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HPQ - Q4 2013 Hewlett-Packard Earnings Conference Call

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OVERVIEW:

Co. reported 4Q13 revenue of \$29.1b, non-GAAP operating profit of \$2.6b and non-GAAP diluted EPS of \$1.01. Expects FY14 GAAP EPS to be \$2.85-3.05 and 1Q14 GAAP EPS to be \$0.60-0.64.



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter 2013 Hewlett-Packard earnings conference call. My name is John, and I will be your conference moderator for today's call.

(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 of IR*

Good afternoon. Welcome to our fourth-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, HP's effective tax rate, cash



flow, 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 FY13 form 8-K. Revenue, earnings, operative margin, 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' webpage 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.

What the final quarter of our fix and rebuild year now behind us, I'm pleased with our progress in fiscal 2013. As we said when we laid out our five-year plan, we expected that our turnaround would not be linear, and we saw that during the year. However, as I reflect on the key priorities we outlined at the beginning of 2013, driving innovation across HP, improving operations, aligning our cost structure, and rebuilding our balance sheet, we made great progress. We also saw some positive momentum in our execution, leading to pockets of revenue growth in key areas in Q4.

The fourth quarter capped a year of significant innovation at HP. We launched OneView, a revolutionary consumer-inspired infrastructure management platform that allows customers to dramatically improve data center operations while reducing cost. We introduced the new StoreVirtual storage appliance, bundled with our industry-leading ProLiant servers, underscoring our leadership in the software-defined storage market. We also launched version 7 of the HP Vertica Analytics Platform, which dramatically simplifies analysis of semistructured data. And just last week, we announced a partnership with Salesforce.com to create the HP/Salesforce Superpod, a dedicated instance of Salesforce running exclusively on HP's converged infrastructure.

In addition to the product innovation happening across HP, we are driving significant business model innovation as well. In printing, we are seeing success with our Ink Advantage program and our newly-launched Instant Ink offering. In software-defined networking, we launched a new App Store that, coupled with our network developer kit, will create the industry's first enterprise-class open ecosystem.

As you all know, in fiscal 2013, we focused on improving our operations, driving better cash flow, and rebuilding our balance sheet. These foundational improvements were critical early steps in our turnaround, and I'm extremely proud of the results we've delivered in this area. In Q4, we brought our cash conversion cycle down to 17 days and delivered free cash flow of \$2 billion. For the full year, we delivered more than \$9 billion of free cash flow, well above our most recent outlook of about \$8 billion. We reduced operating company net debt by more than \$1 billion for the seventh consecutive quarter, and as a result, we achieved our operating company net debt goals ahead of plan.

We also ramped back up our share repurchase activity in the fourth quarter, and returned a combined \$763 million to shareholders in the form of share repurchases and dividends. More importantly, we once again achieved the non-GAAP diluted earnings per share we said we would, delivering \$1.01 in the fourth quarter and \$3.56 for fiscal 2013, at the high end of our most recently provided outlook. Looking forward, we will stay committed to smart capital allocation and profitable growth. As we said at our security analyst meeting last month, we believe we can grow both margin and share over the longer term. We'll continue to be aggressive in targeted cases, but we have more opportunity to improve our profitability.

Now, let me turn to our business group performance in the quarter. Overall, results in Q4 were driven by strong performance in Printing, revenue growth in the Enterprise Group, improved revenue performance in Personal Systems, plus continued execution in Software and Enterprise Services. Our Printing business delivered an excellent quarter with continued strong profitability. We outperformed the market for the second successive quarter, gaining 4 points of total unit market share over the prior year. Revenue for the quarter was down 1%, but we saw growth of 1% in constant currency. For the second consecutive quarter, we grew unit placement, which was up 6% over the prior year, driven by strength in laser volume and our SMB home business. Our managed print services business also had a good quarter, with double-digit TCV growth driven by our partner program.

In Personal Systems, we outperformed the market with particular strength in our commercial PC business. Revenue for the quarter was down 2% over the prior year, but flat in constant currency, against the backdrop of a market declining 9.5% in units in the third calendar quarter. Overall, we gained 1.8 points of share over the prior year and 1.2 points sequentially. As a result, we improved our share position in all three regions. In the fourth fiscal quarter, HP saw its first unit growth since the first calendar quarter of 2012, even as the market saw a continued decline in units.

Our commercial PC business grew revenue 4% over the prior year, driven by commercial notebooks, with our EliteBook Folio doing particularly well. The Personal Systems Team did a good job managing the DRAM challenges in the quarter, but we expect upward cost pressure will create a headwind in the first quarter of fiscal 2014. We continue to manage the end-to-end cost structure of our Personal Systems business, with profitability very much in mind.

In Enterprise Services, the business is now more predictable, and we continue to execute well against our recovery plan. ES revenue was down 9% for the quarter and down 8% for the full year, well within our previously-provided outlook range. Operating margin in the fourth quarter was 4.4%, resulting in operating margin of 2.9% for fiscal 2013, at the high end of the target range for the year. In Q4, bookings were up over 30% over the prior year, driven by strong renewals. At the end of fiscal 2013, trailing 12-month book to bill was approximately 1, in line with our guidance at last year's security analyst meeting.

Looking to fiscal 2014, we are focused on the salesforce retooling program that we outlined at our security analyst meeting. We will continue our relentless attention to cost and productivity as the delayed revenue runoff puts further pressure on our fiscal 2014 services revenue.

In the Enterprise Group, we saw revenue growth of 2%, the first time we have grown revenue in eight quarters. We saw improved sales execution, a strong hyperscale quarter, and stabilization in Blades, complemented by revenue growth in networking and storage. Overall, margins were pressured by a competitive price environment and an unfavorable mix. Looking forward, we are focused on improving our channel performance, driving cost savings to improve operating margins, and bringing new innovations to market in converged infrastructure.

As we discussed last quarter, we made significant leadership changes in the Enterprise Group. Bill Veghte and his Leadership Team have hit the ground running, and the early signs are encouraging. In addition, last week, we announced that Martin Fink will assume responsibility for leading the HP cloud business as its General Manager. This is in addition to his role as HP CTO and Director of HP Labs. Martin is a true technology visionary who brings tremendous understanding of the enterprise hardware and software space, extensive experience in platform development, and he literally wrote the book on Open Source. We believe Martin will help significantly accelerate our cloud business.

In servers we saw very strong growth in hyperscale over the prior year, driven by several key wins, although this did put pressure on our margins in the quarter. Our Blades business recovered as the benefits of our targeted segmentation and efforts to improve operational excellence paid off. We expect to gain over 1 point of share here and extend the market leadership position we have already held for 27 quarters. We saw improved sales in our mainstream server business, but we need to improve our pricing discipline and profitability. Although revenue continued to decline and business-critical systems, we expect to hold or gain share in calendar Q3. And we have announced plans to bring a 100% fault-tolerant HP nonstop platform to the x86 architecture.

In Storage, I'm very pleased with our progress. Total Storage product revenue grew 1% year over year, with good sequential growth. We saw another record 3PAR quarter and are very encouraged by the strong customer acceptance we're seeing. As a result, converged storage product revenue grew 47% over the prior year. Revenue declines moderated in traditional storage, driven by higher storage networking attach and sales of our recently refreshed entry products. With these results, we expect to once again gain share in the combined high-end and midrange markets.



In HP Networking, we saw 3% growth, driven by strong performance in China as well as growth in EMEA. We are also encouraged by our growth momentum in wireless LAN, and we will continue to focus on driving innovation in software-defined networking. In Technology Services, revenue was down, driven by lower hardware sales in prior quarters, particularly in BCS. However, I'm encouraged by the positive traction in new portfolio offerings, like Flexible Capacity Services and Proactive Care, new services that give customers cost-effective flexibility in their data center while ensuring they can manage spikes in demand.

In Software, disciplined cost management resulted in operating profit of 30.8% for the quarter. Revenue decreased 9% over the prior year, although we had a tough compared to a large General Motors deal last year. However, the Software Team did grow in a number of areas, including good growth in cloud and automation and SaaS bookings, double-digit growth in security, after normalizing for the impact of the General Motors deal. And in Autonomy, we continue to make progress and saw the second successive quarter of sequential licensed revenue growth.

Now, let me turn to our future outlook. Overall, I'm very pleased with the progress we have made, but we still have a lot of work to do to drive consistent execution and navigate a rapidly-shifting marketplace. As we enter the third year of our turnaround, we will continue to execute against the improvement areas we outlined at our security analyst meeting last month, including increasing our commitment to research and development.

This work broadly falls into three buckets. The first is the shifting market forces. As an example, in Personal Systems, we are making progress on our mobility strategy, but we still have not broken through. Similarly, we are still in early stages of building an ecosystem to capture a greater share of personal device accessories and services.

Second is the changing competitive landscape. We need to keep the customer at the center of what we do and deliver comprehensive and innovative solutions as our competitors look to expand across the IT stack. And finally, the third bucket is our own ability to execute. At our security analyst meeting, we highlighted a number of areas where we need to execute better. For example, we need to do more work to fix our go-to-market strategy in Enterprise Group, particularly in channel engagement and pricing. On cost management, we are optimizing our service delivery in Enterprise Services, and as we reinvigorate our core software business, we must ensure we have the right back-office systems and operational excellence to support this effort.

As a result of both the challenges and the progress we're making, we expect first quarter non-GAAP earnings per share will be \$0.82 to \$0.86, and our full-year outlook is \$3.55 to \$3.75.

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.

In the fourth quarter of fiscal 2013, we generated revenue of \$29.1 billion, down 3% year over year and down only 1% in constant currency. Total FY13 revenue was \$112.3 billion, down 7% year over year, or down 5% in constant currency. We saw year-over-year revenue growth this quarter in Industry Standard Servers, Networking, Storage, and constant currency revenue growth in Printing. Personal Systems' performance was better than expected, and sales outpaced the market. Enterprise Services was broadly in line, and Software had a tough year-over-year compare, but continued to drive growth in key areas while expanding operating profit.

On a regional basis, America's fourth-quarter revenue was \$13.3 billion, down 2% year over year, or down 1% in constant currency. US revenue was down slightly, with declines also in Brazil and Canada, and America's full-year revenue declined 6%. EMEA fourth-quarter revenue of \$10.3 billion was down 4% year over year, or down 5% in constant currency. The Q4 EMEA environment remained tough, although sales declined less year over year than in Q3, and we saw growth in Germany and other pockets of Western Europe. Full-year EMEA revenue declined 9%.

APJ fourth-quarter revenue was \$5.6 billion, down 1% year over year, but up 4% in constant currency. In Q4, we saw strong growth in India, mostly due to our recent educational PC win in the state of Uttar Pradesh. This offset weaker China performance across many of our businesses, although networking continued to perform well in China. APJ full-year revenue declined 5%.

Overall, we're pleased with our fourth-quarter results. Revenue declines moderated, demonstrating the quality and the competitiveness of our portfolio. At the same time, we recognize we have more work to do on continuing to align our cost structure to support profitable long-term growth. Our Q4 gross margin was 23%, down 1.2 points year over year, and down 0.4 points sequentially. The year-over-year decline was mostly driven by competitive pricing environment and an unfavorable mix across the Enterprise Group, particularly in ISS.

Sequentially, the competitive dynamics in the Enterprise Group and Personal Systems were mostly offset by the seasonal uptick in Enterprise Services and an improvement in printing. Our full-year gross margin was 23.1%, down 0.2 points year over year, as the competitive pricing pressures in EG and Personal Systems were partially offset by margin improvement in Printing. Savings from our restructuring program in Enterprise Services and Technology Services were offset by revenue declines in those businesses.

In the fourth quarter, we had non-GAAP operating expenses of \$4.1 billion, down 1.4% year over year, and up 0.2% sequentially. R&D is down due to streamlined operations across the Enterprise Group and lower R&D expenses, specifically within BCS. Long term, we remain focused on investing in innovation across the organization, and in fact, we've added headcount in engineering in FY13. SG&A is up around 3.8% year over year, although that largely reflects the impact of our real estate gain in the prior-year quarter. We also made investments to improve operational efficiency, which are already driving significantly shorter quote turnaround time and improved win rates.

Total non-GAAP operating expenses in fiscal 2013 were \$16.4 billion, down 2.9% year over year. This reduction was mostly due to savings from our labor restructuring initiative and our ongoing efforts to better align costs with revenue. For the year, across cost of sales and OpEx, we saw labor savings of approximately \$2 billion, slightly below the range we estimated for you at the beginning of the year. But total savings, including non-labor, were in line with expectations. We are continuing to look for further cost savings, and while we are still in the early stages, we believe there may be incremental opportunity.

Our fourth-quarter non-GAAP operating profit was \$2.6 billion, down 16% year over year, but up sequentially 14%. We recorded \$103 million of expense on the other income and expense line, a decline from the prior year, due in part to currency gains in the quarter. With a 22% tax rate and a share count of 1.94 billion shares outstanding, we delivered fourth-quarter non-GAAP diluted earnings per share of \$1.01.

Fourth-quarter non-GAAP earnings exclude pretax charges of \$371 million for restructuring and \$317 million for amortization of intangible assets. For the full year, non-GAAP diluted earnings per share was \$3.56, which is at the high end of the \$3.40 to \$3.60 outlook we provided at our security analyst meeting in 2012. Full-year non-GAAP earnings exclude pretax charges of \$1.4 billion for amortization of intangible assets, \$1 billion for restructuring, and \$22 million of acquisition-related charges.

Turning to the Business units. We're very pleased with the fourth-quarter performance in Printing. The initiatives we've begun executing to increase printing relevance, drive high-usage units, and improve unit shares are paying off. Q4 revenue of \$6 billion was down 1% year over year, but up 1% in constant currency, as hardware unit growth offset declines in supplies. Total unit shipments grew 6% over last year, and this was the second quarter in a row of year-over-year unit growth, and as Meg said, we continue to gain share. We are seeing great results with Ink in the Office, which helped drive Q4 SMB hardware sales up double digits, and Ink Advantage had strong performance across all regions.

In the laser market, in calendar Q3, HP grew at over twice the rate of the rest of the market, and graphics revenue grew to a record level in Q4. Within graphics, digital press, which includes Indigo saw a double-digit growth. Printing operating profit was \$1.1 billion, or 17.7% of revenue, up 0.2 points from the prior-year period. Unfavorable yen impact and operational improvements were mostly offset by lower supplies mix.

Commercial hardware revenue grew 5% year over year, while units grew 9%, driven by strength in transaction laser, Managed Print Services, and graphics. Consumer hardware revenue grew 7%, while units grew 4% year over year in Q4. Officejet Pro X, a great example of our recent innovations, is seeing strong customer traction. Supplies revenue declined 4% from the prior-year period and made up 63.9% of Printing revenue. Supplies declined only 0.5% on a constant currency basis. The Team executed well in the quarter, and supplies channel inventory levels are back down within our targeted range.

Personal Systems performed better than expected in the quarter, driven by commercial sales and supported by the India PC deal I mentioned earlier. Fourth-quarter revenue was \$8.6 billion, down just 2% over prior year, and almost flat in constant currency, reflecting the good progress



Dion is making. Total unit shipments grew 2% year-over-year in Q4, with growth in both consumer and commercial. Consumer sales declined 10% year over year, but grew 19% sequentially, while commercial revenue grew 4% over prior year, and 8% sequentially. Personal Systems operating profit of \$259 million, or 3% of revenue, was down 0.5 points over prior year.

As we discussed in our recent analyst meeting, we remain focused on improving long-term profitability and returning this business to growth. Our channel partners are key to helping us succeed, and we continue to seek opportunities to make it easier to promote and sell HP products. For example, we are expanding our receivable programs to support the demand of our resellers and distributors. Our fourth-quarter Enterprise Group results proved that we can be competitive across our portfolio, but we still have work to do so that we can continue to win deals at the right margins.

EG revenue grew 2% year-over-year to \$7.6 billion in Q4, with growth in Industry Standard Servers, networking, and storage. Operating profit was \$1.1 billion, or 14.5% of revenue, down 2 points from last year. We experienced competitive pricing, particularly in ISS and networking, higher cost of service delivery in TS, and an unfavorable margin mix from strong hyperscale revenue. In general, the pricing environment remains similar to Q3, with continued aggressive pricing specifically in ISS, and to a lesser extent, in networking.

By business, Industry Standard Server revenue grew 10% year over year to \$3.5 billion, significantly outpacing the market, with strong sales in hyperscale, which grew by double digits, due in part to one large deal. Storage revenue grew 1% year over year to \$952 million, with very strong growth in converged storage, which represented 43% of total storage revenue for the quarter, up 13.5 points year over year. As Meg mentioned, we saw great traction with 3PAR, which grew 64% year over year. When you combine 3PAR, XP and EDA, you have a metric that adjusts for the planned product transition, and based on this, we outgrew the market again this quarter.

Business Critical Systems revenue declined 17% year over year to \$334 million, due to a declining UNIX market. Networking sales grew 3% year over year in the quarter to \$656 million, led by strong growth in China and more moderate growth across the rest of APJ and EMEA. Revenue in the Americas was down year over year, but we are taking action to improve results by targeting areas where we can win and deliver disruptive solutions. Technology Services revenue declined 6% year over year, to \$2.2 billion in Q4, or 4% in constant currency. We are moving to reduce reliance on traditional hardware businesses and offer new services to address the new style of IT.

The Enterprise Services business performed broadly, as expected in the quarter. Revenue of \$5.8 billion was down 9% year over year, due to the account runoff we discussed. ES operating profit of \$255 million, or 4.4% of revenue, was down 2.3 points year over year, as the revenue runoff offset continued improvements in productivity and underperforming contracts. By business, IT outsourcing revenue was \$3.6 billion, down 9% year over year, primarily due to runoff pressures, and we saw declines across all regions. Applications and Business Services revenue was \$2.2 billion, down 10% year over year, primarily due to softness in the Applications business.

Overall, we saw good momentum in signings and had strong renewal rates in our expiring contracts. Strategic Enterprise Services, which includes cloud, big data, application modernization, and security, grew double digits. As discussed at our analyst meeting last month, we are pivoting to a more proactive sales approach, and longer term, we are focused on building out our portfolio to push more aggressively with Strategic Enterprise Services.

Now, turning to Software. Overall, Software also performed in line with expectations, with good margin performance in the quarter. Operating profit for the quarter was \$328 million, or 30.8% of revenue. This was up 3.6 points year over year and 10.3 points sequentially, driven by great cost management and our efforts to exit low-margin Professional Service contracts while we continue to invest in innovation.

Revenue declined 9% year over year to \$1.1 billion on a tough year-over-year compare. You'll recall that last year in the fourth quarter fiscal 2012, we signed a General Motors contract. That is the largest customer deployment of HP software on record. Excluding that deal, revenue declined low single digits.

License revenue in the fourth quarter was down 24% year over year, as the shift to SaaS continues to impact us and given the large GM license deal last year. Support revenue grew 4% over the prior year, and Professional Services revenue declined 13%. SaaS revenue was up 15% over the prior year, with higher bookings growth across all business units, particularly in Autonomy, IT Management, and Fortify on Demand. We have received great feedback from our customers and partners on HAVEn, our big-data analytics platform, and going forward, we are focused on delivering new,



innovative solutions. Additionally, as described at our analyst meeting, we are focused on rejuvenating the IT Management business and expanding Autonomy.

HP Financial Services revenue in the quarter declined 6% year over year to \$912 million. Financing volume was down 3% year over year, with net portfolio assets of \$12.2 billion. Operating profit for the business was \$102 million or 11.2% of revenue. The return on equity in HP Financial Services continue to be strong at 18.9% for the fourth quarter and 17.8% for the full year.

Turning now to cash flow and capital allocation. We generated operating cash flow of \$2.8 billion in the fourth quarter and \$11.6 billion for the full year. This drove Q4 free cash flow of \$2 billion and fiscal 2013 free cash flow of \$9.1 billion, up 21% year over year. Our strong cash flow performance was driven by a disciplined focus on working capital throughout the year. In the fourth quarter, we were able to get the cash conversion cycle to 17 days, down 4 days year over year, through improvements in days payable and lower inventory days.

I'm pleased with the progress we've made this year, and we will continue to focus on working capital going forward. For example, we are making improvements to our payment terms with key suppliers. As we said at our analyst meeting, we believe a cash conversion cycle in the low 20 days is sustainable, although we continue to look for ways to drive a better result.

With this Q4 cash flow, we returned \$479 million to shareholders in the form of share repurchases, buying 21.5 million shares, and paid \$284 million in dividends. We ended the year with gross cash of \$12.5 billion and moved to an operating company net cash position of \$103 million. We reduced gross debt by over \$5.5 billion in fiscal 2013, and have improved our net debt position by over \$12 billion since the beginning of fiscal 2012. We are extremely pleased with the progress we've made on our goal of rebuilding our balance sheet. In fiscal 2014, we remain committed to the capital allocation priorities that we outlined at our analyst meeting in October.

Looking forward to Q1, at a macro level, the environment remains challenging and somewhat choppy. EMEA continues to be soft, and China and other high-growth markets continue to face pressure. We expect currency to be about a 1-point headwind year over year to revenue in Q1.

By business, in Printing, we will continue to invest in unit placements, where the lifetime return on the unit makes economic sense, and we expect to drive continued momentum in key strategies across ink, laser, and graphics. For Personal Systems, we expect a greater revenue decline in Q1 than Q4, as we will not have the same big deal benefit, and expect commodity costs to pressure margins. As we focus on profitability, this cost pressure may limit revenue upside.

In Enterprise Group, we expect revenue may decline from Q4 with a smaller impact from the large hyperscale deal we mentioned. However, we expect continued traction in converged storage, networking, and converged infrastructure. In ES, we expect the delayed revenue runoff from fiscal 2013 to negatively impact Q1 growth and put pressure on first-half results overall. Finally, in Software, we will accelerate our shift to SaaS and our Professional Services rationalization, while investing in our disruptive growth opportunities like HAVEn and security.

With that context, we continue to expect full-year fiscal 2014 non-GAAP earnings per share to be in the range of \$3.55 to \$3.75. For fiscal 2014 Q1, we expect non-GAAP earnings per share to be in the range of \$0.82 to \$0.86. From a GAAP perspective, we continue to expect a full-year GAAP earnings per share to be in the range of \$2.85 to \$3.05. And GAAP earnings per share for fiscal Q1 is expected to be in the range of \$0.60 to \$0.64. We don't guide quarterly cash flow, but note that we have several factors that will significantly temper cash flow generation in the first quarter, including our annual bonus payments and accelerated restructuring payout.

With that, I'll open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)



Katy Huberty, Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

Thanks, good afternoon. What do you attribute the improved unit performance in PCs, printers, and servers, if you can just walk through those three segments? And more importantly, does the fiscal fourth-quarter revenue performance give you any confidence that there is at least an opportunity to actually perform better on the revenue line than you had originally planned for fiscal 2014?

Meg Whitman - *Hewlett-Packard Co - CEO*

Hi, Katy. It's Meg. Let me take that, and I'll let Cathie chime in as well.

So let me answer your last question first. I think the characterization of the business that we laid out at the security analyst meeting just 6 weeks ago remains the same. Obviously, there was real acceptance by our products and services in Q4, so we're encouraged by that. But we've got macro economic headwinds almost across the board, and we still have a lot of work to do in our go to market. So I think it's prudent to characterize the business the exact same way we did at the security analyst meeting.

In terms of units, in our printing business, you'll recall we have to look at the total lifetime value of a unit that we place the market. And we, over the last couple quarters, have been aggressive now at placing units that have a positive lifetime value. And we're going to continue to do that because that's an investment in the future of that business.

In the server business, listen, we strengthened our go to market in just the last 6 weeks of the quarter. I think we were more focused on market segmentation. We did a better job with the channel. Of course, we would've liked to have see more margin drop than we did in EG. But listen, I'm encouraged by the fact that we got more aggressive, we had good quality, and I think our products were very well accepted, and I know we can do better in terms of managing the margin.

We're capable of more, and we recognize that we've got more work to do. And whether that's around customer segmentation, optimizing our cost structure, more bundles to get a better blended margin, we know what to do and actually are in progress with that as we head into Q1.

Cathie, do you want to add anything to that?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

I think the only thing that I would add is that in the PSG space, it was heavily skewed to commercial units, which is really where we're seeing more of the mix to shift. And that's been going on now for probably the last couple of years, but certainly a pretty strong shift in fiscal 2013, and we expect that to continue into 2014.

And then IPG, it's really Ink in the Office that helps really drive unit placements. Those are good quality units, high usage units. Multifunction printers, the fact that we've got a pretty -- almost entirely new product lineup is also helping us there.

And then graphics, we had a very strong quarter in graphics, especially when you look at Indigo. And so I would say that in IPG, from a unit placement perspective, we're really hitting on almost all cylinders here.

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

Great. Super. Thanks, Katy for the question. Next question, please?

Operator

Ben Reitzes, Barclays.

Ben Reitzes - Barclays Capital - Analyst

Yes, good day, afternoon. Thank you very much. I just wanted to talk a little bit about the margin sustainability in Printing and how it foots to your guidance for the next quarter and the year.

That there seems like there was major yen benefit in the quarter, and while the operating margin year over year was only a little better, I think it was much better than people expected. So I wanted to foot the margins in Printing to the first quarter in the year and see if you can keep up this level of outperformance. And what you're going to do about pricing and hardware, why not get more aggressive? Thanks.

Cathie Lesjak - Hewlett-Packard Co - CFO

Thanks, Ben let me start with that. As we shared at the security analyst meeting, we are expecting a positive year from an EPS contribution perspective from IPG. As we laid out there, we expect somewhere between \$0.07 and \$0.11 of incremental EPS before they get their share of the \$0.12 of investment.

And our strategies in the segment are paying off. We're really focused on driving print relevance. We're focused on driving high-usage units, whether that's Ink in the Office, Ink Advantage for the emerging markets, ink subscription for the developed markets. And then obviously, the multi-function printers and managed print services.

So we feel really good about the progress that we're making under those initiatives. And we think that that, combined with a disciplined approach to profitability, really looking at opportunities across the portfolio where we can simplify, unify or go to market, really make sure that the contra dollars are as effective as they can be. Ultimately, that that allows us to then focus on the cost side as well, and ultimately allow us to contribute this incremental EPS of \$0.07 to \$0.11 on a year-over-year basis.

Rob Binns - Hewlett-Packard Co - VP of IR

Great, thanks for that question, Ben. Next question, please?

Operator

Mark Moskowitz, JPMorgan.

Mark Moskowitz - JPMorgan Chase & Co. - Analyst

Yes, thanks. Good afternoon. I wanted to touch base here on margin as well, but more from an OpEx perspective at the consolidated level.

SG&A seemed to be a little higher than I would've expected. Is there some sort of accelerated comp that's being revived in the company model?

And then R&D seemed and a lot lighter than I would've thought. Is that a one-off, or is that a sign that maybe PCs and printing are a lot less R&D intensive going forward, and so we could see that line item in terms of R&D, that run rate start to really continue to drift lower? Just trying to get a sense of how we should think about those two line items as we go into fiscal 2014. Thank you.



Cathie Lesjak - *Hewlett-Packard Co - CFO*

So let me address the R&D question first. So as you look at the year-over-year declines in R&D, that was really driven by two primary things. One is the rationalization of R&D, specifically in EG for business-critical systems, so that we really align the R&D investment in that space with the long-term business realities of the UNIX market. And then also, we did get some, what we call the R&D value-added tax subsidy credits that come through, and those basically offset some of the R&D expense.

And when I step back and say, okay, what should you take away from what we're doing in R&D, the first is, innovation is still at the core of Hewlett-Packard. That ultimately, and I think I said this in my prepared remarks, our number of engineers which are at the core of what's going to drive innovation are actually up year over year. And then finally, if I go back to the security analyst meeting, we expect that R&D will be up across most of our segments -- major segments next year and in total at the HP level. So we're still very much committed to driving the right R&D at the right time and the right place.

And then from an OpEx perspective, there's a little bit of volatility in the OpEx, but specifically if you look in SG&A. We had, I guess you'd say a tough compare to last year this quarter because we did have some gains from property sales that obviously don't repeat themselves, or didn't repeat themselves in Q4 of this year.

And then also, we are making investments for improving operational efficiency. And some of that shows up in SG&A as well, and it's showing up a little bit in, obviously, quicker turnaround times from a quote perspective, and that's leading to better win rates. So we believe that we're making the right set of investments in that space as well.

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

Great, super. Thanks for the question, Mark. Next question please?

Operator

Toni Sacconaghi, Sanford Bernstein.

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

Yes, thank you. I was wondering if you could provide us with an update on your cost savings, mainly in terms of number of positions that had been reduced.

Cathie, you mentioned that there are incremental opportunities possible in cost cutting as you look into 2014. Are those labor or non-labor, and can you give us any sense on how big they are?

And then finally, on cash conversion, you're at 17 days. You think sustainable is low 20s. How -- if that's really the case, how does cash flow equal or be better than net income next year?

Meg Whitman - *Hewlett-Packard Co - CEO*

So, Toni, let's start with the restructuring program. Our restructuring program is really on track. At the end of fiscal 2013, on a program-to-date basis, roughly 24,600 people exited under the program, so that's just under 13,000 in fiscal 2013.



As we talked about at the security analyst meeting, our current plan is to end at the end of 2014 at the high end of our range, so 29,000 plus 15%, so somewhere between 33,000 and 34,000 people. We expect incremental labor savings in 2014 of \$1.1 billion. That's on top of the little bit over \$2 billion that we delivered in 2013.

And as you mentioned and I mentioned, is that we are continuing to aggressively look at whether or not there are incremental opportunities. And we've got some work still to do to really vet those, but we do think that there may well be some additional opportunities.

One of the things that is a lot more difficult now than it was a year ago is that we're looking at business processing re-engineering and really going after cost that is what I would consider it not low-hanging fruit. And so it takes us a little longer to really vet through exactly what that's going to look like over the course of the year, but we will update you as we finalize that.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Cash conversion cycle, 17 days. Very pleased with that performance, but we do still believe that the long-term sustainable is in the low 20s, so 20 to 21 days. And in terms of free cash flow, I don't have a change to the outlook that I provided for 2014 at the security analyst meeting. We still expect it to be in the \$6 billion to \$6.5 billion range.

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

Great. Thanks for that, Toni. Next question, please.

Operator

Jim Suva, Citi.

Jim Suva - *Citigroup - Analyst*

Thank you, and congratulations, Meg and Cathie, to you and your Team there at HP. A clarification item is your outlook you reiterated, which is fabulous next year for earnings. And you mentioned since your security analyst meeting in October, which was 6 weeks ago, much of it has remained the same and challenging. But us as investors and analysts take a look at it, and it actually appears as if China has actually slowed a little bit more via the outlooks and results of IBM and Cisco and many other companies, but again you're reiterating.

So the question is this, is something causing you to outperform a little bit stronger and offset that more challenging environment in China? Or back in October, 6 weeks ago, did you already foresee what Cisco and IBM were seeing, or simply does China just not impact you quite as much? Thank you.

Meg Whitman - *Hewlett-Packard Co - CEO*

So, Jim, we flagged weakness in China last quarter, and China does remain soft across many of our businesses, although we saw growth in Enterprise Group led by very strong performance in networking in China. You also probably read that we recently appointed a new executive to run in China for us, a fellow by the name of Robert Mao. And he is in the newly-created role of Chairman of the China Region.

We've actually created a fourth region, and China now reports directly to me, and I think that is going to help energize our overall efforts in China and drive a uniform strategy and a quite differentiated report. So listen, we have a big business in China, so if China is soft, we're going to feel the effects, but we've been flagging this for some time, and I feel like we've got the right outlook on China for 2014.



Jim Suva - Citigroup - Analyst

Thank you very much.

Rob Binns - Hewlett-Packard Co - VP of IR

Great, thanks. Next question, please.

Operator

Steve Milunovich, UBS.

Steve Milunovich - UBS - Analyst

I was curious about your improvement in storage. How much of that is related to selling storage as part of converged infrastructure? I'm assuming you still sell quite a bit of storage in a best-of-breed mode where it might be hooked up to somebody else's server or whatever.

But I think Bill had said at the analyst meeting that in general, converged infrastructure was something like 10% to 15% of your compute sales, if you will. And I'm just wondering how much of the storage success is because it's being sold in a single box, if you will?

Cathie Lesjak - Hewlett-Packard Co - CFO

Thanks for the question. So most of the suspects that we're seeing in storage is in our converged storage solutions, but that's not -- a heavy piece of it is not from selling converged infrastructure. It really is a best-of-breed. And it's really in the mid range, the 3PAR midrange solution.

And this quarter, we also saw really nice growth in the 3PAR high-end solutions as well. And you might note that at some point soon, we're going to -- our storage business, our converged storage solutions are actually going to cross lines. And they're going to become a bigger piece of the storage business.

As I mentioned in my prepared remarks, as of Q4 we are at 43%. Sometime in the first half of fiscal 2014, we will -- converged solutions will be more than 50% of storage, and that will allow us to continue to accelerate growth in the storage space.

Meg Whitman - Hewlett-Packard Co - CEO

And Steve, it's Meg. With regard to converged infrastructure, you will recall, this was our term, our definition, and our vision for the market, and we are going to continue to aggressively pursue that. I think Bill was right, it's probably 10% to 15% of the total components are sold at a converged infrastructure format. But I think it's changing pretty fast because converged infrastructure is the backbone of the cloud.

So we're coming to market with HP OneView -- I talked about that my opening comments -- which is a new management plane that links our server storage and networking together in a very consumer-friendly way. It's almost a consumer UI design for the enterprise. And then, of course, we're working very hard on improving our bundles and our go to market around converged infrastructure, so I think that actually that move in the market is going to accelerate it. Accelerate it, and we're going to actually try to drive that even harder than we have.

Steve Milunovich - UBS - Analyst

Thank you.

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

Thanks, Steve. Next question, please.

Operator

Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Great, thanks. Could you give us a bit more color on how we should think about the steady state for profitability versus revenue growth in the Enterprise Group, particularly in servers. Obviously, you're able to gain quite a bit of share in Industry Standard Servers this quarter, but you did have the fairly hefty margin hit year-over-year. So can you walk through whether or not we should view this as a trend over the next few quarters, or is this more of a one-time issue given the hyperscale performance you discussed earlier?

Meg Whitman - *Hewlett-Packard Co - CEO*

So, Bill, we've thought a lot about this, and in my view, market share and profitability are not mutually exclusive as we believe we can grow both concurrently over the long term. And margins will be managed a lot more effectively, I think, by refining our customer and market segmentation to focus on those segments that we can grow profitably. We still have work to optimize our end-to-end cost structure, that is all the way from designed to logistics, and obviously, offering more bundled solutions.

So I think, listen, we have to be very careful about transaction-only business because it's generally not sticky, so we don't want to trade profit for market share that isn't sticky over time. So listen, I think we've improved our ability to see what's actually going on, to manage it, and now there's clear direction to the Sales Team about how we want to manage this. So I -- my belief is this is not a trend, that we ought to be able to reverse this trend to some degree. That said, obviously, a very competitive pricing environment, but I feel good about our ability to do a better job in the future of managing margin in ISS.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Let me just add that our view of margins and EPS contribution from EG has not changed since our security analyst meeting. And at that time, we talked about the fact that EG would be somewhere between \$0.01 dilutive to \$0.02 accretive to EPS before their share of the \$0.12 of incremental investment.

And that's really made up, if you look at the BU level, you've got BCS that obviously is continuing to come down. You've got both TS and ISS that we think of being relatively neutral. And then HP networking and storage growth and the profit margins that we see there, then, basically bring us up to basically this \$0.01 dilutive to \$0.02 accretive, and that has not changed since the security analyst meeting.

Bill Shope - *Goldman Sachs - Analyst*

Okay, great. Thank you.

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

Thanks very much. Next question please.

Operator

Kulbinder Garcha, Credit Suisse.

Kulbinder Garcha - Credit Suisse - Analyst

Thanks. A question on free cash flow I think for both of you.

And Cathie, you mentioned that your free cash flow targets remain the same, so that's guidance for this year, \$6 billion to \$6.5 billion, which would be down about 28%, even though income probably isn't going to be down anywhere near that. I understand working capital headwind potentially as the days there change, but what are the drivers? And that's my first question.

And the second one linked to that for both of you. If you have another year like you have had over the past 12 months where you are able to operate at these very good levels of cash conversion, where does the incremental cash flow go? Does it still gets split 50/50 between distribution and acquisitions, or do you actually do more in terms of buybacks? Many thanks.

Cathie Lesjak - Hewlett-Packard Co - CFO

Thanks. So let me start with the year-on-year, what's going on with free cash flow. And really, the big impact in free cash flow from a fiscal-year 2014 perspective is the working capital pressure. The fact that at some level, we actually pulled cash into fiscal 2013 by delivering a 17-day cash conversion cycle, and we will give some of that back when we move back to the 20- to 21-day range.

We also will see on a year-over-year basis CapEx pressure. Part of that CapEx pressure is due to better volumes in HP Financial Services, and then the other broad volume comment is there as well, and finally restructuring.

The restructuring cash payouts are significantly higher in fiscal 2014 than in fiscal 2013. And they are also more front-end loaded in 2014 than they were in 2013, so that leads me to something that I think is important to talk about, and that's Q1 cash flow.

Q1 cash flow, as you know, Q1 is typically our seasonally weakest cash flow quarter. It's going to be impacted by the working capital backup a bit and the fact that we've got these restructuring charges or cash outflows are a bit more front-end loaded. And then as is typical, it's also impacted by our annual cash bonus.

Kulbinder Garcha - Credit Suisse - Analyst

I'm so sorry. What would be cash restructuring this fiscal year, then cash restructuring?

Cathie Lesjak - Hewlett-Packard Co - CFO

So the cash outflow this year is \$1.4 billion in fiscal 2014.

Kulbinder Garcha - Credit Suisse - Analyst

Great.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

And then in terms of your question, okay, now that you've generated -- you've gotten back to a net debt position, the OPCO level that is actually a net cash position, does that fundamentally change your capital allocation strategy I think is ultimately what your question is. And the short answer is it doesn't, because at the end of the day, our strategy is a return-space framework with a long-term goal of a mid-single A. That still remains the same.

Now, it does give us a bit more flexibility because we had anticipated needing to reduce our net debt position further in the first half of fiscal 2014, and now we don't need to do that. But it still remains that we're returns based, and we'll look at the opportunities, whether they're share repurchase opportunities or M&A opportunities, and determine what is the best move for Hewlett-Packard and adding shareholder value.

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

Great, thanks very much. We've got time probably for two or three more, so next question, please?

Operator

Amit Daryanani, RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

Thanks a lot. Good afternoon, guys.

Just had a question on the Enterprise Group operating margin. It was down about 70 basis points sequentially. Maybe you could just touch on how much of that was really driven due to the mix headwind that you guys talked about versus the pricing dynamics that you have alluded to. And on the pricing side, do you think that issue becomes less severe now that one of your largest competitor in ISS MPC side, Dell, is a private entity?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So the declines in margin year over year in EG were a combination of both of a very competitive pricing environment and the unfavorable mix. And that's really what drove a lot of the declines on a year-over-year basis.

In terms of will the competitive environment continue to be competitive with Dell going private, our expectation and the way we're planning and modeling is that this environment continues to be very competitive. We are not expecting any change in any of our competitors stance from a pricing perspective.

Meg Whitman - *Hewlett-Packard Co - CEO*

And this is Meg. The way we have to win in our Industry Standard Server Group is obviously, we have to be a competitive -- we have to have a competitive cost structure. But we have to win through innovation, and whether that Moonshot or our next-generation of ProLiant servers or HP OneView or the way we bundle together for the benefit of our channel partners, that's the way we're headed here.

And so we're really focused on go to market and innovation, at the same time, making sure that we, from a server perspective, we look at end to end cost, how we design, how we source, how we ship. And how much of it is config-to-order versus build-to-order is also an important driver of cost.

And then, of course, focusing on SKUs. More SKUs means more inventory, means more logistics, and we've done a good job of actually focusing as we head into 2014.

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

Super, thanks. Thanks the question, Amit. Next question, please?

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. I actually had a question on a commercial PC market with your revenue up 4% year-over-year, I was curious as to -- that included the India units, I believe. But what are you seeing in terms of demand for a convertibles, tablets in the market? How much of this is end-of-life for XP, and how much of this to think is repeatable?

Meg Whitman - *Hewlett-Packard Co - CEO*

Well, I think, listen, we have focused a lot on the commercial business. We like our product lineup for 2014. I think it's too early to tell how the demand for convertibles is going, whether it's in the commercial space or the consumer space.

The Christmas season, we've got a lot of convertibles in the market. So do our competitors. And we're advertising behind those because we think that's a really innovative form factor that is the best of a tablet and the best of a PC, so I think we'll know more after we get through the Christmas season on the consumer side.

And on the enterprise side, I think this is all about price and lineup, as what we see in the enterprise is, CIOs are trying to match the device to the worker group and what they need. So maybe a certain group of workers just needs VDI. There are some who needs workstation, some who needs laptops, and whether they're backwards compatible to Windows, or whether they're Chromebooks depends on what kind of work that the team is doing. So that underscores our multi-OS, multi-architectural, multi-form factor strategy that is frankly as relevant in the commercial space as it is in the consumer space.

So we're cautiously optimistic, although we're not in the business of really forecasting the core PC business growth. We've been wrong over a couple of quarters on this, and listen, IDC and others are forecasting 4% to 5% down next year. And I think that's probably a good assumption going into next year.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

And Shannon, let me just clarify because it is a bit confusing. The PC win that we had in the state of Uttar Pradesh in India in our numbers is in consumer. It is not what's driving our commercial revenue increase. Now it's confusing because IDC puts it in commercial, so it's in the commercial share.

Shannon Cross - *Cross Research - Analyst*

Okay, that's very helpful. Just really quickly on end-of-life of XP, how are you thinking of that?



Meg Whitman - *Hewlett-Packard Co - CEO*

So we're leading, actually, the migration off of XP. And we actually -- I think Microsoft would probably tell you we're among the leaders in terms of spearheading that migration. Within on this for well over a year, and it's actually going pretty well.

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

All right, thanks. Next question, please?

Operator

Peter Misek, Jefferies. Peter Misek, your line is now open.

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

Let's take an alternative question.

Operator

Maynard Um, Wells Fargo.

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

Hello, thanks. Meg, you talked about, in terms of looking for a permanent Chairman of the Board, you've talked about having a lot more interest given the recovery of HP. I'm just curious where HP is in terms of finding a new permanent Chairman of the Board?

And following that, any indication of whether or not Ralph Whitworth would still continue to sit on the Board? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

Ralph, as you know, is Chairman of the Board on an interim basis. And he has stepped up to the plate beautifully, and we really are very grateful to his service. He's done a great job.

And he said the other day he'll continue to serve until we find someone else. So you should assume he is in place for the foreseeable future. And we're just delighted with his working relationship with Management Team, with the Board. He's made an outstanding contribution, so he'll be in place until we find someone else.

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

Super, thanks, Meg. Thanks for the question. One last question, please.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

Okay, thanks. I want to ask a question about the 3D printing opportunity. Meg, you've highlighted this as an opportunity and you seem genuinely interested in the market.

So what are your aspirations in terms of market position relative to your leading position in the traditional printing market? And you think you can reach that organically, or do you think you have to acquire an established player? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

So we intend to play in the 3D printing market because it is an adjacency. It's obviously different than paper printing, but some of the technology is the same. And at least as we sit here today, we anticipate entering this organically.

And what we're doing is focusing on, what's the value proposition by market segment, whether that be consumer or industrial. What's the competitive differentiation? And we've got some very interesting things coming, so stay tuned in 2014.

But this is an acorn, right? You've heard me say we've got to plant acorns, and they will eventually become oak trees. But you should think in 2014 and 2015, this is an acorn that maybe has very good long potential. But the market is at its earliest stages, and there's a lot of technology work that needs to be done to be able to print in the kind of timeframe that most consumers and most industries would actually find acceptable.

Brian Alexander - *Raymond James & Associates - Analyst*

Thank you.

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

Great, super. Thanks for that, and thanks everyone. I think with that, we'll conclude the questions. Thank you.

Operator

Ladies and gentlemen, this concludes our call for today. Thank you.

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