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HPQ - Q3 2014 Hewlett-Packard Earnings Conference Call

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OVERVIEW:

HPQ reported 3Q14 revenue of $27.6b and GAAP diluted net EPS of $0.52. Co. expects full-year FY14 GAAP diluted net EPS to be $2.75-2.79.

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Third-Quarter 2014 Hewlett-Packard Earnings Conference Call. My name is Leslie, and I'll be your conference moderator for today.

At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Rob Binns, Vice President of Investor Relations. Please proceed.

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

Good afternoon. Welcome to our Third-Quarter 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 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 repurchase, currency exchange rates, or any other financial items; any statements of the plans, strategies, and objectives of Management for future operations, and 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 the most recent Form 10-Q. HP assumes no obligation, and does not intend to update any such forward-looking statements. The financial information discussed in connection with this call, including any tax-related items, reflect estimates based on information available at this time, and could differ materially from the amounts ultimately reported in HP's third quarter Form 10-Q.

Revenue, earnings, operating margins, and similar items at the Company level are sometimes expressed on a non-GAAP basis, and have been adjusted to exclude certain items, including, amongst other things, amortization of purchased intangible assets, restructuring charges, and acquisition-related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables and in the slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations web page at www.HP.com.

I'll now turn the call over to Meg.

Meg Whitman - *Hewlett-Packard Co - CEO*

Thank you, Rob. Thanks to all of you for joining us today.

The third quarter of 2014 marks an important milestone in HP's turn-around. For the first time in three years, the Company delivered top-line revenue growth on a year-over-year basis. Revenue for the Company was $27.6 billion, up 1%. As I've said many times before, turn-arounds are not linear, and we face tough comparisons in the fourth quarter; but overall, I continue to be very encouraged by the progress we're making.

In the third quarter, we once again achieved our financial outlook. We delivered $0.89 in diluted non-GAAP net earnings per share, at the high end of our previously provided outlook, and up $0.03 from the prior-year period. In addition, we achieved very strong cash flow performance, delivering $2.7 billion in free cash flow for the quarter, a good sign of improved operations and financial discipline. Our year-to-date free cash flow now stands at $7.4 billion.

As a result, our operating Company net cash position is $4.9 billion. We also returned $881 million to shareholders in the form of share repurchases and dividends.

We're seeing the benefits of the work we've done to get our personal systems and industry standards server business back on track. Our printing supplies business and parts of our software portfolio still face some challenges, but HP today is nimbler and better prepared than ever to respond to rapidly changing business conditions. The leadership teams in both these areas are quickly addressing those challenges.

On the enterprise services side of the Company, we're making progress. The nature of ES, with longer business cycles and lengthy contract periods, make it tough to realize improvements quickly; but I believe the changes Mike Nefkens and his team are making are beginning to take hold. I'm confident that enterprise services is on the right path to improved performance and profitability.

The third quarter saw the introduction of some significant innovation across HP. At our Discover customer event in June, we launched the world's first completely liquid-cooled supercomputer, HP Apollo. Apollo offers high-performance computing while using half the energy of competitive products.

We also introduced an all-flash HP 3PAR storage array. 3PAR is making all flash arrays viable for a range of mainstream enterprises and service providers, driving down cost while also boosting performance and scale. Initial customer reaction has been very positive.

Our software group announced new HP Atalla encryption and data protection solutions that continuously secure an organization's most sensitive information, whether it resides in a data center, an on-premise server, or in the Cloud. And we rolled out our vision for what we call The Machine, a new computing platform for the big data era. The Machine has become a rallying cry across HP, and frankly around the industry, for the re-invention of how we compute. Martin Fink has focused his HP Lab researches on memristors, photonics, and a new operating system at the heart of this once-in-a-generation project.

I believe we're clearly demonstrating what I've said many times before, that innovation is alive and well at HP. Over the next several months, you can expect to see the introduction of game-changing products in personal systems, servers, cloud, and printing that are going to bring some real excitement to these markets.

Before I turn to business group performance, I want to take a moment to once again acknowledge the contributions of Ralph Whitworth. As all of you know, Ralph stepped down last month as Chairman of HP's Board of Directors. I would like to personally thank Ralph for his tireless efforts to help drive HP's turnaround, and for being a wonderful friend and advisor to me during the past three years. Everyone at HP is thinking about Ralph, and we all wish him the very best.

HP's Board of Directors decided to combine the roles of Chairman and CEO, and I'm honored they've asked me to assume this responsibility. I believe this will help us lead more effectively through the turn-around. Let me reassure everyone that the Board and I remain fervently committed to the strong practices and financial disciplines we've put in place during the past three years. The best interest of our investors are always top of mind with me and the HP Board.

Now let me turn to our business group performance in the quarter. Overall, results in Q3 were driven by good performance in personal systems, growth in industry standard servers and networking, as well as disciplined cost management across all of our businesses. In personal systems, we had an excellent performance, with revenue up 12% from the prior-year period. This represents the third successive quarter of revenue growth for personal systems, in a market that has stabilized, but nevertheless continues to contract.

We gained market share both year over year and sequentially, and we're seeing growth across all major categories. The Windows XP expiration has contributed to our growth, although we believe we're now through much of that benefit. However, our product lineup, driven by products like our EliteBook series and our x360 convertible notebook, is the strongest we've had in years. We continue to see customers looking to refresh their aging installed base.

We believe we can continue to gain share in PCs, despite the challenges in this market as it consolidates. The personal systems team continues to do a great job managing profitability, with third-quarter operating profit margins of 4%, up 0.9 points from the prior-year period.

In our printing business we continued to build on sustained, strong margin performance, with an operating profit margin of 18.4%, up 2.6 points from the prior-year period. Revenue was down 4% year over year, driven by supplies, where declines in toner continue, and ink was weaker than expected. We're honing our approach here, and re-focusing our go-to-market, which gives me confidence that we will improve our performance over the next several quarters.

Total hardware unit shipments declined 5% in the quarter; however, we gained share in both ink and multi-function printers, important categories where we now lead the market. As planned, our disciplined unit placement strategy resulted in declines in single-function mono and low-value home printers; but we're seeing continued momentum in focus areas like managed print sevices, where we had another strong quarter of signings. This is an important business for us, as it supports a strong after market sales opportunity for supplies.

In the enterprise group, revenue grew 2% on strength in industry standard servers and networking, offset by declines in business critical systems, technology services and storage. In industry standard servers we saw 9% growth from the prior year period, which represents our fourth consecutive quarter of revenue growth. And we expect to take almost a point of share in the second calendar quarter.

We're seeing good early traction with service providers as a result of our partnership with Foxconn to produce a line of cloud-optimized servers, and we moved aggressively to take advantage of the uncertainty customers feel about the IBM-Lenovo transaction. In head-to-head fights with IBM for deals, we're seeing clear improvement in win rates; all this while delivering stable gross margins.

In business-critical systems, revenues declined 18%, broadly in line with the market and our expectations. Storage revenue declined 4% year over year; however, converged storage was up 9%, while traditional storage declined 14%. 3PAR returned to double-digit growth, and we continued to gain share in the mid range. As the market shifts increasingly from high end to mid range it is pressuring overall market growth, but I believe this plays into a sweet spot for HP, which bodes well for us in the long term.

Networking performed well under the new leadership of Antonio Neary, although there remains opportunity for further improvement. Revenue grew 4% from the prior-year period, and we saw good growth in switching, where we once again out-performed Cisco. We also have made significant progress on our open NFV program. We currently have 15 proof-of-concept projects with carriers around the world, five R&D labs to provide validation of our integrated solutions, and strong partnerships with Alcatel Lucent, NEC, and Nokia.

In technology services, revenue was down 3% from the prior-year period. Despite the revenue head winds in this business from weak hardware volumes in prior periods, we've maintained consistent, stable operating profit margins throughout the year, and we're seeing continued adoption of our new services like Proactive Care and Data Center Care. We saw positive order growth in Q3, the best performance in nine quarters.

In our cloud product offerings, we are making progress with HP Helion. Since launching in May, we're seeing strong engagement from customers, and we're extending our share of leadership in private cloud. In Q3, HP cloud system had another strong quarter, with double-digit revenue growth. And I'm particularly excited about the significant milestones in cloud we have on the horizon.

By the end of October, we expect to deliver commercial versions of HP Helion Open Stack and the HP Helion Development Platform, which will help enterprise customers build and deploy open-stack-based clouds. We will also introduce expanded professional services that leverage HP's unmatched Open Stack experience to accelerate customers' cloud implementations. In fact, HP is the leading code contributor to the next release of Open Stack, also scheduled for October.

In June, we announced the HP Helion network with the support of AT&T, British Telecom, Intel. Synapsis, and Hong Kong Telecom. Together we are focused on delivering a global public cloud platform that is 100% enterprise-focused and open-standards based. In the coming months, we expect to launch an HP Helion Network program, with an even broader set of partners committed to building the world's largest cloud network.

To that end, HP has reached an agreement with China's leading content distribution network service provider to build and operate community clouds for enterprise customers in China using HP Helion Open Stack. This will enable HP to meet customers' fast-growing demand for cloud services in one of the world's fastest-growing cloud markets.

In enterprise services, revenue was down 6% from the prior-year period. As expected, key account revenue run-off negatively impacted year-over-year revenue comparisons. Gross margins expanded as a result of continued labor savings and improvement in under-performing accounts, helping ES achieve an operating profit margin of 4.1%, up 0.9 points from the prior-year period, and up 1.6 points sequentially.

On the sales side, the enterprise services team is making progress on aligning their sales engine, and we once again saw bookings growth in new logos. Enterprise services continues to be a work in progress. While the results do not yet reflect all our efforts to strengthen this business, the work of the team as well as the feedback I'm hearing from customers, tells me we're on track.

In software, Robert Youngjohns has hit the ground running in his new role. Robert and his team are making progress on evolving the software strategy and addressing the go-to-market model. They have a lot of work to do to simplify our portfolio of offerings, streamline our go-to-market, and accelerate our web selling capability.

In the quarter, revenue was down 5% from the prior-year period, driven by certain go to market challenges. These issues impacted revenue in our core focus areas of security and big data. Autonomy and Vertica revenue declined over the prior-year period, and security revenue grew only slightly.

On profitability software executed well, improving its operating profit by more than 1 percentage point on declining revenue, as gross margins improved, coupled with disciplined expense management.

SaaS bookings in the IT management business continued to be strong, with double-digit growth over the prior year, and exciting new products introduced to the market. We are shifting more of our focus on both the portfolio and the operating model to SaaS and subscription-based offerings, which may create near-term revenue head winds while setting up the business for the long-term success. During the quarter, the software team announced a strategic partnership with Hortonworks. The joint commitment will help accelerate the adoption of Enterprise Apache Hadoop by deeply integrating the Hortonworks data platform with Haven.

Overall I'm very pleased with the progress we've made. When I look at the way the business is performing, the pipeline of innovation, and daily feedback that I receive from our customers and partners, my confidence in the turn-around grows stronger. HP is quicker to recognize opportunities in our markets, and responds to challenges faster and with greater discipline than at any time in recent memory. When challenges appear in any of our businesses, we have a much better sense of what's happening, and surprises are fewer and farther between.

The adversity of the turn-around is forging a much stronger Company, a Company focused on results, and determined to drive strategy and decisions aligned with a rapidly changing industry. This sense of purpose is motivating our employees to new levels of excellence and a profound commitment to our customers and partners.

Against that back drop, our outlook for non-GAAP diluted net earnings per share for the full year will be $3.70 to $3.74.

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.

Overall, we're pleased with third-quarter results. Performance was driven by very strong revenue growth in personal systems, as well as growth in industry standard servers and networking. Performance in printing, enterprise services, and software was mixed, with good profitability, but weaker than expected top-line results. Total revenue for the quarter was $27.6 billion, up 1% year over year as reported, and in constant currency.

By region, Americas revenue was $12.3 billion, down 1% year over year, or flat in constant currency. The US was approximately flat, on the back of double-digit growth in personal systems. Brazil was up moderately, while other countries in the region declined. EMEA revenue was $10 billion, up 5% year over year, or up 1% in constant currency, driven by some recovery in mature western economies, partially offset primarily by significant weakness in Russia.

APJ revenue was $5.3 billion, up 1% year over year, or up 4% in constant currency. We experienced solid growth in China, led by a double-digit increase in the enterprise group, partially offset by weakness in Japan and India.

Gross margin for the quarter was 24%, up 0.6 points year over year, and down 0.2 points sequentially. The year-over-year increase was driven by rate improvement across most of the portfolio, partially offset by the strong revenue performance in industry standard servers and personal systems. Total non-GAAP operating expenses for the quarter were $4.3 billion, up 5% year over year. The increase in OpEx was primarily driven by increased investments in R&D, as well as real estate gains in the year-ago period.

Sequentially, OpEx was approximately flat, and in line with normal seasonality. Non-GAAP operating profit was $2.3 billion, or 8.5% of revenue, up 2% year over year, and flat sequentially. We recorded $145 million of expense on the Other Income and Expense line. With a 22.5% tax rate, and a weighted average diluted share count of 1.9 billion shares, we delivered third-quarter non-GAAP diluted net earnings per share of $0.89, at the high end of our outlook range.

Third-quarter GAAP diluted net earnings per share of $0.52 was below our forecasted range, due to a higher-than-originally estimated restructuring charge of $649 million; however, we expect a total FY14 charge for the incremental restructuring activities to be in line with our prior expectation. GAAP earnings also included $227 million of expense for the amortization of intangible assets.

Turning to the business units, personal systems had an excellent quarter across all businesses, with revenue up 12% year over year to $8.6 billion, gaining share across the board. Commercial sales grew 14% year over year, with consumer sales up 8%, and strength broadly across all of the regions, outside of pockets of weakness in Russia and China. Total unit shipments grew approximately 13% year over year, with growth in both consumer and commercial. And Channel inventory remained within acceptable ranges.

Even in a competitive pricing environment, personal systems achieved solid operating profits of $346 million, or 4% of revenue, up 0.9 points year over year. The improvement was driven by volume and some improved pricing, as well as operational cost reductions, as the team continues to segment and target the right market opportunities, as well as streamline and refine supply-chain management across the business.

Printing revenue performance was weak, but profitability remains strong. And as Meg said, the team is in the process of making key adjustments to the go-to-market approach. Revenue was $5.6 billion, down 4% year over year, as declines in both hardware and supplies were partially offset by continued traction in graphics and managed print services. Commercial hardware revenue was $1.4 billion, flat year over year, and consumer hardware revenue was $529 million, down 6%. Total hardware unit shipments declined 5% year over year, as we continue to focus on selectively placing high-value units.

We continue to see success with our new print business models. In Q2 we ran a series of promotions to move older ink-in-the-office products through the channel, ahead of our upcoming product transitions. As a result, older product sales declined in Q3, and drove overall ink-in-the-office sales lower year over year.

However, we saw double-digit, year-over-year growth in our new OfficeJet Pro X and OfficeJet Pro X Enterprise products, and we expect the program overall to grow in FY14. Our Ink Advantage program also saw continued traction, and we once again grew unit shipments and revenue by double digits year over year.

Supplies revenue was $3.7 billion, down 5% over the prior year, and made up 65.5% of printing revenue. Both ink and toner were down. Part of the decline was driven by stronger channel buy-in during Q3 last year, ahead of pricing actions we took on ink, making for a tough year-over-year compare. We also experienced a larger-than-expected inventory correction from the consolidation of US retailers, which may suggest some softness in demand, but it's too early to confirm this is a trend.

Supplies channel inventory levels declined on a year-over-year basis, but have increased sequentially, and are above our target range. We expect to bring inventory levels back within the range in the fourth quarter, and anticipate this will pressure our fourth-quarter supplies revenue. Total printing operating profit was a strong $1 billion, or 18.4% of revenue, up 2.6 points year over year, due primarily to favorable currency.

The enterprise group had a solid quarter. Total revenue was $6.9 billion, up 2% year over year, with growth in industry standard servers, networking, and converged storage, partially offset by declines in traditional storage, technology services, and business-critical systems. Operating profit was $966 million, or 14% of revenue, down 1.1 point year over year. Good discount discipline in the quarter was more than offset by higher cost of sales and the mix impact of strong industry-standard server revenue growth, as well as strategic R&D and sales investments.

By business, industry-standard server revenue was $3.1 billion, up 9% year over year, with improvement in all regions. We also experienced higher average unit prices in ISS as a result of stronger option attach. Technology services revenue was $2.1 billion, down 3% year over year. The team continues to execute well in this business, and we saw a return to positive order growth. And our penetration rate is up over the prior year in BCS, storage, and networking.

Total storage performance was a bit disappointing, with revenue of $796 million, down 4% year over year, driven by a 14% decline in traditional storage. However, converged storage sales grew 9% this quarter, led by double-digit growth in 3PAR, as customers continue to adopt alternatives to traditional high-end enterprise storage arrays. While 3PAR plus XP plus EVA revenue declined 7% year over year, we expect another quarter of share gain in the external disk market overall in calendar Q2 2014.

Networking performed well in the quarter. Revenue was $672 million, up 4% year over year, driven primarily by strength in switching across all regions. Top-line growth is expected to result in share gain in calendar Q2 2014. Business-critical systems revenue declined 18% over the prior-year period, broadly in line with the market to $233 million.

High-performance computing is core to who we are at HP. While we continue to manage the decline in Unix, we are also committed to delivering new solutions to meet our customers' mission-critical needs, and are excited about the product road map. Enterprise services revenue was $5.6 billion, down 6% year over year, driven by continued key account run-off, as well as incremental weakness in EMEA.

By business, IT out-sourcing revenue was $3.5 billion, down 8% year over year, and applications and business services revenue was $2.1 billion, down 4%. Operating profit for ES was $228 million, or 4.1% of revenue, up 0.9 points year over year. The increase was driven by continued cost actions and improvements in under-performing accounts. Looking forward, we expect meaningful incremental benefit in the fourth quarter from the work force restructuring implemented during the third quarter, as well as continued improvements in under-performing accounts.

Turning to sales metrics, small- and medium-size deals grew, and we continued to see strong double-digit bookings growth in strategic enterprise services, or the services for the new style of IT, although lower renewals drove overall signings down.

Turning to software, while software revenue declined, the team continued to drive solid profitability through gross margin expansion, as well as disciplined expense management. As Meg talked about, the software team is focused on evolving the business strategy and go-to-market approach to better leverage the great products we have in the portfolio. Weakness in license revenue offset continued growth in our software-as-a-service offering, driving total software revenue of $959 million, down 5% year over year.

Operating profit remained solid at $203 million, or 21.2% of revenue, up 1.1 points year over year. Licensed revenue declined 16% year over year, with weakness across the portfolio. Support revenue was flat over the prior year, with growth in security offset by weakness in the rest of the portfolio from past license revenue declines. Professional services revenue declined 3% year over year, with softer IT management revenue, partially offset by growth in security. Our continued focus on profitability in this business impacted our top-line performance in the quarter.

SaaS revenue grew 8% year over year, and we continued to see strong bookings growth in IT management. We launched exciting new products in the quarter, including the June release of Service Anywhere, which we believe positions us very well against the competition, and is getting good early customer traction.

HP Financial Services revenue was $855 million, down 3% year over year. Operating profit was $79 million, or 9.2% of revenue. HPFS revenue and operating profit were impacted both on a year-over-year and on a sequential basis by a customer billing adjustment, but were otherwise in line with expectations. New financing volume grew 14%, and return on equity was 14.7%, down 2.6 points year over year, entirely due to the billing adjustment.

Turning to cash flow and capital allocation, we had another strong quarter, with $3.6 billion in operating cash flow, and $2.7 billion in free cash flow. Our cash conversion cycle was eight days in the quarter, with year-over-year improvement of one day in both days of inventory and day sales outstanding, and an eight-day improvement in days payable outstanding. Favorable payment terms with suppliers, strength in personal systems, and the factoring program mentioned last quarter, supported the cash-conversion-cycle improvement.

Although we do not typically update our outlook every quarter, I did want to lay out how we think cash flow will end the fiscal year. Our free cash flow is already $7.4 billion year to date, and I expect that we will exit this year at approximately $9 billion for the full year. Cash flow remains a priority for us, and we continue to execute well.

We repurchased 17.5 million shares in the quarter, and paid $299 million in dividends. In total, we returned approximately $881 million to shareholders in Q3. During the quarter, we were limited in our ability to purchase shares due to material non-public information. We intend to resume the share repurchase program during Q4, and remain committed to returning 50% of free cash flow to shareholders in FY14.

Our restructuring program is on track, and approximately 36,000 people have exited the Company under the program through the end of the third quarter. We expect approximately 41,000 to exit by the end of the fiscal year, and a total reduction of 45,000 to 50,000 under this program, with the remainder exiting in FY15.

Looking forward to Q4, in personal systems while the Uttar Pradesh deal last year will make for a tough compare, we still expect to gain share in the market, on the back of a strong product line up and go-to-market approach. In printing, we expect supplies to remain under pressure in the fourth quarter, as we bring channel inventory levels back within our target range; but we expect to see continued momentum in our innovative new programs across the portfolio.

In the enterprise group, overall we expect the hardware market to remain highly competitive. However in storage, we anticipate that the market will continue to shift from the high to the mid range, where we are well positioned. In ISS, while the Bing deal from last year will create a tough compare, the team is executing well.

In enterprise services, given the incremental weakness we saw in Q3 from EMEA, we are updating our full-year revenue outlook. We now expect full-year revenue to decline 6% to 7% over the prior year. However, given our good progress on cost management and execution, we continue to believe that we can achieve a full-year operating margin within the previously provided range of 3.5% to 4.5%. From a macroeconomic perspective, we expect geopolitical uncertainty to continue, impacting specific territories such as Russia, as well as increased competitive pressures likely in China.

With that context, we expect full-year FY14 non-GAAP diluted net earnings per share to be in the range of $3.70 to $3.74. From a GAAP perspective, we expect full-year GAAP diluted net earnings per share to be in the range of $2.75 to $2.79.

With that, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question is from Katie Huberty from Morgan Stanley.

Katie Huberty - *Morgan Stanley - Analyst*

Thank you very much. Excuse my voice. I have a bit of a cold. This was another great quarter of cash flow, but we're not seeing the EPS up side that I think people are hoping for, given higher revenue and more restructuring savings. What levers do you have to show more operating leverage going forward, or is it as simple as needing a revenue recovery that's not just PC driven?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Katie, over the longer term -- and when I think of that I think about FY15, I think one of the real up sides for us that is not revenue-directly related, and that's really in our enterprise services group. The fact is that we have made really good progress this year, and I believe that Q3 is a great proof point at delivering operating profit of 4.1%.

The fact that we re-confirm we're going to be in the 3.5% to 4.5% for 2014 is also setting us up really well for 2015. We are taking the -- we're making the investments that we need to make to get the costs out of that business. We are improving our under-performing contracts very materially, and that's going to set us up very well for 2015 to improve EPS without strong revenue performance.

Meg Whitman - *Hewlett-Packard Co - CEO*

Katie, this is Meg. I would just add one thing. We have taken out cost of pace with a pretty significant revenue decline in 2012, 2013 -- and up until this quarter we still had declining revenues. Now, if revenue stabilizes, we have more costs to take out. There's operational improvement opportunities across the board. If we can stabilize revenue, then I think you'll start to see the EPS up-tick that you're looking for.

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

Great, thanks for that. Next question please?

Operator

Next question is from Toni Sacconaghi with Sanford Bernstein.

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

Yes, thank you. Meg, you just mentioned that if revenues stabilized, you could really start to see some impact and benefit on EPS. I was wondering if you could just try and address that a bit more broadly. This quarter was clearly a lot of disparate revenue growth in the Company, if PCs grew at 12% and the rest of the Company grew at minus 3%.

I'm wondering if you can comment around -- I know you don't like commenting specifically about revenue growth, but particularly around PCs, how do you envision market growth over the next year or two? Secondly, if we think more broadly about revenue growth, given that 12% may not be sustainable, and given that comparisons are a lot tougher which you noted several times in your prepared remarks, is it really realistic to think that revenue growth can remain stable over the next year or two?

Meg Whitman - *Hewlett-Packard Co - CEO*

Let me address PCs first. The PC market -- and when I say PC, I mean right up through tablets, not including obviously smartphones. The PC business is flat to declining slightly. We think that will continue.

However, what we do believe is we can continue to gain share in a relatively flat market. That's because we've got a terrific product lineup, we've got a great go-to-market. Our relationships with partners is better than it has ever been. While the XP refresh is largely done, we're seeing good growth and continued growth in the commercial side.

By the way, our consumer business grew 8%, which we haven't seen that in many years. I feel like the PC business has some wind beneath its wings, and I think for the foreseeable future we'll be in pretty good shape there.

Overall revenue growth for the Company, we still have a portfolio that has some declining businesses, some flat businesses, and some growing businesses. As those growing businesses get stronger and the declining businesses like business critical systems -- that eventually will be a zero there on the Unix business -- therefore you'll start to see accelerating growth. It's a portfolio management issue.

Again, servers grew this year for the first time, 3PAR returned to double-digit growth, networking had pretty good growth. Graphics, which we don't talk a lot about, is now a meaningful, growing business. Managed print services, security, strategic enterprise services -- we've got real pockets of growth, and we've just got to balance out that portfolio to bring ongoing stabilized revenue.

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

Great. Thanks for the question Tony. Next question please?

Operator

Next question is from Rod Hall with JPMorgan.

Rod Hall - *JPMorgan - Analyst*

Yes. Hi guys, thanks for taking my question. I just had a couple. I wonder, Meg, can you talk a little bit about PC strength regionally? In other words, where was it strong, where was it weaker?

I know you guys called out Russia and China as weak points from a macro perspective, but I'm just wondering if there -- what you're seeing in the emerging markets. For instance, where Cisco called out some weakness. If you can give us a little bit more regional color it would be helpful.

I also wonder, do you guys ever -- are you ever able to quantify the impact of the XP expiration, particularly in fiscal Q3? Was it a material impact in fiscal Q3 that we should see rolling off in fiscal Q4? Can you just help us understand how that progresses over the next few quarters? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, with regard to PC strength regionally, this was broad-based across all regions. Americas and EMEA, in particular, had good quarters. China was a little weaker for us in PCs. Russia was tough for us across the board.

But what I will say is China for HP as a whole was actually a pretty good performance. Servers did very well. Our printing business did very well there. Our software business did quite well there. China was only a weak spot in the PC area.

Cathie, do you want to talk about quantifying the XP impact? It's a little difficult to do. I would say the XP impact was even more in Q2 than it was in Q3. A country like Japan, which is a very significant Microsoft market, they went fast to XP, but maybe you can give a little more color.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Sure. It is very difficult to quantify the impact of XP, because you also have the impact from the older, aging installed base. The fact of the matter is that people realize that there are certain things they need to do, they need to do on notebooks or laptops -- say laptops or a desktop -- and so they really need a PC.

It's really difficult for us to quantify what's going on there. To Meg's point, though, about Japan. If you look at a local currency growth year-over-year last quarter, it was in the mid-single digits. Even this quarter, it's up in the high single digits, but it has obviously moved very quickly from XP to Windows.

THOMSON REUTERS

Let me also just give a little bit more color on the regional. If you look at PCs in Americas, up in local currency double digits, that was led by very strong performance in the US, again double-digit performance. EMEA had double-digit performance growth as well.

That was heavily led by the UK with double digits, Germany double digits, and to a lesser extent Italy. Then APJ was up high single digits. We really had broad-based strong performance in PCs.

Meg Whitman - *Hewlett-Packard Co - CEO*

Even in China, commercial PCs did well. Consumer not so much, but commercial pretty good.

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

Okay, thanks for the question, Rod. Next question please?

Operator

From Jim Suva with Citigroup.

Jim Suva - *Citigroup - Analyst*

Thank you very much and congratulations. A question for Meg and one for Cathie. Meg, when you look at your services, they declined a little bit concerning year over year. You mentioned EMEA weakness. Is it slowly attributable to EMEA that the new incremental item is calling you to be more cautious?

For Cathie, if you can talk about cash flow. Meg talked about more of a stable revenue that we were hoping for. If that happens, your cash flow has been about $9 billion the last two years in a row. Should we expect some changes to that, as I assume the inventory work-down has helped offsetting the cash flow? How should we think about cash flow in a more stable environment versus the past few years of revenue decline?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Sure. Let me first address your question though on the EMEA weakness in enterprise services. That was really pressured by probably three things. The first is that we did see weakness in public sector spending in the enterprise services group within EMEA, mostly in Western Europe. We saw some general run-off in the region.

Then we were also impacted by the geopolitical instability in Eastern Europe. Those were the big impacts in Q3. We actually believe that we're going to continue to see those pressures in the near term.

Turning to cash flow, what we've talked a lot about is that our free cash flow is highly correlated over time to our non-GAAP net earnings. We continue to believe that's the case once we get to a more stable spot with the cash conversion cycle. That's how you should think about our free cash flow going forward.

Meg Whitman - *Hewlett-Packard Co - CEO*

I will say the organization deserves a lot of credit for this cash-flow performance. Because remember, this is about inventory, this is about SKU and platform management, payables, receivables, and making sure we have the least amount of inventory, and yet satisfy our customer demands. It's been a really significant improvement since the fall of 2011. We're getting really pretty good at this.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

We are.

Meg Whitman - *Hewlett-Packard Co - CEO*

I wouldn't say you're going to see a decrease beyond eight days on the cash conversion cycle. In fact, if PCs slow down a little bit, the cash conversion cycle is going to go up. As you recall, we have a negative cash conversion cycle on our PC business.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

To quantify that, the strength in the PC business relative to the rest of the portfolio -- also the fact that the ES business was weaker -- we basically had a cash conversion cycle for PCs which is in quite negative, which is good. We had higher mix of that.

Then we had a lower mix of the enterprise services, which has a higher cash conversion cycle. Those need to normalize over time.

As you think about the future, think about we don't believe that PCs continue to out-grow the rest of the portfolio. That will put upward pressure on the cash conversion cycle.

Jim Suva - *Citigroup - Analyst*

Great, thanks guys.

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

Thanks, Jim, for the question. Next up, please?

Operator

Benjamin Reitzes with Barclays. Please go ahead.

Benjamin Reitzes - *Barclays Capital - Analyst*

Yes, thanks for taking the question. I wanted to ask you about cash priorities. With cash flow at $9 billion-plus for the second straight year, what are you leaning more towards in the upcoming quarters -- buybacks, dividends, or acquisitions, Meg? Obviously during the quarter you had a material non-public event.

You were obviously contemplating a potential material non-public event, and you were contemplating -- obviously it was probably a major acquisition. How are we supposed to reconcile the cash priorities? With such great cash flow, what are you going to do in the future, and how should we reconcile that comment, as well? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

Sure. Our capital allocation strategy remains the same. We have said that we will return at least half our cash flow to shareholders in the form of dividends and repurchase.

Despite the fact we were not buying shares in the third quarter, we intend to return to buying shares, and we believe we will meet that commitment by the time we get to the end of 2014. The first thing is to just reiterate our capital allocation strategy.

With regard to M&A, now that we have repaired the balance sheet -- as I have said before, I do think M&A will be a part of our strategy, but let me assure you this will be returns-based. It will be focused on only things that we cannot do organically. Given the choice, I would rather invest organically. This is the heritage of Hewlett-Packard. We do core R&D better than anyone else.

I think M&A will be a part of our future; but I want to reassure you on capital allocation strategy and the returns-based approach we're taking. Cathie, I don't know if you want to comment between dividends and share repurchase?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

I think the only thing I would say there, and we've said this a few times, is at the current stock valuation, we think that our shares are very attractive. Therefore our bias in the mix is to buying back shares.

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

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

Operator

Maynard Um from Wells Fargo. Please go ahead.

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

Hi, thanks. I had a question just on the server side. I'm wondering how big the opportunity is for HP as we look forward on the Windows Server 2003 expiration. I think some people have sized it, or I've sized it somewhere in that 10 million to 14 million units of servers that are out there that need to be upgraded, which I think is fairly significant. But how do we think about -- or how does HP think about?

Relative to that, what do you expect from a competitive-level dynamic to be? Would you expect that people will get more aggressive in pricing and we see more pricing pressure as people drive after that opportunity? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

We agree with you. We think that the Windows Server 2003 upgrade is an opportunity for us. There's a significant number of servers in the installed base, and they are going to have to upgrade.

There is some similarity between the XP upgrade and the server upgrade. We are following the same program from a marketing perspective.

We are organizing ourselves to go after this. It will be a competitive market, but I think we've got a really good -- we've been thoughtful about this, and I think we've got a really good shot to gain more than our fair share of that refresh.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Let me also add that we recently announced a new program with Microsoft to actually capture some of this end-of-life opportunity that really is around channel-optimized IT solutions, the services, the training, and the financing, as wells as the support to help our partners actually drive the growth and capture the opportunity.

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

Great. Thanks for the question, Maynard. Next up, please?

Operator

Next question is from Shannon Cross with Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. I had a question on your printing business. You talked about making adjustments in go-to-market. Can you talk a little bit more about what the issues are, how you're thinking about what's going on within the channel and usage in that?

Then based on your models, when do you think supplies might grow again? I think inkjet is doing pretty well, but clearly laser is under pressure.

Meg Whitman - *Hewlett-Packard Co - CEO*

Let me step back and give you the perspective on our printing business. This is one of the great HP businesses. Let me just break it down for you in terms of where we are on laser and ink. Laser is a business where we're recovering from a weaker installed base that goes back a number of years. The planned decline in hardware was very deliberate.

We are focusing on high-value, profitable units, that have an annuity of toner that makes sense for us. We think the laser business -- toner we're seeing some signs of recovery in other areas, particularly in Europe, as we rehabilitate if you will, and upgrade the user base. For example, we're the leader now in MFPs, which is quite remarkable since we really weren't a player in that business three years ago.

Ink -- you heard Cathie say in her remarks that ink, what we saw was some consolidation at retail, some channel loading up last year in advance of the price increase. But the real opportunity in ink is ink in the office, to basically take ink up into the small to medium size enterprise in a more profitable way, in a way that is twice the speed, half the cost per page, and more profitable for us.

We think ink will recover over time. We're bullish on that, but we are going to have to correct ink channel inventory as we go into Q4.

What's exciting about ink is we have -- or exciting about printing is we've got innovative business models, we've got some incredibly innovative products. The go-to-market change was simply just dial up our specialists.

When we put printing and personal systems together -- which by the way I think was absolutely the right thing to do, we've gotten tremendous channel leverage, tremendous go-to-market leverage -- we probably over-corrected to more generalists on account management and partner management. We're adding back print specialists in the go-to-market.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Let me address -- I think you followed up on that with -- and when do you expect supplies revenue.

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, good.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

We expect supplies revenue to stabilize in FY15. We've got a number of strategic initiatives, most of which you know about, that will take -- that are relatively early in their maturity stage, and they will take some time to show up. But that's where we start to see it in FY15.

We did see some softness in demand this quarter. We are actively managing that to see whether or not this is going to be a trend. The other data point that I think is important is when you think about supplies mix over the longer term, is that it's probably in the mid 60%s type range.

Meg Whitman - *Hewlett-Packard Co - CEO*

The only thing I'd add is the other thing we're excited about is managed print services. As I said on the call, managed print services -- first of all, it's a growth part of the market. We had terrific bookings, and we get 100% of the after market on that business.

Listen, we feel notwithstanding the results this quarter, we feel really good about the printing business. We've got some things we need to improve execution on a number of dimensions, but we feel really pretty good about this business.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

If I could throw in one more data point on the TCV in managed print services, up strong double digits year over year. We're making really good progress on the signings in that space.

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

Super, thanks for that. Next question, please?

Operator

Next question is from Steve Milunovich from UBS.

Steve Milunovich - *UBS - Analyst*

Thanks. Along the same lines, I wonder if you could address the go-to-market challenges in software, specifically what that means. Also, there's some signs that Europe might be taking a step back economically.

You guys are a bit overweight in Europe. Are you concerned about that looking forward?

Meg Whitman - *Hewlett-Packard Co - CEO*

With regard to go-to-market in software, we've got a very broad software portfolio. We've got big data, security, and our IT performance management suite across three major regions and many countries. Again, we're doing the adjustment to specialist to generalist -- which of these businesses need their own sales force, which can use the leverage of the global software sales force; and frankly, which can use the global HP sales force.

Robert Youngjohns is looking very carefully at market segmentation, the alignment of the sales coverage resources, and the opportunity for better attach with the rest of the HP portfolio. For example, TippingPoint with networking. We've got some work to do on our go-to-market.

We're basically doing the same thing. We've done a lot of work on go-to-market in EG. Mike Nefkens has done a lot of work on go-to-market on our enterprise services, and we're running that same play now in software.

The challenge in software is there is a fundamental market dislocation here, which is traditional license is moving to SaaS. As that happens, it will create a stronger, I think, longer-term revenue stream as an annuity. But it will create some dislocation in the near term, as that market shift gets under way, or continues to be under way.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

To address your question on EMEA, we're not really seeing that in EMEA. Our results from an EMEA perspective, if you look at the top three countries in the EMEA region -- basically Germany, UK, and I, and France -- they're growing mid- to high-single digits -- in the case of one of them, double digits, where we are seeing softness in EMEA is in Russia.

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

Okay, great. Thanks for that. Next up, please?

Operator

Next question is from Bill Shope with Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Okay, thank you. Could you comment on how gross margins are trending in the industry standard server segment, particularly as the mix continues to shift towards hyperscale; and perhaps provide some more detail on how your cost structure's evolving with the changing market dynamics? Obviously, you've regained plenty of momentum on the market share side, but just wanted to dig a bit more into the margin structure, and how you're thinking about that as well?

Meg Whitman - *Hewlett-Packard Co - CEO*

Sure. We actually had a good quarter in industry standard servers -- not just from top-line perspective, but also from a profitability perspective. What you see is our AUPs, or average unit prices, grew significantly double digits year over year, high single digits quarter on quarter, really on the strength of our very strong option attach.

We are also doing a really good job of segmenting the market, and figuring out where growth is, and good profitable growth. That's really helping with margins.

We also saw much improved discipline around discounting. We're driving very strong savings in supply chain. All of that is really contributing, despite the competitive pricing environment, contributing to improving margins in industry standard server.

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

Okay, thank you. Next question, please?

Operator

Next question is from Amit Daryanani with RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

Thanks. Just had a question on free cash flow guidance for the full year for FY14. Cathie, if my math's right, it sounds like you'll do about $1.6 [million] of free cash flow in Q4. I'm curious with the up-tick in net income you're expect in Q4, where do you expect the degradation of almost $1 billion in free cash flow in Q4?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

We don't typically update our free cash flow. We went out on a limb again this quarter to do that, because we are making such progress. The progress in the free cash flow is really on the strength of the working capital improvement that you saw. We saw the cash conversion cycle at eight days basically improve to 10 days year over year. Improvement across all the metrics, but obviously the strongest and better than expected was in the DPO space, where we had an eight-day improvement. We continue to stay focused on free cash flow and drive that hard, and we'll see how we end the year.

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

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

Operator

Sherri Scribner with Deutsche Bank.

Sherri Scribner - *' - Analyst*

Hi, thanks. You guys had very strong results in terms of operating margins for the PC business this quarter. I just wanted to get a sense of how sustainable these margins are in the personal system segment, and what types of margins you expect in this segment going forward? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

Let's talk a little bit about what drove the improvement in margins and PCs, and then we can talk about sustainability, because you can get a read-through a bit. The profitability improvements were driven by obviously the volume, the strength in the top line; but also operational cost reductions around warranty, logistics.

We also got a bit of a mix benefit in the material cost space. Obviously we're continuing to see a very competitive pricing environment. At its core is that we are doing a great job of segmenting the market, and figuring out where the market opportunities are -- where you can grow and grow profitably.

Make no mistake, we are still very focused on profitable growth. We saw some of that improvement in consumer. Consumer was up 8% year over year on the top line.

We also saw improving profitability. That maniacal focus on making sure we've got a very efficient, lean organization, as well as the segmentation on where the market opportunities are, I think are sustainable.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

I agree with that. I would also say that our product lineup continues to be very strong. In the end, you have to lead with great product, whether it's for the commercial space or the consumer space.

I feel good about the work we've done around supply chain, and all the work that Dion and his team has done. Perhaps most importantly, it's the strength of the product line up.

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

Great. Thanks for the question, Sherri. I think we've probably got time for one or two more. Next up, please?

Operator

It's from Keith Bachman of Bank of Montreal.

Keith Bachman - *Bank of Montreal - Analyst*

Hi, thank you. I wanted to go back to services, if I could. In the past, HP said that the booked-to-bill would be about one this year. I know you took revenue guidance down.

Is it still possible for the booked-to-bill to be one? If it is -- let's say it's about one -- signings, that would suggest signings will be down 6% to 7%.

Can you grow revenues in FY15 with signings down so much? Can you grow pre-tax income -- or excuse me, operating income dollars and services with signings down so much?

Meg Whitman - *Hewlett-Packard Co - CEO*

As I talked about, I think at the very beginning of this call, I do think the opportunity to improve the EPS at the HP level is, without revenue growth, is in fact in the enterprise services space, where we have a lot more cost that still needs to come out of that organization. I do think that you can get the EPS improvement that we were talking about. In terms of the booked-to-bill, we'll talk a lot more about this at our Security Analyst meeting, but we do expect to end the year with a booked-to-bill of approximately one in that business.

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

Great, thanks for that one, Keith. Last question, please?

Operator

From Aaron Rakers with Stifel.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Thanks for taking the question. I want to go back to the free cash flow story a little bit. When we started the year, you guys talked about 20 to 22 days of cash conversion cycle. Now we're at eight.

I'd just like to understand on a normal basis how you're thinking about that? On top of that, can you just quantify the impact of factoring, and what that had this quarter, and whether you anticipate that to continue going forward?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Sure, let's start with that. The factoring impact in the quarter over a year-over-year basis was roughly the same as last quarter, one to two days. Sequentially, there wasn't a material impact from factoring in our DSO or in our cash conversion cycle.

In terms of what is the sustainable level of the cash conversion cycle, we definitely believe we're below our sustainable rate at eight days. We certainly got a big benefit from the mix, the revenue mix, on PSG. That was approximately two to three days.

As you look at it long term, that mix is going to come back down. We do not expect that the PC business or the personal systems business will out-grow the rest of the Company over the long term.

Also keep in mind that cash flow can swing quarter to quarter for DSO and DPO based on the linearity of the business in the quarter. We'll talk a lot more about our working capital and our forecast for 2015 at our Security Analyst meeting.

Meg Whitman - *Hewlett-Packard Co - CEO*

Great. Well thank you all for joining us today. I think Cathie and I and the rest of the Senior Management Team continue to be very encouraged by the progress of the turn-around we are making. You can see it every day we're out with customers. The partners and the customers can see an enormous difference in our team members, in our product, in our innovation, and our will to win. I'm pleased because the organization is much quicker to recognize the opportunities, and much quicker to jump on the challenges that inevitably will come our way in a market that's changing as fast as this. Thanks very much -- progress, more work to do.

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

Great, thank you. Thanks everyone, and with that we'll close the call. Thanks very much.

Operator

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