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HP 2Q FY 2015: HP Remains on Course for Separation
May 22, 2015 - IDC Link
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On May 21, 2015, HP announced non-GAAP EPS of $0.87, down 1% from the same period last year. Second-quarter revenue was $25.5 billion. Second-quarter cash flow from operations was $1.5 billion, a drop of 51% from the same period last year. In the quarter, HP returned $950 million to shareholders in the form of share repurchases and dividends.

HP announced a couple of items in conjunction with its earnings results:

- The $2.3 billion sale of a 51% stake in its H3C Technologies Co. to China's Tsinghua Holdings creates a new entity that includes H3C Networking and HP's China-based server, storage, and technology services businesses. The unit will be branded H3C.
- An update was presented on the future leadership of both new HP companies. Current HP CFO Cathie Lesjak will become CFO of HP Inc., while Tim Stonesifer (currently CFO of HP's Enterprise Group) will become CFO of Hewlett Packard Enterprise. In addition, Chris Hsu will become COO at Hewlett Packard Enterprise and Alan May joins HP Enterprise from Boeing and previously PepsiCo as Head of Human Resources.

HP experienced weak demand across a number of its business units, with Printing and Personal Systems shrinking 7% and 5%, respectively, (6% for the combination) from the same period last year, while the Enterprise Group and Enterprise Services were -1% and -16%, respectively. Software declined 8%, while HP Financial Services declined 7% in the quarter.

Geographically, the distribution of revenue was as follows: Americas 45% (down 2%), EMEA 36% (down 12%), and Asia/Pacific 19% (down 17%). HP experienced significant currency headwinds in the quarter with 65% of the company's revenue coming from outside of the United States and 50% of that portion coming from EMEA (which has experienced particularly weak demand).

Financial Details

Performance by business unit was as follows:

- Personal System revenue was down 5% to $7.7 billion. Operating profit was $235 million, representing 3.0% of revenue, down .5 percentage points from the same period last year. Even in a weak demand market, HP was able to gain unit share in all regions with total units up 2%. Notebook units and revenue were up 19% and 5%, respectively, while desktop revenue was down 17% and units were up 4% for the quarter.
- Printing revenue was down 7% to $5.5 billion. Operating profit was $996 million, or 18.3% of revenue (up 3.6% y/y). Supplies revenue was down 5%, while total hardware units were down 4%. Commercial hardware (units) were up 1%, while consumer hardware was down 6%. Notably, supplies inventory in the quarter ended at slightly higher levels. The company noted that it will be working this level back to normal levels in the coming quarter.
- Enterprise Services was down 16% in the quarter to $4.8 billion. Operating profit was 4% of revenue or $194 million (up 1.4% y/y). IT Outsourcing (ITO) was down 20% to $2.88 billion, while application and business services (ABS) was down 8% year over year to $1.9 billion. ITO represented 60% of revenue, while ABS was 40% of the mix — roughly the same mix as the same period one year ago.

- The Enterprise Group revenue was down 1% y/y to $6.6 billion. Industry Standard Servers (ISS) revenue was up 11% (compared with 1% for the same period last year), while Business Critical Systems (BCS) was down 15% year over year (this compares to a 14% decline for the same period last year). Storage was down 8% year over year. Converged storage revenue was up 5% to $356 million, while traditional storage product revenue was down 18% to $384 million). Technology services decreased 8% year over year. Networking was down 16% for the quarter (not including the recently closed Aruba networks acquisition).
- HP Software revenue was down 8% at $892 million for the quarter. Operating profit was $160 million, or 17.9% of revenue. HP reported that new licensing revenue was down 17% and that revenue for software support was down 2%, while revenue from software services declined 11%, year over year. While software-as-a-service (SaaS) revenue declined 5%, the company did indicate that SaaS bookings increased in the quarter.

IDC Analysis

As HP's planned separation approaches, this was a busy quarter for the company. It closed on a number of acquisitions (including Aruba Networks and security firm Voltage), while it divested photo sharing company Snapfish. From an overall demand standpoint, it was a lackluster quarter. Across all business units, the company experienced revenue declines. While there were bright spots, such as industry standard servers, converged storage, and notebook unit shipments, historically consistent areas of strength such as printing (supplies and hardware) experienced weakness. While enterprise services continues to contract, the company was able to increase margins for the unit as it runs off long-standing deals that do not meet margin requirements.

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

- **Enterprise Group making progress.** HP's progress in the Industry Standard Server space is indicative of improvements the company has made in its core Gen 9 product set. In addition to 11% growth, the company indicated that the backlog for ISS products is "strong," indicating likely similar performance for the current quarter. We note that, while the move to density-optimized products pressured margins, the customer reception for the product is impressive. In storage, the company is nearing the tipping point where newer converged storage revenue will surpass legacy storage products in revenue terms by the end of the fiscal year. Interestingly, while business critical systems continue to decline (dragging down Technology Services demand as well), the company saw improvements in operating profit for BCS and strong demand for newer offerings such as the Intel x86-based Superdome X line. Finally, while networking declined in the quarter 16%, we believe that HP's two recent decisions — acquiring Aruba networks and divesting 51% of H3C — will prove beneficial for the company. The Aruba deal significantly improves HP's ability to participate in the growing enterprise WLAN market, while the H3C/Tsinghua transaction will likely improve the company's ability to participate in a far wider set of deals in China. We believe what's most interesting about this deal is that it includes HP's server and storage offerings, thereby significantly increasing HP's portfolio of offerings for Chinese customers requiring an "onshore" headquartered supplier.
- **Personal systems products delivering value but conditions tough.** In the first quarter of 2015, IDC estimates that the PC market declined by 6.7% in unit terms. In that same time period, we estimate that HP grew units 3.4%. We believe this is the direct result of an improved, more focused product line for both commercial and consumer customers. While this is a strong relative improvement for the company, we expect that the current quarter will be challenging as consumer demand will likely slow in anticipation of the Windows 10 announcement and rollout. While this will be a concern for the company, its strong commercial line will limit overall exposure as the enterprise move to Windows 10 will be far more protracted than in the consumer space.
- **Printing under pressure.** HP has taken a number of steps to more effectively compete in the printing space. This has included product innovation investment as well as innovating programs such as "ink in the office" that have driven demand in recent quarters. However, even with a compelling product offering, in the current macroeconomic environment, current

conditions are simply working against HP in this segment. Over the next few quarters, we believe HP will likely target higher-value segments such as large format, graphics, and color laser to a larger degree in an effort to improve margin. As well, the company's expected entrance into the 3D printing space will open new opportunities for the company, particularly if the company can bring the technology to under- and non-served sets of customers.

- **Software must improve.** HP has been investing in the software space for a long time. As is the case for nearly all software suppliers, license revenue is declining. However, for HP, even software as a service is declining in revenue terms. In the software space, it's critical for the company to increase its ability to not only increase software as a service but the percent that SaaS represents of HP's total software business — as license revenue will continue to decline at an increasing rate. We believe addressing this will include meaningful acquisitions in the security, information management, systems management, and analytics space. We believe that post-separation, this business unit will receive the most consideration for potential acquisitions by Hewlett Packard Enterprise.
- **Enterprise Services complexion changing.** Even though Enterprise Services revenue declined 16% in the quarter, margins improved by 1.4% y/y. While we believe this is a function of intentional key account run off, it's also a function of the aggressive cost reductions undertaken by the unit. It's clear that the complexion of this business is in transition, with increased margin pressure in the IT outsourcing space. Given customer demands for smaller, less profitable deals, we expect that HP will initiate additional cost reductions in this area. While the company did not provide detailed guidance, it did indicate that it was considering an additional $2 billion in cost reductions. We expect that the company will provide more detail on these reductions as it nears separation.

Conclusion

HP is moving toward its planned separation later this year. HP has identified approximately $400 million–450 million in annual dis-synergies as a result of the new corporate structure. HP indicated that these expenses would be equally split across the two companies. To offset this, HP is planning an additional $1 billion in expense reductions (in FY 2016) to cover the ongoing incremental expenses. While these are large figures, they represent the scope and scale of what HP in undertaking.

HP is preparing for a massive transformation. Not only will this include the creation of two new fortune 50 companies, it will require that it is completed without revenue or customer disruption. As a result of the separation, HP will have the ability to focus and invest in core markets with the ability to see the impact of these changes in far shorter time frames. In a world of accelerating change, this should translate into opportunity.

In the end, the new structure for HP must translate into revenue growth. Across the company's business, change is the order of the day. While at this point most of HP's change is self-inflicted, much of it is market driven. It's clear that HP is moving quickly to be more relevant to customers. We believe HP's recent moves indicate that it's willing to invest in order to change as rapidly as possible. Change has taken the form of new product investments, acquisitions, divestitures, partnerships, and massive restructuring. In some segments, HP is delivering on change, but in many, it needs to move faster.

The next six months will be a defining period for HP. If done correctly, it will come out the other side stronger and more focused and relevant to customers, both in terms of products and the ability to execute. Given recent execution and decision making, we believe not only that HP can make the transition but that it's worth the risk.

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