HP, Inc.

First Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Dion Weisler - *President and Chief Executive Officer*

Cathie Lesjak - *Chief Financial Officer*

Diana Sroka - *Head of Investor Relations*

PRESENTATION

Operator
Good afternoon and welcome to the First Quarter 2017 HP, Inc. Earnings Conference Call. My name is Denise, and I'll be your conference operator for today's call. We will be facilitating a question and answer session toward 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, Diana Sroka, Head of Investor Relations. Please proceed.

Diana Sroka
Good afternoon. I am Diana Sroka, Head of Investor Relations for HP Inc., and I'd like to welcome you to the fiscal 2017 first quarter earnings conference call with Dion Weisler, HP's President and Chief Executive Officer, and Cathie Lesjak, HP's Chief Financial Officer. Before handing the call over to Dion, 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. We posted the earnings release and the accompanying slide presentation on our Investor Relations webpage at www.hp.com.

As always, elements of this presentation are forward-looking and are based on our best view of the world and our businesses as we see them today. For more detailed information, please see disclaimers in the earnings materials relating to forward-looking statements that involve risks, uncertainties, and assumptions.

For a discussion of some of these risks, uncertainties, and assumptions, please refer to HP's SEC reports, including our most recent Form 10-K. HP assumes no obligation and does not intend to update any such forward-looking statements.

We also note that the financial information discussed on this call reflects estimates based on information available at this time and could differ materially from the amounts ultimately reported in HP's Form 10-Q for this fiscal quarter ended January 31, 2017 and HP's other SEC filings.

For financial information that has been expressed on a non-GAAP basis, we've included reconciliations to the comparable GAAP information. Please refer to the tables and slide presentation accompanying today's earnings release.

And now, I will hand it over to Dion.

Dion Weisler
Thank you, Diana. Good afternoon, everyone, and thank you for joining us today. Let me start by saying I'm very pleased with our performance this quarter. As a more nimble company, we've been able to accelerate our strategy, and we are now firing on all cylinders.

With a strong start to our 2017 fiscal year, we continue to build on our track record of delivering on all of our financial commitments with discipline, focus, and execution. We've also made solid progress in positioning the business for long-term growth, and we accomplished this amidst a market backdrop that remained highly competitive.

Let me take a moment to share the notable highlights for the quarter. We delivered non-GAAP diluted net earnings per share of $0.38, at the high end of our outlook range. We exceeded free cash flow expectations, delivering more than $700 million and returning more than $600 million to shareholders through share repurchases and dividends. And we grew net revenue by 4% year over year to $12.7 billion, with double-digit growth in personal systems.

We are delivering strong results because we are executing on our reinvention and driving our strategy to protect our core, prioritize growth, and invest in the future. We are doing this with a relentless focus on innovation and engineering technologies that consistently amaze our partners and customers.

A perfect demonstration of this is in Personal Systems, where yet again, for the third consecutive quarter, the team delivered exceptional results. This is a story of innovation and execution delivering revenue, margin expansion, and market share growth year-over-year. Personal Systems revenue grew 10% year-over-year with operating profit improvement. The last time we saw this level of revenue growth was in 2014, triggered by the XP refresh cycle.

In contrast, this growth was triggered by HP's innovation engine and ability to outperform the market. I'm particularly pleased with the balanced results in Personal Systems across geographies and product segments. We delivered double-digit revenue growth in all three regions as well as in notebooks and workstations.

Our focus on segmenting the market opportunities and addressing strategic pockets of growth with differentiated products has resulted in profitable share gains in both consumer and commercial.

In calendar quarter four, we beat the PC market unit growth by 8.5 points, outperforming all key competitors and achieving our highest ever worldwide market share position at 21.8%. Our focus is to bring customer value and innovation to market. And because of this, we have been rewarded with share gains. This is the way we like to win.

Without a doubt, our momentum can be attributed to the strongest portfolio in our history. At the Consumer Electronics Show last month, once again we took home nearly two dozen awards for products like the EliteBook x360, the world's thinnest business convertible notebook, and the ENVY Curved All-in-One Desktop, the world’s most immersive at 34 inches.

And one key point of differentiation is security. We worked very hard to ensure that HP's PCs and printers are the world's most secure and manageable. Last week at RSA, we announced HP SureClick, the world's only integrated browsing solution that protects HP devices from the number one attack vector, which is malware. The supplements our best-in-class security stack and is part of our HP Secure promise to customers.

If you ask Ron Coughlin, HP's President of Personal Systems, about the magic within the business, he would tell you that we are continuously changing the way we create and deliver computing experiences that amaze. It is based on a unique understanding of the market and direct collaboration with our customers and partners.

Several large wins this quarter resulted from these deep partnerships. Corning, a leading innovator in material sciences, and Roche, one of the largest biotech companies in the world, both depend on HP to deliver a comprehensive package with everything from desktops to workstations to notebooks.

Now turning to Printing, we made great progress in stabilizing the business. Hardware revenue grew year-over-year in constant currency with units up 6%, bolstered by our new Sprocket product that is helping create a new category in mobile printing. The overall market was a bit better than expected, with slight unit growth year-over-year in calendar quarter four.

Due to our hard work taking cost out, we were well positioned to take advantage of this market upside and place more positive NPV units. Our installed base mix quality continued to improve, supported by share gains in value multi-function printers for the 19th consecutive quarter.

We continued to deliver highly secure and innovative printing solutions for our customers and partners and had several significant wins, including one of our biggest ever with one of the world's largest providers of technology solutions to the automotive industry. And they are leveraging HP products, including the world's most secure LaserJet hardware, Care Packs, and supplies.

We also saw momentum in strategic contractual areas, with strong results in Managed Print Services and continued good momentum in Instant Ink enrollment. You'll recall one of our key growth initiatives in printing is graphics, which delivered strong performance once again, with year-over-year revenue growth in constant currency for the 14th consecutive quarter. We saw strong hardware growth in Indigo, large-format industrial, and PageWide XL, as well as growth in graphics supplies and services.

Among the many strong custom deployments is LSC Communications, a global leader in print services, who is deploying our PageWide Web Press to support its growing client demand, having more than 3 billion pages of capacity in its printing platform.

With our continued progress this quarter, we remain confident that supplies revenue in constant currency will stabilize by the end of fiscal 2017. Consistent with that, total supplies revenue was down just 2% year over year in constant currency. As we always say, it's all about supplies, and we continued to drive a number of initiatives within the four box model to return this revenue stream to growth.

Also in Printing, we are on track with the acquisition of Samsung's printing business that will help to accelerate our A3 portfolio. We expect the transaction to close in the second half of 2017, subject to regulatory approval and other customary closing conditions.

Turning to 3D Printing, this was a milestone quarter with our first unit shipments and revenue recognition. Customers such as Jabil, Materialize, and Shapeways have received installations, and we are tracking to our strategy to disrupt the $12 trillion traditional manufacturing market. According to Jabil, Multi Jet Fusion is one of the few technologies capable of delivering production-grade parts with cost-effective efficiency. And according to them, some of their own end customers have said they couldn't believe 3D printing could produce that kind of quality.

Overall, quarter one was a quarter of innovation and solid execution. I'm proud of the results we were able to deliver, but we are never satisfied. We see plenty of momentum, innovation, and opportunity for us to capture in both the near and long term, and are aggressively pursuing profitable share and targeting our strategic growth segments.

We are continuing to accelerate and deliver for our customers, partners, employees, and shareholders. And I remain confident in our ability to deliver on our financial commitments going forward; again, fantastic quarter across all of our business segments.

And now, I'll turn the call over to Cathie to provide more details on our financial outlook.

Cathie Lesjak
Thanks, Dion. Overall, I'm also very pleased with our performance in the first quarter. We delivered net revenue of $12.7 billion, up 4% year-over-year as reported and up 5% in constant currency. We saw strong momentum globally, with each region delivering top line growth year-over-year.

Gross margin of 17.7% was down 1 point year-over-year, driven by unfavorable segment mix and commodity costs in Personal Systems. Sequentially, gross margin was down 0.6 points, as Personal Systems rate was pressured with incremental cost of components, which was only partially offset by supplies mix and printing.

Non-GAAP operating expenses of $1.3 billion were down 2% year-over-year, with savings in SG&A more than offsetting an increase in R&D, as we continued to invest in innovation and drive productivity improvements.

With a net expense of $90 million in OI&E, a non-GAAP tax rate of 20.5%, and a diluted share count of approximately 1.7 billion shares, we delivered non-GAAP diluted net earnings per share of $0.38.

Non-GAAP diluted net earnings per share primarily excludes, net of tax, restructuring and other charges of $63 million and acquisition related charges of $16 million, partially offset by non-operating retirement related credits of $32 million and tax indemnification credits of $9 million. In Q1, GAAP diluted net earnings per share from continuing operations was $0.36.

Turning to the segments, Personal Systems performance was strong across all dimensions, achieving 10% revenue growth year-over-year as reported or 11% in constant currency. We saw momentum across both customer segments, with consumer and commercial year-over-year revenue growth of 15% and 7% respectively, while share performance is not our first priority, our disciplined focus on market segmentation and innovation enabled meaningful year-over-year share gains in calendar Q4 across consumer and commercial, notebook and desktop, in every region.

PC average selling prices were up both year-over-year and sequentially, driven by favorable pricing rate and mix shift to premium. Gross profit was down both year-over-year and sequentially, driven by component costs and currency headwinds, which weren't fully mitigated by the higher average selling prices.

However, with tight cost management and a reduction in non-revenue-generating expenses, the team delivered a solid 3.8% operating profit, up 0.7 points year-over-year. Beyond the core, we made further progress in our growth strategy in commercial mobility, with strong double-digit revenue growth in detachables. Margin-rich commercial services revenue grew double digits with improved penetration rate, and we continue to increase customer awareness on Device-as-a-Service.

Turning to Printing, we remain on track to deliver operational improvements in the core business while making progress on our growth initiatives. Print revenue was down 3% year-over-year as reported or down just 2% in constant currency.

Starting with hardware, units were up 6% year-over-year, a demonstration of the continued improvement in our cost structure, enabling us to place incremental positive NPV units. In calendar Q4, we gained 3.2 points of share in laser and 0.2 points of share in Inkjet hardware year-over-year.

Outside of the traditional printer markets, we were very pleased to see the incredible interest in our new handheld photo printer, the HP Sprocket, which contributed about 1.6 points of unit growth to the year-over-year metric. The world's smallest printer has become a must-have accessory for mobile and social media printing.

Print hardware average selling prices were down mid-single digits year-over-year, primarily due to rate and to a lesser extent mix. With our improved cost structure, we can be more competitive in A4 laser pricing, and more low-end units can be sold with a positive NPV. As we've stated many times, we will continue to drive positive NPV unit placements, as this is one of the many levers to drive ongoing supplies growth.

In our growth initiatives, Managed Print services revenue grew faster than the market once again, and new TCV was up year-over-year. Graphics also had balanced revenue growth across all regions, with strong performance in Indigo and growth in supplies year-over-year.

In Q1, total Supplies revenue was down just 2% in constant currency. The year-over-year decline associated with the Four Box Model drivers was better than we expected. And as Dion said, we remain on track to stabilize supplies revenue in constant currency by the end of the year Supplies revenue mix was 67%, up slightly year-over-year, driven by graphics. And channel inventory levels were healthy, below the top end of the new reduced and tightened target range.

Operating profit for printing was 16%, down 1 point year-over-year, driven by unfavorable rate due to currency and increased marketing spend for demand generation, primarily to support supplies programs. These factors were only partially offset by operational and cost structure improvements.

Now turning to cash flow and capital allocation, cash flow from operations was $767 million and free cash flow was $735 million. Free cash flow was better than we expected due to the very strong performance of Personal Systems and the material improvement in linearity in the quarter.

Supplies sales linearity also improved, some of which we attribute to the operational changes we implemented to our sales model in the second half of fiscal 2016. Given our confidence that we've made these real structural improvements, we believe our free cash flow could be at the higher end of our $2.3 billion to $2.6 billion free cash flow outlook for the year.

The cash conversion cycle was a record negative 30 days, a 1-day improvement sequentially, better than normal seasonality, with a 5-day decrease in day sales outstanding, partially offset by a 4-day decrease in accounts payable.

During the quarter, we had a total capital return of $613 million through share repurchases and cash dividends, which was 83% of free cash flow as compared to our full-year target of 50% to 75%, so we are well on track to deliver on this commitment.

Looking ahead, keep the following in mind related to our financial outlook. In Personal Systems, we have increased pricing globally in response to unfavorable currency movements and the increased cost of components, which could have a more significant impact on demand than we've assumed. We expect Personal Systems revenue to be down more than normal sequential seasonality given the very strong performance in Q1; including the holiday season in the US.

For Printing, in Q2 we expect improved supplies revenue performance year-over-year as compared to Q1, and we expect to continue to place positive NPV units. For the full year, we are on track to deliver our productivity initiatives and restructuring activities as announced at SAM, which we expect will drive improved profitability over the course of the year.

Lastly, we have accelerated some of the Samsung integration charges from fiscal 2018 to fiscal 2017, which will slightly reduce the full-year GAAP EPS outlook, but to the benefit of fiscal 2018 GAAP EPS.

With all that in mind, Q2 2017 non-GAAP diluted net earnings per share is in the range of $0.37 to $0.40. Q2 2017 GAAP diluted net earnings per share from continuing operations is in the range of $0.32 to $0.35. Our full-year fiscal 2017 non-GAAP diluted net earnings per share remains in the range of $1.55 to $1.65, and our full-year fiscal 2017 GAAP diluted net earnings per share from continuing operations is in the range of $1.42 to $1.52.

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

QUESTION AND ANSWER

Operator
Thank you. 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 limit your questions to one with one follow-up.

The first question will be from Katy Huberty of Morgan Stanley. Please go ahead.

Katy Huberty
Thank you and congrats on the solid quarter. Cathie, a question on free cash flow. You are starting the year up $900 million year-on-year, so I'm struggling to understand why you'd end up even at the high end of the range, down versus last year. Were there any one-time items this quarter? Are there any headwinds that you see hitting as you move through the year?

Cathie Lesjak
Sure, Katy. Thanks for the question. So we are really pleased with the Q1 cash flow, and it really came on the back of two things. One was the incredible strength in Personal Systems where we saw sequential growth, which isn't atypical for Q4 to Q1, where we typically would see a decline. But we also saw much better linearity in the quarter, much more linear. And so that helped basically bring in revenue earlier, and therefore we could collect it. So some of that is timing, but it's not all timing.

So the supplies sales model change that we made in the second half last year, one of the benefits we expected to see was more linear sell-out, which means there's more linear sell-in. And we think that that is in fact structural. And therefore, the uptick that we saw in Q1 as a result of that will stick to our fingers in the year. And that's why we have confidence in going to the higher end of our outlook of $2.3 (billion) to $2.6 billion.

Specifically now, though, looking at Q2, what we see is that given the incredible strength in personal systems, especially around Black Friday and the holiday season, is that we think we'll have a much higher sequential decline than what we typically see. That combined with the fact that print typically would go up sequentially is going to be a bit of a headwind on Q2 free cash flow, but for the year, good confidence that we could be at the higher end of our outlook range.

Katy Huberty
And then just as a follow-up, Supplies declined 2% constant currency. As you said, that was better than you expected, and you arguably had a difficult compare because of the inventory build in the year prior. So as comps ease, why wouldn't you get to that stabilizing supplies growth earlier than the fiscal fourth quarter?

Dion Weisler
Thanks, Katy. Let me tackle it. Listen, as we mentioned in the prepared remarks, we remain confident that supplies revenue growth in constant currency will stabilize by the end of 2017, consistent with our Four Box Model analytics that we see. Actual performance continues to meet and it sometimes beat the Four Box Model forecast, which means that we firmly believe that the strategy that we are executing is the right strategy and that you've seen those metrics play out inside the business results. So it gives us increased confidence as we head towards the end of 2017 that we'll stabilize in constant currency, and that's what we said we would do.

Cathie Lesjak
And, Katy, that's really what the Four Box Model has predicted and is predicting for the rest of the year. And so, that's really the basis on which we feel confident that we will get there by the end of the year, and we feel good about the performance in Q1.

Operator
The next question will be from Toni Sacconaghi of Bernstein. Please go ahead.

Toni Sacconaghi
Yes, thank you. I'm wondering if you can comment a little bit on Printing operating margin dynamics. Operating margins for the printing segment were at 16%. And arguably, you had a more favorable mix than you had envisioned. I think you had forecast that supplies would be down mid-single digits, and they were only down 2% in constant currency. So I'm just wondering, was there anything...and if I look at hardware unit growth, it was good year-over-year, but that was a really easy comp. Sequentially, it was actually the lowest in the last seven years in terms of hardware revenue on a sequential basis. So my question is, is the 16%, which I think is a decline from what we saw in Q3 and Q4 on an adjusted normalized basis, what drove that 16% and is that the right normalized level to think about or what dynamics impacted that?

Cathie Lesjak
So let's first talk about the 16% in Q1 and then we can talk a little bit about what we expect for the rest of the year. So specifically, around the 16% which was a one point decline on a year-over-year basis was really a combination of unfavorable currency, and the hardware mix that we

had combined with the fact that we are investing in go to market. The biggest piece of that go to market investment is in marketing. So what we told you we would do as a result of the change in the sales model, for Supplies is that we were going to take the contra that we were going to save or the discounts that we were going to save in the top line, the net off of revenue and we were going to reinvest it into marketing demand gen to drive print relevancy and usage, and that's what we are doing. And so, those are the things that put pressure on it. Now, what's offsetting that is that, we are continuing to make…have savings from productivity, but those were a bit higher than the productivity savings that we saw in Q1.

In terms of the rest of the year and how to think about it; what I said on the Q4 earnings call is still true on the Q1 earnings call, and that's that, we don't target a particular rate for print from an operating profit perspective, but we do expect in 2017 that it will be in that mid-teens, 6% to 18%. And the variability in that range is largely going to be driven by the units that we place. And where we have got a cost structure now that we think is quite competitive and allows…has allowed us to open-up some TAM, for more positive NPV units. And when they are available we want to go ahead and take advantage of them. And so, that's what we did this quarter and we look forward to doing that the rest of the year as well.

Dion Weisler
The market was a little higher than the analysts have predicted and we took advantage of that with that lower cost structure that Cathie is talking about, and you are seeing that show up in the units at positive 6% versus last year negative 16%, it is like a 22-point spread there.

Cathie Lesjak
And the market was better in the DeskJet lower consumer space, and so, while they were still NPV positives and therefore of interest to us they were at the lower end.

Toni Sacconaghi
Okay, and then, just as a follow-up, please, can you just comment on channel inventory, both for PCs and for printing on a sequential basis? Did you have any change in inventory in either of those businesses in the channel inventory?

Cathie Lesjak
So in both, for print…let me start with PC, for PC channel inventory, we did have some channel inventory reductions sequentially. On the print side, in total we were down a bit, in supplies, we were obviously down materially year-over-year as a result of the change in sales model and we were also down a bit sequentially.

Operator
The next question will be from Kulbinder Garcha of Credit Suisse. Please go ahead.

Kulbinder Garcha
Thank you, just a couple of questions, and maybe for Dion first. When I look at the actual numbers, revenues grew for the first time across the company, 4% year-on-year; you beat estimates by around $800 million, $900 million on the top line. There wasn't as much of a bottom line flow through in operating income. In fact, it was down like-for-like, year-on-year. Was this a quarter just across the company of very high level of investment? I hear what, Cathie said about the NPV units you took advantage of, but whether it's on 3D printing or whether it's on other things you are doing on the PC side or channel initiatives, did you reinvest or invest relatively heavily would you say this quarter, why wouldn't you see that leverage? And my second question is just on supplies, you are still talking about stability by year end, but given the

units you are now placing wouldn't it move beyond the end of the year compared to let's say three or six months ago? What's your confidence that into the following year we might see a year in which the Supplies business actually starts growing? Thanks.

Dion Weisler
Okay, I will start, and then I am sure Cathie will no doubt chime in here. I think Cathie answered the question on Print pretty substantially so I am not sure there is much additional information to add there. We obviously invested in marketing, we invested in units, and there was some currency. We also had currency in Personal Systems, but we also faced some fairly competitive or increased prices for components and that was a headwind to the quarter which we overcame by effectively growing out of the problem, because that cost structure was much more in line with where we need it be from a competitive situation. The innovation portfolio is as strong as it's ever been more than 23 awards that we won at CES. We were leaning into that innovation from customers who expected a lot of demand for our products. So even against that cost headwind from a component level perspective, we are able to substantially improve our performance from a top line perspective. And you saw obviously Personal Systems up 10%, year-over-year as reported 11% in constant-currency.

Cathie Lesjak
And Kulbinder, in terms of longer-term view of supplies, we haven't really provided an outlook out beyond 2017. But what I will say as we have now a very substantial evidence point of down just 2% in constant currency for supplies year-over-year in Q1, we are on that march to get it stabilized in constant currency by the end of the year. And then, of course, we are at the same time focusing on making sure that we are placing the right units, the positive NPV units, and making the right investments across A3 and graphics, as well as 3D for longer term, so that over time we will drive supplies back to growth.

Operator
The next question will be from Steve Milunovich of UBS. Please go ahead.

Steve Milunovich
Thank you very much. Cathie, you talking about currency hurting the printer margin, but I would have thought the weak yen would have really been a help in terms of Canon's supply from you. And then maybe there would be an offset at revenue in terms of competition. And then the second, on Printing, I also was curious. There seemed to be about a $1 billion reclassification from commercial to consumer hardware. Can you explain what that was about?

Cathie Lesjak
Sure, so on the yen, the contract that we have with Canon does not adjust every day. It has a certain band around it. And as a result, we in fact have not seen a benefit from the weakening yen in our cost of sales yet. So it was still an overall headwind for print, and currency was an overall headwind for print both on the top line because of the strength of the dollar, as well as, on cost of sales, because we haven't seen that snap back yet.

In terms of the re-class, at the beginning of November, Enrique reorganized his business. And he basically now has a more aligned along consumer…I am sorry, not consumer…business lines, customer segments. So we have got a consumer, a home division, he has got an office division, he has got basically graphics. And then we've just realigned the units and all of the revenue to line up with that new customer segment view. So what ended up happening is the personal lasers moved from the commercial category to the home/small-medium business category and that's the adjustment that you see. Everything, has been adjusted so that you can get a good apples-to-apples view, it doesn't totally change anything at the segment level or the HP Co level for revenue or profit.

Dion Weisler
And that makes all sorts of sense from our perspective, because we are trying to look always through the lens of a customer. And a customer centric approach means that we try to develop technologies that make sense for a customer whether they happen to be laser or ink based or whatever else we have in our kit bag, as opposed to being driven by technology lines and that's why we made that alignment change.

Operator
The next question will be from Shannon Cross of Cross Research. Please go ahead.

Shannon Cross
Thank you for taking my question. The first one, Dion, can you talk a bit more about the PC market, you talked about strength in PCs that you guys saw, but also noted outperforming the market pretty substantially. So I am just curious how you see, how sustainable you see the growth in PCs, you have Windows 10, aging install base, stability of processors. But what are you seeing out there? And I am curious as to whether or not you are also feeling the pickup in business following the election or what you think is behind some of the growth you are seeing. And then I have a follow-up.

Dion Weisler
Okay, great. I think it's always helpful to answer this question in two parts. There is the short-term view of the market, and I will get Cathie to tackle that, and then I will give you a long-term view of how we see the PC market, and then we will close out with the rest of your question.

Cathie Lesjak
Thanks, Shannon. So yes, we have definitely seen the PC market improve. And in addition to a unit view, we are also seeing a positive mix shift. So while units were down year-on-year in calendar Q4 1.7%, the IDC PC category revenue was actually up 2%. And we are really kind of leaning into that mix shift. We have seen it through kind of premium, gaining convertibles, detachables, even the notebooks being thinner, lighter, better battery life, as well as the discontinuation of the Windows 10 free upgrade. Those are all the things that are helping the market, but also things that we are taking advantage of. If you look out for 2017, our view is pretty consistent with IDC the units will be down low to mid-single digits, but that revenue for the market will again still have this mix shift benefit and will be flat. But one of the things to keep in mind also in 2017 is that there's a fair amount of uncertainty in the PC ecosystem when you think about commodity availability as well as commodity pricing. And as a result of that, we've taken pricing and a lot of our competition has taken pricing as well, and we've got to really see how that impacts demand. We've obviously modeled what we think the impact would be, but we'll have to see whether or not in fact the demand impact is lesser or greater than what we've already modeled into our outlook.

Dion Weisler
And more broadly speaking, if I helicopter up a little bit, I don't think our views have fundamentally changed on this business. It's still a very large business. I always like to remind everyone; it's a $333 billion market. It's very competitive and it continues to consolidate. So when we take share faster than our competitors three quarters in a row and we are executing the way we are executing but not taking share for share's sake, which we're committed to not

doing, what we end up with is a business that's firing on all cylinders. More broadly, we think it's all about innovation.

And as I mentioned in my initial remarks, the growth that we saw in the PC business wasn't as a result of one event. It wasn't like an XP refresh cycle. It was off the back of really strong innovation right across the portfolio, the values that the customer sees and the little sprinkles of magic that Ron and the team are adding to the product portfolio. We have to be excellent in the core. We have to continue to search for those pockets of growth as we segment the market, like commercial mobility, create categories like Sprout and X3. All of it has to be anchored in mega trends that we see changing in the market.

Services and solutions make a big part of that $333 billion market; about half the market is not the core of what you think about as desktops and notebooks. It's a lot of services and solutions and attach and other devices and workstations [indiscernible] clients. There are mega trends around consumer and commercial, this OneLife, millennials, mobility and security. So doing that segmentation, operating, continuing to take costs out of the system means that we are playing our own game and we are being rewarded for it.

Shannon Cross
Great, thank you. And can you talk a bit about your copier strategy? I know it's about to launch. I'm just curious, as you've gone through and you are working through the Samsung transaction and talking to potential channel partners, if you can talk about the reception and what you are hearing? Thanks.

Dion Weisler
The reception has been broadly positive on a number of dimensions, firstly off the back of our own home-grown innovation with the PageWide array and the ability to take that into the A3 line of products. But in addition to that, obviously the line that we were initially OEM-ing from Samsung but then once we complete the Samsung acquisition by the end of this year, we'll round out the portfolio. So, I think across the globe, a lot of very detailed plans at a partner level, down at a customer level. I spend personal time all around the world working with the teams on the go-to-market strategy, which is every bit as important as having a fantastic product portfolio. And then, we marry that together with the marketing work that Antonio and his team are driving, some terrific new marketing campaigns anchored around security, which is really resonating with our Customer Advisory Council and other customers and partners. You put all that together, we are really looking-forward to the launch of these products, which as you mentioned, is coming up pretty quickly here.

Operator
The next question will come from Jim Suva of Citi. Please go ahead.

Jim Suva
Thank you very much. Thus far, a lot of the questions have been on the printing side, which makes sense given the profitability there, so I'll ask a question on the PCs. You had mentioned that you increased pricing. I'm just curious, was that due mostly to FX, or is it also are you seeing component price increasing? And if so, is the addition of the ASPs enough to offset component pricing, or should we just be mindful of that, as I believe some of the component costs, especially storage, have been recently increasing? So I'm just thinking about the profitability of that. Thank you.

Cathie Lesjak

So, Jim, consistent with our expectations, both the commodity supply environment but also pricing tightened up in Q1, and that was absolutely a headwind to Personal Systems OP that we were able to jump over with some pricing, but also with incredible tight management from an expense perspective in reducing non-revenue generating costs. We expect that into Q2 this is going to continue, and in some categories we do expect that the price will continue to increase. And so, this continues to be a headwind for us. But if I take it all the way up to the top level that Dion talked about, it's really all about making sure you've got a great cost structure, the leanest you can have, and then innovate, understanding your markets really well and innovating into those markets. And I think that Ron and his team have really proven this quarter, if not the previous few quarters, that they know how to execute, and they know how to execute in tough environments. And we would definitely say this is a tougher commodity environment for us.

Operator
The next question will come from Wamsi Mohan of Bank of America. Please go ahead.

Wamsi Mohan
Yes, thank you. So two questions, one, on the printing supplies, revenues were down 2%, was somewhat better than expected relative to your comments, I think, last quarter, mid single-digit decline based on the Four Box Model. Can you address, what drove the upside in the quarter in that context of the Four Box Model specifically? And then I have a follow-up.

Cathie Lesjak
So, we don't break it down in that much detail, but I would reiterate the fact that we did better than what the Four Box Model was suggesting. And certainly, we will continue to drive all of the different initiatives that we've got going against each of the boxes because it continues to be true and our fundamental belief it'll continue to be so, that those are the key levers that are going to drive supplies revenue, both to stabilization in constant currency by the end of the year and then ultimately to growth beyond that.

Wamsi Mohan
Okay, thanks. And as my follow-up, can you address specifically within the tighter component environment, how much longer do you think, a) that'll persist? And how are you addressing that, including any large strategic buys maybe that you did within the quarter or that you are looking to do and leverage your balance sheet to do that? Thanks.

Dion Weisler
Yes, look, when we think about personal systems commodities, there are really three commodities that are under pressure. It's memory, which includes random access memory as well as SDD, in addition to that, there's batteries and LCDs. And we take a very long-term approach with our supplier base. We have long-term agreements with many of them. We do seek to leverage the balance sheet wherever it makes sense economically for us to do that. How long will this last? It's a little bit difficult to completely forecast that. But I would say from previous experience, it takes a long time to change factory output levels.

And, for example, what's affecting memory at the moment is the doubling in density across most of the mobile phone market because the mobile phones are selling many more in absolute units, but the fact that they all doubled their density puts pressure on that memory market. So if you want to really adjust that, what you have to do is add capacity, and we are talking about billions of dollars of investments from the memory manufacturers. That doesn't happen overnight. So these cycles can often last quite some time and it varies by commodity, but that should be the way you should be thinking about it.

Cathie Lesjak
And then to the specific question about using our balance sheet, we are absolutely using our balance sheet. We talked about it, I believe it was on the Q3 earnings call, about the fact that we were anticipating this, and therefore in Q4 we were going to build some strategic inventory, and we have continued to do that. In fact, if you look at our working capital, the elements of our working capital, inventory is basically higher than it otherwise would be because of the strategic buys that we are doing. We have that capability and we think it's a competitive advantage.

Operator
The next question will be from Maynard Um of Wells Fargo. Please go ahead.

Maynard Um
Hi, thanks. On your cash return, you returned almost a quarter of the high end of your annual free cash flow guide in the first quarter. So looks like this might put you ahead of the 50% to 75% of the free cash flow return target. Should we expect a deceleration in share repurchases, or do you think you can return greater than that 50% to 75%? And any commentary around your expectation for a cash repatriation holiday, if that's supporting any confidence there? And then I have a follow-up.

Cathie Lesjak
So, maybe I'll start with the second one, our view on cash repatriation from overseas and a tax holiday. At this point, that is unknown what exactly is going to happen. And so, that's really not playing into what we are doing at all at this point in time. We are still committed to returning 50% to 75%. And what we said in FY 2017 is that we would be at the higher end of that, and that continues to be our commitment.

Maynard Um
Okay. And then, can you just talk about the Samsung acquisition charges? More specifically, why they are being brought in and maybe just talk about what specifically they are? Thanks.

Cathie Lesjak
So the Samsung integration expenses run the gamut from transaction costs, legal costs, and then very specifically around integration. And whenever you put this together, it's always a little bit difficult to know exactly what the timing is going to be. In total, we still expect that the Samsung integration costs are going to be in the $150 (million) to $200 million range and that we will take those on a GAAP-only basis and basically call them out each quarter, so I don't think there was anything particularly special about the fact that the timing has changed a bit, just a better assessment of when the costs are going to be incurred.

Operator
The next question will be from Sherri Scribner of Deutsche Bank. Please go ahead.

Sherri Scribner
Hi, thank you. Cathie, I think you said that the Personal Systems Group should be down more than typical, when I think about that segment, I think about it being down about 10% sequentially in 2Q for you. Is that the right way to think about what the normal is and maybe it will be a little bit lower than that? And also, do you expect to see some growth in that segment in the second quarter?

Cathie Lesjak

So Sherri, what is typical for us in terms of normal seasonality for Personal Systems is probably closer to 6%, not your 10%, but we do expect to be worse than that as a result of the strength that we saw in Q1. And as, you know, we don't guide revenue, and certainly don't guide revenue at the segment level, but we have the right cost structure. We are innovating and bringing to market great value propositions for our customers. And so, we will continue to fight the good fight with our competition, and we will see how it works out in Q2.

Sherri Scribner
Great, and then the supplies model change that you made we are roughly three quarters into that now. How do you feel about that change? Is it working, I assume you are going to say that it is working, but maybe some more detail in retrospect about how that's working out for you. Thank you.

Cathie Lesjak
Sure, Sherri, I am very pleased with how it's working out. We basically believe that by getting closer to global pricing consistency that there would be a number of benefits. One was going to be just much more linear supplies performance. As I said, we would have linear sales out, and then therefore we would have more linear sales in, and we are absolutely seeing that. And as I said, that's what gives us some confidence that we will get some permanent linearity benefit this year. But it is also great from a partner perspective because, of course, they are carrying lower channel inventory, then therefore that's their working capital.

Our channel inventory levels are healthy. They are below the top end of the newly lowered and narrowed ranges, so we are feeling good about that as well. And then we are also seeing in the quarter improvement in terms of discounting. And as I mentioned, we are taking that in lower discounts and basically in reinvesting them back into marketing to drive print relevancy and usage. And it's very important that we do that, because we do not want to be selling supplies on promo. We want to drive the value to help our customers understand the value of using HP branded ink and toner and marketing is going to be important to that.

Dion Weisler
And again, looking through the eyes of a customer, it increases customer satisfaction when there is not enormous price volatility in the market that encourages gray imports and all of the issues associated with that and the frustrations associated with that. So we've seen the gray marketing activity significantly reduced, we are seeing much more stable prices in the market which is a benefit for the customers, channel partners and our business performance.

Operator
The next question will be from Rod Hall of JPMorgan. Please go ahead.

Rod Hall
Yes hi, guys. Thanks for taking the question. I just wanted to come back to this question of printing margins. I think one of the questions a lot of people lead the call with is the fact you delivered 16% margins here. And, Cathie, you are saying the range is 16% to 18%, so I guess people are going to continue to wonder whether the new normal is 16% or whether we should get back up into the middle of that range you are talking about. And I wonder if you could just give us a little bit more color on what was abnormal about this quarter or things about this quarter that won't manifest themselves in future quarters and let those margins expand back toward the middle of your range. And then I have a follow-up.

Cathie Lesjak

So Rod, it's all in the eye of the beholder. I love 16, I love 16, when we put units out, positive NPV units out there and we grow units 6%. And if that was the opportunity that existed throughout the rest of the year, I would be okay with it, and I would hope that you would be okay with it, because it's going to drive great supplies connect over the long term. Now, I think that we probably will get higher in the range, but honestly, if there are opportunities to place more NPV positive units we should do that all day long.

Rod Hall
Okay. So just to clarify that, the margins would tend toward the low end of the range only because of unit placement, there is nothing else going on in those margins?

Cathie Lesjak
We have got currency impacts, we have got productivity savings. There is lots of things that are going on in the margins, but the biggest driver for us to be at the lower end of that range is going to be placing positive NPV units.

Rod Hall
Okay. And then my follow-up was just on printing supplies growth. It looks to me with these numbers that you may actually be growing revenues on a year-over-year basis for this full year. Is that a possibility? Do you think that's a likelihood in your plan?

Dion Weisler
We are confident in stabilizing supplies by the end of 2017.

Cathie Lesjak
In constant currency.

Rod Hall
Okay, thank you.

Operator
And the last question will be from Aaron Rakers of Stifel. Please go ahead.

Aaron Rakers
Yes, thank you for taking the question. The first question is on, you talked a lot about the alignment of your cost structure, and I am curious if you can give us an update of where you stand on the incremental headcount reductions that you had announced at the Analyst Day, I think it was 3,000 to 4,000 head count. And how we should think about the rate of reinvestments relative to the $1 billion of the incremental savings you expected to generate through the exit of fiscal 2018. And what I am really trying to get at is how do we think about the operating margin and the drivers of trending it towards the higher end of your 8% to 10% range that you laid out?

Cathie Lesjak
Sure, let's talk first about the restructuring. In Q1, we had roughly 350 employees leave under the plan. And as you said, for the year our target is 1,500 to 2,500, and again we gave that range because we were assessing different outsourcing opportunities, and there is still a bit of a range based on that. I would say we are on track from a restructuring perspective, but restructuring is just a part of the overall billion dollars in productivity savings that we are targeting for the year. And it comes over the course of the year and is a little bit back-end loaded, but we are feeling confident that we will be delivering on those productivity savings as well.

Aaron Rakers
And relative to that 8% to 10% operating margin long-term target model, I don't think the Street is really fully reflective of anything close to the higher end of that range, I am just... is that purely a function of product mix beyond that or how do we think about that higher end of that long-term model range?

Cathie Lesjak
So first, 8% to 10% is really a long-term operating margin view, and we have always said that would be at the lower end of that range if there were good opportunities to place positive NPV units. So there is a theme here. It really makes a difference because of the upfront investment that you need to make on units. Certainly, to get in that range, we also need to get supplies more in a growth mode.

Dion Weisler
And in addition to that, it would be the full execution of our strategy not only in the core, but as well as the growth, there is A3, think about that $55 billion market where we have less than a 4% market share today, continuing our ramp of graphics and commercial mobility, and we've only just begun on 3D printing where we placed those first units and revenue wrecked them, which is even more exciting. And the fact that our customers are telling us that the printers are performing as per our promise, on speed, quality, and cost is really important. And that strategy is anchored in time horizons. The core is the here and now, growth is the next two to three years, and future is three to ten-year timeframe, and that's how we think about this business.

CONCLUSION

Dion Weisler
I thank you all for taking the time out of your busy schedules to tune in today. I think this quarter can best be characterized as relentless execution and innovation that delivered really strong results. It's a consecutive quarter of growth, so this is the second quarter in a row of growth and solid performance. Innovation is at the heart of driving the meaningful share gains that we had. We are the pillar of stability right now in the industry, whether it's on the security dimension or innovation dimension, regardless of the market conditions. We have increased confidence in our ability to deliver on the commitments that we laid out at the security analyst meeting, and I remain convinced, as does the rest of our entire organization, that our most innovative days lie ahead of us. Thanks very much.

Cathie Lesjak
Thanks a lot.

Operator
Ladies and gentlemen, the conference has now concluded. Thank you for attending today's presentation. You may now disconnect.