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HP FY 1Q14: Flat Revenue and the Benefit of Expense Controls Translate to Earnings Leverage

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On February 20, 2014, HP reported a 1% decline in overall revenue to $28.2 billion (flat in constant currency, year over year) for the fiscal quarter ended January 31, 2014. Operating profit (non-GAAP) was up .9 percentage points to 7.1% of revenue, and non-GAAP EPS was $0.90 up 10% compared with the same period last year. It's important to note that the EPS figure was a $0.6 "beat" over Wall Street expectations. Looking forward, HP offered second-quarter EPS guidance of $0.85–0.89.

Once again, HP made significant progress in the process of "improving its balance sheet" by delivering cash flow from operations of $3.0 billion (up 17% y/y) we note that the company has seen a $6 billion improvement in its net cash position since FY 1Q13. The revenue performance announced indicates the first time HP has seen revenue growth for its overall business in the past 10 quarters. Also of note in the quarter were three conflicting forces that ultimately impacted profitability — onetime gains from the sale of real estate and IP and increased expense associated with litigation in which HP is involved.

Around the world, Asia/Pacific was down 1% year over year, EMEA was up 1%, and the Americas were down 2% (in constant currency, they were up 5%, down 1%, and down 1%, respectively). These regions represented 19%, 37%, and 44% of HP's total quarterly revenue, respectively. Interestingly, EMEA increased 1% y/y. On the call, it was noted that EMEA was a region of "relative improvement" compared with recent history.

Performance by business unit was as follows:

- Personal Systems revenue was up 4% to $8.5 billion. Operating profit was $279 million, representing 3.3% of revenue, up 25% from $223 million for the same period last year. HP was careful to point out that profitability is a high priority in this business and that it will be less interested in unit share gains at the expense of profits. Overall units for personal systems were up 6% (compared with a 5% decline last year for the same period). Notebook revenue and units were up 5%, while desktop revenue was down 1% and units were down 3% for the quarter.
- Printing revenue was down 2% to $5.8 billion. Operating profit was $979 million, or 16.8% of revenue (this compares with $953 million for the same period last year). Printing hardware units were up 5% y/y (compared with an 11% decline for the same period last year), with consumer hardware unit shipments up 4% and commercial hardware units up 6%. Overall, supplies were down 3%. Of note was the fact that the company indicated that the ink portion of supplies increased in the quarter, while the toner portion of the supplies number declined. We believe that while HP has seen growth in its laser hardware business, it's currently experiencing a lag between hardware sales and supplies pull-through. As well, this is a highly competitive segment where Japan-based competitors have pricing power through the weakness in the yen.
- Enterprise Services was down 7% in the quarter to $5.6 billion. Operating profit was 1.0% of revenue, or $57 million compared with $76 million for the same period last year. IT outsourcing (ITO) was down 9%, while Application Businesses Services was down 4% year over year. The company indicated that the longer-than-expected revenue runoff of longstanding "key account" projects is hurting revenue growth. The company also noted that overall signings in the first quarter were "soft." We believe that the timeline of this group turnaround is long term, with near-term revenue growth unlikely.

- Enterprise Group revenue was up 1% y/y to $7.0 billion. Industry standard servers (ISS) revenue was up 6% (compared with a 3% decline for the same period last year), while Business Critical Systems (BCS) was down 25% year over year (compared with a similar decline last year). Notably, this portion of the group now represents only 3% of group revenue (down from 4% last year). Storage was flat year over year (compared with a 13% decline for the same period last year). Networking was up 4% for the group. Technology Services decreased 4% year over year, owing to the weakness in the BCS business. We note however that growth in Technology Services associated with storage and networking offset the declines in BCS.
- Software revenue was down 4% to $916 million for the quarter. Operating profit decreased to $145 million, or 15.8% of revenue (down from 17% last year). HP reported that new licensing revenue was down 6% and that revenue for software support decreased 2%, while revenue from Software Services shrank 5%, year over year. In the quarter, HP noted strength in the software offerings associated with security, cloud, and big data — specifically mentioning a win that Autonomy had with China Mobile. For the quarter, Autonomy delivered software-as-a service-bookings growth of 15%.

This was another quarter of progress for the company. Many of its business units saw improvement over recent history. As well, the difficult expense cuts that that company has made over the past 24 months are paying dividends. To the extent that the company can deliver modest revenue growth, the options that the company gains (to either invest in the business or deliver profits to shareholders) are material.

We note the following specific points with respect to the quarter:

- Personal Systems beat expectations, buying time to build out offerings that support new strategy. The PC space is clearly in transition, not simply a decline. HP's performance in the quarter is indicative of a company that can leverage its enterprise footprint to meet the computing needs of customers that require next-generation PCs. We are not too surprised that the company saw growth in commercial revenue, as this class of customer needs to refresh technology on a regular cycle. Interestingly, the fact that consumer revenue only shrank 3% in the quarter may be an early indication that this segment is finding a "bottom." This will take a number of quarters to play out, but these are not the levels of decline expected only six months ago. Overall, the better performance of this group gives the company the ability to further experiment in this segment. We believe this will include additional offerings in the Android and Google Chrome space, and possibly a move back into the smartphone segment. HP will need to be careful not to "overskew" the market but rather develop its ability to quickly "test" the viability of products with an increasingly demanding customer base.
- The Enterprise Group is making progress. HP saw some of its core segments make material progress in the quarter — specifically industry-standard servers (ISS), storage, and networking. Not surprisingly, HP saw strength in the hyperscale businesses — an important, emerging category. However, we believe the fact that the company saw growth in the combination of 3PAR, EVA, and XP storage products is a huge sign of progress. Two of these categories are in decline, with only 3PAR growing. In fact, 3PAR increased 70% year over year, with converged storage growing as a category for HP at 42%. This is impressive growth and speaks to the value HP customers are seeing from the evolution of HP's storage offerings. This growth is significant as it is offset by the 25% decline in the Business Critical offerings. Put simply, HP needs to accelerate the transformation of this business. HP has put a high priority on innovation in this segment, with material investments in Moonshot, Networking, and Storage and ISS offerings. We believe the company is making material progress, and the Enterprise Group will be able to deliver revenue over the course of the year. We note that the group will likely be helped by IBM's x86 Server Group sale to Lenovo, which we believe could give HP the opportunity to gain share as customers consider alternatives.
- Printing is a business in transformation. As we have stated previously, we believe the printing business for HP will be a low single-digit growth business. This growth is highly dependent on HP's ability to generate new sources of revenue not only from products (hardware and supplies) but from emerging services categories. While the near-term

competitive dynamics for this business are very difficult, we expect that the investments HP has made in category expansion (Indigo) and managed print services, combined with product innovation in historically strong areas such as Laser and multifunction peripherals, will allow the company to grow and expand margins modestly over time. This is important as it provides a significant and steady cash flow base for the company.

- Services will be a long-term project. HP's progress in services is slow as a result of the company wrestling with customer commitments and a highly competitive market. HP is undertaking a number of simultaneous maneuvers in this space — unwinding customers as it increases its focus in areas such as application services (via customers' move to the cloud), and business process outsourcing. Overall the goal is straightforward — increase the long-term revenue and profitability of this segment. We believe this will mean more focus HP and, in the long term, a more predictable profit stream, but it will not happen in the near term.
- Software may be a brighter spot than people realize. HP's Software Group has been the subject of much cynicism, with many confusing the Autonomy write-down with a lack of IP in the software space. We believe HP's software offerings have evolved significantly, and initiatives such as HAVEn allow the company to leverage assets such as Autonomy and Vertica into an ecosystem that can address customers' big data challenges. We note that while SaaS bookings continue to grow, they are more than offset by license declines. We believe HP needs to change the discussion around its software strategy and potentially increase its sales focus in the category in order increase its relative mindshare (and bookings) in the segment.

Conclusion

HP's announcement on February 20 was a sign of good progress for the company. Most notably, the company showed flat to slightly growing revenue performance. This is a significant inflection point for the company from two aspects: The company has been steadily declining in revenue terms since prior to HP CEO Meg Whitman's arrival, and many of HP's large capitalization tech rivals are struggling with growth. In short, the direction of HP's progress is going in the right direction.

HP is quick to point out that there's "more work to do," and we agree. HP is perhaps the most complex technology supplier in existence. The forces upon the company are highly diverse and at times work in opposite directions (for example, investing in a sales force and a channel simultaneously). Major parts of the business are in the midst of significant strategy changes, such as personal systems, services, and software. At the same time, customers are rethinking their collective relationship with suppliers like HP. The emergence of the 3rd Platform of IT (cloud, big data, social, and mobile) has changed the conversation and the need for IT as it used to be created and sold. HP is in the unenviable position of needing to make the difficult jump from being a 2nd Platform leader to a 3rd Platform challenger. This starts with innovation and a break from past practices — which the company appears to be willing to undertake.

The progress HP is making allows for flexibility and experimentation. We believe this will translate into an increase in new offerings, more experimentation, and acquisitions that while individually will not be "huge" can collectively make a difference in HP's ability to compete on the 3rd Platform. HP is exiting "recovery mode" and now needs to assess how it will tackle growth for the next era of IT.

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