Hewlett Packard

2015 Second Quarter Earnings Conference Call

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CORPORATE PARTICIPANTS

Meg Whitman - *Chairman, President, and Chief Executive Officer*

Cathie Lesjak - *Executive Vice President and Chief Financial Officer*

Dion Weisler – *Executive Vice President, General Manager of Printing and Personal Systems*

Jim Bergkamp - *Vice President of Investor Relations*

PRESENTATION

Operator
Good afternoon and welcome to the Second Quarter 2015 Hewlett-Packard Earnings Conference Call. My name is Amy and I'll be your conference moderator for today's call. At this time all participants will be in listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference. Should you need assistance during the call, please signal a conference specialist by pressing the "*" key followed by "0."

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. Jim Bergkamp, Vice President of Investor Relations. Please proceed.

Jim Bergkamp
Good afternoon. Welcome to our Fiscal 2015 Second Quarter Earnings conference call with Meg Whitman, HP's chairman, President and Chief Executive Officer; and Cathie Lesjak, HP's Executive Vice President and Chief Financial Officer.

Before handing the call over to Meg, let me remind you that 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, the execution of restructuring plans and any resulting cost savings or revenue or profitability improvements; any projections of revenue, margins, expenses, earnings, earnings per share, HP's effective tax rate, cash flow, share repurchases, currency exchange rates or other financial items; any statements of the plans, strategies and objectives of management for future operations, including the separation transaction, and any statements concerning the expected development, performance, market share or competitive performance related 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 its 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 quarterly report on form 10-Q for the fiscal quarter ended April 30, 2015.

Revenue, operating profit, operating margin, net earnings, diluted net earnings per share, income tax rate, cash and cash equivalents, operating cash flows, total company debt, capital expenditures 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 intangible assets, restructuring charges, separation costs 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 webpage at www.hp.com.

I'll now turn the call over to Meg.

Meg Whitman
Thanks Jim, and thanks to all of you for joining us today. With the first half of fiscal 2015 now behind us, I'm pleased to report that once again we delivered the results we said we would. We executed well in a tough market environment and in Q2 we delivered non-GAAP diluted EPS of $0.87, at the high end of our previously provided outlook range. Cash flow from operations was $1.5 billion, free cash flow was approximately $800 million, and we returned approximately $1 billion to shareholders in the form of share repurchases and dividends.

In the quarter, we executed well across Industry Standard Servers, Converged Storage, Personal Systems and Graphics, and Enterprise Services-improved profitability. We continued to invest in innovation across the company, and improve our go-to-market approach. At the same time, we faced significant market challenges due to currency movements, softness in PCs, home printing, and IT outsourcing markets and execution challenges in pockets of the business that require more work. But overall I'm pleased with our progress and the turnaround.

Turning to the separation, as you will recall last October we announced our plan to separate HP into two independent Fortune 50 companies. Today I'm more convinced than ever that this is the right thing to do. Over the past six months we've seen the markets continue to shift and evolve at a rapid pace.

In Hewlett Packard Enterprise, our customers are demanding services and solutions that will help them manage traditional IT better, while planning their journey to a hybrid infrastructure, and we need to move faster and smarter to meet that demand. At HP Inc., we will continue engineering multi-OS devices and immersive computing experiences for business and consumer, and ink and laser-based solutions that provide a faster, more affordable, exciting way to print, manage and deliver content, all while continuing to invest in strategic areas like 3D Printing. The separation will enable us to do that.

Since October, we've made substantial progress across a number of areas that gives me confidence that we'll complete the separation by the end of our fiscal year. We've completed the leadership and organizational structures for each company and largely completed our work force assignments. We've made progress in recruiting new board members for each company. We've evaluated how we can best meet customer needs and as a result have planned a new, optimized, partner-driven go-to-market approach in over 50 global markets. Our real estate teams have made decisions about our sites around the world, and we've performed thousands of hours of IT system testing ahead of the separation. We've also announced a new brand that represents the future for Hewlett Packard Enterprise. All of that while continuing to deliver on our commitments in terms of FY15 business performance. As I've said before, one benefit of our separation is that the disciplined process of reviewing every aspect of the new companies is uncovering opportunities to take costs out and improve the way we do business.

Even at this early stage, each new organization is optimizing for the realities of their markets and unique competitive sets. As we dive deep into the planned organizations, we've identified both dis-synergies required to run separate companies, as well as opportunities to streamline our processes and ultimately improve both cost structures. Cathie will provide more detail in a few minutes, but we estimate that the total dis-synergies associated with the separation will be approximately $400 million to $450 million annually, divided about equally between the two companies. And we believe we can offset more than half of these dis-synergy costs in fiscal year 2016, and more than fully offset these costs by fiscal year 2017.

As separate companies we'll have sharper focus on the markets we serve, the ability to adapt and shift more quickly, and a tighter linkage between rewards and results, and I can already see this beginning to take hold across HP. There's a greater feeling of accountability and I'm seeing strong execution and more disciplined cost management. We're also continuing to make smart moves to set Hewlett Packard Enterprise and HP Inc. up for success.

Over the first half of this year, we've done a number of small transactions including the acquisition of Voltage, a data security provider that complements our existing information security and encryption business, and the announced divestiture of Snapfish, the online photo-sharing platform. Just this week, we closed on the acquisition of Aruba, and I'm really excited about combining our networking portfolio and broad channel with Aruba's highly complementary solutions and specialized sales team. The teams have already hit the ground running with the cross-selling opportunities.

And just this morning we announced a groundbreaking partnership that will bring together HP's Chinese Enterprise technology assets and China's prestigious Tsinghua University to create the leading Chinese provider of IT infrastructure. Under the agreement, Tsinghua will purchase a 51% stake in a new business called H3C, comprising our H3C technologies business and HP's China-based Server, Storage, and Technology Services businesses for approximately $2.3 billion. This values the overall new H3C business at about $4.5 billion. The combined company will build on H3C's extensive and valuable patent portfolio, best in class products and customer focus, and Tsinghua's world-class research capability. In one move we have repositioned HP and shifted the entire technology landscape in the critical Chinese market to accelerate our overall performance and better serve our customers and partners.

Turning to innovation, we continue to drive the product road maps for both Hewlett Packard Enterprise and HP Inc. We recently announced new and enhanced purpose-built compute platforms and solutions, including our Apollo family of servers which support emerging applications, including mass content storage, block and file storage, unstructured and real time analytics, as well as simple and transactional databases. These platforms are specifically designed to help customers leverage their data to drive business outcomes, like faster decision-making, improved operational efficiency, and direct content monetization.

Network Functions Virtualization, or NFV, is market poised to transform the telecom industry, and we have a strong position in this emerging market. Just over a year ago we introduced the HP OpenNFV program providing telcos the resources to test NFV proof of concepts. Recently, Telefónica, one of the world's largest telcos, selected HP as the technology provider and systems integrator to virtualize its global infrastructure. You can expect to see more as we advance in this space.

In Enterprise Services we announced a partnership with FireEye, one of the leading security software companies. The partnership makes incidence response, compromise assessment and threat detection offerings available to HP's Enterprise Services' most strategic clients globally. This agreement helps HP protect our customers' critical information assets from advanced cyber-attacks, and supports our strategy to be a world class provider of security services.

And in software, we announced several new security software offerings, we also unveiled new software releases designed to help organizations deliver mobile application that accelerate the delivery of every phase of the mobile app lifecycle, from creation and pre-production to delivery and post-production management.

In printing, we announced a new series of laser jet printers designed to make businesses more efficient. Built around the latest in our toner formulation, they use less energy, take up to 40% less space and wake up, print, and duplex in a fraction of the time. This announcement represented HPs most significant laser printing re-engineering since the introduction of the first laser jet in 1984.

Finally in personal systems, HP announced a new Spectre x360 at Mobile World Congress earlier this year. This 13.3 inch convertible PC delivers a high quality ultra-thin design that provides the productivity of a high-end notebook, tablet mode for on the go, tent mode for play, and stand mode for watching entertainment. This product garnered more than 9 Best of Show Awards at Mobile World Congress and continues to be recognized as one of the top products in the market.

Turning to our execution, we have made significant progress across a lot of fronts over the past six months and importantly, we see no distraction from running business. In fact, the go-to-market approach of this company has drastically improved over the past three years and I see that getting stronger going forward. Industry Standard Servers had a very strong quarter growing 17% in constant currency, with growth across all regions driven by strong adoption of our Gen9 portfolio and strength in Density Optimized in support of the explosion of big data in the market.

In Enterprise Services, while the top line remains under pressure, the team improved profitability towards their FY15 outlook of 4% to 6%. Signings were up year-over-year even without the Deutsche Bank deal that we closed at the beginning of the quarter, and Strategic Enterprise Services TCV was strong.

Personal systems once again outgrew the overall market and all competitors, gaining share in every region. We saw particular strength in notebooks supported by key products including our new EliteBook 1020 and Spectre x360 I mentioned earlier.

In Printing, currency is a challenge, but we gained a point of share in laser year-over-year and saw a good growth in value multifunction printers and graphics. We also saw significant momentum in Managed Print Services with year-over-year growth in total contract value led by strong new logo signings.

So overall, our performance in Q2 was in line with our expectations, but we continue to face some significant headwinds that impacted our results in the first half and may continue through the rest of the year. Unfavorable currency movements continue to be a challenge in the quarter, with over 65% of our revenue coming from outside the United States and over half of that in EMEA, we are disproportionally impacted by currency movements versus our competitors. And remember that currency impacts HP in multiple ways, the strength of the US dollar negatively impacted our reported revenue. For example, our second quarter revenue declined approximately 7% year-over-year, as reported, but only 2% in constant currency. In addition, the recent currency movements have enabled our competitors to price very aggressively. For example, aggressive pricing from our Japanese competitors in the printing business, given the weakness of the Yen, continue to be a challenge.

Finally, the currency movements and the associated re-pricing impacted demand. We managed to offset the currency impact to company level operating profit in Q2 through hedges and re-pricing. We also saw geopolitical challenges in certain markets, including Russia and

China, as well as softer public sector spending in the UK. The PC market is also weaker than I expected at the beginning of the year, though Dion and his team are doing a great job managing through and gaining profitable share.

Finally, we continue to face execution issues in pockets of the portfolio, including software and networking. In Software Q2 revenue was disappointing primarily on license weakness, but Robert and his team are making progress on realigning the portfolio and go-to-market towards SaaS as well as partnering more closely with Enterprise Services and Enterprise Group to pull through Software sales in all parts of the business.

In Networking, we made progress in our Americas go-to-market in the quarter and as you can see made some transformative moves with the Aruba acquisition and the partnership with Tsinghua in China.

So to recap, while we have some challenges, I am pleased with where we ended the quarter. The continued success of our turnaround and the progress we are making on separation. Our customers and partners continue to support our efforts as do our employees. I couldn't be more proud of how well the entire company is working to deliver on our commitments for the year. Slowly but surely, HP is tackling its challenges and becoming stronger. It's an exhilarating time to the part of HP and we remain on course.

Before I turn it over to Cathie, I want to provide an important update on the future leadership teams of the two companies after separation. As you recall, on October 6th, we announced that Cathie would become CFO of Hewlett Packard Enterprise; we also said that Dion was commencing a search for the CFO for HP Inc. After looking at a number of candidates during the past few months Dion, Cathie and I have decided that a better solution is for Cathie to take her experience over to HP Inc. So today we've announced that Cathie will become CFO of HP Inc., after separation. This is a great outcome for Dion and his business. Cathie is highly experienced public company CFO, she knows Dion's business cold and she can help Dion manage the business straight out of the box.

Part of the reason we can make this move is that Cathie has done a great job bringing up the next generation of leaders in HP finance. We've got a deep bench to choose from and as a result we've asked Tim Stonesifer to become CFO of Hewlett Packard Enterprise. Tim is currently the CFO of HP's Enterprise Group and has done a fabulous job in that role. Prior to joining HP, Tim served as CFO of International Operations at General Motor Shanghai. Previously Tim held a number of finance leadership positions during his 20-year tenure at General Electric. I've worked closely with Tim already and I can tell you that he is a talented and experienced leader. Both Cathie and I think he is the perfect choice to be CFO of Hewlett Packard Enterprise, but I have to say I'm going to miss working day-to-day with Cathie. Our close partnership during the past four years has been incredibly productive and a lot of fun. But as the future Chairman of HP Inc., it give me great comfort to know that Dion will have Cathie by his side and I will still get to work with her. And, as CEO of Hewlett Packard Enterprise, I know I am getting a fantastic CFO in Tim. This works out well all around.

With that, I'll now turn it over to Cathie to go into a bit more business detail and to provide our Q3 financial outlook.

Cathie Lesjak
Thanks, Meg. Overall, we had a solid quarter, despite a challenging market environment. We delivered revenue of $25.5 billion down 7% year-over-year as reported, or 2% in constant

currency. Our gross margin was 24% down 0.2 points year-over-year driven by competitive pricing in hardware, partially offset by margin improvements in Enterprise Services and Software, and favorable mix. Gross margin was up 0.6 points sequentially, in line with normal seasonality.

Non-GAAP operating expenses were down 8% year-over-year, driven primarily by currency with reported declines in both SG&A and R&D. In constant currency, though, R&D spends was actually up year-over-year. Non-GAAP operating profit was flat year-over-year at 8.6%. Our non-GAAP diluted net earnings per share up $0.87 primarily excludes pre-tax charges of $269 million for separation, $255 million for restructuring and $221 million for amortization of intangible assets. We delivered GAAP diluted net earnings per share of $0.55, just below our previously provided outlook range, primarily due to slightly accelerated restructuring and separation charges. We are nearing the completion of our 2012 restructuring plan. In Q2, approximately 3,900 people exited the company making the total reduction to date approximately 48,000. We are on track to complete this existing program with a total of 55,000 people expected to exit by the end of fiscal 2015.

Turning to the results by business.

Personal Systems performed well in a softening market environment. Currency moves and the associated price adjustments had some demand impact and weighed on profitability in the quarter. Revenue declined 5% year-over-year as reported, or was flat in constant currency with 2% unit growth. Profitability declined 0.5 points to 3%, driven primarily by unfavorable currency.

Consumer revenue declined 2% year-over-year, or grew 3% in constant currency, while commercial revenue declined 7% year-over-year, or 2% in constant currency. The commercial market continued to be soft following momentum in 2014 from the XP refresh cycle; however we achieved 23.1% market share, a record high. Our compelling product lineup in both consumer and commercial enabled us once again to outperform our competitors. Overall, the market slowed during the quarter with units down 7% in calendar Q1. While we outgrew the market we had slower sellout at the end of Q2, putting some pressure on Q3 revenue, but we do expect consumer momentum from Windows 10 in Q4.

In Printing, the top line was pressured by a highly competitive market and aggressive pricing, which is an indirect impact from currency moves. Revenue declined 7% year-over-year as reported or 5% in constant currency. Like last quarter, a smaller gap between as reported in constant currency relative to the other business segments, due to the financial hedges in place. We continued to manage profitability well, with operating margin of 18.3%, down 1.2 points year-over-year driven by competitive pricing, partially offset by supplies mix which was 67.6% in the quarter. We saw strength in key parts of the portfolio, including profitable growth in graphics and high value hardware categories.

We lost 1 point of share in ink but continued our momentum in office print with unit growth of Officejet Pro x. We gained 1 point of share in laser year-over-year and continued to outperform the market in value multi-function printers. We exited the quarter with supplies channel inventory slightly above our desired range, due to a slowdown in sales in April. We expect to reduce channel inventory levels in the second half and will continue to closely monitor demand trends. Our focus remains on stabilizing supplies revenue and the team will continue placing higher value hardware units with greater supplies attached.

In Enterprise Hroup, revenue declined 1% year-over-year or grew 5% in constant currency, with solid operating profit of 14.5% up 0.1 point year-over-year.

Industry Standard Servers momentum continued, delivering 11% year-over-year growth as reported, and 17% in constant currency. We continued to see strong option attach and higher ASPs, but strength in Density Optimized servers pressured margins. We are well positioned for the second half of the year with a strong backlog the Window Server 2003 refresh and overall Gen9 portfolio momentum. And in Business Critical Systems, while revenue was down 15% year-over-year, or 10% in constant currency, the team delivered growth in operating profit dollars driven by improved gross margin and OPEX management. SuperdomeX and NonStopX pipelines are growing and driving momentum across the Mission-Critical x86 portfolio, including Big Data Converge Solutions.

Storage declined 8% year-over-year or 2% in constant currency, while we had solid growth in 3PAR and overall Converged Storage and expect to gain about 0.3 points a share overall in calendar Q1. A decline in Traditional Storage products and weaker than expected performance in EMEA drove revenue lower. All Flash 3PAR revenue grew again and Gartner reported HP was the fastest growing Flash vendor in 2014. In the second half, we expect continued traction in Converged Storage to drive a return to growth overall in constant currency.

Networking had another difficult quarter, with revenue declining 15% year-over- year as reported or 11% in constant currency. We made progress on driving stronger sales execution in the US and grew revenue year-over-year in constant currency in EMEA and Asia Pacific excluding China. China results were disappointing, but overall we expect networking performance will improve organically in the second half of the year. And we are optimistic about the future of this business as we onboard the Aruba team and integrate the competitive portfolio of products and solutions. We are excited to have Dom Orr at the head of the new networking business. And you will begin to see combined financials in the third quarter results.

As Meg discussed, we are also excited about our new partnership with Tsinghua in China. We believe this new structure will turn around and accelerate performance for H3C, our networking business in China. We expect the deal to close after the separation near the end of 2015. So, we won't see an impact to our financials until fiscal 2016. Once it closes, we will account for our ownership using the equity method, with our 49% share of earnings going through the other interest and expense line.

Technology Services revenue declined 8% year over year as reported, or just 2% in constant currency. Orders were down 9% year-over-year as reported, but were up 2% in constant currency, driven by higher hardware volumes from Industry Standard Servers and new solutions including Data Center and Proactive care. Penetration rates were up year-over-year for Business Critical Systems, Networking, and traditional Industry Standard Servers, but the total penetration rate was down on mix. Going forward, we expect TS to stabilize with improving hardware sales.

In Enterprise Services, we continue pressured by key account run-off as well weakness in EMEA and ITO overall although the team continues to execute against its profitability outlook this year. Revenue declined 16% year-over-year as reported, or 10% in constant currency, while delivering 4% operating profit up 1.4 points year-over-year. Strategic Enterprise Services signings continued to grow and Application and Business Services revenue showed marked improvement. Although Q2 revenue was weak, we do expect improvement in the second half and maintain our full-year revenue outlook of 4% to 6% year-over-over decline in constant currency. And given the progress on efficiencies and expected quarterly seasonality we remain confident in our full year operating profit outlook of 4% to 6%.

As we look beyond this fiscal year, we have a past operating profit of 7% to 9%, but ITO industry challenges have been accelerating, driving risks to the longer term sustainability of this profit level without further actions. Our current view is that we need to take up to $2 billion of growth annualized cost out of this business over the next three years. To affect any level of savings we would expect to incur GAAP-only charges of up to a similar amount. We will provide more information as we finalize our plan.

Software had a challenging quarter, with weakness across the portfolio. Revenue was down 8% year-over-year as reported or 5% in constant currency. We did deliver double-digit year-over-year growth in SaaS bookings, driven by strong performance in IT Management and Enterprise Security.

The team continued to focus on disciplined cost controls reducing operating expenses year-over-year. However, the accelerated revenue decline pressured profitably. Operating profit was 17.9%, down 1.3 points year-over-year. In the second half we expect continued pressure on the top line as we evolve our product portfolio and go to market efforts towards SaaS and subscription based offerings.

HP financial services revenue declined 7% year-over-year as reported, or was flat in constant currency. Financing volume was down 1% year-over-year as reported, but was up 7% in constant currency with strength in the direct business. Return on equity was 15.1%.

Turning to cash flow and capital allocation. We generated cash flow from operations of $1.5 billion and free cash flow of $766 million. The cash conversion cycle improved to four days, down 9 days year-over-year and down one day sequentially. We now expect the cash conversion cycle to be better than the 10 to 12 day forecast previously provided.

However, there are a few items creating a cash flow headwind in fiscal 2015. One of the main items is related to how we hedge net monetary assets and liabilities where our hedges and underlying currency gains and losses offset one another in the P&L, but the cash flows may not. Our hedges are 30-day hedges, while our underlying exposures range from 14 days to multiple years. With large moves in currencies, this creates a timing differences between when we realize the cash flow from hedges, versus the underlying exposures. Some of these timing differences reverse quickly, within a quarter or two, while others are longer term. So, while there is an overall headwind in this year's cash flow given the current currency rates, these timing differences will net out over time.

In addition to the hedge cash flow timing differences, we are also seeing cash flow impacts for the year from pulling forward some of the restructuring and separation cash payments from 2016, our reduction in warranty, given lower PC shipments and lower deferred revenue in TS due to currency and lower than expected orders.

Given these headwinds and tailwinds, we are holding our full year free cash flow outlook of $3.5 to $4.0 billion. We repurchased 19 million shares in the quarter and paid $291 million in the dividends for a total capital return to shareholders of $950 million.

Moving to the separation, we continue to make excellent progress and remain on track to meet the timeline for separation by the end of the fiscal year. I want to take some time to provide an update on one time charges, dis-synergies, cost savings, and the Form 10 filing. First, Q2 separation charges were $269 million, and we expect Q3 charges to be $464 million. The multi-year estimates of total separation charges, including taxes and the associated credits that we announced on the Q1 earnings call, remains unchanged. And, as Meg shared, we estimate the ongoing synergies associated with operating two separate companies to be $400 to $450 million, which are split between Hewlett Packard Enterprises and HP Inc. These costs are primarily associated with corporate functions, including finance, legal, IT, real estate, and HR.

As expected, working through the creation of 2 new more efficient and accountable organizations have uncovered opportunities for significant cost reductions. Our assessment is that we could take up to $1 billion of growth annualized cost out of the organizations in total, and would incur a GAAP-only charge of a similar amount. Although we don't yet have specific details to share, we expect to implement enough cost savings in the near term to offset more than half of the separation to synergies in fiscal 2016 and starting in fiscal 2017 would more than offset all dis-synergies.

We have also concluded on a legal form of our separation, based primarily on tax consideration Hewlett Packard Enterprise will be the spin company in the US. The legal form may be different across all of the countries in which we do business. Finally, we still expect to file our Form-10 later this summer and will continue to provide updates as we approach November 1st.

Looking forward, currency may continue to be volatile and if it is, each of our businesses will be impacted differently based on natural hedges, existing financial hedges, re-pricing capabilities and the overall market environment. Based on the current rates, we expect full year revenue to be flat-to-slightly down in constant currency.

With all that in mind, our guidance for fiscal 2015 non-GAAP diluted net earnings per share outlook remains in the range of $3.53 to $3.73. Fiscal 2015 GAAP diluted net earnings per share outlook remains in the range of $2.03 to $2.23. Q3 '15 non-GAAP diluted net earnings per share is expected to be in the range of $0.83 to $0.87 and Q3 '15 GAAP diluted net earnings per share is expected to be in the range of $0.50 to $0.54.

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

QUESTION AND ANSWER

Operator
We will now begin the question-and-answer session. To ask a question, you may press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw your question, please press "*" then "2." We request that you only ask one question.

The first question is from Katy Huberty at Morgan Stanley.

Katy Huberty
Thanks. Good afternoon. It sounds like there are some incremental pressures on cash flow this year, including the weakness in the PC market, so Cathie, can you just clarify what's allowing you to hold the guidance for $3.5 billion to $4 billion free cash flow this year and then just as a clarification, is the $400 million to $450 million of dis-synergies next year, all cash

costs, such that it's unlikely you can get back to the $6.5 billion to $7 billion free cash flow target that you had started this year with? Thank you.

Cathie Lesjak
Thanks Katy. So, when we look at the free cash flow for fiscal '15, we have headwinds and we have tailwinds that are really impacting FY'15 and when you net them both together, you get into the range of the $3.5 billion to $4 billion, so we are able to hold. The tailwind that we see is that the cash conversion cycle, given the performance that we've had in the first half of the year is now expected to be better than the 10 to 12 days that we had previously provided as an outlook. And so that offsets the headwinds around the balance sheet hedging that I mentioned in my prepared remarks, as well as some of the pull-in that we've got around from 2016 for restructuring separation costs and then a little bit on the deferred revenue and warranty reserves.

And then, in terms of the $400 million to $450 million of dis-synergies in 16 and beyond, yes, those are all cash costs, but as I mentioned, we will take approximately $1 billion of gross run rate savings out of the company across HPE and HPI and so we will offset more than half of those with those cost savings in fiscal 2016, but of course we will take a GAAP only charge of about $1 billion.

Meg Whitman
And let me add one thing Katy, it's Meg, while the PC market is weaker than we anticipated, we are actually doing better in some of the businesses like Industry Standard Servers. So while the cash flow might be slightly lower in PCs, depending on how the market evolves, we're actually going to more than make that up and you can see that in our earnings per share, which is obviously, we are holding our earnings per share guidance.

Cathie Lesjak
And I think it's also important to think about the PC business as yes there has been incremental pressure on profits, but we have done a great job of executing in the PC market and in fact have continued to gain really strong shares across all of the regions in the world, including China on a year-over-year basis and have outgrown many of our competitors.

Jim Bergkamp
Thanks Katy, next question.

Katy Huberty
Thank you very much.

Operator
The next question comes from Tony Sacconaghi at Bernstein.

Toni Sacconaghi
Yes, thank you. I just wanted to clarify, you talked about $1 billion GAAP charge associated with restructuring opportunities from the separation and potentially $2 billion in GAAP charges associated with streamlining the Services business. So, is GAAP a code word for cash charges, because not all GAAP charges are cash charges? So, should we be thinking about $3 billion in cash charges and from a timing perspective, I would imagine that most of the $1 billion in cash charges associated with the restructuring is in fiscal 16 with some in fiscal 17, can you help us on that, please?

Cathie Lesjak
Sure, so Tony we are not intending that GAAP is code word for cash, but because there can be GAAP only charges that are not cash but these ones are expected to be all cash charges, and so you got that right. And then, in terms of the timing, we really see these cash outflows related to these charges to be taking place over three years. So it will be a little bit more frontend loaded to offset the dis-synergies, but we would expect them to be of both the billion related to separation, as well as the up to 2 billion for the Enterprise Services business streamlining to be over three years.

Toni Sacconaghi
Okay. And then, could you just clarify currency? You brought down guidance for the year, the last quarter, and said the currency would impact to you $0.60 and $0.30 on a net basis, currency is a lot more benign, based on current spot rates and what you've reported in the first two quarters, is there an update on what the growth and net impact on EPS is for currency and the question is, why wouldn't your guidance be adjusted upwards for that reason?

Cathie Lesjak
So Tony, what we do is at the point of time we provide an outlook, we take that beginning of that month set of rates and we forecast the rest of the year, and if you actually compare the currency rates at the beginning of May to those at the beginning of February, when we provided the outlook for the year of $3.53 to $3.73, they are roughly the same, they are not materially changed.

Jim Bergkamp
Thanks Toni. Next question, please?

Operator
Next question is from Maynard Um at Wells Fargo.

Maynard Um
Hi, thanks. Can I just also clarify that Aruba is included in the guide, and I'm curious because I get some accretions for the back half, but guide is unchanged, so I'm just wondering if that implies there are some incremental pressures somewhere offsetting. And then, just on the question, I get a lot of questions, as do you I'm sure, around free cash flow returning to that $6.5 billion to $7 billion, with the sale of H3C, I estimate you will lose around $400 million, $500 million in operating cash, half goes away and then the other half drops to the investing line on the cash flow statement. You'll have some net dis-synergies of about $200 million to $225 million in fiscal 16 and then any incremental restructuring charges, if you do find these, cost savings post-split. And then, presumably that's offset by the foreign tax credits that come back, no big separation-related costs versus this year and then cash flow from Aruba, but it still seems you'd be short of that $6.5 billion to $7 billion, so can you just maybe help bridge that difference on how we should think about that? Is it M&A that's making it up from the cash proceeds from H3C and Snapfish, or is there something else to think about there? Thanks.

Cathie Lesjak
Boy, Maynard, I'm trying to follow all those numbers for you, but let me first clarify that Aruba is not in our guide, it just closed the other day and it is not in our guide for the year.

Secondly, in terms of how to think about the cash flow model for fiscal 16, I can't validate all those puts and takes that you've given, but I will throw out the following for you to think through. First, we think that the cash conversion cycle will be less of a headwind going into ‘16 than it was going into ‘15, you do want to take into consideration the fact that the 2012 program restructuring charges will be coming down pretty materially, but of course we will have the offset to the incremental GAAP only charges that we talked about today. We will have significantly lower separation impact the cash flow from separation across taxes that we need to pay, the incremental cost associated with that and the CapEx. And then I think currency is a little bit of a complicated topic, for sure, but you need to obviously think about what you think the currency is going to do, but also take into consideration the implications to cash of our broad hedging programs, our balance sheet hedging programs, which I talked a little bit about, but also some of the benefits that we're getting from our revenue hedging programs. And then, of course, that's all on top of what you think the outlook is for earnings.

Jim Bergkamp
Thanks, Maynard. Next question, please.

Operator
The next question comes from Brian Alexander at Raymond James.

Brian Alexander
Okay, thanks. I think you're holding Analyst Day later this year to go into details about each business post the separation, but as you think qualitatively about the operating profiles of each business beyond the split, Meg, should we anticipate that there might be any meaningful changes in organic growth strategies, investment intensity, or the like that could result in a different operating profile than what we're seeing today? Or should it be closer to business as usual and more refinement of existing strategies?

Meg Whitman
So, we will have an Analyst Day as we approach the separation. We haven't exactly set a date yet, but it'll be early to late Fall, and we will lay out the operating profile of both companies, both not only from an operating profit but also a capital structure. Because you'll recall around October 6 when we announced, we thought that HP Inc. would be more Yield Co because of the strong cash flow from printing business, and Hewlett Packard Enterprise would be more targeted to growth at a reasonable price, our GARP investors, and the capital structure will reflect that. Also, I anticipate both companies will actually be doing acquisitions but probably more so on the Hewlett Packard Enterprise, as that market's growing a bit faster.

So, we'll lay all of that out for you at the Security Analyst Meeting, and then actually we'll probably be on a road show to investors to make sure that everyone has a chance to understand, in as much detail as we can provide, what the outlook looks like for each company. I don't know, Cathie, if you want to add anything to that?

Catherine Lesjak
So, I wouldn't add anything more other than to say that we will be filing our Form 10 in the July time frame, and in that, while it will not have all of the information that I'm sure you will want in terms of FY16 forward-looking, it will have a preliminary capital structure review, so you'll get a first glimpse of that in the early July time frame.

Brian Alexander
Thanks.

Jim Bergkamp

Thanks, Brian. Next question, please.

Operator
The next question is from Sherri Scribner at Deutsche Bank.

Sherri Scribner
Hi thanks. I just wanted to get a clarification on the additional restructuring charges that you talked about this quarter. The $1 billion and the $2 billion, in terms of the impact to the cash in fiscal '16, how should we think about that? Should we think of those cost savings as mostly offsetting those restructuring charges, but because the restructuring charges are a bit front-end loaded, that cash benefit won't come until later in the three-year period? And then, I just wanted to get a little bit of detail on the strength that you're seeing in the Industry Standard Server business and why you think you're seeing strength there. Thanks.

Catherine Lesjak
Sure. So, in terms of the potential GAAP-only charges that we've been talking about, they will be a bit front-end loaded, but you should think about them as being over 3 years. And that from a cash flow perspective, from the savings, the savings will lag that just a little bit. I think the insight into fiscal '16 that we've provided is that the dis-synergies of $400 million to $450 million will be more than half offset in fiscal '16, and so we will, obviously, get some cash flow benefit from the actions that we will take with these GAAP-only charges in '16.

Meg Whitman
And then entirely, the $400 million to $450 million we believe will be entirely offset in '17.

Catherine Lesjak
And a bit more than that. But we likely won't get to a full run rate gross savings from these actions until probably the run rate exit of fiscal '18.

Meg Whitman
In terms of Industry Standard Servers, we are seeing very strong momentum, I think driven by a couple of things. First is, I think it's our best-ever product line, and very, very solid sales execution that is actually playing into a pretty healthy market as well. As I said, ISS revenue grew 11% year-over-year as reported and 17% in local currency and we expect to gain share when the Q1 results are out. And I think our products like Gen9, which is off to a very fast start, Cloudline and Apollo are resonating well with customers that are purpose-built for specific workloads to deliver business outcome. So we've got the workload and the business outcome lined with the right infrastructure. And then there is another little tailwind, which is the Windows Server 2003 Refresh, the ramp of our Foxconn partnership and improved win rates, frankly, against Lenovo as they take over the IBM server business.

And I will say one thing, we haven't talked much about Cloud on this call because there was so much to cover here but we are pretty pleased with the results of our Cloud business and what you have to remember it shows up, the success of Cloud shows up in three places in the HP P&L, one is Industry Standard Servers because we are by far and away the leader in private Cloud whether it's Gartner or IDC or whoever, so that shows up in ISS. Our virtual Private Cloud or Managed Cloud Services shows up in Enterprise Services and then CSA, the Cloud Service Automation and Orchestration Software that knits it all together, shows up in software. So, we may over time breakout or run alongside overall Cloud revenues, as opposed to just having it show up in the individual businesses, but for the moment probably through the end of this year, we will report it in the different businesses. So, I just thought I'd say a word about that's another reason that ISS is strong is Private Cloud.

Catherine Lesjak
And let me add just a couple of more things, on the quarter, the win rate that Meg talked about is up relative to the previous quarter low double digits, so really strong improvement there. We are bringing on hundreds of new customers that haven't bought from HP in the last 12 months, so we are making really good progress against the Lenovo lineup.

And then, in terms of the rest of year for ISS, we've got a really nice wind at our back, we are going into the second half with a strong backlog, so a better backlog, frankly, than we normally see going into Q3. As Meg says, we do have the Windows Server 2003 also coming up and as you may recall, that is expiring in I think its July of this year and then Meg mentioned the Gen9 momentum.

Sherri Scribner
Thank you.

Jim Bergkamp
Thank you, Sherri.

Operator
Our next question comes from Amit Daryanani at RBC Capital Markets.

Amit Daryanani
Thanks, good afternoon guys. I was hoping, can you just talk a bit about the 2 billion of potential restructuring you have to do for the Services business, it seems like it's 10% of our revenue stream over there, so what are the challenges you are seeing there that you need to take that big for a new restructuring charge to get the 7-9% margin, and do you think potentially there is a piece of this portfolio that's just unprofitable and you may be better walking away from it, so maybe just talk about what's leading the charges in the revenue stream? That will be helpful.

Company Representative
Yes, I think there is a couple of things going on in our Enterprise Services business. First is, we are making progress towards the long-term goal of 7-9% operating margin, but the ITO industry challenges have accelerated and are driving risk and the sustainability of this profit level if we don't do further cost reductions.

And I say there was a couple or sort of large scale secular trends that are impacting that ITO business. First is government austerity programs have forced a business model transformation, both here as well as in Europe. Basically, the public sector business has gone from buying in a fixed fee model to a cost plus model, so that put some pressure on.

And then secondly, there are definitely accelerated moves to a consumption model, which is going to require us to make a faster labor mix shift to low cost resources and frankly, the transformation of the physical data center footprint to a much more streamlined footprint that are far more automated. So, there's real market shifts going on here and basically the additional savings plan that we mentioned today would de-risk our plan for ES to reach that 7% to 9% operating margins, but more importantly, would enable us to sustain that level of profitability over time. So, we've got more aggressive labor pyramid shifts that have to take place onshore and offshore locations to make sure that we stay competitive in that market and the market is changing dramatically.

That said, our Apps business and our Business Process Outsourcing business and our Strategic Enterprise Services businesses are looking healthier, but remember ITO is a big chunk of our Enterprise Service business.

Catherine Lesjak
And let me just give some data that supports that. If you look at our ITO business in this quarter it was down 20% year-over-year, and it had about 6 points of currency, so it was still down 14% on a constant currency basis.

There is an impact from the top three runoff, but, it is still a lot softer than what we had been seeing and so we are definitely starting to see the pressures in the ITO space. On the App side, we saw declines of 8% as reported in revenue, but only 2% in constant currency and if you adjust for currency we had a couple of our regions that actually were flat to slightly up and we see that progressing as we go into the second half. So, it really is much more than ITO challenge and the change in the market dynamics.

Meg Whitman
And then, Amit, you asked a strategic question, I'm going to interpret it as how do Services fit, and if you pull the lens back let me give you my perspective on this business. As our customers are requiring business outcome solutions as opposed to a migration, which they used to buy on a point product solution basis, we are going to have to lead with Services because our customers are asking for transformation services, for business outcomes, for cost, efficiency, better return on invested capital of their assets and both our Services business in ES as well as our TS consulting businesses are becoming more strategic to the future of Hewlett Packard Enterprise.

And my view is that if we don't have a healthy Services business, that will actually compromise our overall business as we go forward, because increasingly Services is becoming the tip of the spear and how we've got to market not only to direct customers but, frankly, our partners and VARs are seeing the exact same thing. So the combination of ES plus TS consulting is going to be a really important strategic weapon, I think, for HP going forward.

Jim Bergkamp
Thanks, Amit. Next question, please.

Operator
The next question is from Shannon Cross at Cross Research.

Shannon Cross
Thank you, very much. Meg, can you talk a bit about the China JV, why you included both the Servers, as well as Storage and Networking with the JV, how you see it running in conjunction with HP Enterprise? We understand what was the behind the sale of the Networking business, but how you think you are going to be working together with them?

Meg Whitman

Yes, so, first of all, I think we have a terrific partner in Tsinghua. As many of you know, Tsinghua is the Harvard and the MIT of China rolled into one with incredible R&D capability and very much a part of sort of the Chinese community, if you will.

So obviously, H3C was going to be rolled into this joint venture, but frankly, increasingly Servers, Storage, Technology services and Networking they are converging in China just like they are here. And we though it made sense to take all our Chinese enterprise assets and put them into this joint venture. As I said, it will be on 51% by Tsinghua 49% by us and we are excited about the future possibilities. I will tell you already the H3C and the China HP employees are pretty psyched up about this, they woke up to this news this morning, they are pumped up. And I think this is going to unleash a whole host of business in the Chinese market.

So, the things that will remain outside of the Tsinghua JV is our Enterprise Services business, which is primarily a business that serves multi-national customers. So, for example, if we are serving P&G in China that would be Enterprise Services. The other is our Cloud business, HP Helion Cloud business, as well our Print and PC business and then of course Software, which is a very, very small business in China. So, the bulk of our Chinese business goes into this JV with the exception, obviously, we have a very big Printing and PC business, but that's a completely different business, so that was the thinking behind it.

Shannon Cross
Will the JV sell to any other countries besides China or are they just limited to China?

Catherine Lesjak
So Shannon, we're going to be their distributor for all of the networking products in the rest of the world, so they will not be selling any of their products that are developed in China to the rest of the world except through us as distributor,

Meg Whitman
Exactly. So, the real point of this JV is in China for China for the Chinese's market and obviously the networking products we'll distribute globally, as Cathie said.

Shannon Cross
Great. Thanks.

Jim Bergkamp
Thanks, Shannon. I think we have time for one more question.

Operator
Our last question is from Keith Bachman at Bank of Montreal.

Keith Bachman
Hi, many thanks team. Meg, I was hoping you could review your perspective on what Win10 may do for the market, the timing, and if you conclude any comments, your profitability was down a little bit in PCs today, and I know Cathie mentioned FX was a part of it, but how would that impact profitability if at all and also the revenue side and I want to sneak one in to Shannon's question on the Chinese JV, how do you protect your IP in that JV?

Meg Whitman

Yes, okay well I actually happen to have the Dion Weisler here. So, Dion why don't you talk a little bit about Win10 and what you expect on profitability and then I will come back on the China JV and the IP?

Dion Weisler
Sure. I think in the consumer segment, we obviously are expecting and are hopeful that Windows10 will provide some stimulus for the marketplace, I think that will be ahead of some tapering off of demand just ahead of the Windows10 launch. In the commercial segment, we see slower acceptance always in new operating systems as evidenced by the XP migration which was largely completed towards the end of FY14 and therefore we don't really anticipate a significant impact on the commercial business, either positive or negative, yet on the consumer side we expect that towards the backend of this year it will provide some stimulus.

Keith Bachman
Yes, and does it impacts your profitability Dion? Or was 3% the right run rate?

Dion Weisler
We obviously don't guide by segment, but I think it's fair to say that this is a transition just like similar transitions that we've seen in the marketplace. There is a consolidating market going on at the moment, we believe that we will remain a competitive marketplace. We think we are outperforming our competitors and that profitability will run according to that.

Catherine Lesjak
Yes, yes. And the profitability in Q2 was heavily impacted by currency but offsetting some of the currency benefits were really strong operating efficiencies because Dion's businesses are also very much focused on streamlining and staying maniacally focused on costs, as well as a favorable commodity environment and we do expect that commodity view will persist into Q3. And then, the other thing I think I should have pointed out before is that the XP refresh peak quarter was Q3 of last year, and so the entire market is going to come up against very tough compares when you look at our numbers in Q3.

Meg Whitman
Especially markets like Japan.

Catherine Lesjak
Yes.

Keith Bachman
Okay.

Meg Whitman
Let me answer the IP question. So we develop IP in China and have for some time in the context of H3C. And then, as we moved our Server and our Storage business, obviously, into this new JV, we will have an OEM agreement from HP to H3C Tsinghua JV and obviously have been very focused on protecting the IP. I think we've got an excellent framework agreement. We are not naïve, but we've got an excellent framework agreement, and I will say I think Tsinghua in this regard is a very, very good partner. So, we are optimistic about it and I think it is going to accelerate the business in China.

Keith Bachman
Okay, great. Thanks Meg.

Meg Whitman
Thank you.

CONCLUSION

Jim Bergkamp
Thanks Keith and thanks everybody for your questions. I think we are done with the call. Thank you.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.