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## HPQ - Q2 2014 Hewlett-Packard Earnings Conference Call

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**OVERVIEW:**

HPQ reported 2Q14 revenues of $27.3b. Expects FY14 GAAP diluted net EPS to be $2.68-2.80 and 3Q14 GAAP diluted net EPS to be $0.59-0.63.





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## PRESENTATION

**Operator**

EventID. Good day ladies and gentlemen, and welcome to the Second Quarter 2014 Hewlett-Packard Earnings Conference Call. My name is Ellen, 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.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Good afternoon. Welcome to our Second Quarter 2014 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 per share, HP's effective tax rate cash flow, share repurchase, 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 amounts ultimately reported in HP's second quarter Form 10-Q. Revenue, earnings, operating 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 HP's investor relations webpage at www.hp.com. I'll now turn the call over to Meg.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Thank you Rob, and thanks to all of you for joining us today. With the first half of FY14 closed, I am pleased to report that HP's turnaround remains on track. As you would expect in a turnaround of this scale, there are some businesses performing better than we expected, and others with more work to do. We've made significant progress in putting the systems and structures in place to more effectively manage the business. We are focused on putting the right talent in place to lead the next leg of the turn-around.

Most of all, we stabilized the top line, and we're starting to see the benefits of our focus in investments in key technologies. We have more work to do to improve the consistency of our execution and lower our cost structure to drive overall profitability, but I believe we're well-positioned as we enter the second half of 2014. Rest assured, sustained profitable revenue growth remains our top priority.

Innovation is at the heart of our strategy to turn HP around, and in the second quarter you saw the launch of several critical elements of our innovation agenda. In cloud we launched HP Helion, a portfolio of products and services that enables the next phase of our enterprise customers' cloud journey. Helion is changing the game in cloud by allowing the integration of public, private, managed cloud, and traditional IT environments on an open and secure platform. We are addressing a major paying point for the enterprise customers with Helion, and the early interest has been very positive.

We also announced further significant business model innovation in our server business, with the creation of a joint venture with Foxconn. Together we're creating a new line of cloud-optimized servers, specifically targeting service providers. This partnership brings together the high-volume design and manufacturing expertise of Foxconn with the compute services brand and go-to-market leadership of HP. Together, we will redefine the infrastructure economics of the world's largest service providers.

In big data, we unveiled the HP Shark system for SAP HANA. This new converged system is designed to deliver higher levels of performance and availability for in-memory computing at up to twice the speed of other solutions. We saw strong sequential growth in our HANA offerings in the second quarter, and we introduced OpenNFV, a comprehensive network function virtualization program. This new program is designed to help telecom customers launch new services faster with less expense and lower risk. NFV is one of the most significant shifts the telecommunications industry has experienced in the last 20 years, and represents an important opportunity for HP.

As I have said before, we continue to see an acceleration of the massive shifts that are transforming the way customers buy, pay for, and consume technology. This reality is creating both opportunities and challenges for HP and every one of our competitors. To win, we have to continue to focus, and make HP a more nimble, lower cost, and more customer and partner-centric Company. We've made a lot of progress to that end over the past two years, but we still have more work to do in our structure, our systems, and our go to market.

In the second half of 2014, we will be accelerating these activities to ensure that we have the right structure in place as we enter 2015. As a result, we now expect up to an additional 16,000 employees will leave the Company under the previously announced 2012 restructuring program. This will bring the total number of employees leaving under the program to as many as 50,000.

No Company likes to reduce their work force, but the reality is that HP must be maniacally focused on continuous improvement in our cost structure. We believe this further alignment, along with the expected (inaudible - technical difficulty) investments in innovation and infrastructure set us up as a force to be reckoned with in the rapidly shifting markets where we compete.

Turning to the second quarter, HP delivered $0.88 in diluted non-GAAP net earnings per share, at the high end of our previously stated financial outlook of $0.85 to $0.89 per share. For the second consecutive quarter, total revenue for the Company was approximately flat in constant currency, and we once again delivered very strong cash flow, generating $3 billion in cash flow from operations.

Now let me turn to our business group performance in the quarter. Overall, results in Q2 were driven by solid performance in printing, networking, and personal systems, as well as disciplined cost management across all of our businesses. In personal systems, we have a very strong performance, with revenue up 7% over the prior year. Overall, we're seeing a slowing market contraction, and signs of stabilization, particularly in commercial PCs. This is coupled with support from a refresh of an aging installed base, and the expiration of Windows XP.

HP executed well in the quarter, particularly in our commercial PC segment. Overall, PSG operating margins improved, and we gained share, with good growth in Europe and Japan. We reclaimed the number one position in both commercial PCs and in desktops, all against the backdrop of a declining market.

Looking forward, I'm excited about the strength of our product lineup, and we will remain focused on profitable growth, and continuing to drive further action on our end-to-end cost structure. For the fourth consecutive quarter, our printing business once again out-performed the market and saw unit-placement growth; and we held or gained share in every major printing category and region on a year-over-year basis -- all while delivering another quarter of excellent profitability

In enterprise services, as expected, revenue was down 7% over the prior year, as delayed key-account revenue run-off from FY13 continued. The operating profit margin in ES was flat over the prior year, and up sequentially. We expect to see a continued ramp in margins in the second half, and Cathie will elaborate further on this in a moment. We remain focused on our proactive sales efforts in ES, and are in the early stages of this transition. But I can feel the increased confidence from our customers.

While total signings were down over the prior year, strategic enterprise services bookings growth is encouraging, and we saw good new wins in the quarter. For example, the US Department of Homeland Security awarded HP a cyber-security contract worth up to $32 million, and Belgian's Flemish government ordered a seven-year, EUR500-million contract to HP and Belgacom to offer ICT services to all local and provincial government entities. The program will give citizens access to information and services through a virtual private cloud solution.

We've made progress, but opportunities remain for improvement in services bookings, and we need to move faster and ramping up our cost savings and productivity initiatives. However, I'm confident that the leadership team is taking the right steps to get enterprise services back on track.

In the enterprise group, revenue declined 2% over the prior year, driven by lower technology services and storage revenue, as well as the expected decline in business-critical systems. This was partially offset by growth in networking and industry-standard servers. We continue to see a very competitive market in enterprise infrastructure. I am confident that the changes we've made in the leadership and go-to-market execution, coupled with cost-saving opportunities and our investment in innovation, have put this business back on the right path. However, we expect it will take a few quarters for these changes to consistently take hold.

In addition to the new products that I discussed earlier, I'm very excited about some of the innovations that will be rolling out in the second half of the year from our server, cloud, storage, technology services, and converged systems teams. We're doubling down on innovation in EG, because we believe that is how we're going to differentiate in these markets.

In industry-standard servers, revenue grew for the third consecutive quarter. The team continues to make progress on stabilizing this business and improving our cost structure and go-to-market. We continue to see good customer interest in Moonshot, with over 100 beta customers, and engagements through our Discovery Labs, and over 40 partners in the program. While we are seeing a ramp in Moonshot revenue, we don't anticipate this will become material in the near term. However, we believe Moonshot is on its way to becoming a disruptive product in a new category of servers.

The decline in business-critical systems moderated in the quarter. Revenue was down 14% over the prior year, and up 1% sequentially. Storage revenue was down 6% over the prior year, as customers appeared to pause to assess new products and market innovations. Despite the market, we still expect to gain a point of share overall. We have work to do to improve our go-to-market in this business, particularly our execution in the Americas. We've invested in additional storage sales specialists, but these take time to ramp to full productivity.

Overall, we remain very confident in our storage business. We believe our converged storage portfolio is well positioned to address shifting market forces, with products like 3Par, StoreVirtual, and StoreOnce. Networking performed well, with an acceleration of growth. Revenue grew 6% over the prior year, with strength in switching and routing. We saw growth across all of our regions.

As I have said many times in a turn-around, having the right people in the right place at the right time is critical. To that end, we recently announced that Antonio Neary has assumed Management responsibility for the networking business, in addition to his current role leading the server team. Antonio is a proven leader who has done an excellent job guiding our server business over the past several quarters, and our technology services business before that. Integrated systems are becoming increasingly prominent in the data center, and Antonio's new role will help us better align our compute and networking product strategies.

In technology services, revenue declined 5% over the prior year. The nature of this business means performance typically lagged hardware sales overall, so we expect revenue to stabilize in line with the progress we've made in our hardware sales. The leadership team in TS has done an excellent job managing this business, and we continue to see very good customer adoption of our new services, and margins remain strong.

In software revenue was flat over the prior year. Performance in the quarter was driven by growth in autonomy licensing, and strong double-digit growth in security and Vertica, offset by softness in our traditional IT management business. Looking forward, we will continue our transition to FAS, while rejuvenating our core portfolio, and investing in operational improvements across this business.

In addition, I've asked George Kadifa to take on a new role as Executive Vice President, Strategic Relationships. In this role, George will be responsible for leading growth initiatives and alliance programs with key partners, service providers, and our largest customers. After leading HP Software, George has gained a unique perspective on our strategic priorities of cloud, big data, security, and mobility. He understands both the customer requirements and the partner ecosystems that must be built to realize the potential of these technologies.

Robert Youngjohns will take over for George as the Executive Vice President and General Manager of HP Software. Robert is a very seasoned technology executive with more than three decades of experience. He joined the Company last year to lead the turnaround of HP Autonomy, after serving as President of Microsoft North America.

Overall, I am very pleased with the progress we've made, but we still have a lot more work to do. Our focus continues to be driving innovation, simplifying our organizational structure to speed decision-making, and reducing cost. These initiatives are particularly important as we continue to navigate a rapidly shifting market place.

Against that backdrop, our Q3 outlook for non-GAAP diluted net earnings per share will be $0.86 to $0.90. For the full year, the outlook will be $3.63 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. As Meg said, we feel good about where we are overall as we reach the mid-point of the turn-around. In Q2, total Company revenue was in line with expectations, with pockets of strength in PCs and networking. Enterprise group revenue was somewhat lower than expected, as storage revenue fell, although converged storage solutions continue to out-perform the market.

Total revenue for the quarter was $27.3 billion, down 1% year over year, and approximately flat in constant currency. By region, Americas revenue was $11.7 billion, down 6% year over year, or down 4% in constant currency. In the US, revenue was impacted by key account run-off in enterprise services, plus softness in laserjet printing, and in most EG business units. This was partially offset by strength in commercial PCs and networking.

In Brazil we experienced weakness across all of our businesses. EMEA revenue was $10.3 billion, up 4% year over year, or up 2% in constant currency, driven by growth in mature western European economies. We experienced double-digit growth in personal systems in EMEA, partially offset by declines in printing. APJ revenue was $5.3 billion, up 1% year over year, or up 6% in constant currency. We experienced revenue growth in China, primarily on the strength in enterprise group and printing. In Japan, personal systems revenue was very strong due to the XP migration.

Gross margin for the quarter was 24.2%, up 0.5 points year over year, and up 1.4 points sequentially. Year over year, strength in printing and improvements in enterprise services were partially offset by pressure from the strong revenue performance in personal systems, and weaker enterprise group margins due to a competitive pricing environment.

Sequentially, most of our businesses improved their gross margins, due to good cost management and pricing discipline. Total non-GAAP operating expenses for the quarter were $4.3 billion, up 3% year over year, primarily associated with incremental R&D investment. Sequentially, OpEx was up 6% on higher R&D investments, as well as a tough compare, due to the real estate gains we reported in fiscal Q1.

As a result, non-GAAP operating profit was $2.3 billion, or 8.6% of revenue, flat year over year, and up 0.1 point sequentially. We recorded $174 million of expense on the other income and expense line, with a 22% tax rate, and a weighted average diluted share count of 1.916 billion shares, we delivered second-quarter non-GAAP diluted net earnings per share of $0.88. Second-quarter non-GAAP earnings primarily excludes pre-tax charges of $264 million for amortization of intangible assets, and $252 million for restructuring charges.

Now turning to the business units. In printing, we saw very strong profitability, and further traction in key initiatives like Ink in the Office and Ink Advantage, as well as in graphics. However, weak toner sales continue to be a head wind, as the hardware installed base remains under pressure. We are focused on placing value-added units to support the installed base throughout the rest of FY14.

Total printing revenue was $5.8 billion, down 4% year over year, driven by a decline in supplies revenue, primarily related to lower toner sales. Commercial hardware revenue was $1.4 billion, down 1% year over year, while consumer hardware revenue was $566 million, up 1% year over year. Total hardware unit shipments grew 1% year over year.

Ink in the Office and Ink Advantage units and revenue each grew double digits, and we grew share in both ink and laser hardware units. Supplies revenue was $3.9 billion, down 6% over the prior-year period, and made up 66.3% of printing revenue. Although the mix is down a point year over year, ink is a greater part of the supply mix, which helped offset the negative impact of lower supplies on overall printing profitability.

Total printing operating profit was $1.1 billion, or 19.5% of revenue, up 3.6 points year over year. We saw a positive currency benefit of approximately 1.5 points in second-quarter margins, plus we realized some of the benefit from our focus on reducing non-labor costs and disciplined OpEx management. We expect to re-invest back some of these profits in value-added hardware units.

Supplies channel inventory levels remained very slightly above our target range. This was primarily due to softer toner sales in Europe, but we did make progress reducing overall toner channel inventory in the quarter.

The personal systems group had a strong quarter. Despite a contracting PC market, revenue in personal systems was up 7% year over year at $8.2 billion, driven by strong growth in commercial desktops and notebooks. Commercial sales grew 12% year over year, with consumer sales down 2%, although consumer notebook revenue grew slightly for the first time since the fiscal 2010 third quarter.

Total unit shipments grew 10% year over year, with growth in both commercial and consumer. Each segment out-performed the market. Total channel inventory remains well within acceptable ranges. Personal systems operating profit was $290 million, or 3.5% of revenue, up 0.3 points year over year, driven primarily by favorable mix, partially offset by competitive pricing.

Enterprise group revenue was $6.7 billion, down 2% year over year, or down 1% in constant currency, driven primarily by declines in technology services, storage, and business-critical systems. Operating profit in the quarter was $961 million, or 14.4% of revenue, flat sequentially, and down 1.4 points year over year, as the result of a continued competitive pricing environment, and increased investments, primarily in R&D.

By business, ISS revenue was $2.8 billion, up 1% year over year, with strength in EMEA and APJ. Sequentially, revenue declined on lower hyperscale mix after we completed shipping a large deal in the first quarter. Lower hyperscale mix and good pricing discipline drove gross margins up sequentially again this quarter. While the server market remains very competitive, we believe we are taking the right actions to improve our go-to-market, strength in our channel, and align our cost structure.

Technology services revenue was $2.1 billion, down 5% year over year. TS revenue continues to be impacted by past declines in hardware sales, but the strategy we have in place remains unchanged, and the team is making progress. Penetration rates were up year over year, driven by storage and networking attach, and we're seeing strong in our newer offerings like Proactive Care and Datacenter Care. Profitability in this business continues to be strong.

Networking performed well in the quarter. Revenue was $658 million, up 6% year over year, with strength in switching across all regions. We once again out-grew the networking market leader. Storage results, however, were disappointing. Revenue was down 6% versus the prior year period, at $808 million. Converged storage declined 3% year over year, and 3Par plus EVA plus XP also declined, but continued to out-perform the market.

While it's clear we aren't alone in experiencing weakness in the storage market, we also have an opportunity to improve execution, particularly in the US. We still expect converged storage to become greater than half of all storage revenue later this year, but we expect Q2 results to pressure overall storage revenue for the full year.

Business-critical systems revenue declined 14% year over year to $230 million, as strength in Mission-Critical x86 helped offset the continued impact from the UNIX to decline. Enterprise services revenue was $5.7 billion, down 7% year over year, primarily driven by continued key-account run-off.

By business, IT outsourcing revenue was $3.6 billion, down 7% year over year, and applications and business services revenue was $2.1 billion, down 8% year over year. Operating profit for ES was $144 million, or 2.5% of revenue, flat year over year. Sequentially, operating margins were up 1.5 points, driven by ongoing cost management, and continued improvement in our under-performing accounts. We expect to see continued progress in both of these areas in the second half of the year, as well as better top-line trends, as key accounts run-off tapers, driving a full-year operating profit margin within our outlook range of 3.5% to 4.5%.

Although total signings were down year over year, strategic enterprise services signings were up double digits once again, and we saw encouraging improvement in win rates. Our trailing 12-month booked to bill was slightly lower sequentially as we exited Q2. Signings can be lumpy, but we anticipate improvement in this metric during the second half of the year. Overall we're making progress on our sales transformation, and are seeing a better mix of new logos, but we still have more work to do to successfully pivot to a more proactive sales approach.

In software, revenue was roughly flat over the prior-year period, at $971 million, with better license revenue due to continued strength in our key focus areas of security and big data, offset by lower support revenue. License revenue grew 8% year over year, with strength in ArcSight, Fortify, Vertica, and Autonomy. Support revenue declined 4% year over year, as past license revenue declines continue to create a head wind.

Professional services sales grew 1% year over year, driven by strength in security and big data. SaaS revenue grew 6% over the prior year, and with strong bookings growth in IT management and autonomy. Operating profit was $186 million, or 19.2% of revenue, up 0.6 points year over year, primarily driven by continued gross-margin expansion in professional services, partially offset by increased investments in R&D.

We completed a small software acquisition in the quarter. Shunra provides network virtualization technology, and had no material impact on our financial results in Q2, and isn't expected to materially impact the full year.

HP Financial Services revenue was $867 million, down 2% year over year. Operating profit was $99 million, or 11.4% of revenue. While revenue continues to be impacted by financing volume shortfalls from FY13, new financing volume grew 12% year over year. The health of our portfolio of assets remained strong, and return on equity was 18.2%.

Turning to cash flow and capital allocation, we had another strong quarter, generating $3 billion in operating cash flow, and $2.3 billion in free cash flow. We continue to focus on working capital, and brought our cash-conversion cycle down to 13 days in the quarter, helped by a favorable mix with strong personal systems revenue, and the expansion of our factoring program.

Consistent with our efforts to improve our payment terms with key partners that I talked about in previous quarters, we increased net utilization in our factoring program by approximately $750 million in the quarter. However, we believe many of our customers would have taken advantage of early-payment discounts, so we estimate the actual benefit to cash flow to be approximately 1 to 2 days to our cash-conversion cycle. For the year, we continue to expect some up side to our original cash flow forecast, as I talked about last quarter, driven by working capital efficiencies. We further expect the expanded factoring program to provide some additional benefits.

In Q2, we accelerated our return to shareholders by repurchasing 26.7 million shares in the quarter, and paid $298 million in dividends. In total, we returned approximately $1.1 billion to shareholders in Q2, and we are still committed to our plan to return at least 50% of free cash flow to shareholders in the form of share repurchases and dividends for the full year. We improved our operating Company net cash position by approximately $1 billion for the ninth quarter in a row, and ended Q2 to with operating Company net cash of $2.7 billion.

Now looking forward to Q3. In printing, we'll continue to focus on placing value-added units, and expanding our innovative ink, laser, and graphics programs. We expect that toner will remain under pressure for the rest of the year. In personal systems, we expect the market to remain challenging, and that the upward pressure from higher component costs may limit our ability to pursue up side deals as we focus on profitable growth. Also, don't forget about the [Idaprotesh] deal from last year that will make for a tough revenue compare in Q3.

In EG, we have a strong team in place that is focused on aligning our cost structure, managing our margin profile, and improving our go-to-market execution across the businesses, while investing for long-term success. In ES, as I've talked about, we expect the ongoing actions we're taking to improve our cost structure and our under-performing accounts, along with the tapering of revenue run-off to result in better profitability in the second half of the year. In software, we expect to see continued traction in key growth areas like big data and security, while we invest in the business and manage our portfolio's transition to SaaS.

Across all of our businesses, competing and winning in today's challenging environment requires lean organizations with a focus on strong performance management. We're optimizing our work force, and re-engineering our business processes to both build a strong operational foundation, and create capacity for investments to drive future growth.

Through this ongoing focus, we have identified incremental opportunity, as I have signaled in the past quarter, and we now expect approximately 45,000 to 50,000 people to leave the Company under our announced 2012 restructuring program. This is up from our previous estimate of 34,000. We expect a total of approximately 41,000 people to leave by the end of fiscal 2014, with the remainder in 2015. We expect this to create additional run-rate savings in FY16 of approximately $1 billion per year, on top of what we previously laid out, although we expect some of this will be reinvested back into the business.

In FY14, we expect approximately $0.02 to $0.03 of incremental savings, an estimated incremental charge of approximately $500 million, and an additional cash-flow impact of approximately $200 million in the second half of FY14. We will provide further clarity on the specific FY15 impact to P&L and cash flow when we provide our outlook for the next year at our Security Analyst Meeting in October. As we said, we won't do additional restructuring at a corporate level after this program is complete. However, each business will continue to drive work force rebalancing, and will account for those changes within the segment P&L.

With that context, we expect full-year fiscal 2014 non-GAAP diluted net earnings per share to be in the range of $3.63 to $3.75. For fiscal 2014 Q3, we expect non-GAAP diluted net earnings per share in the range of $0.86 to $0.90. From a GAAP perspective, we expect a full-year GAAP diluted net earnings per share to be in the range of $2.68 to $2.80. GAAP diluted net earnings per share for fiscal Q3 is expected to be in the range of $0.59 to $0.63. With that, let's open it up for questions.

**Meg Whitman** - *Hewlett-Packard Company - CEO*

Thank you, Cathie. Before we go to questions, I am sure you all noticed that earlier today the HP press release with earnings went live before the appropriate time. We are sorry about that, and will make sure that doesn't happen again. Now we will go on to questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions)

Keith Bachman, Bank of Montreal.

**Keith Bachman** - *BMO Capital Markets - Analyst*

Yes, thank you. I have two, if I could. The first one, Meg, you are taking some incremental cost out of the system with the additional head count targets. It clearly says that you're -- it would seem to suggest that you're disappointed in some areas. Where specifically is the head count coming out of in the system? Where are the targets? Then I have a follow-up, please.

**Meg Whitman** - *Hewlett-Packard Company - CEO*

Sure. You will recall that this program goes back to FY12. We've actually increased the number of people who will leave the Company a couple of times during this program. Actually on earlier calls, we actually signaled that there might be more opportunity. I am actually not disappointed at all with how we're doing. We just see more opportunities to lower our cost structure, streamline our operations, without impairing our effectiveness -- in fact, making us a more nimble and decisive Company.

The longer I've been here, I see opportunities where we can become even better. That's the genesis of the program. It will be across almost all the business units and across all the geographies, and particularly in some of the functional areas that help the businesses grow. Listen, I am not at all disappointed. I think it's the natural course of what makes sense in a turn-around of this size and scale.

**Keith Bachman** - *BMO Capital Markets - Analyst*

Okay.

**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

The other thing that I would add real quickly is that it's going to create more capacity to invest. I think that's really important to HP. Because as Meg has talked many times, the turn-around, and our success in this turn-around, is going to be on the strength of the innovative products and solutions that we bring to market.

**Keith Bachman** - *BMO Capital Markets - Analyst*

Okay. On my follow-up then if I could, I wanted to turn to the printing business. I was a little bit surprised to hear you say the installed base seems to be declining with the good unit placements you had for last three to four quarters. It really speaks to the supplies. The supplies, I thought, was disappointing this quarter. It sounds like you're saying it's going to continue to be under pressure. If you could just flesh out a little bit more some of your comments on the printing business, in particular? Thank you.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Let me start with the comment about the installed base largely relates to laser hardware, and the softness in supplies largely relates to toner. Actually, ink is doing reasonably well. This actually goes back a number of years. You recall that we for about seven years didn't probably make the necessary product innovations in terms of the next generation of these machines in terms of multi-function printers.

It's also important, our managed print services business, we were late to that market and we're catching up fast. We are going to place the right units. We now have the right products -- not only for multi-function printers to direct customers and through the channel, but also importantly for managed print services. I think as Cathie said, we will see some softener in toner through the rest of the year, and then I think we'll start to see more normal patterns. I think Cathie wants to add one thing to that.

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

I think the absolute size of the installed base is one dimension, but it is also the quality of the installed base. If we place a unit today that has a much higher usage, like an Ink in the Office unit, or an Ink Advantage unit -- and that's replacing a unit that didn't have as high usage, we actually are doing exactly what we want to do. We've got to be focused on the size of the installed base as well as the quality.

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**Keith Bachman** - *BMO Capital Markets - Analyst*

Okay, great. Thank you.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks for the question, Keith. If we could have the next question, please?

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**Operator**

Toni Sacconaghi, Stanford Bernstein.

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

I wanted to follow up on the last question, in terms of the restructuring and anticipation of this. It just strikes me as odd that you have a 2012 restructuring plan that is doing significant incremental work force restructuring in 2015. My understanding originally was 27,000 was what was needed to right-size the Company. Then it went to 29,000, then it went to 34,000. Now it's going to 50,000. To me it feels like a whole new restructuring effort and a whole new outlook on the business. I can't help wondering why something so significant has come up relatively suddenly.

Moreover, I would like to get your input on your confidence for 2015, because clearly $1 billion in incremental savings is significant, and should be applauded. But is that a message that you are not as confident that you can grow EPS in 2015 without these work force re-balancings? In other words, do you think HP will grow in 2015? Is the reason for this incremental work force rebalancing because you have lost confidence, or you don't have as much confidence in the Company's ability to grow top line in 2015?





THOMSON REUTERS

**Meg Whitman** - *Hewlett-Packard Company - CEO*

Toni let me take that, and I will let Cathie talk about guidance. We're not actually going to give guidance today for 2015. But this actually has nothing to do with our confidence in the business. This has to do with really now understanding the opportunities that we have to make this company better. You've got to remember this Company was built over many years by acquisition. It has five major business units. We sell through 150,000 stores. We operate in 166 countries. As you look at our processes and you look at how we go to market, as you look at things like sales ops and marketing and frictional-less e-commerce, there are so many opportunities to improve this Company.

We went after the ones that were immediately obvious. But the longer I'm here and this Management team is here, the more opportunities we see. We think that's goodness. That's goodness because it is makes us easier for customers to do business with. It makes it easier, frankly, for employees to get things done here. By the way it has an added benefit of making us lower cost, so we're better able to compete in a new world order.

My view is I've done a number of turn-arounds in my career -- not at this scale, I will say -- but they are always -- you see more opportunities the deeper that you get in. I'm actually quite excited about the opportunities it provides. Cathie said it well. It does give us the capacity to bring money to the bottom line, but frankly also invest in the things that are going to have this Company grow in a sustainable way over the future.

**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Toni, I would add, we actually tried to signal this at the Security Analyst Meeting and on the earnings call last quarter, because we knew we were working feverishly to understand the re-engineering possibilities, and what kind of ramification that would have for the head count that we need to run this Company. Really what I view us doing now is finally getting to the point of quantifying for you all what that looks like. It has been work that's been ongoing since last year.

**Meg Whitman** - *Hewlett-Packard Company - CEO*

I'll just say in terms of revenue, I think the good news is we've seen revenue stabilization in the last three quarters. It wasn't that long ago where this Company was declining 7%, 6%, 9% quarter over quarter. We have had three quarters of basically flat growth. To me that's encouraging, because you've got to stabilize before you can grow. You can see the improvement in virtually all the different businesses.

**Rob Binns** - *Hewlett-Packard Company - VP IR*

Great. Thanks for the question, Toni. Next question, please?

**Operator**

Katie Huberty, Morgan Stanley.

**Katie Huberty** - *Morgan Stanley - Analyst*

Thanks. Given the services signings are coming in slower than expected, is this an area where it makes sense to acquire for growth. Then as a follow-up to that, full-year services margin guidance requires you to exit the year around 6%. Cathie, can you talk in more detail around where that meaningful improvement comes from over the next couple of quarters?

**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Let me speak to the signings and the revenue growth. I think as we said at SAM and as we've said quarter over quarter, we're in the early innings of the sales transition to drive a much more proactive sales approach. While total signings were down a bit year over year, the places that we want to grow -- what we call strategic enterprise services signings -- were up double digits once again; and we saw a very encouraging improvement in win rates; and actually signed over 200 new logos, which is actually a big turn-around for the sales organization over there.

We've got more work to do, but I am feeling confident that we are pivoting the sales organization to be more proactive. I think we're being invited to a lot more bids, if you will, than we had in the past; because I am seeing it every day, customers are much more confident in HP, and much more confident in our services business.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Katie, let me address the margin question. We have made good progress in improving on both our under-performing accounts as well as really realizing good savings out of productivity initiatives. We expect this progress will continue in both of these areas throughout FY14. If you couple that with better top-line trends, we do expect that we will operate -- have operating profit margins in the 3.5% to 4.5% for the year.

Again, we've got to continue to execute well. We've got to take advantage of the restructuring that the previous restructuring, that by the way is a bit accelerating; as well as this incremental program. But we are starting to get labor out of some of the protected geos, which tends to be higher cost. We're also focused not just on labor savings, but also on non-labor savings that come from better efficiency across processes, consolidating service centers, looking at data centers -- I'm sorry, I can't talk -- data-center automation, all of which will help us reach these margins of 3.5% to 4.5%.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks Katie. Next question, please?

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**Operator**

Ben Reitzes, Barclays.

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**Ben Reitzes** - *Barclays Capital - Analyst*

Hi. I've got to ask you to clarify your answer to Toni's question. Because with you getting $0.40 in run-rate savings by 2016, with such a big increase in the head count reductions, what are we supposed to do here? Are we supposed to raise our out-year numbers? We can't just wait for the Analyst Day. We kind of need to know what you guys are thinking. The $0.40 in 2016 means we have to raise our estimates, unless something really changes with the top line. I know you want us to wait for the Analyst Day, but a lot of us have got to make a decision by tomorrow. We really need some clarity there. I would also like to know on the free cash flow side, your preference for buy-backs versus acquisitions at this point of out-performance? Thank you.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Ben, I'm not exactly sure how to answer that question. You know that we don't provide guidance for the future until we get to our Security Analyst Meeting. That's really no different than what we have ever done. What I will say is that the growth savings of $1 billion is incremental to the $3.5 billion to $4 billion we announced for the 34,000. Those are gross savings. They are -- there is a cost to migrate some of that work, and so those are not the net savings. In FY14 we do expect the net savings from this incremental program is $0.02 to $0.03. Stay tuned for a FY15 update at the Security Analyst Meeting.

**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks Ben. Next question, please.

**Operator**

Amit Daryanani, RBC Capital Markets.

**Amit Daryanani** - *RBC Capital Markets - Analyst*

I have a question on the PC side. You've seen nice growth the last two quarters in a row, especially on the commercial side. Can you talk about how much of that growth is driven by Windows XP going end of life, versus more other factors in play, as you go through the rest of the year?

**Meg Whitman** - *Hewlett-Packard Company - CEO*

Yes, for the market overall, we're seeing some good signs of stabilization, particularly in commercial PCs, which was up 2% year over year. By the way, there's some strength in EMEA -- flat year over year for the first time in seven quarters. The market's definitely stabilizing. I think we are benefiting from the migration from XP to Windows. We saw that in spades in Japan. Had a very strong quarter in Japan as that migration took place. We actually think that migration's going to extend for some period of time, maybe other 12 to 18 months.

But we also see some momentum in what I would call a long overdue PC refresh; and frankly the fact that companies are realizing there's a need for a productivity tool that's different than just a tablet. Listen, I think we expect over time this is still to be a low growth to slightly negative-growth category. I think we actually have a bit of wind at our back over the next year to 18 months.

I also actually have to call out credit to our team, our leadership team led by Dion Weisler. They have focused on profitable growth, creating incredibly compelling products, very crisp market segmentation, leveraging our distribution strength in commercial and go-to-market, and really focusing on only doing profitable growth, not share for share's sake. It's a combination of all those things, I think.

**Amit Daryanani** - *RBC Capital Markets - Analyst*

That's helpful. Then a follow-up on the cost-cutting initiative that you're expanding this quarter. What is the comfort level that this is the final number and there shouldn't be another expansion for this? Since you've started in May of 2012, this number's close to doubled in total head count. Maybe talk about the comfort that this is it? Secondly, how does this play out for the morale of the Company, given the head-count cuts seem to almost accelerate a little bit every six months?

**Meg Whitman** - *Hewlett-Packard Company - CEO*

I don't anticipate an additional program. After the end of this program, obviously we are in the process of building productivity into the HP DNA into our business unit and function DNA. That productivity, that ever-ongoing quest for efficiency, will be borne by the P&L of each of these different business units.

Again, I would just say that this Company had been through a lot -- the acquisition of Compaq, the acquisition of EDS, 11 to 20 software acquisitions. A lot of change. Part of what we're doing is we are integrating, we're streamlining, we're putting in new ERP programs. We're investing in systems and technology to automate processes that frankly had not been done in a while. I actually think this is good news that we are continuing to take advantage of the opportunities that we see. What I will tell you is I don't anticipate an additional program after this.

**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Let me address the second part of Ben's question. I apologize I didn't catch that one. Ben, I think your question was around capital allocation and how are we thinking about that. We are still committed to the capital allocation approach that we outlined at our Security Analyst Meeting, which means that between dividends and share repurchases we do anticipate returning at least 50% of our free cash flow to investors in FY14. We will see the timing of the share repurchase activity levels will vary quarter to quarter.

I think it's really important that given the attractiveness of the valuation of HP shares, as well as our anticipated cash-flow generation levels, our approach to capital allocation will have a bias towards share repurchases. When we then shift to what about M&A, as we've talked about, we will evaluate any M&A using a returns-based framework. Any of the near-term considerations in terms of what types of things we might be interested in are absolutely going to be in our strategic focus areas, such as cloud security and big data.

**Meg Whitman** - *Hewlett-Packard Company - CEO*

Amit, let me answer your question about morale. Listen, no Company likes to decrease the work force. We recognize that is difficult for employees. What I will tell you is I think our employees live it every single day. The environment that we are in, our employees know that there's ways we can be more efficient. They are in some ways the biggest source of ideas on what we can do differently.

I think everyone understands the turn-around we're in. Everyone understands the market realities. Everyone understands the need to create financial capacity to invest in innovation, which will be our point of difference, and making sure that we have the right sales force coverage in every geography. I don't think anyone likes this; but I think actually we've done a good job of explaining where we are in the turn-around, what the strategy is, and what's going to be required to get HP to where we all want it to be in the industry.

**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks for that, Amit. A reminder if we can try and keep the follow-ups to a minimum so we can get through more questions that would be helpful. Can we have the next question, please?

**Operator**

Sherri Scribner, Deutsche Bank.

**Sherri Scribner** - *Deutsche Bank - Analyst*

Hi, thank you. I wanted to get a little more detail on the pause in the storage business. You did give us some detail, but I was a little surprised to hear the converged piece actually saw some deceleration. Maybe some more detail on do you think you are losing share, or do think there's something more systemic going on in the industry right now? Thanks.

**Meg Whitman** - *Hewlett-Packard Company - CEO*

We actually think we'll gain a point of storage in this market. I think what is going on here, and I'm not sure anyone has total clarity on this. But as I have talked to customers here is what I've learned, and I've talked to our sales team. Effectively, there's an efficiency thing going on here around compression and thin provisioning. Then of course Flash is on the horizon in a much more important way than it has been in the past. Then what's interesting is the high end, you can now get high-end performance for mid-tier pricing. There is a lot of choices now in front of storage buyers, whether it's small to medium-sized, to the big enterprises.

My sense of the situation is there is a pause, trying to figure out what the right thing to do is, and that this market will come back in the second half. Obviously, we have to wait to see that happen, but that is what most of our customers and our partners are telling me.

The good news is we are completely perfectly positioned for where this market is going. 3PAR is the exact right product. The Flash product is exactly the right product. We are -- I think we're really well-positioned for where the market is going. Obviously no one knows exactly what's going to happen. If this market doesn't rebound in the next half, then there's another situation that we're facing. But I don't actually think that's the case. Again, we'll gain probably a point of share in this calendar quarter.

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**Sherri Scribner** - *Deutsche Bank - Analyst*

Thank you.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks for the question, Sherri. Next question, please?

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**Operator**

Brian Alexander, Raymond James.

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**Brian Alexander** - *Raymond James & Associates - Analyst*

Okay, thanks. Good afternoon. Maybe back to the M&A question, given the stronger cash flow outlook that you expect this year, I'm curious how that impacts the appetite to make larger acquisitions than what you previously discussed. I think you said in the past small to medium-sized. But with the cash flow continuing to out-perform, how should we think about deal size now?

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

First and foremost, I will reiterate what I've said. It's we expect to be return-focused in our approach to acquisitions. As I said before, we don't feel the need for large transformative acquisitions. We haven't put a specific size range or limits on this, but I'd say they are most likely in the range from the small, low hundreds of millions, to mid-sized deals; and will largely be in the area of the strategic focus for HP, which would be largely cloud, security, big data, that we think will advance our position in those businesses.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks, Brian. Next question.

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**Operator**

Kulbinder Garcha, Credit Suisse.

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**Kulbinder Garcha** - *Credit Suisse - Analyst*

Thank you for the question. Again on the restructuring, I guess for Meg. Maybe if I ask the question this way: Has your revenue visibility for this business over the medium terms, or the growth outlook that you've had, whatever that might be, in any way significantly changed in the past six months that may have prompted some of this incremental restructuring you're pursuing? Linked to that, previously you made it very clear, both you and Cathie did, that you were going to re-invest a large part of the initial round of savings. Would the retention of savings be significantly higher in this next round, or are you essentially valuing them?

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

I'll tell you, my outlook has actually not changed in terms of where we are in the turn-around, what my view is of the revenue trajectory. We obviously live in a market that's shifting at warp speed. This is the fastest market shift I've seen in my career. By the way, you know I grew up mostly in the consumer space, which tends to move faster than the enterprise space.

I would actually say I am feeling more confident, because we have seen a stabilization of revenue. The very high single-digit declines are over. We've had three quarters of pretty good stabilization. I really like our product road map. Many folks who have been around HP for many years have said this is the product lineup -- best product lineup we've had in a decade. I feel confident in it.

What I will say is that we need to run this Company more efficiently, not only for the benefit of cost, which is good because we can reinvest in things that will make us stronger; but frankly in terms of ease of doing business, ease of working here, and faster, more nimble decision-making. We're going to have to be quicker and faster and more nimble to compete in this new world order. By the way, having a lower cost structure is an added benefit to that. Cathie, do you want to add anything to that?

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

No, I think you're exactly right.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks, Kulbinder. Next question, please?

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**Operator**

Bill Shope, Goldman Sachs.

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**Bill Shope** - *Goldman Sachs - Analyst*

I have a question on the printing segment. Even excluding the yen tail wind you discussed, your operating margin strength is fairly substantial given a 6% decline in supplies. Can you give us a bit more detail on the components of the printing margins, and particularly what's occurring within hardware margins? I understand you have more ink mix on the supply side. But what's going on within hardware margins, and what do you view as sustainable outside of the yen impact?

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Thanks, Bill. The increase in margins year over year are 3.6 points. The currency is about 1.5 points. The rest is really strong cost management. It's across the portfolio. It's not a hardware comment versus a supplies comment. It is a comment about making sure that we've got the right cost structure. Offsetting that a little bit is unfavorable mix.

But it's really important that we step back a bit. We talked about at the Security Analyst Meeting in October the fact that we expected from IPG $0.07 to $0.11 of incremental EPS. That was before incremental investment that we talked about at the time at being $0.12 across the Company, and now we've upped it to $0.14. We've got to stay -- we've got to remain focused on investing for the long term in this business.

That means placing units. That means continuing to invest in R&D. We think there is a real opportunity to increase the amount of print specialists across the world, so we're focused on doing that. It's also really exploiting these new business models -- Ink Advantage, Ink in the Office, our multi-function printer lineup and our managed print services. Those are all really important points that we've got to stay focused on.

Finally, I would say that we've got to continue to be very competitive. The market is tough. We've got Japanese competitors who have an even bigger war chest as a result of the yen depreciation. We will be more aggressive where we need to be.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks Bill, for the question. Next question, please?

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**Operator**

Rod Hall, JPMorgan.

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**Rod Hall** - *JPMorgan - Analyst*

Hi guys. Thanks for taking the question. I wanted to ask you guys if you could talk a little bit about the R&D increase. I know you gave a little bit of color, but could you give us more color in that area -- what you're increasing, what are you focusing on with the additional R&D? Then I know this question's been asked a bunch of times, but the $0.02 to $0.03 that you expect to realize in net savings here in the last part of this year, can you talk to us about the phasing of the savings over the period? Is most of that $0.02, $0.03 coming in fiscal Q4, or is it coming linearly across those quarters? Help us understand how that's ramping through the back end of the year? Thanks.

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Let me start with that last question. Those $0.02 to $0.03, there's a little bit that happens in Q3, and a little bit that happens in Q4. If you actually go and look at the guidance that we provided for EPS, the mid-point would suggest -- and we've got it flat sequentially -- normal seasonality was suggest it'd be down about a point. The restructuring savings are actually bringing it to being flat sequentially. That will give you a little indication of what is going on from a Q3 perspective.

I'm sorry, I've lost track of your first question. R&D. In terms of R&D, the increase in R&D year over year is actually very broad-based. Just about every business that we have is increasing R&D on a year-over-year basis. Obviously it's focused in strategic areas -- cloud, big data, security, page-wide array, 3-D printing. Across the board we're increasing R&D. It's really not a specific comment for a particular business.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Can I just say that actually we've increased our R&D in servers. We love our road map. We love the opportunities there. We're pretty excited about some of the innovation that's coming down the pike there.

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

We've got R&D increases in EG, in -- within that we've got storage. You've got industry standards there. It's really broad-based that we're making incremental R&D investments year over year.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Thanks for that one, Rod. One final question, please?

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**Operator**

Jim Suva, Citigroup.

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**Jim Suva** - *Citigroup - Analyst*

Thank you very much. Meg, when you think about a lot of things are changing in the industry on the server-side, you've got Lenovo purchasing IBM x86 series. Is seems like there's a lot of disruption going on, and an opportunity for HP to gain share in servers, as we're seeing a lot of CTO confused and not sure how that'll all pan out. Can you help us confirm if indeed you expect to gain from shift. Not to be blunt, it would seem like a blatant mis-execution step if HP doesn't take advantage of this here on the very term, as an opportunity.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

We're focused on this. There's some early signs that show that we're making some progress, as we've seen an increase in win rates attributable almost directly to the uncertainty in the market place around the IBM business moving to Lenovo. We're building pipeline for future incremental deals. Good win rates, good pipeline, feeling good about this. It's a longer sales cycle than you think, particularly in blades and some of these other areas. This takes a bit of time. But I think we have got the sales team focused on this. They're pretty excited about it. It's an open door that we're running through.

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**Rob Binns** - *Hewlett-Packard Company - VP IR*

Great. Thanks for that, Jim. With that, I think we'll conclude the questions.

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**Meg Whitman** - *Hewlett-Packard Company - CEO*

Great. Thank you very much for joining us today.

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**Cathie Lesjak** - *Hewlett-Packard Co - CFO*

Thank you.

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**Operator**

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

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