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**HP Delivers Revenue Growth on Strength in Volume Segments**
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On August 20, 2014, HP reported a 1% revenue increase (up 1% after the effects of currency) for FY 3Q14 to $27.6 billion. This represents the first time the company grew revenue since the third quarter of FY11. Operating profit (non-GAAP) was $2.3 billion, flat with the same period last year. During the quarter, HP generated $3.6 billion in cash from operations, up 36% Y/Y. Free cash flow for the quarter was $2.7 billion. Overall, stabilization and strong execution in the PC space helped the company materially in the quarter, as did a better performance from critical parts of the Enterprise Group, specifically Industry Standard Servers (ISS) and Networking.

Earlier in the quarter, HP announced that Meg Whitman will be taking on the role of Chairman of the HP board of directors, in addition to her responsibilities as Chief Executive Officer. We view this as a very positive step for the company and an indication that the board has full confidence in Whitman's ability to execute her long-term turnaround strategy for HP.

Around the world, HP experienced mixed demand, with Asia/Pacific up 1%, EMEA up 5%, and the Americas down 1%. Geographic revenue contribution was as follows: Americas represented 45%, EMEA 36%, and Asia/Pacific 19%. We note that Personal Systems saw growth in Americas. Overall, Western Europe was stronger than in the past, while Russia was weak for most segments. In AP, China demonstrated "solid growth," while India and Japan were weaker than the rest of the region.

Performance by business unit was:

- Personal Systems revenue was up 12% to $8.6 billion. Operating profit was $346 million, up 51% Y/Y, representing 4% of revenue. Notebook revenue increased 17%, and units were up 18%; desktop revenue was up 8%, and units were up 9% for the quarter. Total units for Personal Systems were up 13% Y/Y. Commercial PC revenue was up 14% Y/Y, and consumer PC revenue was up 8% for the quarter, in stark contrast to the 22% revenue decline the consumer PC business experienced for the same period last year.
- Print revenue was down 4% to $5.6 billion. Operating profit was $1.026 million, or 18.4% of revenue. Overall, the business was pressured by weakness and associated inventory issues related to supplies. Supplies revenue was down 5%, hardware units were down 5% Y/Y, with consumer hardware unit shipments down 6% and commercial hardware down 2% Y/Y.
- Enterprise Group revenue was up 2% to $6.9 billion. Operating profit for the group was $966 million, or $14% of revenue. Industry Standard Servers revenue grew 9% Y/Y (compared with an 11% decline for the same period last year). Business Critical Systems (BCS) was down 18%. Storage was down 4%, while Networking was up 4%. Technology Services was down 3%. Interestingly, all segments of the Enterprise Group demonstrated relative improvement over the same period last year.
- HP Enterprise Services was down 6% in the quarter to $5.6 billion. Operating profit was 4.1% of revenue, or $228 million. IT Outsourcing was $3.2 billion (down 8%), while Application and Business Services was $2.4 billion, down 4% Y/Y.
- Software revenue was down 5% to $959 million for the quarter. Operating profit was $203 million, or 21.2% of revenue. Licenses were down 16% to 28% of revenue, with support flat at 52% of revenue and services up 1% at 12% of revenue. Software as a service (SaaS) doubled its growth rate Y/Y for the company to 8% and represents 8% of software revenue.

HP's performance was mixed this quarter. Volume segments such as PCs and Industry Standard Servers helped the company achieve an important milestone — a return to revenue growth. We note some specific points with respect to the quarter:

- HP has made very good progress in the PC space.The PC business is one of the toughest sectors of the IT industry. As recently as six months ago, the category was left for dead as the conventional wisdom was that PCs were being overtaken by tablets. However, this has not been the case. Tablet shipments have slowed, and PC shipments have meaningfully stabilized. At the same time, HP has done an excellent job of managing the channel, warranty costs, and inventory such that the company is gaining share in the space. As well, HP's product line has greatly improved for both enterprise customers and consumers. We note that some of the recent strength can be attributed to Microsoft's decision to cease support for Windows XP; however, we believe this wave of buying is fading. Quite simply, HP is executing better with better products. In a business that operates at tremendous scale, it can (and did) move the revenue, cash flow, and cash conversion cycles metrics for the company.
- The Enterprise Group made meaningful progress this quarter. HP's Enterprise Group is a grab bag of some of the most difficult market segments in the enterprise IT sector. IDC believes that the move to the cloud will make the enterprise hardware space an increasingly difficult place to do business. We believe that recently, HP saw the benefit of customer fallout associated with the IBM/Lenovo deal. Long term (2020), we believe that 70% of x86 servers will reside in third-party datacenters. This shows how fast the dynamics are changing in this segment. For HP's Industry Standard Servers Group to deliver 9% growth indicates that the products and the strategy are working, that is, delivering products that customers can leverage in their journey to the private cloud. In storage, HP needs to accelerate its progress in the converged space. This is where the proverbial "puck" is going. HP has a strategy, but growth is still hampered by older underperforming traditional storage line. We note that the fact that the sum of 3PAR, XP, and EVA systems declined at 7% (as opposed to 9% for traditional storage products) is a step in the right direction.
- We all know that printing is a cash cow for HP. What many don't realize is that printing is not going away; it's just changing. HP is executing on its strategy to go after the higher-value segments of the print space. This means that the company needs to transition out of some lower-margin consumer segments and older product categories in commercial that do not deliver a strong margin profile. We believe this can work over time as HP has the IP to deliver on the performance these products and customers demand. However, in the near term, it means at times the company will struggle with ink inventory (as it exits), and toner demand (as it calibrates demand). We believe HP can drive meaningful upside revenue from the printing space as it makes the transition to new products and offerings that meet new customer needs. In the quarter, HP indicated relative strength in areas such as graphics and managed print services. These are good signs that HP can add to its printing revenue base as it transitions its core product set.
- The Services Group is still migrating to a higher margin model. In the quarter, operating profit in the group increased nearly 1 percentage point. We believe this increase came from better engagement management and general labor savings from staff reductions (we believe services will have the largest number of employee reductions of any business unit as part of HP's turnaround plan). We believe services will continue to improve, and as the process of running off key accounts that do not achieve their profit profile with increasing the footprint in target accounts is managed, operating margins in the segment can be expanded. We expect this process will not be complete until FY15.
- HP software is refocusing for growth. From our perspective, the two most interesting trends for HP software are the move to SaaS, which is now growing at 8%, and the company's decision to reorganize the Software Group around four key domains. On August 22, HP announced in a blog post that HP software is now composed of four divisions: Marketing Optimization, Big Data, Security, and IT Management. By reorganizing in this manner, HP is effectively moving portions of Autonomy and Vertica into new areas to the Software Group in an effort to unlock value. Over the next few months, HP will be moving sales and marketing assets around to support this division. While this will take some time, we believe it's a more logical structure that will allow HP to focus the group around key areas of customer demand and HP strength.

**Conclusion**

There are many forces at work in executing HP's turnaround plan. A number of them played out this quarter:

- If HP can sustain its better performance in the PC segment, the benefits are not only material to the company's financial performance but buy the company precious time to execute the other parts of the turnaround plan. Importantly, we view the PC market as a long-term large slightly declining segment, meaning that HP's long-term strategy cannot hinge on PC dominance.
- HP's near-term execution in the enterprise segment is critical. The company's ability to succeed in the volume server, converged storage, networking, and technology services space will drive gross margins for the company higher, offering important leverage to the business. Beyond hardware, HP needs to build on its recent investments in its Helion Cloud services offerings. The company is taking a meaningful role in the OpenStack development efforts. Going forward, it needs to use its channel footprint to drive faster adoption of Helion in order to create a new enterprise revenue stream beyond hardware and, more importantly, in the cloud.
- Services and software need to transform faster. Enterprise Services is making the turn to a more profitable future. While the transition has been arduous, it's in the later stages of the transition. Over the next 12 months, it will be very important for the Enterprise Services Group to be able to point to deals that contributed to top-line growth, as opposed to contraction. In software, HP's focus on core areas of strength will be helpful in messaging to customers where HP is headed, and why it makes sense to engage. Today, HP's software customers many times have a relationship with one of HP's acquired brands, but not really HP's overall Software Group. Focus will change that and allow HP to engage customers in a more strategic discussion of how and where HP software can solve customer problems.

We believe progress in the areas stated above will have meaningful impact for the company. HP's performance this quarter built on recent momentum in its turnaround efforts. The company's move to cut costs and rethink multiple aspects of its business is vast. By the end of the restructuring program, HP will have shed up to 50,000 jobs while committing to innovation in areas such as computing architecture, semiconductor design, and next-generation imaging. HP is making progress. It can be seen in the performance of each of the business units — which in many cases have stemmed the declines of the past, or in some cases resumed growth. The progress is clear in the level of support the company consistently gets from its partners and customers. However, in many senses, HP has improved its ability to deliver for traditional IT segments. Now is the time to move beyond that base. In short, HP needs to more fully participate in the emerging long-term growth segments of the market. In FYQ3, we saw progress. Now it's time for acceleration.

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