Hewlett Packard Enterprise

Second Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Meg Whitman - *President and Chief Executive Officer*

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

Andrew Simanek – *Head of Investor Relations*

PRESENTATION

Operator
Good afternoon and welcome to the Second Quarter 2017 Hewlett Packard Enterprise Earnings Conference Call. My name is Austin, and I'll be your conference moderator for today's call. At this time, all participants will be in listen-only mode. We will be facilitating a question and answer session towards the end of the conference. Should you need assistance during the call, please signal a conference specialist by pressing the "*" key followed by "0." As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Andy 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 2017 second 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. 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 quarterly report on Form 10-Q for the fiscal quarter ended April 30, 2017.

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, unless noted otherwise, are presented on a year over year basis, and beginning with fiscal year 2016, 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 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
Good afternoon, everyone. Thank you for joining us on the call today.

As you know, during the past year and a half, we've made significant progress in strengthening HPE to compete and win well into the future. We've been marching towards becoming a smaller, nimbler, and financially stronger company that is more committed to customers and partners than ever before.

With this goal in mind, we separated from HPI in November of 2015 and, last month, we spun our Enterprise Services business and merged it with CSC to form DXC Technology. Completing this transaction was a major milestone in our strategy, and I'm proud that we were able to execute such a significant change within the tight schedule we laid out, and on budget. Later this summer, we'll complete the spin-merger of our Software business. The two spin-merger transactions will deliver more than $20 billion in value based on the current stock prices of DXC and Micro Focus.

We've also made a number of strategic acquisitions in key growth segments of the market that are directly aligned with the three pillars of our strategy. In November, we acquired SGI, which has cemented our leadership position in the high-performance computing market, which is growing 6-8% per year; Earlier this year we acquired SimpliVity, a leader in hyper-converged, a market growing 25% per year; Niara, a leader in network security that uses machine learning and big data to discover network attacks, will make Aruba even stronger; Cloud Cruiser brings IT consumption analytics to our Flexible Capacity Services offering, giving customers clear insight into IT usage and spend, and the ability to effectively plan and manage their IT systems; And, with the addition of Nimble, we now have a complete, world-class flash storage portfolio, from entry-level to the high-end, in a market growing around 17% per year. Nimble also brings a simple user experience platform based on predictive analytics that we plan to roll out across our storage portfolio.

These were all the right strategic moves for HPE's long-term success. But, they were not done in a vacuum. In fact, we've been re-engineering our company while facing challenging market conditions, including stiff competition, unfavorable foreign exchange movements and industry-wide commodities constraints.

All these challenges have only made us fight harder. In fiscal Q2, we delivered results in line with our outlook. But just as important, we also saw growth in key areas that portend well for HPE's future.

Total Q2 revenue was $9.9 billion, which includes revenue from both continuing operations – EG, Financial Services and Software – as well as two months of Enterprise Services, which is now accounted for in discontinued operations.

Revenue from continuing operations of $7.4 billion was down 5% year-over-year, when adjusted for divestitures and currency, driven mainly by reduced server demand from a single Tier 1 customer, and lower license and professional services sales in software. But, absent Tier 1 server sales, the future HPE, which excludes enterprise services and software, delivered revenue growth of approximately 1%, driven by continued strength in key growth areas.

For example, we saw 20% organic growth in High Performance Compute, where we are very well positioned. All-flash storage revenue grew 33% as enterprises move more workloads to flash in order to take advantage of its performance and low-latency benefits. Aruba continued to perform well, driven by 32% growth in wireless solutions. And Technology Services, which includes our new services brand, Pointnext, grew for the fourth consecutive quarter, up 3% YoY, driven by strong customer demand for our advisory and transform services, as well as data center care.

And, we overcame most of the execution challenges we discussed on the Q1 call. In particular, core servers stabilized, with revenue down only 1% globally.

Finally, I'm excited about our rapidly growing partnerships with system integrators. While DXC remains a very strong partner to us, we are seeing accelerating demand from other system integrators following the spin of ES. In fact, our overall revenue through these alliance partners saw strong growth in the quarter, with double-digit growth in APJ and with certain partners in North America. Our Indian SI partners grew by more than 20% year over year, driven by strength in the financial sector, strong demand for our flexible capacity offering, as well as the first placements of Synergy.

Turning to margins, as we discussed on the Q1 call, margins in EG continued to be pressured by DRAM pricing, currency, and short-term dilution from recent acquisitions. We also experienced a very competitive pricing environment, which we expect to continue. Tim will talk more about margins in the quarter and going forward, however, let me say that we believe we experienced the worst of the margin pressure in Q2. We believe the situation will improve as we move through the end of the year, as we work to mitigate the increased commodity prices, and we eliminate stranded costs from the spin mergers and acquisitions.

And, now that we've completed the ES spin-merger, we're taking a fresh look at the cost structure for the new HPE. As a smaller company, it should be much easier to spot opportunities to optimize the business, streamline processes and reduce cost. We believe we can take out another $200 to $300 million in cost in just the second half of this year. Tim will talk more about this in a minute.

With all of that, we delivered non-GAAP net diluted EPS of $0.35, at the mid-point of our previously provided outlook.

Looking forward, I remain confident in our strategy for the go-forward HPE. We remain focused on creating a nimbler, faster-moving company, committed to the three strategic pillars that are aligned with where the market is moving.

First, we make hybrid IT simple. We help customers and partners build the right mix of intelligent, software-defined infrastructure that provides speed and agility for business innovation, while also reducing cost.

For example, High Performance Compute is increasingly the answer to managing the expanding amounts of data being created every day. We are seeing strong demand from companies like global chemical company BASF, which recently selected HPE to build one of the world's largest supercomputers, based on HPE's Apollo systems. We also announced an expanded partnership with Nvidia to create a portfolio of solutions and services purpose-built for Artificial Intelligence and Deep Learning.

And, we continue to be the leading SAP HANA infrastructure and services provider, with 2x the market share of our next closest rival. Our continued investment in HANA solutions, coupled with our 28 year alliance with SAP, is helping us break into new accounts and drive incremental revenue.

On the storage front, we are seeing a rapid shift to all-flash. We are extremely well positioned here, given our leading 3PAR portfolio and the recent Nimble and SimpliVity acquisitions. Just last week we announced a full refresh of our storage portfolio, designed to give our customers even more options – at a variety of price points – to help aid their transition to Flash storage.

And, we continue to gain momentum with Synergy, the industry's first composable infrastructure platform. We now have nearly 400 customers, like Dreamworks, Redbox and Hudson Alpha, who have installed Synergy, and we expect that to continue to ramp into the end of the year.

The second pillar of our strategy is to power the intelligent edge that will run campus, branch, and Industrial IoT applications. Aruba is at the core of this pillar, and we have seen accelerating momentum as Aruba leverages HPE's go-to-market. In Q2, Aruba's wireless business grew at 3x the market rate, with strong demand across industry segments. For example, we had a significant win with the leading global fast-food company, as well as major wins in retail, healthcare and education. And, remember that these Aruba installations pull through high-margin services, often up to twice the value of the hardware and software.

As industrial IoT takes off, we're also seeing strong demand for our Edgeline converged systems which offer compute, storage and analytics at the edge, fully integrated with traditional operational technologies such as control and data capture systems, and industrial networks.

Given its small form factor and low energy consumption, Edgeline has been in high demand for the distributed applications that will drive industrial IoT. While off a small base, Edgeline saw significant growth in Q2 and we are seeing a number of promising “proof-of-concept” programs with major institutions across retail, manufacturing, transportation and smart cities in particular.

Finally, we are focused on providing world-class expertise and flexible consumption models to help customers transform their IT environments. HPE Pointnext draws on the expertise of more than 25,000 specialists in 80 countries covering 30 languages and spanning a range of disciplines -- from cloud consulting to operational services experts. These teams collaborate with businesses worldwide to speed their adoption of emerging technologies, including cloud computing and hybrid IT, big data and analytics, the Intelligent Edge and Internet of Things. We’re also seeing strong demand for our data center care as customers look to consolidate their data center footprints, and flexible capacity, which delivers cloud-like consumption models with on-premises solutions.

During the quarter, we continued to invest in each of these three key areas. As you know, one of the projects we are most excited about is the Machine, which is an entirely new computing architecture that puts memory at the core. And in May, we announced the latest milestone in our Machine research project – a powerful prototype that connects 160 terabytes of memory to 1280 processor cores. In other words, an amount of memory that would hold 80,000 human genomes and simultaneously run anomaly detection algorithms on every core. And, while that is impressive, the most exciting thing about this milestone is that it demonstrates the ability to scale the architecture to a potentially limitless pool of memory – which is the secret to delivering scientific breakthroughs, industry-changing innovation or life-altering technology from the mountains of data we create every day.

So, overall, despite some current headwinds, I remain very confident in our strategy. We will continue to invest in our three strategic pillars: hybrid IT, Intelligent Edge, and our Pointnext services model. And we will continue to find efficiencies and productivity in the new HPE that will allow us to run the company more profitably with each passing quarter.

Next week, you’ll see some exciting product announcements during our annual Discover conference in Las Vegas, where thousands of customers and partners join us from around the world for three days of inspiration, learning and networking. I hope to see many of you there.

With that, let me turn it over to Tim.

Tim Stonesifer
Thanks Meg.

As discussed, while our overall performance in Q2 was impacted by tough markets and the external factors I discussed last quarter, we continued to drive growth in our higher-margin businesses and align our cost structure with the future HPE operating structure.

Total revenue for the quarter was $9.9B. This includes $2.5B for two months of Enterprise Services, which is now reported in discontinued operations. Revenue from continuing operations of $7.4B was down 5% adjusted for divestitures and currency driven by declines in Software and Tier 1 server sales. If you exclude Software and Tier 1, and consider just the Future HPE, revenue was actually up 1%. I'll dive into the business segment performance in a minute.

From a macro perspective, we continue to see competitive pricing and a challenging commodities environment. Currency remained unfavorable and was an 80bps year over year headwind to revenue. HPE's performance in the US was stable excluding Tier 1 servers as core servers improved and strong growth in networking was offset by a challenging storage market. Revenue in Europe continued to be weak, driven by the UK, although strong results in Germany helped the region. APJ was mixed with good performance in Japan and India, more than offset by broad softness in the rest of Asia.

Turning to margins, gross margin of 33.8% was down 200 bps year over year and down 240 bps sequentially. Non-GAAP operating profit of 7.8% was down 130 bps year over year and down 270 bps sequentially. As Meg discussed, EG margins were negatively impacted by increased DRAM pricing, currency, stranded costs, and short-term dilution from the recent acquisitions, as well as a very competitive pricing environment. I will discuss these in further detail in the context of the Enterprise Group.

Combined non-GAAP diluted net earnings per share of $0.35, was at the mid-point of our outlook of $0.33-0.37. Non-GAAP diluted net earnings per share from continuing operations was $0.25 and $0.10 was from discontinued operations. Non-GAAP diluted net earnings per share from continuing operations primarily excludes pre-tax amounts for separation charges of $141M, restructuring charges of $118M, and amortization of intangible assets of $107M.

GAAP diluted net earnings per share from continuing operations was negative $0.37, below our previously provided outlook range of ($0.03) to ($0.07), primarily due to a one-time, non-cash, GAAP-only valuation allowance of our US state domestic deferred tax assets resulting from the changes to our legal structure related to the spin-off of Enterprise Services. As a reminder, this was similar in nature to the HPE-HPI separation and discussed as part of our first quarter earnings announcement but not integrated in our GAAP EPS outlook.

Now turning to the results by business…

In the Enterprise Group, revenue was down 7% in a tough market with continued commodities pricing pressure. However, EG revenue grew slightly year over year when adjusted for Tier 1 sales driven by several areas of encouraging growth across the portfolio. Aruba was up 27%, 3Par all-Flash arrays were up 33%, High Performance Compute grew more than 40% with SGI and over 20% organically, and Technology Services was up 3%. These are some of the areas of the business that we expect to drive profit expansion and top line growth for the future HPE.

That said, operating margins were down 300bps year over year, and 390bps sequentially to 8.8%. The margin declines can be broken out into three categories:

First, we had structural changes including the year over year impact from our H3C divestiture. We now report our remaining stake in equity interests below the operating profit statement line. Q2 will be the last quarter we have a significant compare issue for EG margins related to H3C. Also, we now have stranded costs that were previously allocated to Enterprise Services, which are now hitting the Enterprise Group results. These stranded costs are most acute immediately following the spin-off, and we will quickly work them down to zero on a run-rate basis by the end of the fiscal year.

Second, we have the short-term dilution impact from our recent acquisitions of SGI, Nimble, and SimpliVity. We are moving quickly to reduce their costs so all of these acquisitions are accretive in FY18.

And third, and most significantly, we continued to be impacted by elevated commodities costs in DRAM and a year over year headwind from currency. The pricing environment was also increasingly difficult and hindered our ability to raise prices as an offset. We anticipate the impact from commodities will remain significant in the near-term but believe we can begin to mitigate it as we move towards the end of the year.

Given these margin pressures, we are taking significant steps to optimize the cost structure of the future HPE, and believe we can drive an incremental $200-300 million in cost savings in just the second half of this year. These savings will be a combination of tight control over spending and simplifying the organization through delayering and span-of-control actions as we become a smaller, more nimble company.

Server revenue declined 14%, primarily due to Tier 1 as we deemphasize the category to focus on more profitable areas. While we will continue to focus on strengthening our go-to-market, integrating the recent acquisitions into our portfolio and driving targeted, organic R&D, we are making solid progress and saw stabilization in more profitable core servers, which declined less than 1%.

Storage revenue declined 13% driven by continued challenging markets and tight SSD supplies. However, we do expect to maintain share in the high-growth all-flash portion of the market. Our all-flash array growth accelerated this quarter and was up 33% year-over-year and results were still meaningfully impacted by SSD supply constraints. The supply constraints will likely linger in the near-term, which we expect to loosen towards the end of the year. Also encouragingly, all-flash still has a relatively low penetration rate in the datacenter and with the recent acquisition of Nimble, and the portfolio refresh announced last week, we believe we are very well positioned to accelerate our customers' journeys to an all-flash datacenter.

Networking revenue grew 14% driven by Aruba wireless solutions, which was up over 30%. Aruba was especially strong in North America with over 100 new logo wins and is expected to take more than 2 points of share worldwide adjusted for H3C. HPE's campus and branch switching business delivered mid single-digit growth demonstrating that its combination with Aruba is working. We have also stabilized the Data Center Networking business, which grew slightly.

Technology Services, which includes our newly launched Pointnext business as well as Aruba services and CMS, remains a bright spot with revenue up 3%. Orders also grew year over year for the fourth consecutive quarter, giving us strong confidence that TS will grow through the current fiscal year. We saw strong order performance in consulting with particular strength in Network and Datacenter as well as Commercial Media Solutions. We again improved service intensity, or attach dollars per unit, which helps offset pressure from declining hardware unit sales.

HPE Financial Services revenue grew 11%, its fourth consecutive quarter of year over year growth driven primarily by one-time lease conversions and an increase in operating lease mix. We have been pleased with the performance of Financial Services as it has become strategically more important to our customers as they increasingly value flexible consumption models. Operating profit declined 40 bps year over year to 8.9% reflecting the increased operating lease mix. Financing volume declined 7% due to the indirect business. And, return on equity was up 60 bps year over year to 13.5%.

Software revenue was down 9% as declines in License and Professional Services more than offset growth in SaaS as the team works through the transition to Micro Focus. The team continued to focus on disciplined cost controls, leading to an operating margin of 26.4%. This is a 160 bps improvement year over year as reported, and the improvement is over 10 points when adjusted for one-time items last year including the Tipping Point divestiture gain.

And now to cash flow…Free cash flow was better than expected at negative $64M. However, this was artificially high since we accrued approximately $300M for Enterprise Services payroll ending March 31st that was paid by DXC and we expect to repay in the second half. The cash conversion cycle now reflects the removal of Enterprise Services and was negative 12 days, down one day sequentially.

Turning to capital allocation, during the quarter we paid $107M in dividend payments and repurchased $670M of outstanding shares. We have now returned $1.5B to shareholders in the first half of FY17, aligned to our $3.0B full-year commitment.

Moving to our two spin–merge transactions...We completed our ES-CSC spin merge transaction on April 1st, on schedule and on budget. The Software-Micro Focus transaction is also progressing as planned and we continue to anticipate the transaction closing on September 1st. We are making progress removing stranded costs and continue to anticipate a 6 cent diluted EPS impact in FY17, with all costs eliminated on a run-rate basis by the end of the year.

Turning to our outlook...The seasonality of EPS will be more back end loaded given that the stranded costs and M&A dilution will be worked down over time. Also, the majority of the $200-300M of incremental costs savings will come in Q4.

Also, keep in mind that our outlook reflects the company as it stands today, with a partial year contribution from ES and a full-year contribution from Software, since we haven't yet closed that transaction. As is our typical practice, we will update our outlook when we close the Software transaction.

With that, we expect Q3'17 non-GAAP diluted net earnings per share of $0.24 to $0.28. From a GAAP perspective, we expect Q3'17 GAAP diluted net earnings per share of ($0.02) to $0.02. For the full year, we are holding to our prior FY17 non-GAAP diluted net earnings per share outlook of $1.46 to $1.56. From a GAAP perspective, we expect FY17 GAAP diluted net earnings per share of ($0.03) to $0.07.

Finally, turning to the cash flow outlook. As previously mentioned, we anticipate paying DXC approximately $300M in the second half for the ES payroll ending March 31st. Also, we expect to pay DXC an incremental $300M in the second half for agreed upon balance sheet adjustments primarily related to working capital. This incremental payment will not reduce our overall cash balances as our ES pension funding requirements were less than expected by roughly the same amount. In total, we continue to expect full year FY17 free cash flow of negative $1.8B.

Overall, while this quarter presented some challenges, like Meg, I am confident that our plan is the right long-term strategy to position the future HPE for success.

Now let's open it up for questions.

QUESTION AND ANSWER

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

Our first question comes from Sherri Scribner with Deutsche Bank. Please go ahead.

Sherri Scribner
Hi, thank you. If we look at the midpoint of your 3Q guidance and the midpoint of your full-year guidance it suggests and EPS for 4Q of somewhere around $0.45, which is a pretty significant acceleration versus the 3Q guidance. Can you give a little bit of detail on how you get to that number? Is that primarily the cost cutting that you are seeing and some of that

accelerated costs that you can take out or maybe give us a little detail on why you are confident you can hit number?

Tim Stonesifer
Sure, Sherri. So first of all, just to remind everybody, the full-year guide includes a partial year for ES and a full year for software. So it may be easiest to start with Q2, so Q2, we ended up with an EPS of $0.35, now $0.10 of that was related to ES which was in discontinued operations. So when you move from Q2 to Q3, that's relatively flat and basically what you are seeing there is the impact and the pressure from the stranded costs, from the short-term dilution of the acquisitions and some of the commodity cost pressures. Those are being offset by the second-half cost actions. And then to your point, when you go from through 3Q to 4Q, you would see that would imply about a $0.19 improvement quarter-over-quarter, and there is really three elements to that. The first one is just typical seasonality. So if you were to go look at last year's results, we saw a similar uplift in Q3 to Q4. Same thing in 2015, we would anticipate that same type of lift due to seasonality in Q4 of this year. If you just think about the software business as an example, Q4 is typically much higher than Q3.

The second component of it is as we eliminate the stranded costs and as we get right size the cost envelopes around the acquisitions that will be favorable in Q4.

And then thirdly, is $200 (million) to $300 million of cost out. So the way I would think about that is roughly a third of that will come in Q3, and then two thirds of that will come in Q4, and that's what's going to drive the remainder of the lift. So that's why you see that ramp up in Q4.

Sherri Scribner
Okay, thank you. That's very helpful. And then looking at the operating margin in EG, it's a little disappointing. Can you give us a little more detail on which segment that came from, is it related to the weakness in the server market? I would assume it would be that much related to servers given that a lot of that is tier 1 which doesn't have a lot of margin. So is it more a result of the weakness in the storage market? Thank you.

Tim Stonesifer
Yes, we don't really give BU specific guidance on the margins. But yes, I would say servers is driving a component of that, and again the way I think about it, as we talked about in the prepared remarks, there is a component of that that's structural, there is a component of that that's one-time cost, and then you have the operational headwinds, which is primarily the commodities cost increases. Again, most of that is memory, so that has a heavy impact on the server margin.

Sherri Scribner
Thank you.

Meg Whitman

I think the other thing I would add to that is, we believe that the worst is over from a margin pressure perspective in Q2, and we expect year-ago levels by Q4 as the structural challenges that Tim mentioned roll off, as does the one-time acquisition dilution that goes away. So what you are left with is the more normal business challenges that we all have where it's commodity price increases or whatever. And then, of course, obviously the $200 (million) to $300 million of cost reduction also helps the margin.

Sherri Scribner
Thank you.

Andrew Simanek
Great, thank you, Sherri. Can we go to the next question, please?

Operator
Next question is from Toni Sacconaghi with Bernstein. Please go ahead.

Toni Sacconaghi
Yes, thank you. I wanted to revisit that operating margin question. My understanding from the conference call last quarter was that, you expected the enterprise group to be pretty similar in Q2 to Q1, both from revenue and from a profitability perspective, and there was a dramatic downturn in profitability sequentially, 390 basis points. And I understood your bridge Tim, but many of the things you noted like H3C divestiture you had in Q1 or the acquisition impact you had most of that in Q1, the stranded costs I think where very visible to you. And so my question is, was this simply incremental competition that didn't allow you to raise prices in the way that you thought or what changed. And as I think about like a reality check, if TS is 30% of your business, and EG has 30% margins, that means everything else is zero profitability today, pre-overhead allocations and with overhead allocations, it's negative. And how do we reconcile such dramatically weak levels of profitability?

Tim Stonesifer
Okay, I think there were few questions in there. So let me see what I can do. So I think to your point we did on the Q1 call, we did think that revenues would stabilize. We did not say that margins would stabilize. And again, if you are going through a quarter-over-quarter walk, to your point, stranded costs is a big element of that. We did not see that in Q1 obviously because we just separated the ES business in March; so all of the overhead that we are allocating to ES in Q1, a lot of that was being allocated to EG. There is some FX impact; again, we were hedged from an FX perspective in Q1 from the prior hedges that we put on in Q4. So there was some pressure driven by that. There was also some dilution in the acquisitions which we really didn't talk about in Q1 nor did we have that pressure. That gave us some pressure from an overall margin perspective.

DRAM is causing a pressure point, we did know about that in Q1. To your point, we talked about that, obviously that's why we took our guide down, but if you look at memory costs in 2Q, they are actually up another 10%. So we saw a big increase in Q1 that was when we got the

40% to 50% lift, but those have continued to go up in Q2. So that drives some incremental pressure. And then from a pricing point, we did go out with global price increases, but to be honest with you, the results were mixed. We saw some traction in APJ and those came in, in line with what we thought they would. When you look at the Americas, we did not gain as much traction as we had anticipated, particularly in the US and that's driven by some very difficult competitive behaviors and challenges. We saw those same types of competitive dynamics in EMEA as well. So the overall pricing mitigation that we had talked about I'd say came in lighter than we had expected. And then lastly, you have typical seasonality from Q2 to Q1 or from Q1 to Q2. So that's driving a lot of the variation from quarter-to-quarter.

Now, to get to your question on product margins, yes, if you look at TS, the good news with TS is it's been very stable over the years not only from a revenue perspective but also from a margin perspective. So we expect that stabilization to continue as we go forward. Given the pressures that I just walked through between stranded costs, short-term dilution, DRAM pricing, yes, margins were pressured in Q2 and product margins would be negative.

Now, as I think about how do we progress going forward and to Meg's point earlier, we think 2Q is going to be a low point and basically that's driven by the fact that one, we are going to work out the stranded costs. Again, those will be debt zero on a run rate basis. By the time, we exit Q4, we will have time to right size the cost envelopes to the appropriate levels on the Nimble and SimpliVity acquisitions. And then lastly, we've got the $200 (million) to $300 million of costs that we've targeted to come out in the second half. Again, I think a third of that will come out in Q3 and two-thirds of that will come out in Q4. So as we take those costs out, and the other thing that we should get is, we should get a mix lift. As we continue to grow the higher margin businesses, HPC up 20% organically, all-flash array up 33%, Aruba up 27%. Obviously, those parts of the portfolio carry a higher margin. So we should get a margin lift going forward. So, hopefully that gives you a little bit more color.

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

Operator
Our next question is from Jim Suva with Citi. Please go ahead.

Jim Suva
Thank you very much. In the press release as well as the prepared remarks, you mentioned several times that excluding the tier 1 server sales, can you just help us understand strategically is that just you guys at Hewlett Packard Enterprise have strategically decided to shift away from that? Is it permanent share loss, timing, absorption? Is this something we should expect to have you call out many times in the future quarters to come or one-time in nature because last quarter came it up and now hear it again? How should we just think about this huge issue of excluding tier 1 server sales? Thank you.

Meg Whitman
Yes, so tier 1 service providers is a segment that we entered I think maybe 18 months ago, two years ago and we are heavily dependent on one customer. So we are doing a couple things. We anticipate that one customer to continue to purchases to decline and so this tier 1 rationale or the way we talk about is going to continue for the next couple of quarters because it's a pretty big number. We are doing a couple things, one is we are really thinking hard about what the future strategy is for tier 1. We continue to get new tier 1 customers, but this is low calorie business actually and so we need to think through, does it make sense to continue that business on a go-forward basis or are we better off actually putting our selling resources and our R&D resources against more margin-rich sustainable profitability. But the answer is yes, there will be I think for another at least a couple of quarters, there will be the explanation of what does our server business look like ex-tier 1, which we think gives you all a better understanding of what's happening with that one customer and then what's happening with the rest of the core industry-standard server business.

Jim Suva
Are there other tier 1 server customers, precisely one that we should think about?

Meg Whitman
It's the vast majority is with one, there is a few others and we are building out some more tier 1 customers, but fundamentally the strategic question is, is this a business we really want to be in because we are not in the business for share for share's sake. We are in it to get a return on our investment dollars and right now that doesn't look like a particularly productive segment for us.

Jim Suva
Thanks for the details, much appreciated.

Andrew Simanek
Thank you, Jim. And can we have the next question, please?

Operator
Our next question is from Katy Huberty with Morgan Stanley. Please go ahead.

Katy Huberty
Yes, thanks. Good afternoon. I appreciate it wasn’t in original guidance, but had you contemplated the idea of removing $200 (million) to $300 million post the ES transaction or is that incremental work to offset the memory cost that surprised you this year and then just as a follow-on to that, how should we think about incremental cost takeout, as we head into next year post the software divestiture, is that $200 (million) to $300 million run rate or more like $400 (million) to $600 million for the full-year the right run rate to think about for next year?

Tim Stonesifer

Yes, sure Katy. So, I'll answer the first piece and then Meg you can jump in here. From a cost perspective, the $200 (million) to $300 million is incremental and it is all in the second half. So, as you know, we are always looking at cost. Now we are trying to be and we continue to be very sensitive to protecting our R&D, protecting our sales costs. But, net-net, particularly given the spinoff and now the fact that we have 110,000 fewer people and we've had a little bit of time under our belt to operate in the new model if you will, we do think there are opportunities and there are going to be opportunities in the usual suspects.

So, if you think about just tighter spending around travel, around optimizing program spend, around tighter policy enforcement, we think there's more work to do there and we can continue to do that, but there's also an opportunity to simplify. So, if you think about now as a standalone or as RemainCo, if you will, you have the global structural versus the regional, versus the country. You have span of control, you have all those types of things. Those are the things that we are having better line of sight on and that's some of the cost that we will address in the second half the year. And Meg, do you have anything else to put on it?

Meg Whitman
Yes, I think Katy, if you copter all the way back up, we have just gone through one of the largest transformations, maybe in American business history. We've created four industry-leading companies that I think are poised to do very well in their given segments. And so now we are very focused on the go-forward Hewlett Packard Enterprise financial architecture. And I think there's a couple things, Tim said it well, we now need to look at that cost structure and say what is the process reengineering we need to do? What are some of the policy decisions we need to make upstream to be a much more efficient, leaner company that we can really see the productivity benefits and Tim mentioned simplification. There is a lot we can do here.

So, we are now in a different stage. I can see this very clearly now that ES is gone, Software is on its way and of course, HPI has been on its own for 18 months. So, we are at that next stage that I think we can have a major impact in how we run this company more efficiently and leanly. So were super excited about it. It's going to be a lot of work because whenever you restructure a company, it's a lot of work, but I can see it very clearly.

Now, I want to say one thing, it’s that we will not be adding to the restructuring dollars that we had already laid out for you. So, remember there is $700 million of restructuring in cash payments in this year, another $200 million in '18. We may pull that $200 million in, depending we are still working on that, but any incremental cost savings will be funded through the P&L. There will be no more restructuring dollars, which I think is an important point to make because I remember many of you especially when we owned ES that said this is the perennial restructuring, that actually is not going to be the case going forward.

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

Operator
Our next question is from Maynard Um with Wells Fargo. Please go ahead.

Maynard Um
Hi thanks. On the server business, can you just help us with the expectations over the next couple of quarters? You'll have SimpliVity for another full quarter, you'll have Synergy ramping and the alliances look like they're growing. Do you think that gets you back to flattish type growth in Q3 and Q4? Then I have a follow-up.

Tim Stonesifer
Sure. As synergy comes online, as we continue to grow particularly if you think about high-performance compute and some of the areas of the portfolio, again excluding tier 1, from a year-over-year component, we would expect to return back to growth in the latter part of the year.

Maynard Um
Great. And then on the storage side, how long do you think it will take to fully integrate Nimble storage to be ready from a go-to-market and channel perspective and when do you think we start to see the ramp in storage from Nimble? Thanks.

Meg Whitman
So, we are working hard to integrate Nimble into our data center storage sales teams. SimpliVity is all the way in both from an R&D perspective and as a sales perspective. Nimble R&D is going to merge with 3PAR R&D to be a more powerful storage R&D team. And then we are just about now ramping Nimble into our data center storage business. What's interesting about Nimble is there are some markets where Nimble actually had quite a good position and there are some markets where Nimble is not at all. So, we are actually building from scratch in a number of those markets, which is great, actually.

But I'd say certainly by the end of this quarter, Nimble will be firmly integrated into our go-to-market motion and I think you'll start to see the ramp. Interestingly, what we saw with Aruba, what we saw with SimpliVity and what we believe we will see with Nimble is actually being part of the HPE family helps accelerate those wins. There's many customers who said, “We would not have considered Nimble as a standalone independent company without being part of HPE.”

Actually, I think Keerti Melkote at Aruba would tell you the same thing; we are winning deals there because they're part of the family. SimpliVity, we are winning deals there because they recognize that it actually folds into our overall offering and you are not purchasing an island. In other words, a completely new technology that's unconnected to the rest of your data center. There is actually its part of the family of HPE infrastructure. So that's worked really well for us and I think you're going to see Nimble ramp through the end of the year nicely.

Andrew Simanek
Great. Thank you, Maynard. Can we go the next question, please?

Operator
Our next question is from Shannon Cross with Cross Research. Please go ahead.

Shannon Cross
Yes. Thank you for taking the question. Can you talk a bit about your cash usage strategy? Obviously, you made several acquisitions over the last few quarters and you've had cash come in from both sometimes operating cash flow as well as what you've got from the divestitures. So how are you thinking about cash as you normalize it out? Has there been any change and how are you thinking about acquisitions given all the ones that you have that you are now integrating? Then I have a follow-up. Thank you.

Tim Stonesifer
Sure. So, I'll give it a shot and Meg you can jump in here. So again, I think our strategy is still the same. We are going to continue to focus on organic investments because we do that well and we do it right, it's good for customers, it's good for shareholders, it's good for partners, it's good for employees. We always continue to look at share buybacks. Obviously, we are biased toward share buybacks right now. And then we are going to continue to look at M&A as long as it fulfills gaps in our strategy. So the way we think about M&A again has being very consistent and it's all around complementary IP, where we can leverage our distribution and drive profitable growth. So, it's all returns based. That a framework that's worked well for us in the last 12 to 18 months and I'd expect us to continue to operate within that framework going forward.

Meg Whitman
No. I don't have much to add to that. The only think I would say is as we think about innovation, as Tim said, our first choice is organic innovation, think synergy. We will also look at innovation coming from M&A, but as Tim said, its returns based. We have to buy it right. It has to be complementary technology that can leverage our distribution channels. And then the third area is actually our Pathfinder program where we make small investments in new generation companies. We are not to be a venture capital company, I am not looking for venture returns there, and I'm looking for companies that further our strategy powering hybrid IT, powering the intelligent edge and the services that we can weave into our solution.

So, for example Docker, Mesosphere, Chef are all woven now into HPE one view. That makes HPE one view much more valuable to our customers, actually creates beginnings of a new stack as a control plane for hybrid IT and it's actually good for those small companies and doesn't require us to outlay $300 (million), $500 (million), $600 (million) or $1 billion for relatively unproven technology. So that's the way we think of it and it's been a cultural change for the company because we are used to selling only what we own, but actually this Pathfinder program has been great success. I think it's a differentiator for Hewlett Packard Enterprise because in some ways what we do is we curate Silicon Valley for our enterprise customers.

Shannon Cross
Okay. Great. Thank you. And then, my second question is just as we think about remain co. given all of the moving parts, then you talked about sort of EPS ranges in the past and that, is there any shifting around given the accelerated restructuring versus maybe the pressure from component or from a server standpoint that we should take into account as we look forward past '17?

Tim Stonesifer
Yes. So if you look at remain co. and again I'll take you back to SAM, we guided $1.25 to $1.35 from an EPS perspective and we had normalized free cash flow of $2.1 billion to $2.4 billion. Now obviously we took that number down or we took our number down in total by $0.12; that was in Q1 that was driven by some of the FX pressures we saw, some of the commodity cost pressures we saw as well some execution issues that we were working through.

So, as I look at those three categories, those were all primarily EG related. So I would adjust the $1.25 to $1.35 by that $0.12 and then I would also adjust your $2.1 billion to $2.4 billion of normalized free cash flow. I would take that down to roughly $2 billion of normalized free cash flow to reflect the earnings pressure. So that will give you a baseline as we exit '17 of about $1.13 to $1.23. And then I think there are two or three areas of an impact that you need to think about as we move forward. The first one is commodity cost movements and the corresponding pricing mitigation.

Again, as we talked about earlier, we are making traction in that we anticipate an APJ, but we are finding it very difficult in the Americas and EMEA. So, depending on how that equation plays out, that would have an impact on your baseline. From the second-half cost actions, the $200 (million) to $300 million that we talked about, to the extent that a piece of that is recurring, which we would expect, that would also impact your baseline going forward. And then when you look at the rightsizing the cost envelopes particularly around the acquisitions, that should provide a little bit of accretion going forward. So that's how I would think about the baseline for remain co. from both a cash and EPS perspective and we will give much more guidance and clarity and visibility at SAM in October.

Shannon Cross
Thank you.

Andrew Simanek
Perfect. Thank you, Shannon. Can we go to the next question, please?

Operator
Our next question is from Steven Milunovich with UBS. Please go ahead.

Steve Milunovich

Thank you very much. Regarding the storage business, first of all, I didn't see the converged traditional breakout. Are you still giving that and you did say that you are supply constrained in the quarter on storage and that that would continue, is that correct?

Tim Stonesifer
Yes, sure. So, from a converge perspective, I think the converged part of the portfolio was down roughly 8%, traditional was down roughly 20%. And then from a material perspective, really the supply constraints are much more around SSD and again as that market is very tight right now, we are getting our fair share of supplies, but given the complexity of our broad product portfolio, we are finding it challenging to what we call demand shift. But we would expect that to loosen up in the second half of the year particularly as 3D yields improve as well as more factories come online. So that should loosen up in the second half of the year.

Steve Milunovich
Okay. And then, Meg, internally last quarter you talked about execution issues, could you bring us up date in terms of if those are alleviated and externally what are you hearing from your customers in terms of the splits? I've heard a few customers wonder if you may be pruned too far relative to having full solutions capability.

Meg Whitman
Yes, so let me talk a little bit about the execution issues. I would say we have largely overcome most of the execution issues that we discussed in Q1 and the biggest hurdle was getting through the ES separation that in many ways was far more complex than the HPE HPI separation because we had to spin and then merge into a third-party. So, a third party actually had to be managed and worked with here. So, the first time it was separating the siblings, now we had to merge with the cousin. I would say, by the way, that took a chunk of our leadership time in every country around workforce councils and things like that.

The other thing that we talked about last time was we had three new heads of all of our regions plus a new head of worldwide sales. And that as I said last time might've been a little bit too much change at once, but now I'm firmly convinced we got the right people in the right job. They've now been in place six months and you are starting to see their impact. For example, the server business in the US ex tier-1 actually had a pretty good quarter and that's thanks to Jim Merritt and his team. So, I feel like execution-wise we are back on track and I think you saw that in terms of the growth areas that we talked about on the call. The feedback from customers that I'm getting is actually they are amazed at how smoothly the separation of these companies has gone, whether it was HPI or CSC.

I think if customers are saying have we shrunk back too far, we still need to educate them about the services capability that we still have at HPE and it's not only our TS business, our services and support business, it's our TS consulting business, it's Aruba Services and that's very important, that advice and transform capability, I think we need to do a better job of, if you will, advertising that. But customers who know us well, I think are super excited about the focus. They know the services capability that we have. They really resonate to the strategy. This strategy of we make hybrid IT simple, we power the intelligent edge and we have the services to make it happen totally resonates, and so we are excited about that. So, I have no doubt about the strategy. I have no doubt about the validity of the spins. We are going to end up as a much stronger set of companies than we would have before and I think you all recognize the value creation for shareholders that has occurred here.

Andrew Simanek
Great. Thank you, Steve. I think we have time for one last question, please?

Operator
And our next question is from Wamsi Mohan with Bank of America Merrill Lynch. Please go ahead.

Wamsi Mohan
Yes. Thank you. Tim, you mentioned bulk tightening on travel; other discretionary spend items that sound obviously transitory in nature. How much of that $200 (million), $300 million of incremental cost saves would you view as transitory versus elements that could be more structural like the span of control initiatives. And my follow-up, Meg just to clarify, did you say that the worst of the pricing environment in servers is behind you and if yes, what do you think that's the case? Thank you.

Meg Whitman
Yes, I actually said that I thought the margin pressure was the worst that we are going to see in Q2 and it should return to last year's level by Q4. And I can't say necessarily that the pricing is going to alleviate but we've got the $200 (million) to $300 million of cost structure, we've got the structural things and we've got obviously the one-timers like stranded costs and acquisition dilution. So that's why I say it's going to come back to last year's level by Q4.

Tim Stonesifer
And then from a cost structure perspective, ballpark I think roughly half of that $200 (million) to $300 million is more of the discretionary type stuff like policies, like travel and then the other half is labor related and within that labor piece, I'd break it out into two components. I think half of that is really around lowering our rehire rates, taking a look at contractor. So, when you think about the cost to do those things, there really is no cost to do that and then there's the remaining 25% that would be more structural and that's why we are evaluating the restructuring that we have in 2018 and pulling that forward.

Meg Whitman
Yes, I would say the other thing I would add here is I think of that $200 (million) to $300 million as a down payment on the cost structure and reengineering that we need to do on the go-

forward Hewlett Packard Enterprise. As I said to the answer to one of the earlier questions, I am now laser-like focused on what is the future of Hewlett Packard Enterprise financial architecture? How do we simplify? How we reengineer the processes and how we take out overhead given that we are now a $28 billion company, down from $110 billion company just five years ago. So, I have a much clearer view of how this company needs to be re-architected from a financial perspective and reengineered from a process and complexity standpoint. So, I'd say listen, the way I think about that is the down payment on what we could do in 2018 and beyond.

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Andrew Simanek
Great. Thank you, Wamsi. I think with that we can wrap up today's call. Thank you.

Operator
Ladies and gentlemen, this concludes our call for today. Thank you and you may disconnect your lines.