Hewlett Packard Enterprise Company

Fourth Quarter 2016 Earnings Conference Call

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CORPORATE PARTICIPANTS

Meg Whitman - *President, Chief Executive Officer*

Tim Stonesifer - *Executive Vice President, Chief Financial Officer*

Andrew Simanek - *Head of Investor Relations*

PRESENTATION

Operator
Good morning, afternoon, and evening and welcome to the Fourth Quarter 2016 Hewlett Packard Enterprise Earnings Conference Call. My name is Angie, and I will 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 any 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 of today's call, Mr. Andrew Simanek, head of investor relations. Please proceed.

Andrew Simanek
Good afternoon. I'm Andy Simanek, Head of Investor Relations for Hewlett Packard Enterprise, and I'd like to welcome you to our fiscal 2016 fourth quarter earnings conference call with Meg Whitman, HPE's President and Chief Executive Officer, and Tim Stonesifer, HPE'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. We posted the press release and the slide presentation accompanying today's earnings release on our HPE Investor Relations web page at investors.hpe.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 the disclaimers on 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 HPE's filings with the SEC, including its most recent Form 10-K and Form 10-Q. HPE 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 HPE's annual report on Form 10-K for the fiscal year ended October 31, 2016.

Finally, for financial information that has been expressed on a non-GAAP basis, we have provided reconciliations to the comparable GAAP information on our website. Throughout this conference call, all revenue growth rates presented, beginning with fiscal year 2015, are adjusted to exclude the impact of divestitures and currency. We believe this approach helps provide a better representation of HPE's operational performance given the significant divestitures we've recently completed including the sale of Mphasis, 51% of our H3C business in China, and Tipping Point amongst several others. Please refer to the tables and slide presentation accompanying today's earnings release on our website for details.

With that, let me turn it over to Meg.

Meg Whitman
Thanks Andy, and thanks to everyone for joining us on the call today…

FY16 was a historic year for Hewlett Packard Enterprise. During our first year as a standalone company, HPE delivered the business performance we promised, fulfilled our commitment to introduce groundbreaking innovation, and began to transform the company through strategic changes designed to enable even better focus, flexibility and financial performance.

Our success in FY16 is proof that we're on the right course. HPE today has the ability to better respond to the constantly evolving marketplace while generating long-term value for shareholders. The leadership team can dive more deeply into the products, have more time to spend with customers and partners, and can confidently develop our strategy. From an innovation perspective, we can be much more targeted in the investments we make. The results of all this focus are reflected in our performance.

For the year, we delivered revenue of $50.1 billion, up 2% year over year when adjusted for divestitures and currency, and in line with the outlook we provided at our analyst meeting in 2015. While there is always more work to do, our go-to-market motion is strong and our increased confidence is really paying off.

We saw growth this year in key areas of the portfolio including high-performance compute, Cloudline servers, all-flash storage, converged systems, mission critical systems and networking with Aruba. Technology Services returned to growth in the last two quarters of the year and we expect that momentum to continue into FY17. Strategic Enterprise Services revenue grew over 30%, driven by Helion Managed Cloud, which grew over 50% and Virtual Private Cloud, which grew over 100%. And, in software, we saw solid SaaS and security growth, with particular strength in Vertica and Voltage solutions.

In terms of profitability, we grew our non-GAAP operating profit as a percentage of revenue, due in large part to the tremendous progress the Enterprise Services team has made. ES ended the year with a non-GAAP operating profit of 7.7%, above our outlook range of 6-7%, and in line with our long-term target of 7-9%.

In the Enterprise Group, we continued to hone the balance between revenue growth and profitability. During the past two quarters, we've seen steady margin improvement and feel confident that the ongoing cost actions we're taking, and the greater mix of converged and software defined solutions as well networking and storage, will offset the pressure in core servers going forward.

And in software, the team maintained a disciplined focus on cost controls, driving margin improvement in the year.

Overall, we delivered FY16 non-GAAP EPS of $1.92, at the high end of our original outlook for the year.

Turning to cash flow, we delivered free cash flow of $2.1 billion, above our most recent guided range of $1.7-$1.9B. This is particularly strong, given that we were able to offset the lower cash flow resulting from the divestiture of 51% of our H3C business through careful working capital management. Given the strong cash flow, and the proceeds from recent divestitures, we were able to return over $3B of cash to shareholders throughout the year, and still end the year with an operating company net cash position of $7.6 billion – the highest since I've been with the company.

In FY16 we also announced strategic changes to the company that will help strengthen our performance over the long-term. We completed the divestiture of our stake in Mphasis and our sale of 51 percent of our H3C business in China. In May, we announced the spin-merge of our

Enterprise Services business with CSC. And in September, we announced the spin-merge of our Software business with Micro Focus.

Together, these transactions are valued at over $20 billion dollars. They will enable us to be more nimble, provide cutting-edge solutions, play in higher growth markets and have an enhanced financial profile.

The success of the separation of HPE and HP Inc., and the progress we've made as an independent company, have been recognized by investors. HPE's stock is up more than 50% since we launched the company on November 2, 2015.

Looking forward, the HPE that emerges after the two spin-mergers will have a clear vision, the right assets, and direct line-of-sight to significant market opportunities.

Our goal is to be the industry's leading provider of hybrid IT, built on the secure, next-generation, software-defined infrastructure that runs our customers' data centers today, bridges them to multi-cloud environments tomorrow, and powers the emerging intelligent edge that will run campus, branch and Industrial IoT applications for decades to come. All delivered through a world class services capability.

Let me spend a minute on each element of our vision.

First, we believe the world is going to be Hybrid, and our mission is to make Hybrid IT simple. To do this, we offer market-leading technology across the traditional data center, software-defined infrastructure, and private cloud.

We are focused on winning in key growth areas in the Traditional Datacenter like big data analytics, high-performance compute, all-flash storage and networking. To that end, this year we announced game-changing new products with new versions of our Gen9 servers and 3PAR StoreServe systems. We also acquired SGI, cementing our leadership position in high-performance computing and strengthening our capability in data analytics. In fact, it was just announced that we now have 140 high performance computing systems on the TOP500 supercomputing list – more than anyone else in the industry.
In Software Defined Infrastructure, we launched new categories with offerings like Synergy, the industry's first Composable infrastructure, and our hyper-converged 380 solution, which was just named the number one data center infrastructure product in CRN's annual Tech Innovator Awards, beating out solutions from Dell-EMC and Cisco.

And, we are establishing an ecosystem of partners to bring together and integrate the industry's best technologies from companies like Arista, Mesosphere, Docker, Chef and Microsoft Azure to allow customers to seamlessly manage across an increasingly complex set of environments.

Second, we will power the emerging Intelligent Edge. As data volumes increase in business environments outside of the datacenter, like factories and retail stores, customers need a new set of tools to gather, process and analyze the critical information that will allow them to make decisions in real-time. This means that they need compute, storage and connectivity at the edge, integrated into their operational environments and seamlessly connected to their hybrid IT environments. Through our Aruba offerings in security, analytics and connectivity, and our Edgeline Converged IoT Systems, we're building an ecosystem of partners and bringing unique solutions to this fast growing market. I like to say, we are going to be the IT in IoT.

Third, Services is going to be more critical than ever. As customers look to deploy both Hybrid IT and the Intelligent Edge programs, they need a partner who can help them manage through change and complexity. Our Technology Services organization delivers world-class advisory, support, and consumption models, as well as building customer solutions from the ground up. In addition to our TS group that provides these advisory, transformation and support capabilities, our Financial Services organization brings the financial flexibility and consumption models that our customers are increasingly looking for.

With this portfolio, we estimate we have a total addressable market of over $250 billion that's growing at 2-3% per year. And, within that, there are areas of very high growth – like high-performance compute, private cloud, software defined networking and industrial IoT. We are already well positioned to lead in these areas and you will see us continue to invest in a targeted way.

What is most exciting, is that our approach is resonating with our customers, partners and the industry. In the fourth quarter, we continued to win customers looking for hybrid IT and intelligent edge solutions and services.

For example, in hybrid IT, we recently replaced a 19 year EMC relationship with a major global healthcare company, where we will provide services and technology to deliver simplicity, operating efficiencies, and automation as the company modernizes and re-aligns their core storage and compute platforms.

In the intelligent edge market, Nordstrom recently named Aruba as their preferred provider for their Wi-Fi service strategy in all their Stores, Distribution Centers and Corporate Sites.

And, we announced a significant new wireless network rollout at Penske Truck Leasing, to enable greater workforce productivity and connectivity at its truck facilities.

Finally, our technology services business continues to deliver significant value to customers and win deals. For example, in Q4, TS won a major, 5-year deal with its Flexible Capacity service for a large European auto manufacturer. It also won a 5-year agreement with a large global bank based in Europe, which chose our Datacenter Care service to operate its data centers around the world.

Looking ahead, next week we kick off Discover London, where we will bring together nearly 10,000 customers and partners to demo our latest products and services. During the week, you will see exciting product announcements across hybrid IT and the intelligent edge, and hear from some of our customers about how we are helping them achieve their business outcomes.

So, overall, I'm very pleased with the progress we made in FY16. We delivered the financial performance we promised, fulfilled our commitment to groundbreaking innovation, and began to transform the company in ways we believe will deliver an exciting future for customers, partners, employees and investors. I'm excited about the path we see ahead and very much look forward to the journey.

And now I will hand the call over to Tim, who will provide details on the quarter.

Tim Stonesifer
Thanks Meg. Good afternoon everyone.

I agree that FY16 was a strong first year across a number of fronts. We successfully delivered the financial outlook we laid out at the beginning of the year, while making several strategic portfolio changes.

Now, I'll spend some time providing more detail on our fourth quarter results. Overall, I would say that we performed well in a tough market and continued to make progress improving our cost structure and strengthening our go-to-market approach.

Fourth quarter revenue of $12.5B was down approximately 2% when adjusted for divestitures and currency, as we continued to focus on profitable market share, and executed well in an uneven global demand environment.

From a macro perspective, we saw continued revenue softness in Europe, particularly in ES, due to a persistent slowing in the UK public sector business. On an as-reported basis, performance in the Americas was encouraging, with low single-digit growth in the Enterprise Group and Services. APJ performance was mixed, with improved EG and ES results in both China and Japan, but weakness in the rest of Asia.

Currency fluctuations were a headwind to revenue by 110 basis points year over year, driven by depreciation in the British pound and somewhat offset by appreciation in the Japanese Yen.

Turning to profitability, gross margin of 30.4% was up 80 basis points year-over-year due to continued improvements to deal profitability in Enterprise Services. Sequentially, gross margin was up 110 basis points principally due to normal seasonal uplift in both ES and Software.

We continued to drive cost productivity, and reduced non-GAAP operating expenses as a percentage of revenue by 120 basis points sequentially, and 70 basis points year over year, with significant improvements in ES delivery costs. Also, EG continued to execute on the cost plan we discussed at SAM, in order to further align costs with revenue.

Given those actions, non-GAAP operating profit of 11.1% was up 150 basis points year over year and 230 basis points sequentially.

Non-GAAP diluted net earnings per share of $0.61 was in line with our outlook of $0.58-0.63. For the full year, non-GAAP net diluted earnings per share was $1.92, in the center of our outlook of $1.90-1.95. Fourth quarter non-GAAP EPS primarily excludes tax obligation settlements of $647M and pre-tax amounts for restructuring charges of $395M, separation charges of $293M, and amortization of intangible assets of $126M, offset by tax indemnification adjustments of $311M and the gain from the Mphasis divestiture of $253M.

We delivered GAAP diluted net earnings per share of $0.18, below our previously provided outlook range of $0.44-0.49, primarily due to the previously mentioned settlements of outstanding Hewlett-Packard Company tax obligations that we shared with HP Inc. through our separation agreement.

Now turning to the results by business…

In the Enterprise Group, we continued to work on improving operating margins by focusing on profitable deals, reducing discretionary spend, and delayering as we right-size the organization ahead of the separation from ES and SW. Operating margins, while down slightly year over year, were up 60 bps sequentially to 13.2%.

Revenue declined 3% in Q4, however we had several areas of encouraging growth across the portfolio. Aruba was up 13%, all-Flash arrays were up more than 100%, high performance compute was up more than 30%, and we had our third consecutive quarter of year over year growth in Mission Critical Systems. *[pause]* And, our highest-margin business, Technology Services, grew for the second consecutive quarter. These results are a reflection of the continued investments we've made in our higher-growth businesses, like our software-defined, converged, and hyper-converged offerings, as well as our go-to-market efforts.

Server revenue declined 6% as growth in high-performance and mission critical compute was offset by pressure in the core servers and service provider vertical. In the core, we saw some incremental competitive pressure, particularly in blades. However, our recently launched Synergy line will allow us to better compete in the blade segment and we anticipate taking back share as this product line ramps. As we have previously discussed, we are prioritizing profit over market share, and as a result, saw some sales contraction in Tier 1. While this has put some pressure on revenue, we see opportunities to grow in the Tier 2 and Tier 3 space, which are growing faster, and have better economics, including greater TS attach. Encouragingly, the growth in High Performance Compute and Mission Critical Systems was independent of our acquisition of SGI, which we completed just after the end of the quarter, and should help drive further profitable growth.

Storage revenue declined 3%, with continued contraction in the legacy portfolio. However, the higher margin converged storage portfolio was up 1% and is now 56% of the total storage mix. Traditional storage declined by 11%, particularly challenged by weakness in entry storage. However, our recently introduced MSA entry offerings should drive improvement going forward. 3PAR + XP + EVA was up 2%, while all-Flash 3PAR revenue grew nearly 100% and now makes up approximately 50% of total 3PAR revenue. Keep in mind, all flash only makes up 10% of datacenter storage today, so we see a significant growth opportunity going forward. We also anticipate some uplift from our recently announced compression offerings which fill a gap in our portfolio.

Networking revenue was flat, but encouragingly, Aruba continued to take share, and grew 13%. We should see this growth in Aruba accelerate next quarter as we had some installations in the quarter pushed out into Q1. Also, we did see a slowdown on e-rate government infrastructure spending for education, which impacted both wireless and switching in campus. And keep in mind that we just launched our new Arista partnership which enables us to offer highly differentiated datacenter networking solutions which we expect will grow in future quarters.

Technology Services grew for the second consecutive quarter, with revenue up 2%. Orders also returned to growth in the quarter and grew for the full year. We saw encouraging performance in non-attach and proactive services and continue to improve service intensity, or attach dollars per unit, both of which are helping to offset increased Tier 1 mix and lower server units.

Enterprise Services revenue declined 2% as growth in the Americas and APJ was more than offset by softness in EMEA. For the full year, revenue declined 1.1%, in-line with the outlook we provided at the 2015 analyst day. Operating profit improved 250 basis points year over year, to 10.7%, the highest since Q4'09, as the team continues to execute on productivity improvements in delivery and sales. For the full year, we delivered operating margins of 7.7%, well above our original guidance of 6-7%. We continue to track against our longer-term goal of 60% headcount in low cost locations and completed the quarter with 51% of our headcount in low cost locations.

This is an 8 point improvement since the beginning of the fiscal year. It's also worth highlighting that our customer satisfaction has increased following these cost structure improvements and the spin/merge announcement.

Software revenue was flat as strength in Security was offset by declines in IT Management and Big Data. We have stabilized license revenue which was only down 1% as compared to down 18% in Q3. Also encouragingly, the renewal rate for high margin support contracts improved 3 points year over year to over 90%. SaaS had another record quarter with 11% revenue growth. The team also continued to focus on disciplined cost controls, and as a result, the operating margin improved 220 basis points to 32.1%.

HPE Financial Services revenue grew 2% and delivered its second consecutive quarter of year over year as reported revenue growth. Operating profit declined 70 basis points year over year to 10.2%, from higher operating expenses and lower residual maturities. Financing volume declined 3% in constant currency, from a tough compare. Return on equity was down 200 basis points year over year to 14.1%, and was pressured by lower residual sales resulting from lower volumes in FY13 and FY14.

Cash flow generation was strong in the quarter as we continued to improve working capital management. Cash flow from operations was $2.2B, up 44% year over year on an adjusted basis, and free cash flow was $1.5B, up 84% year over year on an adjusted basis. For the full year we generated free cash flow of $2.1B, above our most recent outlook of $1.7-$1.9B, and despite the H3C divestiture delivered cash flow in-line with our original guidance for the year. The cash conversion cycle was 6 days, down 12 days sequentially. Payables were the largest contributor to working capital improvement, as we continued to make progress with vendor terms.

Turning to capital allocation, during the quarter we paid $92M as part of our normal dividend. We also continued to reduce share count in the fourth quarter through our accelerated share repurchase program, which required all cash be paid when the program started in Q3. For the full-year, we returned over $3.0B of capital to shareholders, primarily through $2.7B of share repurchases. This is approximately <u>three times</u> our original commitment at the start of the year. Lastly, as part of our continued efforts to return capital to shareholders we increased our dividend payment by 18% to 6.5 cents per share effective for the January 4, 2017 payment.

Now moving to the announced spin/merge transactions. Both the ES-CSC and Software-Micro Focus transactions are on schedule and on budget. We filed the initial Form 10 and S-4 for the ES-CSC spin merge earlier this month. We anticipate filing the final registration statements in late February and we are on track to complete the transaction by April 1st. The Software-Micro Focus transaction is also progressing as planned, and we continue to anticipate the transaction closing on approximately August 31st.

We recently gave detailed FY17 guidance at our Securities Analyst Day, and I encourage you to review our financial overview presentation for a more detailed discussion of that outlook. However, I think it's worth reiterating a few points. We continue to expect FY17 non-GAAP diluted net EPS of $2.00-2.10 for the Combined HPE as it stands today, $1.25-1.35 for the Future HPE, and "reported" EPS of $1.45-1.55.

Normalized free cash flow for the combined HPE should be $3.6-3.9B, while future HPE would generate $2.1-2.4B in FY17. And, we expect "reported" free cash flow of ($1.8B), as cash will be significantly impacted by restructuring and separation payments, the ES pension funding, and the mid-year impact of the spin/merge transactions on cash generation.

As we discussed at SAM, please keep in mind that Q1 will use a significant amount of cash, and cash flow will be even more back end loaded in FY17 as compared to normal seasonality. The key drivers include the fact that our first quarter is typically the weakest cash generating quarter, due to the seasonality of ES and SW earnings. We also make our annual bonus payment in Q1, and we expect to fund the majority of the ES pension payment in the first quarter.

And finally, we expect Q1'17 non-GAAP diluted net earnings per share of $0.42 to $0.46, and we expect GAAP diluted net earnings per share to be $0.03 to $0.07.

Now 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 telephone keypad. If you are using a speakerphone, please pick-up your handset before pressing the keys, to withdraw your question, please press "*" then "2." We also request that you ask only one question and one follow-up question.

First question comes from Sherri Scribner from Deutsche Bank. Please go ahead.

Sherri Scribner
Hi, thanks. I was hoping you could give us a little bit of detail on your thoughts about the change in the administration in the US. I know, its early days and we don't have a lot of details, but can you maybe give us your thoughts on repatriation, if there is a repatriation holiday and will you see any benefit if there's a tax cut for US corporations?

Tim Stonesifer
Yes. Sure, so it's obviously early days, but if they were to make some tax changes, I would break it down into a couple of buckets. The first one would be the US statutory rate, so to your point if they were to reduce that, we would definitely benefit from that and probably provide us a little bit more flexibility, maybe level the playing field a little bit with non-US multinationals.

The second bucket is around the repatriation tax. So if they were to reduce that or provide some sort of tax holiday that would be a benefit to us. As you know, a majority of our cash is offshore. So that would again give us some more flexibility to bring that cash onshore and make investments in the US.

Sherri Scribner
And if they were to…if you were to bring that cash back, would you use it for dividend or to raise the buyback or the dividend?

Tim Stonesifer
Yes, we would continue to implement our disciplined ROI based approach towards capital allocation. I mean obviously, right now, we were aggressive in 2016 with our share repurchases. To Meg's point earlier, we returned $3 billion, which was three times our original commit. For '17, obviously, we are biased toward share repurchases and '17 we commit

another $3 billion. So I think, we will continue to work the disciplined ROI based approach it is working well for us so far and we will continue to operate within that framework in ‘17.

Sherri Scribner
Thank you.

Andrew Simanek
Great. Thank you, Sherri. Can we have the next question, please?

Operator
Next question comes from Kulbinder Garcha from Credit Suisse. Please go ahead,

Kulbinder Garcha
Hi, thank you for the question. One for Meg, and just on the visibility, it looks like the company returns to declining revenues after a few good quarters of growth that we saw this year. Could you speak about how visibility has changed going through 2016, whether there has been any major change? And then just one thing that’s linked to that, there was a period of time when your storage business was gaining share and on top of that your networking business is benefiting not only with Aruba, but also because Aruba was driving revenue synergy was switching has that now fully played out or should that growth there return at some point? Thanks.

Meg Whitman
Yes, let me talk about the decline in the growth rates in the last two quarters and particularly Q4. But I would say when you look at the full-year, the company grew 2% and enterprise group, obviously which is going to be the anchor of the go-forward Hewlett Packard Enterprise, grew 3% for the year. But I think, as FY16 demonstrated that there are challenges balancing revenue and margins in EG. And now we are going to be focused on growing overall operating profit dollars.

So as you know, in the first half, we delivered great growth and in the second-half while we delivered great growth, but the margins were lower than we would have liked. In the second half, we pivoted back more towards margins focusing on the profitable deals and improving our cost structure that resulted in a quarter-over-quarter margin improvement of 90 basis points in Q3 and another 60 basis points in Q4, but revenue slowed to flat in Q3 and was down 3% in Q4. So we really have…we’ve spent some time titrating, if you will, the balance between revenue growth and profitability.

And so now, as I look at 2017, I think we can grow revenue and operating margins at the same time going forward. And let me tell you why I think that? First is, we need to shore up core ISS rack with improvements in the channel, improvements in quote to cash, and more focus on the distributors and VARs for the volume related ISS rack business.

Second, we have got to continue to invest in the higher growth businesses which are doing pretty well, high performance compute with SGI, 3PAR all flash, Aruba, synergy, the HC 380. And those offerings are actually growing nicely and are accretive to the overall enterprise group margins.

Third, and this is one of those unintended great consequences of the separation of ES from the Hewlett Packard remaining company, is that alliances with former ES competitors like Accenture, PwC, the Indian outsourcers, they no longer view us as a competitor, and we are being integrated into a lot of their offerings that we were never integrated in before, and it's been fascinating to me how much more traction, I think, we are going to get with those alliance partners.

And then fourth, we are enhancing our go to market with a new focus on tier two and tier three that offer better growth at a higher margin. And then finally, as you noted in the quarter, TS has returned to growth and this is important because of the margins in TS. Everyone knows how margin rich TS is, so even a slight return to growth in TS actually helps mitigate margin pressure in ISS rack.

And then lastly, we are continuing to optimize our cost structure. A flatter and leaner organization with lower G&A spend, tighter alignment of R&D spend to the market opportunities and then a further improvement in our go to market model. So listen, we sort of titrated a bit during the year, first half was faster growth, lower margin; second half of the year was lower growth, higher margin; and now we've got to drive down the middle of the highway for next year. And as I outlined, I think there is real good reasons to think that's going to be the case.

With regard to net working, Aruba actually is doing really well; it was a little slower growth this quarter because a big implementation moved into Q4. It is still driving campus switching and then, of course, now we are a reseller of Aruba…I mean, of Arista. And so those revenues will fall in our P&L and the margin that we make selling Arista will actually be margin accretive to the overall EG Group. So that's why I am optimistic about revenue growth and operating margin in EG in 2017.

Kulbinder Garcha
Thank you.

Andrew Simanek
Great. Thank you, Kulbinder. Can we have the next question, please?

Operator
Next question comes from Toni Sacconaghi from Bernstein. Please go ahead.

Toni Sacconaghi
Yes, thank you. I have one for Meg, and I guess, one for Tim. Meg, I appreciate your response on the last question. I suppose the cynic could say your comps were pretty easy in the first half of '16, and so you were able to grow EG; and your comps became more difficult in the second half and you weren't able to grow and the bad news is the comps are even tougher for the next couple of quarters for EG. And I can't help noting that your characterization of the server market is much more cautious than it was a couple of quarters ago. I think you characterized it as seeing ongoing pressure in core servers, and talking about hyper converged being lower margins and lower support attach. So it feels as though…perhaps the market is getting tougher when you adjust for comps, I am not sure the performance was…and for TS, I am not really sure the performance was much better in the second-half. So I was wondering if you could characterize what you think the status of the server market is going forward. And what you think is a realistic market growth rate on a go-forward basis? And whether my characteristic of you having a different opinion that now versus six months ago is fair?

Meg Whitman
Yes. So listen, I actually think your comp point is actually correct, because remember Q1 and Q2, we were not yet anniversarying Cloudline and Cloudline was a big grower for us. We also,

Aruba was there as well. I would say, when you look at the market, and we did say by the way, we thought it was going to get tougher in the second-half. The main pressure we are seeing is an ISS rack. A little bit in Blade but frankly, we are going to recover in Blades, because of synergy. But ISS rack is where the most ongoing pressure is. Hyper converged is actually growing and is higher margin than our core ISS product as is synergy, as is high-performance compute, as is mission critical systems and of course, as is TS.

So the main area that we've got to work on is shoring up that ISS rack and that's all volume-based and it's all through the channel. So distyss, VARs, those things like our newly redone value added reseller program and our ability to do quote-to-cash fast and our ability to fulfill faster than our competitors. So I would say that if we can shore up ISS rack then I'm confident in the growth rates of these other businesses that we are now gaining real traction in. So there's weakness in ISS rack. I think, we are not executing as well as we could and we aim to fix that.

Toni Sacconaghi
Okay. If I could follow-up…

Meg Whitman
Sure.

Toni Sacconaghi
Meg, a question for Tim. But Meg, you didn't give me your sense of what you think the market growth in servers going forward. But Tim just quickly on cash conversion cycle, I think, you've talked about a sustainable level being in the mid-teens, you were down at six days this quarter, is that sustainable and if it's not, then isn't that a cash headwind for next year? And are your cash flow assumptions still doable i.e. did you kind of pull forward on cash conversion, have better cash flow this year at the expense of next year? Do you really think, we can take six days to the bank for next year? And Meg, if you could follow-up on that, great?

Meg Whitman
Yes, okay.

Tim Stonesifer
Yes. So on the CCC to your point; we did come in a little bit hot in Q4. It was primarily driven through working capital improvements. And to your point about sustainability, we do think it's sustainable, because when you look at the improvements we've made in 2016, in general, it's really around three areas. So if you look at AP, for example, we went out in 2016 and we hit up all of our suppliers and extended our payment terms. So those terms should hold through 2017, and they came in fourth quarter a little bit better, the improvement came in a little bit better than we had anticipated.

If you look at AR, we really spent a lot of time this year, improving our processes, improving our line of sight around past dues, as an example. So we cut our past dues from call it 10%, down to 5%. And again, those are sustainable as you think about going into 2017, assuming we execute. And then even in inventory, inventory levels were lower than we had anticipated in Q4. Again, similar to AR, we put in some tighter reporting, improved accountability, particularly around buffer stocking in our key commodity.

So you we have plans in place, and more important, I think, we have better visibility and accountability to execute. So we would anticipate those to hold in 2017. The only thing I would say about 2017 is, we don't guide cash flow on a quarterly basis. But just keep in mind, if you are looking at CCC, there tends to be a seasonal uplift from Q4 to Q1 and that's primarily driven by purchasing linearity. But overall, we feel comfortable with our guidance, 2017.

Meg Whitman
On market growth, Toni, we've got sort of dialed in about 1% to 2% growth rate in servers. And remember that includes things like high-performance compute, which is an $11 billion to $12 billion market growing 6% to 8%, mission critical systems actually now growing again for us, hyper converged and converged growing as the market with the core ISS declining. So…but overall, to answer your question directly 1% to 2%.

Toni Sacconaghi
Thank you.

Andrew Simanek
Great. Thank you, Toni. Can we have the next question, please?

Operator
Thank you. Our next question comes from Katy Huberty from Morgan Stanley. Please go ahead.

Katy Huberty
Yes, thank you. At the beginning of the call, you talked about networking and storage offsetting weakness in core servers. But when you look at the storage business, it declined 3% converged up only 1%. So what is your outlook for storage? How quickly can it return to growth? And are you happy with the storage portfolio or are there are gaps that could help, if you fill those gaps helps return to growth sustainably in that segment? Then I have a quick follow-up?

Meg Whitman
Sure. Well, let me take the first part of that and then Tim you can weigh in. So listen, storage, as we said, it continues to be challenged by declines in traditional storage. But we are seeing very solid growth in pre-PAR, overall it was up 5% and all-flash was up 100% year-over-year and it's now at $750 million annualized run rate and that excludes services. And all-flash now makes up 50% of our 3PAR portfolio and interestingly still only comprises 10% of the data center. So we see more running room in our all-flash business. And the introduction, we are introducing our new de-duplication technology that should provide some further uplift in all-flash array, because there has been a gap in our portfolio.

Traditional storage this quarter declined 11% and that was particularly challenged in entry storage. And I think you know we introduced a new MSA offering to address the entry market that I think should benefit us going forward. So I think, you'll see storage continue to be a strong point for us, we've got that old, you've got traditional storage declining and the new stuff growing, but feeling pretty good about the 2017 outlook, given the strength of the portfolio and the momentum we have in all-flash.

Katy Huberty
Meg, is there opportunity to add to the portfolio and get the converged mix even higher, so that it can offset the weakness in traditional longer-term?

Meg Whitman

Yes, listen, if you think about our growth strategy, honestly, it's got four different pieces to it. And we talked about this at the Security Analyst Meeting. But obviously, it's organic investment. Look at our 380…HC380, our Edge line products, 3PAR all-flash, our synergy offering. The second is partnerships. And actually, we are very excited about our Microsoft Azure partnership is getting real traction, as well as our Arista partnership which is new, but actually off and running, we've got very nice pipeline building there. And then the ones that are obviously Shaft, Docker, Mesosphere things like that.

And then M&A, so it's…I mean, Tim said it well, it's the return-based M&A strategy. And the M&A that's worked for us is 3Com, 3PAR, Aruba, SGI, what do they have in common? Reasonable and understandable valuations, enhancing the current portfolio, leveraging our distribution capabilities, and driving profitable growth. But we are very focused on returns-based look at this. And as Tim said, we still think that the stock price that's embedded in Hewlett Packard Enterprise today around remain co, if you can sort of pull out what you think as software is worth, what you think ES is worth. We still think there's tremendous value in the remaining company that's still embedded in overall HPE. So stock repurchases, and as I said, stock repurchase, share buyback is…that's where we lean towards.

Katy Huberty
And finally, did you see any impact of the US election? You talked a couple of times about installations being pushed out in the quarter; obviously, there were some areas of weakness maybe HP execution-related. But curious if you think there was any delay in spending ahead of election that would then come back in the January quarter?

Meg Whitman
We did not see that, not at all in the US. Actually, we saw a bigger impact of Brexit when the UK decided to leave European Union, because it actually froze purchasing quite broadly across Europe for a bit. We didn't see that in the US.

Katy Huberty
Thank you.

Andrew Simanek
Great. Thank you, Katy. Could we have the next question, please?

Operator
Next question comes from Steve Milunovich from UBS. Please go ahead.

Steve Milunovich
Thank you. Back on servers, Antonio at the Analyst Day talked about ASPs going up and don't necessarily follow microprocessors, because there's more storage and so forth. Is that occurring and do you expect that to continue to occur? And kind of the flipside of that is, you talked about backing off maybe some of the tier one hyper scalars. I know Cloudline has been fairly material to you particular the first-half of last year. Are you anticipating Cloudline is going to be significantly less than it's been and do you still believe you can get revenue growth?

Meg Whitman
Yes. So ASPs are going up, as exactly as Antonio suggested that at the Security Analyst Meeting and we expect that to continue. So Cloudline, listen, Cloudline is a pretty big business for us. And when done correctly, we actually make money on Cloudline. But we just have to be

sure every deal has to be looked at on a one-off basis, which is what's the forward pricing going to look like? Can we imagine making money at a forward pricing? And I basically said to the team, listen, we do not want to be doing negative deals here for the most part. What's the point in selling things at a loss?

And so we really want to make sure that we make money on these deals and profitable deals in Cloudline is more important than market share. That said, Cloudline particularly relevant not only in tier one, but tier two and tier three. The profit margins are better in tier two and tier three. So I think Cloudline has a bright future in 2017, especially as we do a better job of penetrating tier two and tier three, which is the sales force is all focused on. But frankly, there's not a big sales force component to those deals. The sales force gets the leads and then it's turned over to an engineering sale, so it has lower FSC associated with it. But Cloudline has been absolutely the right thing for us to do. We just need to continue to lever it into profitable deals.

Steve Milunovich
If I could sneak one in on industrial internet of things, I thought it was interesting at the Analyst Day that the edge became kind of a third pillar. And I understand that you defined it as anything out of the data center, so Aruba is most of that today.

Meg Whitman
Yes.

Steve Milunovich
But what about the more true internet of things, you talked about maybe some edge servers. Most of us have heard this for five-plus years. Are we closer to something happening and what particular role does HP play?

Meg Whitman
Yes. Well, I don't…you probably haven't heard it from us in the past five years, because really, I think, we've begun to understand the opportunity for compute and storage at the edge with intelligence built in in the last year-and-a-half since we owned Aruba. And our first product there, the edge line converged systems, we are pretty excited about that, and you can start to see some real momentum in the field. But it's early days for us; it's early days for us.

And the way I would think about it is, IoT is largely very industry vertical focus, which is why we've focused on industrial IoT with probably four verticals that we want to go after. And then become known for being the IT in IoT, so that you can compute and store at the edge with Vertica built in. So that's the strategy. Its early days. I think it is another growth leg for the company. But remember, this is early days. We were excited about it, but we've got some work to do to prove it out over the next year to 18 months.

Steve Milunovich
Thanks.

Andrew Simanek
Great. Thank you, Steve. Could we have the next question, please?

Operator
Next question comes from Simon Leopold from Raymond James. Please go ahead.

Simon Leopold
Great. Thank you for taking my question. I wanted to talk about what you've been doing in response to the shifts in foreign exchange rates? In particular, I have the impression you've had to raise some prices in Europe, just want to understand whether that's some of the issue you experienced with a little bit softness in Europe? And then in terms of the outlook, if there is inflation in the United States and what your assumptions are for foreign exchange rates, as we go into 2017? Thank you.

Tim Stonesifer
Yes, sure. So, as far as Q4, we did see a little bit of FX pressure, but not significant, but to your point, as you look, the currency environment has definitely been volatile in the last few weeks. And to your point, when you look at sort of where the rates are today versus where we guided, call it, mid-October, some of the rates are unfavorable. For example, if you look at the euro, the euro was at 1.10, and now it's probably at 1.06, 1.07, something like that. So, given our global footprint that does put some pressure on the operations now.

Having said that, it's very early in the year and we do have some hedging programs in place. So we didn't feel it was prudent at this stage to adjust our guide. And then in addition to that, the teams are being very proactive and very aggressive around the cost structure. There are also to your point in EMEA, we are looking at opportunities to improve pricing to offset some of that pressure. So, I would just say this to wrap it up is, we are keeping a close eye on the currencies. And at the same time, we are also implementing operational actions to help mitigate any pressure.

Meg Whitman
One of the things, I think, that we sort of figured out probably three or four years ago is, we were probably in a strengthening dollar environment for the foreseeable future. And that was after 10 years, where our currency was the wind that most businesses back. And three or four years ago that changed and it changed hard. So, we have completely internalized that we have to have a cost structure that allows us to win in a challenging foreign exchange environment. And so, that's why we've taken the cost out of the company that we have. That is why we are making sure that there are virtually no stranded costs left at Hewlett Packard Enterprise after Software goes and ES goes.

I mean, we basically by the end of this fiscal year, we'll have no stranded costs at all relative to these two big divestitures, which for a company our size and scale is a pretty big achievement. Because one of the things, I think, we've come to realize is the overhead structure that was required to knit together the old HP and then Hewlett Packard Enterprise was a pretty high overhead structure, because the diversity of the businesses, we ought to be able to run much leaner and meaner and we anticipate exiting the year at a much lower overhead as a percentage of revenue than we have in the past.

Simon Leopold
Thank you for taking the question.

Andrew Simanek
Thank you, Simon. Next question please?

Operator
The next question comes from Maynard Um from Wells Fargo. Please go ahead.

Maynard Um
Hi, thanks. You talked more about focusing more on profits versus revenues in the back-half. But, as I look at your EG margins, it's lower than I think would be normal sequential growth. So can you just walk us through the factors there and whether this should be the base to use for op margins going forward pretty much from here bottoming Q1 and then rising going forward? And then I have a follow-up, please.

Tim Stonesifer
Yes, sure. If you look at sequentially, EG margins were up about 90 basis points in Q3, and then in Q4 up another 60 basis points. So we are seeing some improvement. If you look at total year, or if you look at year-over-year, there's a negative 40 basis points. So one thing that you do need to keep in mind is the H3C divestiture. So that was profit. That was flowing through our profit in last year and this year; it's flowing through OI&E. So I think that could be part of the discrepancy as well.

Maynard Um
Got it. And then can you help us understand your thought process around the timing of share repurchases this fiscal year. Do you think you'll wait until the spins to get more aggressive in the buybacks, or because if you wait until the spin-off of ES, for example, you'd be able to buy back shares presumably in the teens versus where your stock is now in the low 20s. So I'm just curious if you can give us a sense about how you think about timing on share repurchases?

Tim Stonesifer
Yes, the stock price will go down, or will be adjusted, if you will, once we do the divestitures. But, we try to take a balanced approach. So, we will be buying stock back throughout the course of the year. So we just want to make sure we keep a balanced perspective on the share buybacks.

Maynard Um
Great. Thank you.

Andrew Simanek
Alright, thank you, Maynard. Next question, please.

Operator
The next question comes from Shannon Cross from Cross Research. Please go ahead.

Shannon Cross
Thank you. I was curious, Meg, can you talk a bit about what you are seeing on the competitive landscape? Obviously Dell/EMC is closed, Lenovo just announced their deal with Nimble. I'm just kind of curious as to what you are seeing from your competitors? And then I have a follow-up.

Meg Whitman
Yes. So, listen, as always is a very competitive environment out there. And I can just sort of start at the top. I think, Cisco is aggressive, but we've seen some weakening in UCS and VCE. They are not as aggressive as they were probably two…18 months to two years ago. Dell/EMC, it's hard for us to tell how well Dell/EMC is doing, because of course, they are not a public company anymore. But, we like our win rate. We like our strategy of getting smaller and

more focused, while they are still integrating a very large acquisition. And Lenovo, we intercepted a huge amount of server volume in the move from IBM to Lenovo, and we haven't seen them pop back yet. I don't ever count Lenovo out, okay. So they may be just about ready to get up off the mat here, but we'll see in the next 6 to 18 months.

And then, we are actually seeing some Huawei pressure in Latin America and a little bit in Europe, not in the United States, a little bit in Europe, quite a bit in Latin America, and we are trying to basically make sure that, in my view, it's easier to hold share than to gain it back. And so, we are making some investments in areas that they are trying to make inroads into. So that they don't create a profit pool from which they can leap to another country. I think, one of the advantages, Shannon, of the separation is, people used to ask me, who is my list of competitors, and there would be 20 people on that list. This is a much smaller group of competitors, including the public cloud competitors to some degree, and we can be much more laser like focused, and in the volume business, react very quickly from a pricing perspective, from of a VAR perspective, probably much more quickly than we could have before, and that actually helps us, as we think about pricing in a particular region or a particular product line.

Shannon Cross
Thanks. And then if you can talk a little bit more about China in terms of what you are seeing there, obviously, it's the Tsinghua joint venture, but I'm curious, there are supposedly some delayed deals that we're waiting for it to close, now that it is closed and you've gotten through it. I'm curious as to what you've heard from them? Thank you.

Meg Whitman
Well, I'll start off and let Tim weigh in. So, first of all, we are thrilled that we have done this deal with Tsinghua University. It is much better to own 49% of a leading player in China than own a 100% of an American-owned subsidiary. And I think you've seen a lot of our competitors try to figure out how they can replicate that deal. I also think depending on what happens with the trade relations between the US and China, we are going to be thrilled to death that we are in a partnership with Tsinghua University. They are running the company as a very local Chinese company. We like their CEO. Their networking business is doing really well, and they are integrating now our storage and server business. So we are optimistic. They're sort of early kinks in some ways, they are working out running this very big company that they've absorbed and they've got some integration issues. But, overall, we are really pleased with the joint venture.

Tim Stonesifer
I would just say from a financial perspective, if you look at the Q4 equity interest, it was about $31 million. So if you recall in the third quarter that number was a little bit lower as we were running through some one-time accounting items. So we are much more at a normalized run rate now. So we expect that to continue to improve, as we get into 2017.

Meg Whitman
And we are still involved in the company. There's a board meeting once every quarter, in Hong Kong, where we go over the plan and how we can help them be successful and learning's from the rest of the globe, and how they make that their own in the local Chinese market. So I think, its working as well as we possibly could have expected. And again, I got to tell you, I think, we may be very, very glad that we are in a Chinese joint venture, as the dynamics change across the globe here.

Andrew Simanek

Great. Thank you, Shannon. I think, we have time for one more question, please?

Operator
Certainly. Our last question comes from Rod Hall from JPMorgan. Please go ahead.

Rod Hall
Yes. Hi, thanks for taking my question. I wanted to start off, Meg; to just ask you to characterize the economic environment that you were operating in the quarter you just reported, in the forward quarter we saw a lot of weakness from other enterprise exposed companies like Cisco and Intel and so on. So there were a lot of people calling out enterprise spending weakness. I know you've talked about comps and some of the other puts and takes around the numbers. But I'd just be curious to know what you've hearing back from your counterparts and in your discussions with your customers about their spending thinking at this point in the game? And then I've got a follow-up?

Meg Whitman
Sure. So, listen, I would characterize this quarter as uneven global demand. But, I have to say, I've been characterizing the last three or four years as the uneven global demand. This feels like the new normal to me. There will be spots that do better, spots that are not as good as last quarter. And my view is, our performance is entirely in our own hands, yes, we are influenced by the global demand. But I wouldn't use that as an excuse for performance or even a buttress for performance. We need to deliver the innovation, continue to deliver on our go-to-market, and gain share as we have for virtually every single quarter. And so, I wouldn't take our guidance for next year to be influenced one way or the other about the global demand. This is what we think we can do, given the environment that we've been in for the last four or five years.

Rod Hall
Okay. I guess what I was looking for there is whether you saw any deterioration in overall demand in the quarter, because obviously numbers are a little bit disappointing. And then the follow-up question, I had for you is the server unit numbers, at least, preliminary numbers for Q3 are down. So there's a deterioration in the overall server market and yet you guys are thinking 1% to 2% growth next year. And I just wonder how optimistic you have to be about the overall market next year considering the demand situation seems to deteriorate here?

Meg Whitman
Yes. So, listen, as I said before, what we are saying is in the core ISS business, there is some deterioration, what I would characterize as core ISS rack for us, other parts of the server business are doing really well. And I think that core ISS rack deterioration has a number of different things. One is in part our execution in the channel and pricing and things like that.

And the second is to move to the public cloud. I mean, we are definitely seeing some impact there offset by growth in other areas. From a 1% to 2% range, my view is from our perspective, that's a revenue number and longer-term. And remember, our revenues are holding up better than the units because of our high attach. And then also the features and functionality that we add on to those servers, whether that's storage or whatever it happens to be.

So again, we look at…when we look at unit share, we look at revenue share and we also look at share of profits and we are gaining share of profits in this business, which is actually really important. So that's kind of the way we think about it. So I think actually 1% to 2% feels pretty reasonable to me. We've got some work to shore up that ISS rack, but I think well offset by some of the other things that are really going well from an innovation perspective.

Rod Hall
Great. Thank you.

Andrew Simanek
Thank you, Rod, and thank you everyone for joining us today.

CONCLUSION

Operator
Ladies and gentlemen, this concludes our call for today. Thank you.