to play and how it is that we're going to win. And then make sure that you have done a perfect job of segmenting your market and marrying the right products to that market segmentation. And if you do that and manage your cost structure, we'll have a very successful business here. So that's what I'm looking for. And this is something, historically, HP's done really well. But it is not being done as well as it could be in all parts of the business, and it needs to be a real strength of the Company going forward, especially as we are navigating these incredible shifts in the industry. It's not business as usual in our industry, and we have to be better at it than we've been in the last year or two.

Ben Reitzes - *Barclays Capital - Analyst*

Great. Thank you.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Thanks very much. Thanks, Ben. Next question, please?

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

Just on the leadership change. Do you expect trends in the Enterprise business to deteriorate further as you go through this transition, and at what point, Meg, would you actually hope that this business would start growing again? And with the change in responsibilities for Dave Donatelli, how should we think about HP's emphasis on returning to M&A as a key growth driver, given you now have two very senior executives focused on early stage opportunities? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

So listen, we are in the happy position now, from a capital allocation perspective, of being able to -- our capital allocation strategy has been very clear, return cash to shareholders in dividends, buy back enough shares to offset dilution and pay down debt. So we now have an opportunity to say, where can we use strategic acquisitions to further our overall objectives as a Company. And we will be back in the market, as we think about acquisitions that can further our objectives. Again, we will be incredibly measured and disciplined. We are very mindful of the event that we just came off with Autonomy, so don't worry about that. We are very focused and disciplined. But I think as we see these big tectonic plate shifts, there's no question that acquisitions are going to have to be a part of how we turn this Company around. So listen, there's a lot of changes going on in the marketplace.

The good news about EG -- someone asked me the question earlier, do you think it's a technology problem, in other words, you're not spending enough R&D? I actually don't think that's the case. I think we have the right technology. We've got to work on go-to-market, we've got to work on cost structure, and we've got to work on market segmentation, which frankly are easier, more near-term things that can be fixed, as opposed to hoping that we're going to have the right product two or three or four years from now, based on what's in the labs today. I am less worried about that and much more focused on what I would call more prosaic execution.

Brian Alexander - *Raymond James & Associates - Analyst*

Thank you.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Thanks for that one, Brian. Next question, please?

Operator

Maynard Um, Wells Fargo.

Maynard Um - *Wells Fargo Securities, LLC - Analyst*

Hello. Thanks. On your go-to-market, I'm just curious, your partner changes were put in place on May 1 or somewhere around there, so you've had about three months since implementation. Is the go-to-market change a function of not having had it right initially, or is it something else? And I'm curious how long, you seem to imply that these are short-term things, I'm curious if it really is a short-term thing or if these are changes in the channel that need to sort of play out over a period of time, multi quarters? And if not, why it's a short-term phenomenon? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

So whenever you make changes to your go-to-market selling motion, these take a while to work through the system. And our channel partners have just gotten their first checks from the new compensation program that went in in June. And actually, there's some light at the end of that tunnel. We feel good about the changes we made to our partner selling motion. But go-to-market is more than just a coverage model. It is our



ability to price. It is our ability to provide the specialists and the solution architects that are needed to sell. It is about our ability to provide compelling bundles of server and storage, like an appliance for some of our software elements. So it is a holistic view of go-to-market. I think there's some real light at the end of the tunnel. We've had our AGMs and our AEs in place now for a number of quarters, in fact, a number of years now, and so there's more account consistency. But there's still work to do here. And frankly, my view is we've made this a bit more complicated than we need to have and simplicity -- in my experience in sales organizations is simplicity and clarity of role and the right people against the right opportunities is critical.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Great. Thanks, Maynard. Next question, please?

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. I have two questions. Well, one with a follow-up. The first is, can you talk a little bit about strategy in terms of profit versus your willingness to price and to take share? Obviously, some of your competitors are being extremely aggressive in certain areas. Is this a situation where you just don't want to follow them down and so you're going to continue to give up share, or how are you weighing that? Because obviously, on printers, you're willing to do that, where you have the yen benefit, but I'm thinking in some of the other categories where you have seen some share slippage.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Shannon, our focus, whether it's in Industry Standard Service, which Meg talked a little bit about a few minutes ago, or in PCs that we've talked about for a long time, same thing in printers, is that we're focused on long-term profitability. And so if in the short-term there are reasons to make an investment that we think will give us a good return, then we'll do that deal. And it may not always make money, at least on a fully loaded basis. But our goal is long-term profitability. And we believe that ultimately the way we're going to get there is investing in our own IP, driving products and services that have a strong value proposition for customers and will then enable us to compete very effectively. You even saw in PCs this quarter, we were able to do well from a profitability perspective and also gain share. So we gained share both year-over-year and quarter-on-quarter. But ultimately, the decision is what's the best thing for this business over the long term and how we're going to drive profitability.

Shannon Cross - *Cross Research - Analyst*

Okay. Thanks. And then can you just talk a bit about what you've seen in China, if there are any more details in terms of demand, enterprise, government, consumer, linearity during the quarter, just any color you can provide on what's going on over in China?

Meg Whitman - *Hewlett-Packard Co - CEO*

Well, I'll make some top level comments, and Cathie can chime in. China is softer than we'd anticipated. And it is actually across-the-board. We are seeing more rapid growth in tier 4 through 6 cities, a little less in the big areas. But it is reasonably soft demand across the board, at least as we see it. Do you want to add anything to that, Cathie?



Cathie Lesjak - *Hewlett-Packard Co - CFO*

Let me give you some data points. Networking in China, for us, was very strong. We saw very good growth year-over-year in Networking in China. And you all may not focus on this, but we do. We are the leading market share holder in China for Networking. So we're pleased with the results in Networking. And then in Printing, as well, on a local currency basis year-over-year, we grew revenue, as well. That's in the context of what Meg said, is that overall, the economy does seem to be slowing a bit.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Great. Thanks, Shannon. Next question, please?

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *BMO Capital Markets - Analyst*

Hello. Thank you. I wanted to see if you could give us update on the restructuring and the cost opportunities that still have yet to show up. And the reason I ask the question, it's not apparent that HP's getting material benefits from the cost restructuring activities. So if I look at the guidance for this fiscal year, your operating profit dollars are going to be down roughly \$1.5 billion, and that's assuming that you're getting cost savings that are flowing to the income statement of about \$1.5 billion. So why aren't we seeing more of this show up in terms of the income statement? Because I know, Meg, you've said that you're making some investments, but it seems like an extraordinary amount. And then how much still has yet to be delivered in terms of the cost actions, and will we see any of that show up? And that's it for my question. Thank you.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So Keith, let me give some update on the restructuring program. Of course, we've got two dimensions to it. Of course, we've got the labor and the non-labor. From a labor perspective, the restructuring remains on track. We had roughly 3,800 people leave under the program in Q3. On a program to date basis, that's roughly 22,500 people have left under the program. And we're on track to hit the 26,000, roughly, exiting under the program by the end of fiscal '13. So I would say good progress on the labor side.

On the non-labor side, we're on track in most areas and ahead in others. And so we're feeling good about the non-labor progress, as well. And it's really both the labor and the non-labor savings that's enabling us to compete and price more effectively in the market, and I think that that gets to kind of your second question. If you go back to our EPS guidance implied for Q4 specifically, that's roughly normal seasonality at the EPS line, but we don't have the same seasonal growth in the revenue line. And the difference between that is basically the savings that are getting generated under the labor and the non-labor restructuring efforts. That's what's cushioning the bottom line. If it weren't for those savings coming through, the results would be materially lower.

Keith Bachman - *BMO Capital Markets - Analyst*

I guess, Cathie, just to follow-up, if I could though, but the challenge there for investors is when the cost cuts run out, the pricing in the market will presumably still remain. How do we reconcile that with HP being able to grow its earnings over time? And then, sorry, I'll cede the floor.



Cathie Lesjak - *Hewlett-Packard Co - CFO*

Well, I think, Keith, part of the challenge, obviously, is the macro and our execution issues. These savings are, frankly, giving us the -- if I can call it, air cover or room and time to actually fix execution issues; and hopefully, over time, the macro environment starts to become a little bit easier. We're not planning on that when we think about '14, but it does give us kind of this time to fix some of our execution issues.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. Thank you.

Meg Whitman - *Hewlett-Packard Co - CEO*

The other thing I would add here is that while we are making these cost cuts, we are making investments that we think will result in revenue growth over time. And we have three segments of businesses. We've got businesses that are growing, businesses that are maintaining roughly flat, and then we have declining businesses. The mix is now quite heavily weighted toward declining businesses. Over time, that mix will shift because of the investments we're making and frankly, the market shift. So our mix of business is not helping us right now, but we think over time -- take Storage, for example, so our Converged Storage business is growing very rapidly. The traditional Storage business is shrinking. At some point, the Converged Storage gets bigger than the traditional Storage, and then you have a growth story in Storage. And that actually is a metaphor for the whole company.

So it's a financial architecture that actually works in our favor over time. But to your point, we have to continue to be vigilant about costs, we have to restructure our business, we have to make this very large company as lean and efficient as we possibly can. And some of the organizational changes that I announced today, I think there's more efficiency that we can gain from combining Marketing and Communications. And we need to think through new models for delivering what our customers want and being laser-like focused on that, and not doing a lot of other things that aren't laser-like focused about the places that we can win and then how we're going to win there.

Keith Bachman - *BMO Capital Markets - Analyst*

Right, right. Okay. Thanks, guys.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Thanks, Keith. I think we've probably got time for maybe one more.

Operator

Ananda Baruah, Brean Capital.

Ananda Baruah - *Brean Capital - Analyst*

Hello. Thanks, guys, for taking the question. I guess to that end, can you give us a little bit of a sense of what's -- maybe a preview, if you will -- of what the opportunity for cost savings might be going forward? Presumably, we are going to get market forces that are going to continue to be pretty aggressive across a number of segments. So even if you give us something anecdotal, that would be helpful. Thanks.



Meg Whitman - *Hewlett-Packard Co - CEO*

So listen, we have done, I think, a very good job of identifying areas of cost savings. Cathie very accurately described the labor savings. We have a non-labor program also in place, and we continue as we are in place. And consistency of leadership for Hewlett Packard is so important, because you actually have one year to the next of learning behind you and an ability to see things that you might not have seen even two or three years ago. So listen, I think there's still opportunity for us in how we support the sales force. Sales operations is an opportunity for us. How we are organized between product marketing and category management and product management versus what takes place in the field versus what takes place in the business unit. How do we leverage our key accounts, our big accounts, between ES and the Enterprise Group? So I think there is a next generation, if you will, of learning how we can be more efficient.

You also have to remember, this Company was the product of many acquisitions, going all the way back to Compaq, EDS, Arcsite, Tipping Point, Fortify, Opswear, you name it. And while there were many acquisitions that I think were integrated well, not all of them were fully integrated in such a way that we had the right ERP systems, et cetera. So I think you'll see pockets of growth over the next year, as we continue to work on this. And I think we continue to take out costs.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

And we will talk a lot more about this at our security analyst meeting in October, when we really lay out all of the different elements of the fiscal '14 plans. And continued cost reduction will certainly be prominently featured.

Meg Whitman - *Hewlett-Packard Co - CEO*

But let me -- I think we're ready to close. Okay. So listen, I feel very confident in our turnaround. This is a journey. We have achieved a lot of milestones along the way, and I'm confident we're on the right track. And I'm really excited about this new management team and what we're going to accomplish for the benefit of customers, shareholders and employees. So I feel like we're on track and things are headed in the right direction.

Rob Binns - *Hewlett-Packard Co - VP, IR*

Great. I think we're done. So with that, we'll conclude the call. Thanks very much, everybody.

Operator

Thank you, ladies and gentlemen. This concludes our call today.

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