Hewlett Packard Enterprise

Third Quarter 2016 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 Third Quarter 2016 Hewlett Packard Enterprise Earnings Conference Call. My name is Aaronson and I'll be your conference moderator for today.

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. Andrew Simanek, Head of Investor Relations. Please proceed.

Andrew Simanek
Good afternoon. I am Andy Simanek, Head of Investor Relations for Hewlett Packard Enterprise. And I would like to welcome you to our fiscal 2016 third 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 releases and the slide presentation accompanying today's earnings release on our HPE investor relations webpage 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 and transaction materials relating to forward-looking statements that involve risks, uncertainties and assumptions.

For a discussion of some of these of risks, uncertainties and assumptions, please refer to HPE's SEC reports, 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 quarterly report on Form 10-Q for the fiscal quarter ended July 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 to provide a better representation of HPE's operational performance given the significant divestitures we have recently completed, including the sale of 51% of our H3C business in China and TippingPoint 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…

Let me start by saying I'm pleased with the progress we made in Q3. Overall, we had a strong quarter. While revenue was down slightly on an operational basis, we saw several areas of growth in key parts of our portfolio, including networking, all-flash storage, high-performance compute and Technology Services. Profitability was very encouraging as we continue to deliver margin improvements in Enterprise Services and focus on profitable deals in the Enterprise Group. Our non-GAAP EPS was 49 cents, which, even before the impact of a favorable tax-rate, was at the high end of our previously guided range. Free cash flow also improved to $1 billion through diligent working capital management. And, we returned $1.5 billion to shareholders primarily through share repurchases.

Tim will provide further color on the quarter, but I would like to take the bulk of my time to discuss today's spin-merge announcement and put it in the context of the strategy we have been executing against for the past several years.

Last November, we launched the new Hewlett Packard Enterprise with the vision to be the industry's leading provider of hybrid IT, with the secure, next-generation, software-defined infrastructure that will run our customers' data centers today, bridge them to multi-cloud environments tomorrow, and enable the emerging intelligent edge that will power campus, branch and IoT applications for decades to come. We believe this is what our customers are looking for, and what we are best qualified to do. And, most importantly, achieving this vision will create a faster-growing, higher-margin, stronger free cash flow company for our shareholders.

To realize our vision, we looked at our portfolio and our product roadmaps to determine gaps that we needed to fill and then evaluated how best to do so. Some we fill through increased R&D, like the investment in our recently launched HC380 hyper-converged product. In other areas, we pursue innovative partnerships like the ones recently announced with Docker and Mesoshpere. And in some cases, acquisitions make sense, like Aruba and SGI.

Next, we identified areas of the business that were not aligned with our go-forward strategy. Here, we have looked at how best to maximize shareholder value with these assets. We have already made a number of decisions, including the sale of TippingPoint, the H3C deal in China, and of course, the spin-merge of our Enterprise Services business with CSC.

And, today we announced plans for a spin-off and merger of our non-core software assets with Micro Focus. These assets include our Application Delivery Management, Big Data, Enterprise Security, Information Management & Governance and IT Operations Management businesses. This transaction is valued at about $8.8 billion, including a 50.1% ownership of the new combined company by HPE shareholders, which is currently valued at $6.3 billion, and a $2.5 billion cash payment to HPE.

The combined company will be led by Kevin Loosemore, current Micro Focus Executive Chairman, and Mike Phillips will serve as Chief Financial Officer. After the transaction closes, Micro Focus's board of directors will include an HPE senior executive, and HPE will nominate 50% of the independent directors on the board.

The new combined company is expected to have annual revenues of approximately $4.5 billion, with strong recurring revenue streams. The company will be well diversified across product lines and geographies. It will also have a stronger go-to-market capability with nearly 4,000 sales people worldwide, and deep R&D resources to deliver best-in-class solutions to customers and partners.

Micro Focus's approach to managing both growing and mature software assets will ensure higher levels of investment in growth areas like big data analytics and security, while maintaining a stable platform for mission-critical software products that customers rely on.

For employees, Micro Focus's approach will mean each product line will have a clear and important role in the overall company performance, and employees will have a high level of clarity on the strategy for their organization. It also means employees will get to work on long-term, customer-focused projects – and the software technology that they love.

We believe the software assets that will be a part of the spin-merge will bring better value to our customers, employees and shareholders as part of a more focused software company committed to growing these businesses on a stand-alone basis.

With this announcement, Robert Youngjohns, the current head of our Software business, will assume the role of Executive Vice President, Strategic Business Development, reporting to me. In this new role, Robert will partner with other members of the leadership team to drive strategic customer and partner initiatives focused on growing key parts of the business.

With Robert taking on this new role, Chris Hsu, our chief operating officer, will lead the software business, effective immediately, in addition to his current responsibilities. Chris' track record of driving strong performance and understanding market dynamics at HPE and throughout his career make him a great fit for this role.

To be clear, both software and services are still key enablers of HPE's go-forward strategy. Our newly created Software-Defined and Cloud business will build upon key software assets like OneView and the Helion Cloud platform to deliver software-defined Hybrid IT solutions, like Synergy – HPE's composable infrastructure offering that enables customers to operate their workloads with unprecedented speed and agility.

And, in Services, we continue to have a world-class capability in our Technology Services group, which will represent about 25 percent of HPE's revenue following the two spins that we have announced. TS's 22,000 service professionals build solutions from the ground up, with the consulting and support our customers need to transform their environments and take advantage of opportunities in emerging areas like campus, branch and IoT.

Once the ES–CSC and the Software–Micro Focus transactions are complete, HPE will be an even stronger company, well positioned for the future. With approximately $28 billion in annual revenue, the future HPE will have significant scale, a diversified, world-class portfolio, and a global footprint to meet the evolving needs of our customers and partners. We will be a market leader both in the data center and on the edge with our world-class portfolio of software-defined servers, storage, networking, and converged infrastructure. We will have strong recurring revenue streams that account for approximately 60% of our operating profit. And, we'll have an improved free cash flow profile.

Given our experience with divestitures, we are confident in our ability to execute, and, more importantly, that we are making the right choices to set both HPE and our customers up for the long-term while delivering maximum shareholder value.

The market is already recognizing what we are doing. With these strategic moves and our continued strong operational performance, HPE's market cap has increased by over $10 billion, or 40%, since the separation from HPI on November 1, 2015.

In addition to the portfolio changes, we also made important leadership and organizational changes this quarter that will make our business stronger and more efficient.

For example, we've started the process of right-sizing our corporate functions for the more focused, stand-alone HPE.

In addition, the Enterprise Group businesses have been simplified and streamlined to better address market opportunities, improve cost structure, accelerate innovation and strengthen our competitiveness.

Furthermore, all business unit and corporate marketing efforts will be consolidated under our global marketing function, and all sales will be under a single global leader.

Finally, we announced that Hewlett Packard Labs would move into the Enterprise Group, which will better align our research and go-to-market efforts.

While there is more work to do, we are already seeing that our strategy is working. As a more focused organization, we have been able to allocate resources more effectively and introduce truly best-in-class solutions.

For example, as I mentioned earlier, we announced plans to acquire SGI. High-performance compute and big data analytics are exciting areas for us, as customers are increasingly looking for ways to gain deeper, more contextual insights from the ever-expanding volumes of data. Industries like financial services, semiconductors, and energy are all increasing their HPC investments. In Q3, we won several significant automotive deals where HPC is used for electronic prototype designs, improving fuel economy and improving crash-worthiness. The SGI acquisition will further strengthen our position in the $11 billion HPC segment, as well as the high-growth data analytics segment.

In storage, we extended our leadership in the all-flash data center with enhancements to HPE 3PAR, and also introduced next-generation software-defined storage to enable a composable data fabric. We also brought enterprise capabilities to the entry storage market with the introduction of StoreVirtual3200 and MSA 2040.

We announced HPE OneView 3.0 to provide software-defined intelligence across HPE's family of infrastructure solutions. To date, we've sold over 500,000 HPE OneView licenses across a variety of key verticals such as healthcare, industrial and financial services, and we have a growing partner ecosystem, including Docker, Chef, Turbonomic and SaltStack.

We unveiled the industry's first converged systems for the Internet of Things – the HPE Edgeline 1000 and 4000 – which will enable real-time decision-making and deliver heavy-duty analytics at the edge by integrating data capture, control, compute and storage.

We also announced updates to the HPE Helion cloud portfolio, including HPE Helion Cloud Suite, a new software suite enabling customers to manage their full spectrum of applications across infrastructure environments, and HPE Helion Cloud System 10, a hardware and software solution to build and deploy an enterprise-grade private cloud environment.

But, most of all, we are winning with our customers and partners.

Aruba continues to win customers and drive growth with its industry-leading technology. For example, we helped Rio's airport handle the massive surge of travelers passing through for the Olympics this summer. And, Home Depot and Best Buy are currently implementing Aruba wireless solutions to provide a better in-store experience for customers and employees. Keep in mind, deals like this have great TS pull-through as well.

At Discover in June, we announced a new partnership with GE Digital that will enable industrial analytics from the edge to the cloud. HPE will be a preferred storage and server infrastructure provider for GE's Predix cloud technologies, and the Predix platform will be a preferred software solution for HPE's industrial-related use cases and opportunities.

HPE was also instrumental in helping Dropbox transform to a hybrid infrastructure to help it meet the growing demands of its users. Dropbox moved the majority of its cloud storage business away from AWS to an on-premise data center using HPE ProLiant and Cloudline servers, all financed by HPE Financial Services.

We also announced a groundbreaking strategic alliance with Docker to help customers transform and modernize their data centers to benefit from a more agile development environment. At the heart of this alliance is HPE's Docker-ready server program, unique to the server industry, which ensures HPE servers are bundled with the Docker Engine and support.

And, today we announced plans for a commercial partnership with Micro Focus that will name SUSE as HPE's preferred Linux partner and will bring together HPE's Helion OpenStack and Stackato solutions with SUSE's OpenStack expertise to provide best-in-class enterprise-grade hybrid cloud offerings for HPE customers.

So, in summary, I am pleased with the progress we've made this quarter and am just as pleased with the execution of our strategy since we separated from HPI. I'm also excited about the opportunities we've created for shareholders in the spin-mergers of ES and CSC and our software assets with Micro Focus. We are setting up HPE for long-term success while unlocking the kind of value we believe our shareholders appreciate.

On that note I will hand the call over to Tim…

Tim Stonesifer
Thanks Meg. Overall we performed well in the quarter.

While revenue of $12.2B, down less than 1%, was not quite as strong as last quarter, margins were up as we focused on profitable market share. We also executed well considering we faced difficult compares across the portfolio and an uneven global demand environment. As we indicated last quarter, compares became more challenging as we are no longer benefitting from the large Deutsche Bank deal we signed in ES last year and in EG we are lapping the compares from Aruba and the ramp of Cloudline servers.

From a macro perspective, we did see weakness in Europe, particularly in ES from a slowing in UK public sector business and also in Japan in the Enterprise Group. The Q3 currency impact to revenue was a headwind of 210 bps year over year that we expect to moderate further.

We did have several areas of solid growth across the portfolio including networking up 12%, all-Flash arrays up 70%, high-performance compute up 12%, and our highest-margin business, Technology Services, returned to growth for the first time since Q2'12. To improve growth in the overall portfolio, we are continuing to make investments in our higher-growth businesses around software-defined, converged, and hyper-converged while we continue to enhance our go-to-market efforts that we expect will improve growth going forward. Overall, we are still on track to deliver what we said we would do at the beginning of the year by growing total FY16 revenue adjusted for divestitures and currency.

Gross margin of 29.3% was up 60 bps both year over year and sequentially. This was principally due to continued improvements in Enterprise Services, and Enterprise Group to a lesser extent. Non-GAAP operating profit of 8.8% was up 30 bps year over year and 90 bps sequentially.

Non-GAAP diluted net earnings per share of $0.49 was above our outlook of $0.42-0.46, that was primarily the result of tax benefits realized through the recent divestitures, equating to approximately $0.04 per share.
Non-GAAP EPS primarily excludes pre-tax amounts for the gain on divestiture of H3C of $2.2B, restructuring charges of $369M, amortization of intangible assets of $210M, and separation charges of $135M.

We delivered GAAP diluted net earnings per share of $1.32, above our previously provided outlook range of $1.10-1.14, primarily due to a higher than expected gain on the H3C divestiture, lower separation costs, and the previously mentioned tax benefit.

Now turning to the results by business…In Enterprise Group revenue was flat as we focused on profitability and delivered encouraging improvements in operating margins, which while flat year over year were up 90 bps sequentially to 12.6%. The sequential improvement was primarily due to lower discounting, better server option attach, favorable mix and operational cost improvements as we right-size the organization ahead of the separation from Enterprise Services and Software.

Server revenue declined 2% as solid growth in Tier 1 and high-performance compute was offset by pressures in core servers. Within the core, we did have some market coverage issues that we are addressing through recent sales leadership and go-to-market changes with an emphasis on SMB. We also doubled-down in the fast growing high-performance compute market with the acquisition of SGI, and continue to invest in workload-optimized solutions like SAP HANA. From a margin standpoint, the team did a nice job prioritizing profitability over share for share's sake, expanding margins year over year. We also anticipate we held server share in the second calendar quarter overall and gained share in the Americas, density optimized and Tier 1.

Storage revenue declined 5% with continued declines in the legacy portfolio more than offsetting growth in converged storage of 1% that was impacted by a softer than expected market. Margins increased year over year driven by favorable converged mix and improved pricing in all-Flash. 3PAR + XP + EVA was up 5% and all-Flash 3PAR revenue continues to drive the portfolio, growing 70% at record revenue levels. Despite a challenging market, we estimate we gained share in the second calendar quarter, our 11th consecutive quarter of share gains. And, we continue to expect Storage to gain share through the remainder of the year.

Networking revenue grew 12% and encouragingly, Aruba growth has accelerated, growing 20% and is exceeding our internal plan. We again saw growth across all regions as we continue to see the benefits of the combined Aruba/HPE portfolio. Margins improved year over year, driven by both a better mix and higher margin rates of Aruba.

TS returned to growth, for the first time since Q2'12. Revenue was up 1%, as the strong order growth from FY15 becomes a larger portion of the portfolio and revenue grew in both support and consulting. And, while orders were flat, we saw encouraging performance in non-attach and proactive services that are growing at double-digit rates and becoming a larger mix of the total portfolio. We continue to improve service intensity, or attach dollars per unit, which is helping to offset increased Tier 1 mix and higher server ASP's.

Enterprise Services revenue declined 3% as growth in the Americas and APJ was more than offset by weakness in EMEA, resulting from a pause in UK public sector spending and a tough compare with the Deutsche Bank deal in the prior year. Operating profit improved 260 bps year over year to 8.3%, the highest since Q2'11, as the team continues to execute on productivity improvements in delivery and sales. We also benefitted from improving location mix and new deal profitability. Progress made on cost improvements, sales strength, and normal quarterly seasonality provides us with continued confidence that operating margins for the full year will be approximately 7%, at the high-end of our original outlook. Revenue is still expected to be down 2% to flat in constant currency, even with the Mphasis divestiture. We continue to track against our longer-term goal of 60% headcount in low cost locations and completed the quarter with 49% of our headcount in low cost centers, a 6 pt improvement since the beginning of the fiscal year.

Software revenue declined 3% as strength in security and big data was offset by declines in IT Management. SaaS had a record quarter with 17% revenue growth. The team continues to focus on disciplined cost controls, decreasing opex 16% year over year, however revenue declines ultimately outpaced operating improvements, causing a 270 bps decline in operating margins to 17.8%.

HPE Financial Services revenue grew 2% and delivered the first quarter of as reported revenue growth since Q1'13. Operating profit declined 90 bps year over year to 9.9% as lower residual sales from weaker volume in prior years pressured margin rates. Financing volume declined 4% year over year in constant currency on a tough compare that saw Deutsche Bank sale lease back volume in Q3'15. Return on equity was down 190 bps year over year to 13.3%, and was similarly pressured by lower residual sales resulting from lower volumes in FY13 and FY14.

Cash flow generation was strong in the quarter as we continue to optimize working capital management. Cash flow from operations was $1.7B, up 10% year over year on an adjusted basis. Free cash flow was $971M, up 15% year over year on an adjusted basis. When adjusted for the sale of Mphasis, the cash conversion cycle was 19 days, down 5 days sequentially. Receivables were the largest contributor to working capital improvement due to favorable payment term mix and reductions to aged receivables. Going forward, we expect the cash conversion cycle to be in the mid-teens with FY16 free cash flow of $1.7-1.9B.

Turning to capital allocation, during the quarter we repurchased $1.5B of stock through an accelerated share repurchase program, and we paid $91M as part of our normal dividend. Year to date we have returned $2.9B of capital to shareholders, primarily through $2.7B of share repurchases. With our free cash flow generation and the recent divestitures, we are on pace to return more than $3B of cash to shareholders in the year, which, as a reminder, is approximately 3 times our original commitment at the start of the year.

Finally, I would like to discuss the financial impacts of the HPE Software / Micro Focus transaction. As Meg mentioned, the transaction is expected to deliver approximately $8.8B of enterprise value to HPE. This includes 50.1% of the equity in the newly formed company that will go to HPE's shareholders, valued at approximately $6.3B based on Micro Focus's current stock price, and receipt of a $2.5B payment of on-shore cash to HPE. HPE and Micro Focus also expect to improve the margins on HPE's software assets by approximately 20 points by the end of the third year following the deal close, while investing in key growth area like big data and security. As owners of 50.1 percent of the equity in the new merged company, HPE shareholders will share in the value of these operational improvements, as well as future growth of earnings. We expect this transaction to close by the end of the second half of HPE's fiscal year 2017.
To recognize this $8.8B of enterprise value and unlock a more attractive financial profile for HPE going forward, we will incur one-time separation cash payments of approximately $700M, with the vast majority occurring in FY17.

Following the separation from ES and SW, Hewlett Packard Enterprise will be a faster growing, higher margin, stronger cash flow company for our shareholders. Just looking at FY16, revenue growth would be about 3 points greater. Operating margins would be about 1 point higher at just over 10% and free cash flow as a percentage of revenue would be roughly 50% higher. It's also worth noting that we will have roughly 30% of revenue recurring but more importantly, more than 60% of profitability will be recurring that comes from TS and Financial Services.

HPE will also have a very healthy balance sheet that currently sits at $5.3B in operating net cash. On top of that, we just closed the Mphasis deal receiving approximately $825M of before-tax cash proceeds. We continue to see share repurchase as an excellent use of capital and, similar to the H3C transaction, plan to buy back shares with the vast majority of the Mphasis proceeds. In FY17, our net cash position will also be further enhanced by over $1B from the cash and debt transfers with CSC and the $2.5B cash dividend from Micro Focus. We will continue to deliver shareholder value with these proceeds just as we've done this year by following our returns-based capital allocation approach. This approach is currently biased towards share repurchases and we will provide more details on our FY17 capital returns plans to shareholders at our upcoming analyst day.

With all that in mind, we expect to finish fiscal 2016 with non-GAAP diluted net earnings per share of $1.90 to $1.95, at the high-end of our original outlook for the year. We expect GAAP diluted net earnings per share to be $2.09 to $2.14.

Before we open it up to questions a quick reminder that we are holding our annual securities analyst meeting on October 18th in San Francisco, where we will provide additional P&L and cash flow details on the total company as it stands today as well as the go-forward Hewlett Packard Enterprise excluding ES and SW.

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 question.

Our first question comes from Katy Huberty of Morgan Stanley. Please go ahead.

Katy Huberty
Thanks, good afternoon. The slowdown in storage was a bit of a surprise given that most other players in this space beat expectations, so just to begin I wonder if you could talk about what you think drove that, was it macro or execution? And then I have a follow-up.

Meg Whitman
Yes, hi Katy, this is Meg, so the storage performance was not as strong in Q3 as we saw last quarter. I think because there was a weaker market, but we also increased margins and we expect to take about a half a point of share year-over-year in the second quarter. And I want to remind you this is the 11th straight quarter in a row that we've taken market share and revenue was down 5% year-over-year, adjusted for divestitures and the currency as traditional declined 12% more than offsetting the 1% growth in converged.

So, listen, we saw a softer market and we have introduced our new StoreVirtual 3200, the MSA 2040 that brings the enterprise capabilities at a fantastic price to the entry market and that has been a drag for us. We haven't had a great competitive offering in the entry market. And what you know about the storage market, it's moving from high end to mid and entry very, very fast. So looking forward, we think the market is going to continue to be soft, and that will keep our growth muted, but we continue to gain share and we are very pleased with our HPE 3PAR all-flash performance that grew 70% year-over-year. So some work to do there, but we feel good about where we are and on a go-forward basis, I think you'll see us return to growth, a little bit more robust growth.

Katy Huberty
And through the July quarter, you've essentially met your objective to return 100% of free cash flow plus half of the H3C cash to shareholders, how should we think about the balance of additional buybacks versus accentuating the RemainCo portfolio of products after the two spin-merge deals?

Tim Stonesifer
Yes, so we did the $1.5 billion in the ASR in the third quarter; so there will be some shares taken out in the fourth quarter as we complete that as that was a six month program. I think looking forward we will have nice cash balances, particularly as we close these transactions. So we are going to continue to execute our disciplined ROI based approach. We think it has worked well so far. At the same time, we will consider some acquisitions right; I think SGI is a great example of complementary technology in the high performance compute data analytics space that we should benefit from a profitable growth perspective. So right now we will stick with the ROI based approach, and we will obviously share more details with you on 2017 at next month's analyst meeting.

Katy Huberty
Okay. Thank you congrats on the deal.

Meg Whitman
Thank you. People always ask us, “What kind of acquisitions work well for HPE?” And I think we’ve got the formula down which is, what is complementary technology in the HPE strategy of being leading provider of hybrid IT with secured next generation software defined infrastructure, and also at the edge. So Aruba and SGI are perfect examples. Complementary technology that we can put through our distribution mechanism that really enhances value for customers. So I think those are two perfect examples of the kind of deals you could see us do going forward. Unfortunately, there aren't that many deals like that, but when they come along we will do them.

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

Operator
Our next question comes from Toni Sacconaghi of Bernstein. Please go ahead.

Toni Sacconaghi
Yes, thank you. Meg, a year ago, you were out on the road show talking about the split of HPE, what is now HPE and HPQ. And at that time, you talked about cash balance being an asset and that acquisitions would be an integral part of the strategy. You also talked about HPE being a solutions company and a growth company.

Less than a year later it feels like a different story, cash return has been the absolute priority; acquisitions have been extremely minimal. Arguably divesting software and services which are essential ingredients to many solutions seems different. And so, I applaud the flexibility because the stock price has done extremely well and it's certainly been in the vein of value creation.

But I was wondering if you could comment on what appeared to precipitate this change in thinking from, I think an impression that seemed different to most from the road show a year ago? And is there a different end state for Hewlett Packard Enterprise going forward? Is this really a viable ongoing hardware centric company going forward or should we expect more portfolio rationalization? And believe it or not, I have a follow-up.

Meg Whitman
That is hard to believe. So Toni, let me take you all the way back to November 1st of 2015, where we separated HP Inc. from Hewlett Packard Enterprise. And we very much laid out the strategy of beating a leading provider in hybrid IT, both in the traditional data center, which by the way is still a robust market, it's 85% of the spend in IT today, and we are the leader there and we need to continue to gain share.

And then we wanted to focus on software defined infrastructure which is really the next generation of infrastructure that our customers need, and then finally, build out our cloud platform and compute storage in networking at the edge. And that’s exactly what we have done, and as we laid out that strategy, we looked at our portfolio. What do we need to add to the portfolio, either in acquisitions or partnerships? What do we need to divest, because those assets are non-core to the strategy, it doesn’t mean they are bad assets, it is just they are not core to what we are doing.

So if you take the ES transaction, listen, we are still going to be in the services business, in fact 25% of the revenue of HPE will be services. It is just a different kind of services business than IT outsourcing, business process outsourcing and apps maintenance. If you think about software, we are still going to be in the software business, it's just not in application software like ITOM, it is system software like OneView, and the software that powers synergy. So it is a portfolio matching to the strategy that we see our competitive advantage in.

As far as, I think you asked about further divestitures, so enterprise group as currently configured needs to stay together and I will tell you why. My view of the market is everything is moving to converged, and we have a differentiated position, because we have networking storage and compute, and our two major competitors are missing a key component of that offering. So that we think is important to keep together. And then as you think about technology services, technology services is the key differentiator for our company. We can help customers support, maintain, advice and consult across the globe, and it would be uneconomic to simply support storage only or networking only. So TS is absolutely integral.

And then finally, obviously campus, branch and edge is a new growth area for the company. There is no reason that we should not own compute at the edge. There is no reason that we shouldn't own analytics at the edge, in addition to obviously Aruba. So I think it is to some degree the strategy has evolved, but really quite consistent with what we laid out and a big part of what we did this past year was portfolio optimization for the strategy. So on a go-forward basis, I think as Tim said well, I think you can look for more ROI based smart acquisitions, like Aruba, like SGI. And so, I think it's entirely consistent with the strategy that we laid out a year ago.

Toni Sacconaghi
Okay. Thank you for that. Just as a follow-up, any time you divest or acquire particularly in this case, you say, "Well, could I have done what others are going to do on my own?" So what I mean by that is, I can't help thinking that HP software business is going to be like 75% of Micro Focus going forward. You are far, far, far bigger than they are, from a revenue perspective. And they believe as a much smaller player, that they can improve operating margins 2,000 basis points. 2,000 basis points on your revenue base is $750 million a year in operating profit which at a 10 multiple $7.5 billion, you haven't given up the business.

So the question is, if the margin improvement opportunities are so huge, even for a relatively small player, why did you either not extract a better price or why did you not believe that you could have extracted those, and created even more value for shareholders?

Meg Whitman
So, I think the first answer is, this is what Micro Focus does they are pure play Software Company who is expert at managing mature software assets. And as Micro Focus will tell you most people who work in the software business and Silicon Valley want to grow assets. And actually some of these assets should actually be maintained on a stable platform that extends the value for customers, and it's actually not what we do, it is what they do. But then you come to the question of, why did we do a spin-merge as opposed to sell the whole business? The reason is, is because our shareholders will be able to ride the upside of what Micro Focus does. Remember our shareholders will own 50% of the new company.

And by the way, I will be a shareholder of that new company given my vested options and my vested RSUs in HPE. And I can tell you, I will be holding those shares because I think they are going to do very,

very well. And so, this was a much better alternative than selling the company today on a PE multiple operating income, because you would get cash, but you pay taxes and then our shareholders wouldn't get to ride the upside unless they went out and took new money to buy those shares. So we thought that was absolutely the right thing to do.

And I have to tell you Tony in today's world where technology is changing at lightning speed, I've got to tell you the value of focus I am seeing it every single day. And so while, maybe back in the day it was great to be a technology supermarket, like the financial supermarkets of yesterday. What I am pretty sure of is the next four or five years is going to be, all about speed, agility and focus and innovation in something that is a more narrow focus.

Andrew Simanek
Great. Thank you, Tony.

Tony Sacconaghi
Thank you.

Andrew Simanek
Can we have the next question, please?

Operator
Our next question comes from Sherri Scribner of Deutsche Bank. Please go ahead.

Sherri Scribner
Hi, thank you. I wanted to get a little more detail on the software spend. Will any of the software apps that stay with HPE business or will everything be spun-off? And then as part of that question, thinking about what you talked about at the Discover event, the opportunities in big data, internet of things, analytics. How does HPE benefit from those trends without having that software business? Thanks.

Meg Whitman
Sure. So what lives in our software business unit today is in fact spun and merged with Micro Focus. But we still remain in the software business, it's just a different kind of software business as I said, system software. The software defined infrastructure is all powered by software, but it's not applications software if you will, like ITOM or ADM, it is actually system software that powers the infrastructure of our customers.

Now, you say, “Alright, so how do we capitalize on the big data and analytics?” Well, first of all, we will be the leader in high performance compute with the acquisition of SGI. So companies need to process and compute huge amounts, ever escalating amounts of data. So really the high performance compute market which is an $11 billion business growing at 6% to 8% will really be between HPE now with SGI and Cray, but many of the other competitors like Dell, Lenovo, they are not in that high performance compute business. So as people need financial services, energy, as they need to compute to process all this big data if you will, we will be the leading player there.

If you think about campus, branch and edge, I think this is the next big growth area. If you think about autonomous driving vehicles, jet engines, healthcare sensors in healthcare beds and in devices, this is an area where huge amounts of data needs to be processed real time at the edge as opposed to enduring the latency of coming back to a major datacenter. So we are going to be able to capitalize in the IoT trend, by analytics at the edge and be able to compute and store at the edge. So that's the way we will play in those trends, it will be different then like Vertica, which will go to Micro Focus which is a big columnar database that processes huge amounts of data on a database side. But we will pick-up the ability to process on compute storage and networking at the edge.

Sherri Scribner
Okay. Thank you, and then just a quick clarification for Tim. On the TS, the Technology Services side, it looks like there was an eight-point difference between the actual revenue and the adjusted revenue. Was there something other than currency in that number, because that seems like a big delta? Thanks.

Tim Stonesifer
The H3C transaction impacted that as well.

Sherri Scribner
Thanks.

Meg Whitman
Because, H3C had TS in China that went with that deal.

Sherri Scribner
Okay, great. Thank you.

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

Operator
Our next question comes from Steve Milunovich of UBS. Please go ahead.

Steve Milunovich
Thank you very much. Well, we've come a long way from better together here. I give you a lot of credit because you are basically creating these very focused companies, whatever Computer Sciences is called, and now Micro Focus which, I think does create a lot of shareholder value.

But again, when all is said and done, you are becoming more and more a hardware company. And I would think your competitors ultimately are going to be primarily Cisco and Dell. And obviously, they will use their large size against you, and claim they have got AI capabilities and so forth. How do you see matching up against them, when all is said and done? And are you going to have relationship with Micro Focus that's a favored nation, like you appear to have with Computer Sciences going forward?

Meg Whitman
Yes, the answer to that is absolutely, yes. And actually beyond that, you saw what we announced today with SUSE, where there will be our preferred partner for Linux, as well as the OpenStack Distro, and listen, a lot of the software products that are going in the spin merge will be important to us going forward. So there will be a relationship there.

So let me just give you a sense. I think we are in a great position to compete with both Cisco and Dell. So for example, actually the HPE go-forward strategy will be about a $28 billion company, that's only slightly smaller than Dell's enterprise business, and it is more focused with better innovations. I think we should just contrast our strategy with Dell, okay. So we are getting smaller, well they are getting bigger. And this is important, because I believe speed and agility is critical in innovation and go-to-market. The second is they are levering up and we are delivering, we have $5.3 billion of net cash on the operating company and we are going to have a lot more by the time we are done with these transactions and that gives us dry powder, it also gives us the ability to return cash to shareholders. And I think it's difficult to be levered as much as Dell is in this environment.

And then secondly, we are leaning into new technology, either through our own innovation, acquisitions or partnerships and we've got major focus on our side. What they are doing is doubling down on old technology and the cost takes out play. And listen, I think, it might be quite successful for leadership team there, from a financial perspective, I am not so sure it's good for customers.

Steve Milunovich
Okay. And then on enterprise group, I just want to confirm that you said you do expect storage growth in the future now that's reported or adjusted or whatever. But also can you talk about servers and what went on in the quarter and do you expect that to return to growth?

Meg Whitman
Sure, and by the way I forgot to address Cisco in your last question. So listen, Cisco is a good competitor. But they are missing a key element, which is storage. And as this converges, I think as the environment converges and we look at hyper converged and on synergy, we are innovating really nicely now for the traditional data center, as well as the software defined data center. And I got to tell you Aruba at the edge is killing it. And a 20% growth rate above our internal plan and we are just winning deals hand over fist there. So we feel really good about our ability to compete with Cisco.

Okay so back to servers, so listen what's happening in servers is, there is core server growth, then there is tier 1 servers which is to the big service providers, and then is obviously high performance compute, and the reason we did the SGI acquisition is to really stake out a great position in an $11 billion business as I said before that's growing 6% to 8%, that's very profitable for the compute itself, but also there is very high TS attached to high performance compute.

Core servers around the globe are under some pressure right now. But you saw what we did in terms of increasing the margin, and we are doubling down on SMB, which actually there is pockets of growth in that area, and we are also doing workload specialization.

Okay, we have the best compute in the world to run SAP HANA; it's not even close with anyone else. So we are specializing around workloads. And then, obviously there was a tough compare because of Cloudline a year ago, we have just ramped that business into a multi billion dollar business. And so, it's hard to compete with those compares, but we expect to continue to gain share in that market profitably. We are not in it for share-for-share stake; we don't want to take unprofitable deals.

But as we continue to work on our supply chain and the rationalization of platforms and skews, we become ever more competitive there. And we are very mindful that ultimately there is Chinese competitors there as well, and whether that's Huawei or Lenovo, it's not just Dell. So we are very aware of the cost structure we have to have to continue to compete.

Steve Milunovich
Any prediction of growth?

Meg Whitman
I think low single-digits is probably what we will grow, it will depend on how much tier 1 service provider business we want to take. But I would say what you saw 1% to 2% is probably a good estimate going forward.

Steve Milunovich
Thank you.

Andrew Simanek
Next question, please.

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

Maynard Um
Hi, thanks. I was wondering if you can help me understand the $700 million after tax separation costs. When you say we will unlock a more attractive financial profile, what exactly does that mean, are those redundant employee restructuring costs and will that drive up EG margins? And I've a follow-up.

Tim Stonesifer
I think it's really a combination of couple of things. When we separate the software business and you look at the remaining piece of HPE, if you were to extract ES and software from our 2016 financials. To Meg's earlier comments, revenue growth would be an incremental 300 basis points.

Margins would be up an incremental 100 basis points just north of 10%, and free cash flow as a percent of revenue would be up 50%. If you look at the absolute free cash flow, it would be relatively neutral, driven by the fact that software does generate some free cash flow but that's offset by the pressure in ES. So when we are talking about the financial profile it's really related to RemainCo if you will.

Meg Whitman
And I have to say that with our enterprise group really being now the anchor for RemainCo, we've been very conscious about making sure that we have got an overhead cost structure that is in line with the $28 billion business, that we are making changes to how enterprise group is organized internally, there will be savings around our OpenStack Distro with our new relationship with SUSE. And then, finally moving HP Labs, Hewlett Packard Labs to EG is going to tighten the linkage between downstream development and commercialization which I think is something that needs to be done. So we are all about making enterprise group more cost effective as we drive the RemainCo strategy.

Tim Stonesifer
And I would also add on RemainCo, keep in mind that the recurring op profit will be about 60%.

Maynard Um
Great, and then, it looks like Dell raised pricing in the UK to offset the currency impact from Brexit. I was wondering, if you could just talk about what impact that had on your business, both in terms of revenue and margin, and how we should think about that going forward? Will the hedging offset that to the bottom line? Thanks.

Meg Whitman
Let me tell you what we saw from a demand perspective, and Tim can talk a little bit about our broader hedging strategy. We were not able to hedge in the quarter for the Pound degradation. But what we saw was actually a pause in purchasing in the UK, certainly, the UK public sector, but the also the UK and then more broadly Europe which was, “Hmmm, this was unexpected, a big change, let's take a pause and decide what we want to do here,” and when we saw it in a very marked way.

What I will say in the last couple of weeks we've actually seeing orders pick up again. It was almost like, they took a pause. And basically had to take stock of what was happening, and then basically the orders have started to flow again.

We continue to also monitor the competitive pricing environment that we see, and we adjust as necessary, particularly in the channel. So the channel is where we serve SMB, and that's where our ability to move the pricing in response to competition, we look at that actually every single week sometime multiple times a week.

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

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

Shannon Cross
Thank you very much for taking my question. I want to talk more about TS; it was up this quarter for the first time in a while and on a net of divestitures and constant currency basis. How do we think about it as you look at the placements you've made over the last year, I think you mentioned some benefit from some of the hardware that went in place.

But just as you look at the mix of hyper scale and what have you that you put out there, do you expect this to continue to grow net of everything, is there an opportunity given weakness in certain some quarters that it may dip? Just how should we look at it because it's obviously very important from margin perspective?

Meg Whitman
So I think a little-understood element of HPE is the dramatic transformation that TS has gone through. TS is and was a very profitable business that was largely attached to business critical systems, very profitable, very high attach. You didn't really sell business critical systems without TS attach. And when business critical systems, both from a market perspective, as well as the Oracle Itanium situation, by all rights TS should be down 25%.

Do you remember, Shannon, over the last four or five years BCS was down 25% like clockwork every single quarter for four years? It is growing a little bit now, but by all rights TS should have shrunk with BCS and it did not.

And the reason it did not was very impressive new product offering, proactive care. Other areas where we help customers maintain their data center estate. And so the fact that it has actually only been down a few percentage points over the last 12 months is a testament to the leadership team in that business. And now what you are seeing is those new product offerings are starting to get real traction.

Orders has been positive for the last three or four quarters, and those orders are translated into growth this quarter, not a significant amount of growth, but 1% we will take it all day long, because it is a very, very profitable business.

So we have more work to do on Technology Services. I will tell you it is the benefit of now being a smaller and more focused company. Antonio Neri and I are going to spend a whole lot of time now on what is the next iteration of Technology Services, and whether that's flexible capacity services that allows consumption based model, whether it's proactive care, data center care, we are going to spend a lot of time there because it is a key strategic enabler of RemainCo HPE.

Shannon Cross
Okay. And then just as a follow-up, I am curious, do you feel for the core company that you are going to have less; the cost structure is relatively close to where it needs to be? Or are there more opportunities whether, I think you mentioned a little bit, in terms of the corporate costs, but then just also within EG, where you might be able to optimize over time to perhaps offset some pressure in mix or pricing?

Tim Stonesifer
Yes, sure. I think from a cost structure perspective, we spent probably in the last 18 months; we've done some detailed benchmarking, particularly in the functional areas, as to where the business needs to be basically cost as a percent of revenue. So we are getting closer to those benchmarks, we are not quite there yet, but we are close and we are there in some of the functions.

So as we have done these divestures or as we are doing these divestures, we obviously incorporate that into what the new cost structure needs to look like and obviously we need to be very aggressive around what we call stranded cost. So I think the good news is when you look at the HPE-HPI separation, we did have some "dis-synergies," we called them, we have worked those through the system, with the H3C divesture. We've gotten much better with identifying the stranded cost, we've been much more proactive in managing them out and we are starting to see those come out. So we are confident that we can continue to do that to get to the benchmarks we need to get to when these transactions are done.

Meg Whitman
I'll just add a couple more things. We've been streamlining the cost structure of this company for four or five years. Now we are starting to do things differently because you can only take out so much cost, there is only so much low hanging fruit, you have to do things differently and whether that is supply chain and logistics, whether that is how we are organized internally with all R&D under one R&D leader, whether it is putting our software defined infrastructure and our cloud offering under one leader, whether it is putting all of our go-to-market under one leader, where we have consistent go-to-market strategy, discounting across the board. Frankly, we were much better at minimizing discounting in APJ and EMEA than we were in the United States. We now have that discipline across the company.

And then finally corporate overhead, we got to have a corporate overhead that is designed for a $28 million company. And when we started we had a corporate overhead design for a $110 billon company and then a $50 billion company and now a $28 billion company. And I have to say I am really pleased with our ability to right-size the corporate overhead and be lean and mean, and that includes everything from HR, finance, legal, IT, things like real estates, systems. So we have made a lot of progress, but you will see more of that benefit I think in '17 and '18.

Andrew Simanek

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

Operator
Our final question comes from Jim Suva of Citi. Please go ahead.

Jim Suva
Thank you, Meg, and congratulations to you and your team there at Hewlett Packard Enterprise. My question is regarding the separation costs. If I remember from the press release, I think it was around $700 million. Is that correct? And how should we think about the timing of that, and is that all-in costs?

And I also take it relative to say the divestiture of the services was $900 million. And while $900 million is $200 million more than $700 (million), it seems like to me that the services was a much bigger, heavier lifting divestiture. So I almost wonder, is $700, why is it so much, and not much lower or is it just so much integrated in Hewlett Packard Enterprise, that's why it costs so much to break out? Thank you.

Tim Stonesifer
Sure. So, yes, so $700 million is the right number. Again, we feel like the value that that transaction is driving is phenomenal for HPE as well as its shareholders. However, to realize that value we need to make investments and allocate resources to do the separation, so to your point, software although the activities are similar in nature to the transaction in ES, they are discreet, and they are not necessarily driven by revenue base or headcount levels.

So when you look at software, it's a global complex business, it has multiple legal entities that have been accumulated over time through a series of transactions and because of that when you look at the tax, the finance, the legal, the operating structure, it is still very, very complicated. So in order to separate that there are some large expense items in there, for example, separating 650 IT systems, doing the carve out financials translating GAAP to IFRS, splitting a 150 legal entities in 60 countries, trying to figure out what we want to do with 200 real estate sites across the globe. So there is certainly a lot of work that needs to be done there. The good news is we have done this before, so we know how to do it. The team has been very proactive and we are all over it, we have the work screens identified. So, we are confident we'll get there when we go forward.

Meg Whitman
The other thing I think that's important Jim is, on these separations that we have done to date, whether it was HP Inc. from Hewlett Packard Enterprise, whether its ES from Hewlett Packard Enterprise, we have come in on time and actually below budget. And so, we are really proud of that. And we expect that to happen, I don't know how much, listen $700 (million) is what you should have in your models. If we are on target, we ought to come in a little lighter than that.

Tim Stonesifer
Yes, and the other way I think about it is the benefit of the deal far outweighs the cost, right? So when we get that $2.5 billion cash dividend and that will be on shore cash that far outweighs the cost of doing the transaction.

Jim Suva
Thank you for the details and congratulations to you and your team.

Meg Whitman

Thank you very much.

CONCLUSION

Andrew Simanek
Appreciate it. Thank you, everyone for joining today.

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