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HP Inc. (HPQ) CEO Dion Weisler on Q3 2019 Results - Earnings Call Transcript

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FQ3: 08-22-19 Earnings Summary



Press Release



10-Q



Slides

EPS of \$0.58 beats by \$0.03 | Revenue of \$14.6B (0.12% Y/Y) beats by \$19.59M

Earning Call Audio



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HP Inc. (NYSE:HPQ) Q3 2019 Earnings Conference Call August 22, 2019 5:00 PM ET

Company Participants

Beth Howe - Head, IR

Dion Weisler - President and CEO

Steve Fieler - CFO

Enrique Lores - President of HP Imaging, Printing & Solutions Incoming President and CEO, HP Inc.

Conference Call Participants

Katy Huberty - Morgan Stanley

Shannon Cross - Cross Research

Toni Sacconaghi - Bernstein

Amit Daryanani - Evercore ISI

Ananda Baruah - Loop Capital

Tim Long - Barclays

Jeriel Ong - Deutsche Bank

Operator

Good day, everyone, and welcome to the Third Quarter 2019 HP Incorporated Earnings Conference Call. My name is Shaun and I will be your conference moderator for today's call. At this time, all participants will be in a listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the call over to Beth Howe, Head of Investor Relations. Please go ahead.

Beth Howe

Good afternoon. I am Beth Howe, Head of Investor Relations for HP Inc., and I would like to welcome you to the fiscal 2019 third quarter earnings conference call with Dion Weisler, HP's President and Chief Executive Officer; and Steve Fieler, HP's Chief Financial Officer; and Enrique Lores, HP's President of Imaging and Printing.

Before handing the call over to Dion, let me remind you that this call is being webcast. A replay of the webcast will be made available on our website shortly after the call for approximately one year. We posted the earnings release and the accompanying slide presentation on our Investor Relations webpage at investor.hp.com.

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

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

We also note that the financial information discussed on this call reflects the estimates based on information available now and could differ materially from the amounts ultimately reported in HP's Form 10-Q for the fiscal quarter ended July 31, 2019 and HP's other SEC filings.

During this webcast, unless otherwise specifically noted, all comparisons are year-over-year comparisons for the corresponding year-ago period. For financial information that has been expressed on a non-GAAP basis, we've included reconciliations to the comparable GAAP information. Please refer to the tables and slide presentation accompanying today's earnings release for those reconciliations.

And now I'll turn it over to Dion.

Dion Weisler

Thanks, Beth. Good afternoon and thank you for joining us. We have a lot to talk about today, and I want to start with the topic that I'm sure is most on your mind. As you've seen I will be stepping down as President and CEO of HP. This is a decision I made following a great deal of reflection and its among the hardest choices I've ever had to make.

There's nothing more important to me than my family, and I'm making a personal decision to return to Australia to attend to a family health matter. Serving as CEO of this great company for the past four years and having the opportunity to work alongside a truly incredible team has been the honor of my career.

I also feel privileged that we've such an incredibly strong bench of capable leaders and robust succession planning at every level of the organization. The HP Board has had a rigorous succession planning process since day one of our company, and this process led the Board to exactly the right leader to usher-in the next era for HP.

After a thorough review and careful consideration of a full bench of external and internal candidates, I rest easy knowing that the company I love is in the best of hands with Enrique as the next CEO.

As you spend time with Enrique and get to know him as I have, you will see why he is uniquely positioned and exactly the right leader HP needs to build on the company's progress and capitalize on future opportunities

Enrique began his career 30 years ago as an HP intern and spent decades becoming one of the company's most accomplished, multifaceted leaders. From his engineering roots and expertise across the print, personal systems and service organizations to leadership roles at a country, region, and worldwide level, Enrique is relentlessly dedicated to serving customers and partners and passionate about next generation innovation.

Since I arrived at HP seven years ago, I've seen what Enrique is made of. He combines the strategic acuity and operational rigor needed to be a great executive, with the passion for people and deep sense of purpose needed to be a trusted leader.

I personally benefitted immensely from his leadership during the separation of Hewlett Packard company in 2015. When we spent many long days together setting HP on its current course. Enrique brought incredible vision to our separation management office and was a key architect of one of the largest, the most complex corporate separations in business history.

He then operationalized the strategy that transformed HP's cost structure, while simplifying the organization and creating the capacity to invest in innovation and drive profitable growth.

More recently Enrique has led a comprehensive global review of HP strategy and business operations, working directly with our Board to define our future operating model and prioritize initiatives that maximize shareholder value.

Just like at separation, he is bringing incredible vision and energy to this work and I know will open exciting new doors for our company. You will no doubt be spending a lot of time with Enrique, but I invited him to our call today to say a few brief words before we dig into

our Q3 results. Enrique?

Enrique Lores

Dion, let me start by thanking you for everything you have done for our company. I have worked for 19 years building my career in HP, and you reflect the values of our founders and our company better than anyone. Your leadership has been a source of strength and it has positioned HP well for the future.

I'm grateful for all the time we've spent working together side-by-side. And I look forward for our continued partnership over the coming months. I know I speak for everyone at HP. When I say that we will always heed your advice to keep raising the bar. You will always be the first CEO of HP, Inc.

I also want to thank HP's Board of Directors for the confidence they have placed in me. And I would like to thank the extent that HP team for their support and key contributions.

30 years ago, I was an engineering student in Spain. A group of HP engineers came to my school to share their passion for a printer. I've never seen anyone so passionate about a product and are changing the world through innovation. It opened my eyes to new and wonderful possibility. It taught me that imagination has no limit, but it inspired me to join this company.

Today, I continue to be inspired by this company and our unique ability to bring out the best of humanity through the power of technology. Each day, our people across the company are constantly creating game changing innovation that pushes the limit of human potential. Our opportunities to grow digital manufacturing and graphics printing, redefine the model of computing and transform print [indiscernible]. This is the magic of HP and it is why I'm so excited about our future.

Since separation, we've built on the foundational things of HP, which include our powerful portfolio, operational excellence, rigorous cost management and purpose driven culture. Yes, as far as we've come, I believe we've great opportunities to do more and to continue our invention journey.

An important part of our strategy is to focus on delivering short-term results and setting the company up for success in the long-term. As part of a review, I've been leading with the Board, we focused on growth, but also in simplifying our operating model, evolving our business model and driving significant improvement in our cost structure. Our end objective is to create a more digitally enabled customer-centric organization.

It's critical that we do some because the needs of our customers are rapidly changing and we must become a more agile organization that is trying to fully capitalize on the opportunities ahead. I've great confidence in our ability to deliver sustainable returns to our shareholders, and I can't wait to share my thinking and vision with you at our Investor Update in October.

I would now like to turn the call back over to Dion and Steve to discuss the third quarter results.

Dion Weisler

Thanks, Enrique. I'm truly proud of the work we've done to reinvent HP and I've no doubt you will be successful.

Now let me turn to the quarter. We have a solid operating and financial foundation in place, which was on display once again in Q3. We delivered revenue of \$14.6 billion, up 2% in constant currency. Non-GAAP earnings per share of \$0.58, up 12% and we generated free cash flow of \$2.2 billion, while returning almost \$800 million to shareholders in the form of stock repurchases and dividends. And we've also raised the midpoint of our full-year non-GAAP EPS guidance.

Our positive performance demonstrates HP's strong foundation and ability to compete successfully in the global marketplace that continues to be shaped by opportunities and challenges including macro and geopolitical uncertainties. These results also reflect a consistent focus on executing our strategy and our leadership in key markets. We are still in the relatively early days of HP's reinvention, and you're going to see Enrique and the team taking actions to build on their progress.

Now let me provide more detail on our business group performance in Q3. It was an exceptional quarter for personal systems with revenue up 6% in constant currency and operating profit increasing 51%. We are achieving these results with incredible innovation across the personal systems portfolio anchored in a relentless focus on customer insights. We launched more than 40 innovations in the quarter. We also continued to invest in key priorities, including new products, services and solutions.

In the commercial business, we're meeting the needs of an increasingly mobile workforce. This quarter, we launched our latest EliteBook x360 lineup, which includes convertibles with up to 24 hours of battery life. More broadly, we continue to expand our security leadership position across our segments.

This quarter, we rolled out HP Sure Sense across our latest EliteBook's and ZBook's leveraging artificial intelligence to enable real time malware protection. It's a similar innovation story in our consumer business where we continue to set new benchmarks in design, performance and security.

Our latest HP ENVY Series features new stunning materials, our integrated privacy screen and the HP webcam kill switch which enables users to electrically turn off their webcams when not in use. No more post-it notes or stickers required. And in gaming, our OMEN ecosystem continues to thrive. At Gamescom this week, we announced a new lineup of having Edge displays and accessories as well as the expansion of OMEN Command Center software and services to enable players at all levels to enhance their competitiveness.

Across personal systems, we're driving an aggressive forward-looking agenda that's reinventing the way people work, live and play and our product's supply chain and go-to-market are well positioned to capture ongoing demand and navigate industry dynamics.

Turning to print, revenue was down 5% driven by supplies. We once again outperformed the market in an increasingly challenging environment. HP continues to lead the print category with a sharp focus on innovative products and services. In the contractual market, which includes A3, we continue making progress and are leveraging our differentiated technology and IP to capture opportunities in the market. We achieved 10% A3 market share in calendar Q2.

From where we started, we've now reached critical mass in this important market segment. We continue to gain traction and scale driven by the strategic decision we made to enter the A3 market and the smooth integration of Samsung printing into our portfolio. More broadly, our contractual office business and consumer Instant Ink portfolio both have gained revenue double digits in the quarter.

In Graphics, we continue to see adoption of our technology as customers increasingly go digital. Our new HP Stitch portfolio is being positively received by customers and we've had several key wins with our HP Indigo Packaging presses. We are also launching new products to address customer needs and adapt to the realities of today's marketplace.

In Q3, we introduced HP Never Stop Laser, the first of its kind in the industry, designed for small business owners in emerging markets. It features toner that can be reloaded in 15 seconds with capacity of up to 5,000 pages with a very competitive cost per copy. We also unveiled HP Smart Tank for home printing, which delivers best-in-class print quality and Ink Tank experience allowing for up to 38% faster printing compared with previous generation.

Turning to Supplies. This category remains a work in progress, particularly in EMEA. We've been aggressively addressing supplies and we're making progress relative to the strategic and operational initiatives we outlined on prior earnings calls. Strategically, we're growing our contractual businesses and adapting our business models.

Operationally, among other actions we've made and continue to make improvements in our business management systems, strengthen our pricing discipline, improve our channel partnerships and lower EMEA channel inventory levels in the Tier 1 and monitored Tier 2 ecosystem. We are also making senior leadership changes in EMEA. We believe these are all important steps in the right direction and there's still more work to do.

We acknowledge that these changes are having a short-term impact on EMEA's results both in terms of the immediacy and the extent of the impact in the second half of fiscal '19. In addition, we are also seeing increasing macroeconomic softness, particularly in EMEA where we saw the most significant revenue declines and industry-wide signs of market softness. This contributed to Q3 supplies revenue being below our prior expectations.

We are focused on doing the right things structurally and operationally for the business, but we need to do more. We are making significant changes in our cost structure and demonstrating market leadership with the scale to navigate a dynamic environment.

Turning to our 3D printing business. This quarter marked another set of important milestones. We opened the doors to 150,000 square foot 3D printing center of excellence in Barcelona. This is HP innovation at its best, bringing together the strength of HP's resources along with our partners and customers and what we believe is the largest and most advanced 3D printing and digital manufacturing R&D center in the world.

We also continue to drive installations with industrial-grade customers and are seeing early traction for our Multi Jet Fusion 5200 solution. We are especially pleased to see customers embracing new data and software capabilities to achieve new levels of industrial manufacturing predictability, reliability efficiency and quality.

Lastly, as we grow our business, we continue to do so in ways that serve the needs of our people, planet and communities. In Q3, we published our annual sustainable impact report documenting the progress we are making. These are not just the right things to do. They're the right things to do for our business. For example, as sustainable impact programs contributed to more than \$900 million of new revenue in 2018, and that's a 35% increase versus the prior year. And we believe this will be a growing source of competitive advantage for HP in the years ahead.

To sum up, we continue to deliver strong earnings and free cash flow, reflecting the power of the broad portfolio we've built and the ability of our teams to navigate market opportunities and challenges. We still have a lot of work ahead. We always will. I've enormous confidence in our business, our strategy and our team, including Enrique as our next CEO. You will see Enrique and the leadership team take actions to make significant changes in our cost structure, advance key strategic priorities and position HP for the future.

Let me now pass the call over to Steve for more insight into this quarter's financial results.

Steve Fieler

Thanks, Dion. Before I go through the results, I just want to thank you for your leadership of HP. I appreciate your partnership and you know that I won't be removing you from my speed dial just yet. And Enrique has already been on my speed dial for a long time, so that won't change. I look forward to a seamless transition in our partnership going forward.

Our third quarter performance reinforces HP's ability to deliver consistent company results, profitably grow and effectively manage our broad-based portfolio. In Q3, we grew operating profit dollars, generated strong cash flow and delivered double-digit non-GAAP EPS growth.

Our financial performance this quarter demonstrates our ability to successfully invest in our business while delivering strong financial results. We remained focused on pursuing returns based opportunities ahead of us, while also addressing challenges when we've them. This helps set up the company to deliver in the short-term and generate long-term value creation.

Let's look at the details of the third quarter. Net revenue was \$14.6 billion flat year-on-year or up 2% in constant currency. Regionally, in constant currency, Americas and EMEA were flat and APJ grew 11%. Gross margin was 19.9%, up 1.5 percentage points year-on-year, driven by disciplined execution, and improved rate in personal systems.

Non-GAAP operating expenses were \$1.8 billion, up 9% driven by increased investments for both growth and efficiency, including investments in innovation, targeted marketing spend as well as investments in HP's digital infrastructure. Non-GAAP net OI&E expense was \$68 million for the quarter. We delivered non-GAAP diluted net earnings per share of \$0.58, up \$0.06 or 12% with a diluted share count of approximately 1.5 billion shares.

Non-GAAP diluted net earnings per share excludes amortization of intangible assets of \$23 million, acquisition related credits of \$12 million, restructuring and other charges of \$14 million as well as non-operating retirement related credits of \$19 million. It also excludes a net gain of \$305 million for tax adjustment. This net gain is primarily driven by the net income tax gains resulting from several tax settlements across various jurisdictions. Partially offset by the tax indemnification associated with these gains recorded an OI&E, which is part of the Hewlett-Packard Enterprise Tax Matters Agreement. As a result, Q3 GAAP diluted net earnings per share was \$0.78.

At the segment level, in Personal Systems, we are very pleased with our results. Revenue in the third quarter was \$9.7 billion, up 3% or 6% in constant currency. By customer segment, we once again saw divergence in performance with commercial revenue up 10% and consumer revenue down 11%.

By product category, revenue was up 8% for desktops, up 4% for workstations and flat for notebooks. The team continued to successfully manage our overall product mix as commercial demand remains strong, while navigating some of the softer consumer markets.

Q3 operating margins were very strong at 5.6%, up 1.7 points year-on-year. The exceptionally large increase was driven mainly by the teams continuous focus on our strategy and disciplined execution in a favorable commodity cost environment. Operating profit was \$547 million, up \$185 million from the prior year.

In print, the business outperformed a more difficult market. That being said, the results were mixed. We grew commercial hardware revenue, increased our market share and continue to make progress in our contractual offerings. However, operating margins were down 0.4 points to 15.6% due to lower supplies revenue.

Looking at the details, Q3 total print revenue was \$4.9 billion, down 5% nominally and in constant currency. Commercial hardware revenue was up 3% and consumer hardware revenue was down 10%. Total hardware units were down 9% with commercial units down 4% and consumer units down 10%. In calendar Q2, HP gained market share to 44% as the overall market declined.

Third quarter supplies revenue was \$3.2 billion, down 7% in constant currency with EMEA down in the mid-teens. Tier 1 channel inventory levels remained below the reduced ceilings. We are making progress on the operational and strategic plans described in prior quarters and remain confident we are taking the right actions. However, with the increasing softness in the EMEA market, we expect supplies revenue to remain weak in Q4 as we continue to make progress on our plans, and thus, we expect supplies revenue to decline approximately 4% to 5% for the full fiscal year.

Looking forward, we expect to take significantly more cost out of the business, while also making more financial shifts in our business model across our combined hardware services and supplies profit pools. The combination of these operational, market and strategic factors means that we are not planning for supplies revenue to grow in FY '20. Importantly, having said that, at our next Investor Update, we will share the multiple levers we have that give us confidence in growing non-GAAP EPS in FY '20.

Turning to cash flow and capital allocation. Q3 cash flow from operations and free cash flow were very strong at \$2.3 billion and \$2.2 billion, respectively. In Q3, the cash conversion cycle was minus 36 days. Sequentially, cash conversion cycle improved 4 days in line with normal seasonality with a 3-day increase in days payable outstanding, a 2-day decrease in days sales outstanding and a 1-day increase in days of inventory.

We returned \$533 million to shareholders through share repurchases and \$240 million via cash dividends in Q3. Year-to-date, we've returned 75% of free cash flow to shareholders.

Looking forward to Q4, keep the following in mind related to our overall financial outlook. We continue to expect a headwind from currency. In Personal Systems, we expect the pricing environment to be competitive, and in Print, we expect the market to remain soft in the fourth quarter. In addition, for the full-year, we continue to expect our non-GAAP tax rate which is based on our long-term non-GAAP financial projection to be 16% in FY '19.

Taking these considerations into account, we are providing the following outlook, Q4 '19 non-GAAP diluted net earnings per share to be in the range of \$0.55 to \$0.59. Q4 '19 GAAP diluted net earnings per share to be in the range of \$0.51 to \$0.55. We are raising our full-year fiscal 2019 non-GAAP diluted net earnings per share to be in the range of \$2.18 to \$2.22 and full-year fiscal '19 GAAP diluted net earnings per share to be in the range of \$2.31 to \$2.35. And we continue to expect to return approximately 75% of free cash flow to shareholders through a combination of dividends and share repurchases over the course of the full fiscal year.

Operator, let's open the call for questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question will come from Katy Huberty with Morgan Stanley. Please go ahead.

Katy Huberty

Thank you. Good afternoon. Dion, I've really enjoyed watching you succeed as CEO, sorry to see you go, but best wishes for both you and your family. In terms of questions, the midpoint of fiscal fourth quarter EPS guidance is down a penny versus the fiscal third quarter. If you look at the past two years, EPS expanded in the fourth quarter. Can you just talk about some of the incremental headwinds that are driving the worst seasonality this year? And then I have a follow-up.

Steve Fieler

Sure. I will take that one, Katy. We've been steadily delivering all year on our EPS, and as you know we did increase the full-year outlook on the strength of Q3. I would describe Q4, we remain prudent and balancing our current view of the risks and opportunities. Maybe I will just touch a little bit on what we're thinking in our outlook for Personal Systems and Print. So for Personal Systems, I will still have a CPU constrained environment across certain products. We are assuming that the incremental China tariffs on notebooks do not happen in Q4 according to the existing plan of record. But importantly for the guidance, we're expecting a dynamic and competitive pricing environment with some of the supply chain costs and benefits we had in Q3 softening as we enter into Q4. So in essence the headwind we are seeing in FX offset by some of the supply chain tailwind that we've had from a cost perspective will steady out in Q4. In Print, expecting the overall print market to be soft. We will continue to look for opportunities to place units. That being said, we do expect that the units could be impacted, assuming the tariffs are impacted, which could, I mean, we've raised prices and could impact units, but less of an issue on operating profit dollars. We are expecting supplies decline closer to our Q3 results in Q4, but we do expect to drive overall expense management. So when I take that all into account, it's sort of a prudent guide, with confidence we can deliver within the range of \$0.55 to \$0.59.

Katy Huberty

Thank you for that. Printer supplies as you mentioned down 7% was worse than expected, you talked about some of the macro headwinds. But how did you perform in the inventory drawdown in EMEA. Your partner Canon suggested that the drawdown is now over and growth can improve in the back half of the year. Do you share that view, or how much inventory depletion and investment to drive branded supplies market share is still left to come into the model in the fourth quarter?

Steve Fieler

So I said previously, the sizing of the overall inventory is a triangulation, given our lack of visibility into the entire channel ecosystem. But I will start with some of the data to address your point Katy, and then I will provide some additional color. So in EMEA, since Q1, we brought down our channel inventory dollars that we monitor, so this is both the Tier 1 and parts of the Tier 2 where we have visibility. The total channel inventory dollar reduction is nearly the \$100 million that we initially estimated. So we've made good progress.

However, it's not possible to specifically quantify what impact we've made in the rest of the unmonitored downstream ecosystem. In addition, we do know that we've been reducing channel inventory dollars at the same time the EMEA market is softening, which is the right thing to do, an important business discipline. It does make it more difficult to distinguish the market factors versus operational factors. It's important that we continue to maintain our Tier 1 channel inventory under the reduced ceilings globally, which we are, and we're also improving the monitoring of our Tier 2.

Operator

Our next question will come from Shannon Cross with Cross Research. Please go ahead.

Shannon Cross

Thank you very much. And Dion, I want to echo Katie's comments. We've enjoyed working with you and we want to hope for the best for your family. My first question is just -- if we can understand a bit more about what's going on in printing and I don't know if Enrique is still around, but I would be curious as to how much of this seems to be a secular shift. I

mean, we started to hear a lot more concern out of the Japanese in the most recent quarter that they've reported relative to some of their prior commentary, not just Canon but others. So I'm curious if there's something really changing here or if you think it's more again the macro pressures? And then I have a follow-up. Thank you.

Enrique Lores

So, Shannon, thank you for the question. Let me talk first about supplies and then I will give you an overall view of the print market. On the supplies space, as we discussed in Q1, we see two different type of issues, some are operational, some are strategic. The strategic issues are going to be -- we will have a longer term impact and we think it will be impacting us not only this year, but also the years to come and this has -- though that some of our competitors have also been highlighting. During the last year, we have created a very attractive profit pool of supplies that now has attracted many other companies to try to attack it and capture a portion of it without having to have a significant investment that are necessary to create a hardware installed base. And because of that, we see an erosion of the overall profit pool that according to our model means a reduction in share and a reduction in price. We are experiencing that and many of our other competitors have experienced in similar dynamics. On top of that, during the last quarter, we've seen a slowdown in the economy -- we've seen an economic slowdown. And this is also having an impact, especially in the consumer side. So when we look at the combination of all the factors I described, you can understand, many of the comments that many of the other companies in the industry have been making during the last quarter.

Shannon Cross

Thank you. And maybe, I don't know if you want to take my follow-up question, but I'm curious as -- and I know I'm not trying to front run what you're going to say at the Analyst Day. But as you look at some of the top line pressures that you're facing and the fact that PCs are going to go probably will be under pressure next year, following the end of life for Win 7 and the Win 10 refresh. How does that impact your thoughts on investment in some of the other areas that the company is looking at like 3D printing and the A3 market? Will that shift any of where the spend is going? Thank you.

Steve Fieler

I will maybe address that first and then Rick, if you want to chime in. Shannon, so I think the reality is that we expect to continue to do both. It's about investments, innovation and also productivity and efficiency. And as you heard in our prepared remarks from both Dion, Enrique and myself, we do think that there's an opportunity to take significant cost out of the business, while maintaining our investments for growth. I mean just to give you a little bit of context as you all see in our P&L, but we've got over \$50 billion of annual spend. So we've got a rather large addressable spend opportunity to go after across cost of goods in OpEx. So really every percentage point here really matters. And so you will be hearing more about the opportunities we see in the months ahead at the Investor Day. But overall, we can sort of align our cost activities with our growth in investing activities.

Enrique Lores

I think Shannon you will see that our plan going forward is going to be aligned around three different complementary directions. First, we need to continue to expand into some of the growth opportunities that we had identified in the past, 3D printing, contractual businesses are all opportunities for us to grow. At the same time, we need to continue evolving our business model. I highlighted that already last year during the Investor Day and we will share some of the progress and the plans that we've to double down in this space. And third, we've a great opportunity to create value by continuing to simplify our company, get close to customers -- getting closer to customers at all and also reduce our cost structure, because this reduction in cost structure will give us also the opportunity and the capacity to continue to invest in the growth area.

Dion Weisler

To get to round that out, I will just finally say that that's what gives all of us, myself, Steve and Enrique the confidence of these multiple levers that we see and gives us that confidence in our ability to grow EPS again next year.

Operator

Our next question will come from Toni Sacconaghi with Bernstein. Please go ahead.

Toni Sacconaghi

Yes, thank you and let me reiterate previous comments. Dion, I wish you all the best and for your family going forward and Enrique look forward to working with you more closely. I just wanted to follow-up on the printing. So it sounds like things have gotten notably worse in the last couple of months because as you noted your guidance originally was supplies to be down 3% and you were tracking to that through the first half of the year and now you're suggesting it's going to be down 4%, 5%, which suggests that the second half is going to be down 6% or 7% which is dramatically worse than you had thought, and I think initially you have thought through tactical improvement, things might actually get a little progressively better over the course of the year. And so if I just reflect on the magnitude of that change and outlook, are you really suggesting that most of this is a bigger strategic headwind from cloning and alternatives than you had originally thought, or are you suggesting that the economic weakness in Europe is the principal driver because, I guess, my observation would be globally the economy is still pretty healthy. And so if we're seeing with relatively healthy global economy normalized supplies growth is minus 6% or minus 7%, that's pretty rough to me. So perhaps you could clarify that and I have a follow-up, please.

Steve Fieler

So, I think maybe provide some financial context and hand over to Dion for additional color. So in the first half, our total supplies revenue was down 3%, EMEA was down roughly 9% in the same period, and then in Q3, total supplies was down 7% with EMEA down mid-teens. I say that because I want to be very clear that our supplies performance continues to be driven by EMEA.

Dion Weisler

Yes, let me Toni add a bit of context here. There's two primary factors here that are occurring simultaneously. The first one is, as we look across the macroeconomic environment, particularly in EMEA, we are seeing even more uncertainty in industry-wide market softness. And secondly, as I described in my prepared remarks, we're making progress in the plans we outlined on the prior earnings calls and are taking the appropriate structural and operational actions, including our marketing and our brand protection business management systems as well as our deal pricing discipline that we've talked

about in the past, just to name a few. In addition, we're making senior management changes in EMEA, and all of these are designed to put our EMEA print business on a stronger footing. And while we had expected that these changes would create short-term impact in the channel, we underestimated the immediacy of the reaction and the size of the impact on the back half of the year and it's the combination of these two factors that have the larger than anticipated decline in EMEA. But as Steve mentioned in his prepared remarks, we are confident that in spite of all of this, we can navigate through these challenges and hit our senior metrics of EPS and free cash flow. And finally, we're confident in the multiple levers that we see and that again gives us confidence in our ability to grow EPS again next year.

Toni Sacconaghi

Thank you for that. Just to change topics. As you noted that the PC margins were exceptionally strong this quarter. And Steve it sounded like your guidance for Q4 in your description of a more competitive PC environment was suggesting that margins may not be as strong. But how do we think about normalized PC margins? I think you had at one point said 3% to 5% and then sort of lowered that to 3% to 4%. What do you think is normalized and how quickly do you feel that the following component prices will ultimately be passed along to end customers?

Steve Fieler

So we do view Q3 as an exceptional quarter for us growing operating profit dollars at \$185 million in personal systems alone and I do want to give kudos to the team that stuck with this strategy. They've remained disciplined, candidly they've been remained disciplined all year with the year-to-date performance of 4.7% op margins and over \$300 million of profit drop on that segment alone. But to directly address your question, we do expect margins to normalize back, I would say into the 3% to 5% range, Toni. Our goal of approaching the higher end of that over time. There will always be more shorter-term headwinds and tailwinds whether it be commodity costs, FX, other pricing dynamics that tend to move pretty rapidly. What we're focused on is the longer-term shift of our mix and improvement

of our portfolio across our products and services, and this is a stickier more structural margin improvement that we expect to get over time, again, with the goal of getting to the higher end of that 3% to 5% over the years ahead.

Dion Weisler

And I think, Toni, you've seen the team very consistently over multiple years deliver against that strategy and that's what you can expect from us in the future.

Operator

Our next question will come from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani

Thanks a lot for taking my question guys. And Dion best wishes to you and your family in the future. I guess two questions from me as well. Given the supplies discussion we've had so far versus what you guys thought 90 days ago, how much of the shortfall is the macro getting worse versus execution issue. Is there a way to split those two buckets up? And then Dion or Enrique, I would love to hear your conviction and confidence on why you think these issues not spread beyond EMEA to North America or APJ as well?

Steve Fieler

So on the first part of it, it's really hard to bifurcate the data between what's the two actions -- the two items that Dion described sort of the actions we're taking in the market and how that's changed. What I will highlight, I think it's important to highlight is, if you just reflect in the first half of the year in Print, our supplies were down 3% and we grew operating profit dollars in that period. And I do want to acknowledge, we did not grow op dollars in Print in Q3, given the larger supplies decline. But we do have multiple levers across our print business from more profitability in our hardware services, more growth in our growth initiatives as well as cost structure items to address in print. So there are other levers beyond supplies.

Dion Weisler

Yes, I will also chime in here and I'll ask Enrique to give us his thoughts. But as I discussed in Q2, we continue to make progress on the action plans that I laid out in February. Our supplies task force is really taking the appropriate and very decisive steps in EMEA to put our supplies business in better fighting shape in light of the industry-wide and macro headwinds that we're seeing. We expected an impact from these actions of the size and the timing of the ripples caused in the back half of this year is something that we underestimated, and I'm sure Enrique can give you sort of a little more color on our progress there as well.

Enrique Lores

Okay. So let me cover first some of the operational improvements that we've made, because as we outlined in Q1, the nature of the [indiscernible] had both an operational and a strategic side. On the operational side, we outlined four areas of progress, so let me share some of them. We said that we needed to increase our investment in demand generation in the online side. We have done that and we are seeing the progress. For example, in most of the key European market, we've seen at 10 point improvement in coverage when customers look for our -- for supplies in Google. We have also double down in our brand protection activities both increasing our efforts to fight counterfeit, but also in protecting our IP. And protecting our IP is something that we've done by ourselves. But those of you who have been kind on taking very decisive actions in the side of the portfolio where they own the IP. We have also continued to improve the visibility that we have in the Tier 2 space, and just in Europe we have increased the number of reporting partners by 50%. And as Dion said in Q1, we have also improved our business management systems. We have centralized pricing decisions and we've changed and improve the controls over our -- around our discount policy again to make sure that we manage the business more effectively. As you can see, this had -- the role is very broad and deep action and it will take some time until we see the full effect of all of those.

Operator

Our next question will come from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah

Hi. Good afternoon. Thanks for taking the questions and again Dion I will echo the same as everybody on the call. It's been great working with you thought you did just a really fantastic job with the company. And wish you and your family all the best in the future. So, yes, good luck. Two if I could. I guess just sticking with supplies and then I have one on PCs, any sense of how long you think I guess getting to sort of, call it, critical mass with some of the structural channel dynamics in Europe would take. It sounds like you have some sense of what's going on since you've adjusted the guidance here. And then maybe you're going to give up your guidance at the Analyst Day, but it would be helpful if we could get some sense of how many quarters we are -- how many months we are when you guys kind of giving structural critical mass? And then I have a follow-up.

Steve Fieler

So maybe I will take that one first. And as I said in my prepared remarks, and I think Enrique went into a long detail about FY '20 and the strategic and operational things. So I would bifurcate the two. So on the operational side, what we're driving in EMEA, we are making good progress. And yes, the timing to the extent in sort of the immediacy of the impact was higher than we anticipated. But we are making good progress and would expect to work through these operational changes in a relatively short order in the quarters to come. As it relates to the more strategic impact that's a more sustainable impact for us. And it is really the primary driver of why we don't expect supplies to grow in FY '20. That being said, as I commented previously, we have multiple levers. We have demonstrated this through the first half of the year of growing operating profit dollars even with our supplies business declining. We've got levers around the growth initiatives that we're driving. We got leverage around the business model itself. The shift to contractual. The shift to more profit in hardware and services itself. And we got levers around our cost structure and the significant cost saving opportunities. And these things holistically is why we have confidence in our EPS plans for next year to grow. We've been working on this plan as a team. Enrique, Dion, myself and the leadership team and we're all confident in our ability to grow EPS next year.

Enrique Lores

I have a little to answer. The strategic problem on the supply side will be we are addressing by business model changes. The acceleration of our printing as a service business is critical there. You have seen us introducing printing with a different business model, both on the Ink side and in the Laser side. And actually we are leading now many of these markets, and also we will be looking at our cost structure. We will continue to reduce our cost structure to make sure that we deliver on the EPS goals, that Steve was mentioning before.

Steve Fieler

We look forward to lining all these plans out with you at the Investor Meeting.

Ananda Baruah

And guys, is it possible to return to growth at any quarter in fiscal year '20?

Steve Fieler

I'm assuming that question was in relation to supplies. And I don't think we want to get and comment specifically on any particular quarter.

Again, I think we're looking at our portfolio holistically about ability to drive the company results both earnings per share and cash flow. I do want to also highlight we have a strong personal systems business that represented 42% of our operating profit in Q3. So we have multiple levers at our company to grow our earnings per share.

Operator

Our next question will come from Tim Long with Barclays. Please go ahead.

Tim Long

Thank you. Yes, just two if I could. First, could you just give us a little color on the personal systems side, consumer has been tough the last few quarters. Could you just give us a little insight into what it's going to take to get that segment going again? And then second

on the A3 side, you mentioned getting to 10% and getting some scale there. What does that scale mean? When will we start seeing some more supplies pull through? What does that scale gain you when it comes to the financial model? Thank you.

Steve Fieler

Yes, so when we look at our personal systems results, and actually our company results, we did see a softer consumer similar to what we saw last quarter and a stronger commercial. I think when we look at the results we are seeing softer consumer across the board with a stronger commercial. Some of that is driven on the personal systems side by the supply and availability of supply we're getting and demand shaping as appropriate. It's important that you all understand we've got a very diversified portfolio across consumer and commercial even commercial is SMB enterprise and we sell it to the industrial space. So given the diversity of the geographies we play in and the product portfolio that we have and customer segments that we plan, we feel like we can manage through up and down environment.

Dion Weisler

Yes and as it relates to the second question, we've said all along that will be very strategic and systematic in how we go after this \$50 billion plus A3 market. I've also said on many occasions that customers don't think about their printing in context of A3 or A4, in fact, many of them don't even know the difference. They think about their overall printing solutions, and I realize that we said a 12% share target by the end of 2020. But our overall focus has always been on building a contractual business and A3 is a key element of that strategy. It's also been important that we validate our technology and achieve critical mass in a competitive field and we're doing just that. We achieved double-digit market share at 10% and we expanded our OEM partnership that we announced earlier in Q3 with Xerox which further validates the strength of our strategy and the product portfolio. So I'm really not fixated on getting to 12% share by any particular period, and I'm not saying that we will or we won't. But what is important is we build the right distribution and partners to penetrate the contractual office. So from the customers' perspective which is what guides us. What I can say is the overall printing solution is what matters most. And when you combine our A3 products, our technology, our channel and our overall capabilities and

then couple that with our market leading A4 presence, we really have a very compelling and formidable portfolio. So remember our larger strategy is to grow in contractual and to evolve our business model into more services and solutions.

Operator

Our next question will come from Jeriel Ong with Deutsche Bank. Please go ahead.

Jeriel Ong

Hi, guys. Thanks for letting me ask the question. So print margins have degraded to kind of the lowest point in at least a couple of years. I think asking -- focusing on printing a different way, is there a scenario where print margins maintain even if supplies revenue decline and what would be the growth drivers in other businesses perhaps to get the margins to stabilize?

Steve Fieler

I think it's important that we communicate our focus is on operating profit dollars. It always has been. It's op dollars and not related to any particular quarter. As I alluded to earlier, we have different levers not just supplies to drive more profit dollars. As it relates to the rate specifically, we did deliver a 15.6% op margins in Q3, it is below our target of at least 16%. I would expect Q4 margins to remain weaker given my supplies commentary and probably be more in the range of our Q3 margins as we work through the EMEA supplies challenges in overall print market weakness. That being said, in the near-term, our annual op margin target remains at at least 16%. But to reiterate our focus is on op dollars and opportunities to drive even more operating profit dollars outside of supplies with the items I talked about earlier today.

Dion Weisler

And look additionally I will add that at the company level, we're really proud of how we manage our total portfolio and we continue to deliver consistently against our senior metrics of earnings per share and free cash flow. The commitments that we make. I think

you should draw a great comfort from this and this highly experienced team knows how to operate in both up and down markets and how to respond positively to the inevitable business challenges that are just part of business.

Jeriel Ong

Got it. I appreciate that. I got another one, but I will flip over to the PC side. There's about 130 basis point improvement quarter-on-quarter in margins. So it seems like while some of your peers might have seen better margins in their PC business is a quarter earlier probably due to memory components. It seems like you're predominantly seeing the memory prices better in the latest quarter. I guess is there any way that you guys have thought about breaking down how much of this quarter-on-quarter increase in margins was due to components versus perhaps better mix from more consumer versus -- or better mix from more commercial versus consumer. I'm sorry. And any way you can break that down for us?

Steve Fieler

Well, I would say it's all of the above. I mean we continue to make progress. The team has been very disciplined with our pricing strategy, but are also -- our overall personal systems mix on a year-over-year basis continues to improve. I don't think I'm going to break it down specifically, but it is to the earlier question, I believe, from Toni, our operating margin rate target is between 3% to 5%, and over time our plans are to drive to the upper end of that rate.

Dion Weisler

So unfortunately, we are out of time and I want to thank everyone for joining us today. I also want to extend a personal thank you to all of you for your warm wishes and for your personal support over the years. It's been an honor working with you. We obviously have a lot to talk about today. Four years ago, many people doubted this business. We didn't -- we reinvigorated this business and reinvented HP. The team's executing against our strategy and investing in innovation, while simultaneously taking cost out of the business and we always have to do both. As a result, we've delivered consistent free cash flow and met or exceeded our non-GAAP EPS outlook for the last 15 out of 15 quarters. I like that

batting average. Enrique you need to continue that. We have strong foundation, a really strong foundation, a powerful portfolio. We have world class talent, we have a culture of performance. It's been an honor to serve as CEO of this iconic company. Enrique has been a tremendous partner to me as we've reinvented HP and I couldn't be more excited and optimistic for him and for the future of HP under his leadership. I'm 100% focused on finishing out Q4 and the fiscal year and to ensuring a smooth transition at the company that I love and then to look forward to continue to guide the company as a Director moving forward. Thank you very much.

Operator

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