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HP FY 2Q14 Earnings Expectations Met, But More Layoffs Ahead
May 23, 2014 - IDC Link
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On May 22, HP announced the next milestone in its longstanding turnaround plan. The company announced non-GAAP EPS of $0.88, up 1% from the same period last year. Second-quarter revenue was $27.3 billion (roughly $110 million lower than expectations). Second-quarter cash flow from operations was $3.0 billion, a drop of 16% from the same period last year. Notably, cash flow from operations improved by 44% last year, making for a difficult comparison.

On the call, HP indicated that it would be increasing the number of employee reductions associated with its 2012 multi-year restructuring plan. The company is now estimating an additional 11,000–16,000 employees will be impacted. We expect that by the end of this fiscal year, the company will have reduced the total number of jobs by 41,000, adding 7,000 job cuts for the remainder of this year. The company indicated that the additional $1 billion in costs savings would take the form of additional earnings and research and development investment dollars.

HP saw mixed performance across its business units, with Printing and Personal Systems growing 2% from the same period last year, while Enterprise Group and Enterprise Services (ES) were -2% and -7, respectively. Software was flat. Notably, within Printing and Personal Systems, Personal Systems was up 7%, while printing revenue declined 4% for the quarter.

Geographically, the distribution of revenue was as follows: Americas 43% (down 6%), EMEA 38% (up 4%), and Asia/Pacific 19% (up 1%). Notably, in EMEA, Western Europe grew, with double-digit growth in Personal Systems. In the Americas, Brazil was "weak," while in APJ, China saw growth in the Enterprise Group and printing, while PCs were strong in Japan due to the migration of customers off Windows XP.

Financial Details

Performance by business unit was as follows:

- Personal Systems revenue was up 7% to $8.2 billion. Operating profit was $290 million, representing 3.5% of revenue, up .2 percentage points from the same period last year. HP's performance in PCs was impressive given overall market performance. In a weak overall market, the company was able to grow units 10% (compared with a 21% decline for the same period last year). Notebook units and revenue were up 6% and 7%, respectively, while desktop revenue was up 8% and units were up 6% for the quarter.
- Printing revenue was down 4% to $5.8 billion. Operating profit was $1,140 million, or 19.5% of revenue (up 3.6% y/y). Supplies revenue was down 6%, while total hardware units were up 1%. Commercial hardware was up 3%, while consumer hardware was flat. The margin improvement in the quarter can be attributed to both the positive impact of currency (+1.5% pts) and a more favorable mix of hardware and supplies. In the quarter, supplies inventory increased slightly due to EMEA, while the company's ongoing struggles with toner demand continue to be a drag on the performance of the group.
- Enterprise Services was down 7% in the quarter to $5.7 billion. Operating profit was 25% of revenue, or $144 million. IT Outsourcing (ITO) was down 7% to $3.6 billion, while Application and Business Services (ABS) was down 8% year over year to $2.1 billion. ITO represented 63% of revenue, while ABS was 37% of the mix.

- Enterprise Group revenue was down 2% y/y to $6.7 billion. Industry Standard Server (ISS) revenue was up 1%, while Business Critical Systems (BCS) was down 14% year over year (this compares with a 37% decline for the same period last year). Storage was down 6% year over year. Converged storage revenue was down 3% to $338 million, while traditional storage product revenue was down 8%. Technology services (TS) decreased 5% year over year. Networking was up 6% for the quarter (compared with 1% growth for the same period last year).
- HP Software revenue was flat at $971 million for the quarter. Operating profit was $186 million, or 19.2% of revenue. HP reported that new licensing revenue was up 8%, and that revenue for software support was down 4%, while revenue from software services grew 3% year over year.

IDC Analysis

HP's ability to manage its business has improved materially over the past two years. The ability to respond to market changes and deliver new products faster has allowed HP to gain share in core markets while repositioning its business to new growth areas. However, in many business units, the company is simply not yet seeing the growth need to fund the long-term profit and investment needs of the business — hence the additional reduction in employees.

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

- **Enterprise Group still in transition.** Compared with other groups in HP, the transition of Enterprise Group is perhaps most representative of the changing environment. As customers leverage all forms of the cloud, buying patterns change. This puts pressure on HP's Industry Standard Server business and requires that the company develop new offerings (such as its recently announced partnership with Foxconn) to profitably deliver products to this accelerating class of customer. At the same time, lackluster demand for storage is putting pressure on the business in an area that has been steadily improving. We expect that HP will see storage return to growth as we expect 3% revenue growth for the category overall in 2014. In terms of other transitions areas, the decline in Business Critical Systems is showing early signs of decelerating (with sequential growth in the quarter but still a 14% y/y decline). Finally, Technology Services is starting to see a more meaningful contribution from new offerings such as Proactive Care and Datacenter Care, which offset the declines associated with the steady decline of BCS.
- **Personal Systems gains impressive.** In PCs, HP delivered a strong quarter in a declining market. HP's 10% growth for the quarter is impressive given that IDC is forecasting a unit decline for the worldwide PC market of 6.0% for all of 2014. Interestingly, HP saw stability in the EMEA segment (recently a weak spot for all worldwide players). As well, the company clearly benefited in all segments from the buyer activity associated with the cessation of support for Windows XP. Interestingly, the fact that HP saw modest growth in the consumer notebook segment is potentially an important inflection for the industry in that it could be an indication that the long-awaited consumer and commercial upgrade cycle is starting. While in both the consumer and the commercial PC segments life cycles have expanded, we believe this is an indication that the role of the PC is more secure than many believe, and that new innovative PC form factors can be a source of growth in segments previously thought to be in steady decline.
- **Larger contribution needed from printing.** It's not a secret that HP has come to depend on the profits derived from its printing business. Through better management of the hardware and supplies business (and the impact of currency) the company was able to expand operating profits in the quarter. However, we believe the leverage HP gains if this segment can deliver growth is significant. Over the course of the past few years, while HP has invested in innovative programs to improve ink sales (Ink In the Office and Ink Advantage), the weakness associated with older products (hardware and toner sales) continues to be a drag on the group. This combined with the fact that the company was late to the managed print services space has meant that HP is not fully capitalizing on this opportunity. We expect HP will further invest in this important segment, driving higher absolute profits in areas such as color laser, large format, and even 3D printing.

- **Enterprise Services reengineering continues.** While ES shrank again in the second quarter of the fiscal year, operating profits were flat year over year. Importantly, we expect that the majority of the large account runoff that the company has had underway will be largely complete by the end of this fiscal year. This is an important milestone as HP will then have a steady base of business from which to grow. While we do not expect HP will change its strategy in the enterprise services space, we do expect that it will be increasingly focused on smaller, more profitable Infrastructure Technology Outsourcing and Application and Business Services deals in areas where the company can differentiate. This focusing of efforts will likely translate to additional cost reductions in the group as part of the company's stated multi-year restructuring plan.

Conclusion

The IT market is moving at breakneck speed. HP's management team has a daunting task in reengineering the world's largest IT supplier as its core customers transition to a new model of computing based on cloud, mobile, big data and analytics, and social technologies. In this sense, the progress that the company has made is impressive. The operating company's balance sheet has improved significantly, long-term debt is down, and free cash flow has improved. These are the result of better management of the core business and the leverage associated with increased efficiency in a more stable revenue environment.

However, even with increased efficiency, HP needs revenue growth. As the quarters have passed, HP has pushed out its time frame for growth —increasing the need to further reduce costs. We note that the company believes that it can return to growth, and that the cost reductions announced on May 22 are more a function of uncovered opportunities for efficiency. Given the significant number of acquisitions HP has undertaken over the past 14 years, there are certainly opportunities for improvement; however, reducing costs is also a hedge against lackluster growth.

HP's improved business management has afforded the company critical time to invest in the business in terms of process and technology. While the fruits of these investments have not fully been realized, we are seeing signs of progress. Acquisitions such as Vertica and Autonomy have now been integrated into HP software. Each experienced significant growth in the quarter but only allowed HP to keep its software division flat in terms of overall growth.

As HP looks to its next chapter, we believe the company needs to think even more strategically about where it will find growth, and how it will place its bets. HP talks about the new style of IT, where cloud, mobility, security, and analytics are the drivers of growth. We agree these are huge areas for customer investment. Near term, HP needs to participate more fully in each of these segments — perhaps through targeted midsize acquisitions — to help customers address next-generation infrastructure pain points across industries. The next era of IT is upon us, and for HP to thrive, it needs to step up the transformation.

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