25-Feb-2021

HP, Inc. (HPQ)

Q1 2021 Earnings Call

CORPORATE PARTICIPANTS

Beth Howe
Vice President, Head of Investor Relations, HP, Inc.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

Marie Myers
Chief Financial Officer, HP, Inc.

OTHER PARTICIPANTS

Shannon Cross
Analyst, Cross Research

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Toni Sacconaghi
Analyst, Sanford C. Bernstein & Co. LLC

Amit Daryanani
Analyst, Evercore Group LLC

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Krish Sankar
Analyst, Cowen and Company, LLC

Wamsi Mohan
Analyst, BofA Securities, Inc.

David Vogt
Analyst, UBS

Jim Suva
Analyst, Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone. And welcome to the First Quarter 2021 HP, Inc. Earnings Conference Call. My name is Ailey, and I'll be your conference moderator for today's call. At this time, all participants will be in listen-only mode. We will be facilitating a question-and-answer session toward 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
Vice President, Head of Investor Relations, HP, Inc.

Good afternoon, everyone. And welcome to HP's first quarter 2021 earnings conference call. With me today are Enrique Lores, HP's President and Chief Executive Officer, and Marie Myers, HP's Chief Financial Officer. Before handing the call over to Enrique, let me remind you that this call is being webcast. A replay of this webcast will be made available on our website shortly after the call for approximately one year.

Earlier today, we issued our earnings release, and we have posted the 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 these risks, uncertainties, and assumptions, please refer to HP's SEC reports, including our most recent Form 10-K. HP assumes no obligation and does not intend to update any such forward-looking statements.

We also note that the financial information discussed on this call reflects estimates based on information available now and could differ materially from the amounts ultimately reported in HP's Form 10-Q for the fiscal quarter ended January 31, 2021, and HP's other SEC filings. During this webcast, unless otherwise specifically noted, all comparisons are year-over-year comparisons with a 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 Enrique.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you, Beth. And thank you, everyone, for joining the call today. I hope you and your families are safe and well. HP had an exceptional start to the year, with strong revenue and profit growth in Q1. We are benefiting from the strength of our portfolio and the diversity of our businesses. We continue to evolve our business models to meet changing customers' needs, while expanding into adjacencies to grow our addressable markets, and we are driving an aggressive transformation agenda by regularly managing our costs, while investing to drive future growth. Simply put, we are doing what we said we would do, and our strategy is working.

Our Q1 results are impressive across many dimensions. We delivered strong top-line growth with net revenue up 7% to $15.6 billion, and balanced growth across Personal Systems and Print. We delivered strong bottom-line growth with $295 million in non-GAAP operating profit dollar flow-through and double-digit profit growth in both Personal Systems and Print. We delivered non-GAAP net earnings of $1.2 billion, up 24%, with $0.92 of non-GAAP diluted net earnings per share. This is up $0.27 compared to Q1 of last year. And finally, we delivered $108 million of free cash flow in the quarter. We also remain committed to significant return of capital. We returned $1.6 billion to shareholders including $1.4 billion in share repurchases and $250 million in dividends. Over the last three quarters, we have returned $4.4 billion to shareholders and repurchased approximately 13% of our shares.

At the onset of the pandemic, I told our teams that this is a time when strong companies find ways to emerge stronger, and last quarter's results show that's exactly what we are doing. HP's broad and differentiated portfolio and leadership across consumer and commercial markets make us more resilient across business cycles. We continue to capitalize on the strong demand for our offering, particularly in consumer to drive profitable growth. Yet, the impact of the pandemic is ongoing, and the pace of the economic recovery remains uneven. We are continuing to manage our business in a disciplined and prudent manner, while remaining agile in the face of change

This means capitalizing on opportunities when they arise, while also managing volatility when need occurs. As we balance all of these dynamics, we have stayed focused on executing against our strategy to advance our leadership in Personal Systems and Print by optimizing our core and expanding into attractive adjacencies, disrupt industries with our technology to create new businesses in areas like 3D, industrial print and microfluidics, and transform the way we work to be more digitally enabled and cost efficient.

Our continued progress against these strategic priorities is reflected in the strong revenue and profit growth, free cash flow and capital returns we delivered in Q1, and in the positive momentum in each of our businesses. I will start with Personal Systems, which had another strong quarter with revenue of $10.6 billion. We shipped more than 18 million units and generated operating margins of 7.1%. Consumer revenue growth accelerated to 34%

with consumer premium up 34%, gaming up 29% and consumer accessories up 22%. And on top of this, Chromebook revenue quadrupled. We exited the quarter with a record backlog as we continued to operate with component supply shortages that are expected to constrain our growth through at least Q3.

It's clear we have entered a new era of innovation and growth for PCs. They have become an essential part of how people work, learn and play, and we continue to innovate to create new experiences. It's funny to say, but the PC is personal once again, and we are seeing this in the awards we are receiving. At last month's Consumer Electronics Show, we introduced new devices and solutions to power hybrid work environments and personal creative studios, and we were recognized with over 70 awards for our latest launches including our new 5G-enabled products. Looking ahead, we expect to see continued PC unit growth through 2021, which we anticipate will create additional opportunities for us to drive profitable growth.

We are also accelerating in attractive adjacencies such as gaming and peripherals. As with every market in which we play, our goal is to be a leader in this space. This week, we announced the acquisition of HyperX, the market leader in gaming headsets. The addition of HyperX expands our presence in the growing peripherals market with a brand that is trusted by gamers around the world. Our existing strength in gaming hardware combined with HyperX portfolio spanning gaming headsets, microphones and other peripherals, will further expand our ecosystem and create another growth engine in Personal Systems.

Much like Personal Systems, Print is off to a terrific start to the year. This quarter demonstrated the power of Print to help people learn, create and perform with 7% revenue growth, 16% unit growth, and 32% profit growth. In Q1, our Printing business generated revenue of $5 billion and operating profit of $1 billion. Similar to the Personal Systems business, we'll remain supply constrained, particularly in consumer printer hardware and supplies. While the COVID-19-related impacts on our manufacturing and supply chain have diminished, we anticipate these constraints to continue into the third quarter.

HP is outperforming its Printing peers and remains uniquely well-positioned given our leadership across both Consumer and Commercial Print. Our strong Consumer business is a clear competitive advantage as hybrid work and school becomes the norm. We have seen that people who didn't have home printers went and bought them, and people sign up for Instant Ink in record numbers, accelerating an already growing part of our business. In Instant Ink, we added 1 million new subscribers, surpassing 9 million enrollees in the first quarter.

Commercial Print improved in Q1 with most product categories showing sequential revenue growth. In CQ4, total Print market units grew 6%. We continue to expect a gradual recovery in the overall Commercial Print market, though the pace might be uneven given the varying pace of economic recovery. And we expect that the strength in Consumer will gradually subside as more schools and offices reopen. We continue to execute on our strategy to modernize Print and evolve our Print business models. In Q1, we roll out our end-to-end platform strategy called HP+, that combined convenient Instant Ink and HP Smart app services with innovative hardware. It's early days, but we are already seeing positive adoption. In the coming quarters, we will be rolling HP+ out more broadly across multiple markets and product lines.

New value propositions like HP+ are indicative of the opportunities ahead as we continue to innovate to meet evolving customer needs. This also applies to our contractual businesses such as Managed Print Services, where we see attractive opportunities to deliver services designed for the hybrid workforce of the future. One example is our HP Flexworker Service. This service can be added to a company existing MPS contract to help remote workers maintain their productivity. This means being able to seamlessly print, scan and copy securely, all while working from home. With leadership in both Consumer and Commercial, and a strong track record of innovation, HP is positioned to define and lead the future of Printing in a post-pandemic world.

In 3D Printing and industrial graphics, we continue to innovate across the portfolio to position ourselves for future growth. Customers continue to use Multi Jet Fusion for production-grade output and we are seeing more than 30% growth in the number of 3D-printed parts across our customer base. We are also seeing strong early traction in our new Molded Fiber business that leverages our 3D Printing technology to create an end-to-end service for a quick, customized and environmentally sustainable packaging.

In industrial printing, we continue to see growth in digital labels and packaging, with double-digit growth in impressions and square meters printed. Georgia-Pacific, one of the world's largest packaging and paper goods providers, is deploying their third inkjet web press to expand their digital printing business. This is a great milestone and validation of our technology. We are excited for the disruptive potential in this sector as our innovative technology opens up entirely new possibilities in personalization and digital manufacturing.

We are doing all this, while continuing to transform the company to unlock value and become a leaner, more digitally enabled company. Our transformation journey continues to be ahead of plan. We have significantly reduced structural costs and driven productivity savings. At the same time, we're enabling enhanced digitization and we're shifting investments to attractive growth areas where we see opportunities for us to continue driving innovation and long-term sustainable growth. We are focused on both reducing structural cost and accelerating investments for the future.

Recently, we announced several new appointments to further strengthen HP's innovation capabilities and support its long-term growth strategy. Savi Baveja joined as our Chief Strategy and Incubation Officer. And Tolga Kurtoglu has joined HP as Chief Technology Officer. In these roles, they will drive cutting-edge research and incubate new business opportunities working together with the leadership team. And last week, we named Marie Myers as our Chief Financial Officer. Marie is a veteran of HP, having held a number of leadership positions at the company, including as our Controller and most recently as our Chief Transformation Officer. Marie and I have worked together for many years, and she's a truly outstanding leader. I know you will all enjoy getting to know her better.

Overall, I am very pleased with the way we have started the year. We built on our momentum from the end of 2020 and our teams are performing at a very high level. And on top of delivering strong results, we are also staying true to HP's values. Last quarter, HP was recognized by Newsweek as America's Most Responsible Company for the second straight year, and we appear on the Barron's list of 100 Most Sustainable Companies for the third straight year. In December, we were named one of the ten Best-Managed Companies by The Wall Street Journal. These accolades simply mean that we continue to ensure that making a sustainable impact remains an integrated part of our business strategy.

Let me close by saying Q1 was a strong quarter that increases our confidence about the opportunities ahead. We have a diverse and resilient business model. We are leading in our core Print and Personal Systems markets, while taking the steps necessary to create and scale new businesses for the future, and our strong cash flow generation provide us flexibility to return significant capital to shareholders, and invest in businesses, while also exploring disciplined M&A.

We believe this is a time when strong, successful companies, like HP, can get stronger. We are not running our business to achieve incremental improvements. We are driving a much bolder transformation agenda that will expand our portfolio, fuel innovation and unlock attractive new sources of long-term growth and value creation. That is our ambition.

With that, I will turn the call over to Marie who will take you through the details of the quarter and our fiscal year outlook. Marie, over to you.

Marie Myers

Chief Financial Officer, HP, Inc.

It's great to be with all of you today and I wanted to thank Enrique for his trust in me as his finance partner. I'm excited to take on the CFO role after more than two decades at HP. I'm looking forward to getting to know the investment community as I settle into my new role. It's clear that HP remains focused on executing each quarter, while also positioning the company for the future, and our results demonstrate this balance of delivering in the near-term, while investing in growth and leading through this dynamic environment. Q1 was a very strong quarter. We grew revenue, non-GAAP operating profit dollars faster than revenue, and non-GAAP EPS even faster. We are off to a strong start for the year and overall, we are very pleased with our results.

Now, let's look at the details of the first quarter. Q1 net revenue was $15.6 billion, up 7% both nominally and in constant currency. Regionally in constant currency, Americas increased 17%, EMEA increased 3% and APJ decreased 5%. Gross margin was 21.2%, up 1.6 points year-on-year. The increase was driven by favorable pricing and commodity costs in Personal Systems and favorable pricing in Printing, particularly in consumer hardware. Non-GAAP operating expenses were $1.8 billion, up $157 million. The increase in operating expenses was driven by investments to position for future growth and an increase in certain one-time expenses.

Non-GAAP net OI&E expense was $63 million for the quarter. Non-GAAP diluted net earnings per share increased 42% to $0.92 with a diluted share count of approximately 1.3 billion shares. Non-GAAP diluted net earnings per share excludes a net expense totaling $120 million primarily related to restructuring and other charges, amortization of intangible assets, other tax adjustments and partially offset by non-operating retirement-related credits. As a result, Q1 GAAP diluted net earnings per share was $0.83.

Turning to segment performance. In Q1, Personal Systems benefited from strong demand related to working and learning from home, with revenue of $10.6 billion, up 7% year-over-year. Our top-line remained constrained due to industry-wide component shortages. Drilling into the details, we continued to see differing results by customer segment, with Consumer revenue up 34% while Commercial revenue was down 6%. By product category, revenue was up 23% for Notebooks, down 18% for Desktops and down 36% for Workstations. Strong demand for Notebooks drove total unit growth of 15% year-over-year with Chromebooks representing 16% of our total Personal Systems units, as the need for technology and education continued to grow.

Personal Systems delivered a record $758 million in operating profit and operating margins of 7.1%, much higher than our outlook. The year-over-year increase was primarily due to favorable pricing, including fewer promotions and favorable commodity cost. In Print, our results reflected very strong execution as we continued to benefit from the strength of our portfolio as a leader across both Consumer and Commercial Print. Q1 total Print revenue was $5 billion, up 7%.

By customer segment, Consumer revenue was up 55% with units up 18% and Commercial revenue was down 11% and flat in units. In total, hardware units were very strong at 11.1 million units, up 16%. Supplies revenue was $3.1 billion, up 3%. In the first quarter, ongoing consumer demand combined with favorable pricing and inventory replenishment more than offset lower Commercial demand. Sequentially, Supplies revenue was flat. Print operating profit was very strong at $1 billion, and operating margins were 19.8%. The year-over-year increase was primarily due to favorable pricing including fewer promotions.

Let me now turn to our transformation efforts and specifically, our cost savings opportunities. In Q1, about 700 people exited the company as we continue to be ahead of plan against our three-year, $1.2 billion gross run rate structural cost reduction plan. During the quarter, we continued to execute real estate site optimization activities at six sites that are aligned with our location and ability strategies. In addition, we have achieved additional efficiency improvements in customer service and support as we continued to shift to digitization and automation. Finally, we continue to be focused on further digital enablement and driving a lean cost structure as it provides us the flexibility to reinvest in other areas of our business.

Shifting to cash flow and capital allocation. First quarter cash flow from operations and free cash flow were solid at $1 billion and $908 million respectively. In Q1, the cash conversion cycle was minus 30 days. Sequentially, the cash conversion cycle was flat as growth in inventory primarily driven by strategic buys and finished goods drove increases in days of inventory offset by increases in days payable outstanding. Day sales outstanding also decreased during the quarter. For the quarter, we returned a total of $1.6 billion to shareholders, which represented 179% of free cash flow. This included $1.4 billion in share repurchases and $250 million in cash dividends. Looking forward, we expect to continue buying back shares at elevated levels of at least $1 billion per quarter in the coming quarters unless higher return opportunities emerge.

Looking forward to the second quarter and the rest of fiscal 2021, keep the following in mind related to our overall financial outlook. While we expect year-over-year revenue growth at FY 2021 to reflect our continued progress on our strategy, it is also important to note that growth trends in Q2 and Q3 will also reflect the easier year-over-year comparisons due to unusual COVID-related impacts we saw last year. And in the second half of the year, we expect to see a more normalization of the market environment as more people return to the office and kids return to school and as the pricing environment normalizes. Our outlook range is broader than usual given the current market environment. We are modeling multiple scenarios related to supply availability, pricing dynamics and the pace of economic reopening.

Our comments for Q2 are the following. In Personal Systems, our backlog remains elevated as demand in consumer and education remains very strong and we expect industry-wide component constraints to continue to negatively impact our ability to meet demand, especially for Notebooks, which will constrain top-line growth. We expect the costs from the overall basket of commodities to be slightly higher compared to Q1 levels. And from a margin perspective, we expect Q2 operating margins to be in the range of Q1 margins.

In Printing, from a demand perspective, we expect to continue to see strong demand for home printing as well as the continued economic pressure in Commercial Printing. We expect to have to navigate supply constraints and the need to replenish stock so that our ecosystem of partners are well positioned to satisfy the strong demand that we see in printers and supplies. We expect our operating margin for Q2 to be at the high end of our long-term range of 16% to 18%.

Taking these considerations into account, we are providing the following guidance for Q2 and FY 2021. We expect second quarter non-GAAP diluted net earnings per share to be in the range of $0.84 to $0.90, and second quarter GAAP diluted net earnings per share to be in the range of $0.82 to $0.88. We expect FY 2021 non-GAAP diluted net earnings per share to be in the range of $3.15 to $3.25, and FY 2021 GAAP diluted net earnings per share to be in the range of $2.98 to $3.08. For FY 2021, we expect our free cash flow to be at least $4 billion.

And now, I would like to hand it back to the operator and open the call for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now begin the question-and-answer session. [Operator Instructions] Our first question today will come from Shannon Cross with Cross Research.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. And, Marie, I just wanted to congratulate you on the new role. My question – I'm going to – it's a two-part question, so I'll just leave it to one question today. I was wondering, Enrique, can you talk a bit about sustainability and sort of beyond the quarter that you've guided to? And that's one of the big questions, I think, people have right now. Maybe if you can – you've pointed to shortages in PCs lasting until third quarter, so maybe you can talk on the PCs side a little bit about what you see long term for the market? And what might support the PC business sort of in future quarters?

And then if you could turn to Printing, if you can talk a bit about what HP+ means for the long-term model and how you see that impacting margins, as well as discussing a bit, because I think maybe it's underappreciated, how the shift to inkjet is going to help margins long term since you own the whole inkjet stack and have to partner with Canon for laser? So, if you could maybe address those two parts, that is my – completes my question. Thanks.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

Thank you, Shannon. And I will try to answer all your points. So, let me start with sustainability of the momentum that we see. And I would say that we are very optimistic about what are our expectations for the market for the coming quarters. We think that many of the underlying trends that are driving demand today are going to stay. I think the pandemic has made technology clear necessary for people to work, to entertain, to live and this is going to continue to drive very strong demand for PCs and for home printers for the foreseeable future, but especially for PCs. We also think that as offices will reopen, we're going to see an increase of demand on the PC space because CIOs will have to invest on PCs again to make their employees productive. And we are going to continue to see a shift towards Notebooks that also helps on the demand side as the renewal cycles are shorter.

We also think that the need to the hybrid model of working between office and home opens new opportunities for us on the Printing side to offer new services, create new services, by combining both. So, overall, again, we see that this is creating an opportunity for us not only to leverage new opportunities, but really to continue to drive change and to continue to gain momentum. If I go now to the second part of your question on PCs, we expect to continue to see very strong demand for PCs in the coming quarters, and this strong demand is what is creating the supplies, the component shortages that you were mentioning. We have provided strong guidance today both for the quarter and for the year, and this is based, of course, on the visibility that we have today for components, what we think we're going to be able to ship. If we get more components, we could do even better.

And then your final question on Print. As you know, we launched HP+ during last quarter. Their reception has been very positive in terms of both adoption of the end-to-end model and also feedback from customers in terms of the value proposition and feedback from partners. So, it's going – I would say we are optimistic about the results we have seen. And as you know, we are going to expand into more countries and more categories during the coming months until we complete the rollout in the middle of 2022.

You were also asking about the impact on margins. Let me start there and maybe Marie will complement that. Clearly, we see a benefit from the mix moving into inkjet versus laser, because as you know, we are in the full end-to-end system. But this quarter, we are also seeing a strong benefit from pricing, especially on hardware that is really helping to increase the profitability on Print.

Marie Myers
Chief Financial Officer, HP, Inc.

A

And yes...

Operator: Our next question -

Marie Myers
Chief Financial Officer, HP, Inc.

A

And thank you for your...

Operator: Oh, go ahead.

Marie Myers
Chief Financial Officer, HP, Inc.

A

...warm introduction, Shannon. Yes. But we expect our Print margins to remain strong throughout FY 2021 and we expect our operating dollars to grow an operating profit rate to be at the higher end of the 16% to 18% range for 2021. And in Q2, we'd expect to be above the range as well.

Operator: And our next question will come from Katy Huberty with Morgan Stanley.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Thank you. Good afternoon. I want to ask a clarification first. You said in your prepared remarks that you see PCs growing through 2021. Does that mean that you will see growth in each of the four quarters? Obviously, you grew strong in 1Q. Or is that just implying that you will grow for the full year? And then in terms of my question, just following up on the Print business. Can you talk about how much channel inventory rebuild contributed to Print revenue in the quarter? And, Marie, you made it clear that you expect Print margins at the upper end of the range but why would they come down sequentially given that the pricing environment remains quite favorable? Thank you.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

Okay. Thank you, Katy. Let me start with a clarification. When I was talking about PC growth to continue, I was referring to markets. As I was saying in Shannon's – during the answer to Shannon, we expect the market to continue to be very strong both this year and in the long-term. And then let me offer a data point. If we look at the projection that we have for PC market in 2021, the one we have now, and we compare it to the projection that we have for 2021 before the pandemic started, the market is 45% bigger. So, this talks about the growth that we are seeing in PCs. And really, the how – why we are so optimistic about this business going forward. And now, Marie will talk about the margins for Print in Q1.

Marie Myers
Chief Financial Officer, HP, Inc.

A

Actually, I'm going to move on and just cover your question around channel inventory, Katy. So, look, with respect to that, overall channel inventory is below what we believe a healthy appropriate level for Print, and that's really as a result of that strength that we're seeing in Consumer. And right now, we're also below the range and it's driven by that demand in-home. We do expect, however, some replenishment of stock throughout our partner ecosystem into Q3, and that's going to help to bridge some of that demand from our customers. So, overall, we want to make sure that our partner ecosystem is very well positioned to satisfy that demand.

Operator: Our next question will come from Toni Sacconaghi with Bernstein.

Toni Sacconaghi
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yes. Thank you. I have two questions as well. First, if I look at your guidance for the full year, it implies an EPS decline at the midpoint down more than 20% in the second half versus the first half. Typically, seasonality would point to EPS being up 10% in the second half, so I was just wondering if you can comment on that? Are you being conservative, because it sounds like you're going to be supply constrained through potentially Q3? Or are you believing that this very favorable price environment is going to come off? So, are you expecting this deceleration because of conservatism? Are you expecting it because of weaker than normal sequential revenue growth? Or are you expecting it because you expect margins to go down to lower levels in the second half? And then I have a follow-up, please.

Marie Myers
Chief Financial Officer, HP, Inc.

A

Right. Hey, Toni, good afternoon. It's a pleasure to meet you. So, look, frankly, Toni, we've provided actually a very strong guide for the year, and we're investing for our future. In fact, we expect revenue growth in FY 2021 and EPS to be up 38% to 43% and free cash flow growth as well. So, while, to your point, this is front-end loaded in the first half, the second half EPS growth is actually 23% to 32% of the 1.11 that we actually delivered last year. And this actually includes earnings growth as well as the benefit of lower shares. So, given thecurrent environment, as you could imagine, we are modeling multiple scenarios for the second half. So, look, all- in-all, we believe that this is a prudent guide based on what we know today, and clearly, if we can do better, we absolutely will.

Toni Sacconaghi
Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. I guess I was trying to get a better sense of whether there was more confidence in the revenue trajectory or the margin trajectory. Just in terms of the follow-up, I want to better understand this re-stocking, whether this is hardware or supplies or both on the Print side? Is it principally consumer? So, I presume your stock is going down on the corporate side since demand is much weaker, and your channel inventory in dollars is going up on the Consumer side, and that's obviously very, very favorable.

But you talked about this being a benefit last quarter, this being a benefit this quarter, this potentially being a benefit next quarter, I'd like to understand exactly what that benefit is? And then maybe you could kind of zoom out a bit and just talk about how we should think about normalized supplies growth. I think over the last eight or nine years, it's gone down about 4% per year. The aspiration was to get to flat supplies growth. I think it took you a little longer to get there. You haven't really provided an update on how you think about supplies growth sort of in the more normalized environment. How should we think about that? Thank you.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

Okay. Thank you, Toni, let me start and let me emphasize that we are very confident on both the revenue and profit projections for the year and this is what supports the strong guide that we have provided today. In terms of channel inventory, the comments from – that we made in the prepared remarks are not only for supplies, but also for hardware, and we continued to be across-the-board in PCs, printers and supplies, below what we think are the ideal inventory levels that we have for the channel. So that's – this is where we are today, and all this is driven by the very strong demand that we continue to see, especially in our home products.

Now I'll let Marie explain what do we see on supplies and what do we think is the impact on the replenishment this quarter.

Marie Myers
Chief Financial Officer, HP, Inc.

A

Thanks, Enrique. So, Toni, looking at supplies performance, there's sort of really three key dynamics to discuss. First of all, ongoing demand in consumer supplies with work-from-home and learn-from-home. And there are ongoing challenges in Commercial print as you know. And then secondly, there's that favorable pricing environment which was actually a tailwind. And then thirdly, the year-over-year compares also benefited from that replenishment of stock, which was consistent with what we had indicated on the call in Q4.

Now, if you adjust for the impact of inventory movements, we estimate that supplies revenue was down roughly 1% year-on-year. As you know, we have a multi-tiered channel so this is our best estimate based on the data we have, including our estimates for product across the channel and at end-user stock, so this replenishment should have a short-term benefit to supplies revenue.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

And talking – commenting on the projections for the future, Toni. As you know, we are – we have redesigned the strategy of the company to reduce the dependency on supplies to deliver our goals. This is why the subscription programs, HP Plus, are so critical. And we are very pleased with the progress that we're making on that front.

We shared in the prepared remarks that we reached 9 million subscribers on Instant Ink, which means we added 1 million subscribers this quarter, which is the fact that on the most we have done in the history of the program, so clearly that is accelerating. And at the same – and I also shared before, we are really pleased with the response that we have got on HP Plus and we are also making good progress on what we call big ink and big toner for – in emerging countries which are a key part of our strategy as well.

Operator: Our next question will come from Amit Daryanani with Evercore.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Perfect, thank you. Looks like I really have no Printing questions for you guys anymore, but I do want to talk about free cash flow. And if I look at the fiscal 2021 guide, I think you talked about $4 billion of free cash flow. It's really a modest uplift from the $3.9 billion we did in fiscal 2020, so really just help me understand, with revenue up the way it is and I think EPS is going to be up 35%, 40%, why is free cash flow up $100 million and change? Just what are the puts and takes that would be really helpful.

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yes. And good afternoon, Amit. So first of all, look I'd start-up by saying look, we're really pleased with the results of free cash flow and what we saw in the quarter. Now as we look forward to FY 2021, Amit, we expect free cash flow, as I said in my prepared remarks, to be at least $4 billion. And then that is being driven by the earnings growth in both PS and Print. And it is being sort of the headwind that we do have is – it will be partially offset by changes in working capital, which we expect to, from higher expected inventory and AR, and that's being driven obviously by the environment that we're in with PS.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Got it. And then I guess, Marie, really from your perspective, as you step into the CFO role and your background as the Chief Transformation Officer, I'd love to get a sense on, as you go-forward, how do you go between managing the need to reduce costs and optimize margins versus perhaps investing for growth as you go forward? And as we think about HP over the next two, three years, what are the big priorities for the company for investments?

Marie Myers
Chief Financial Officer, HP, Inc.

A

No, thanks, Amit. Look, frankly, I believe that great companies like HP focus on the end. We have to do both. We have to reduce costs, and we have to make the right investments for the future. So I could tell you as the CFO, I'm going to be relentless about going after inefficiency and making sure we're driving value from our investments. I think my role as the Chief Transformation Officer really teed me up nicely for that outlook. But with respect to investments, I'm going to turn it over to Enrique to add some color there.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

And before I do that, let me emphasize a comment from Marie about the end. We need to continue and we will continue reducing cost, and we will continue to invest in areas where we see opportunities for the future. And my answer is not going to surprise anybody, because this is a strategy we have been executing during the last year. It's about modernizing our core businesses, both Personal Systems and Print. We see opportunities to create value on both.

It is about expanding into adjacencies. And yesterday we shared the acquisition of HyperX, that is an example of very attractive adjacency for us, and we're also investing to create new businesses in industrial graphics, in 3D Printing, in microfluidics. And we see also the need to invest in improving our digital infrastructure that will help us to create new business models, but as Marie was saying, also to become more efficient, leaner, and really being able to respond to our customers in a better way.

This is a strategy we have been executing. The results show that it is growing. And this is where we're going to be investing going forward.

Operator: Our next question comes from Matt Cabral with Credit Suisse.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah. Thank you. Enrique, you just mentioned HyperX, so I wanted to dig a little bit more into that. I guess, first, just a clarification. I saw in the release you guys said it's EPS accretive, but wondering if you guys can comment to the revenue contribution you expect from HyperX going forward?

And then more broadly, just wondering for your perspective on PC gaming and just how we should think about sustainability there once people start leaving their homes in a more normalized manner? And just how you think about HyperX's peripherals fitting versus your OMEN brand within the lineup?

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

So, first of all, let's start on gaming. Gaming is a very attractive opportunity for us, both on the hardware side, where we have been growing significantly during the last quarter and where we expect to continue to see growth in the coming years. More and more people are using gaming as their main entertainment and this is driving growth today and will continue to drive growth in the future.

When we look about gaming, the peripheral opportunity is especially attractive. A gamer spends about 15, 16 more money on accessories than a normal PC user. And when we think about that opportunity, the acquisition of HyperX makes us really excited about the opportunity of really capturing that. HyperX is a leader in gaming headsets. They have a very strong portfolio on microphones, in mice, keyboards. And really, the growth – the value proposition of the acquisition is very clear. We are going to accelerate their growth by leveraging our geographical presence and our broader retail presence as well as we will be taking their portfolio and expanding into new segments like Commercial. So, it's all about growth and this growth is what makes it accretive for us in 2022.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks for that. And as my follow-up, I wanted to broaden out the discussion on M&A. And just talk about how you think about M&A strategically? And I heard in the prepared remarks the plan is still outsized buybacks unless the better opportunity comes along. So maybe just help us understand the criteria as you think about that trade-off between repurchases and other uses of capital going forward?

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

So, our approach has not changed from what we have been communicating during the last three quarters. We continue to believe that our stock is undervalued and we are going to continue to buy aggressively our shares. Marie mentioned that we are going to be buying at least $1 billion of shares every quarter. And at thesame time, we are always looking for opportunities to accelerate our strategies through M&A.

We're looking at opportunities in the core businesses, in adjacencies and also to support our new businesses. And the criteria are very simple. Any M&A we will do will have to be aligned to the strategies we have explained. It will have to have attractive financial returns, at a minimum, a better ROI than buying our own stock. And third, we need to have a strong operational plan to execute on the value proposition of the acquisition. These are the criteria we have been applying. This is what we used to decide to acquire HyperX. And this is how we think about M&A.

Operator: Our next question comes from Krish Sankar with Cowen and Company.

Krish Sankar
Analyst, Cowen and Company, LLC

Q

Yeah. Hi. Thanks for taking my question and congrats on the solid results. And Marie, congrats on the full-time CFO title. I have two quick questions. First, either Enrique or Marie, is there a way to quantify what will be the upside to revenues if you had no supply constraints? And then I had a quick follow-up.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

Let me take that question. What you have in the guide is what we think we – based on the current supply that we see available, we can deliver. Of course, if there was more supply, we will be able to drive more, but I don't think we will quantify though what this number is. But let me tell you, as I said in the prepared remarks, our backlog is at a record high, so it will be a significant number. But again, we are seeing shortages given how strong the demand is across the board.

Krish Sankar
Analyst, Cowen and Company, LLC

Q

Got it. Got it. Thanks, Enrique, for that. And then as a quick follow-up. The gross margins in the January quarter were really strong. What were the drivers there and how to think about gross margin for the rest of the year, especially as component costs get inflationary for you folks?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yeah. Sankar, thanks for the kind words. So look, fundamentally, it's just all about demand, frankly, outpacing supply and really creating that favorable environment. So, it's basically just the laws of supply and demand which helped us with better pricing in the quarter. So regardless of whether you're sort of talking year-on-year or quarter-on-quarter, that improvement in gross margin was primarily driven by favorable pricing which showed up as fewer promotions and as cost improvements.

Operator: Our next question will come from Wamsi Mohan with Bank of America.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. I was wondering if we can go back to Print margins for a second and look at this on a quarter-on-quarter basis. When we look at the sequential revenue improvement that was about $200 million on Print, the Print profitability went up by $300 million. So maybe you can help us think through how much of it was pricing on hardware where there is fixed-cost leverage that you might be recognizing versus higher mix on HP ink versus laser toner?

If there's a way to dissect this somewhat differently in the $300 million. And clearly, replenishment has a role there, too. Any way to maybe size those different components. And also, if we can split between hardware and supplies, I think that'll give us a better sense of how the trajectory of this could progress. Thank you.

Marie Myers
Chief Financial Officer, HP, Inc.

A

Sure. No, thanks for your question. And so, look, the Print rate really benefited from improved gross margins, particularly in home hardware, and that was driven by that favorable pricing that I mentioned earlier. And it was particularly in the consumer side and some of those – and then we had reductions from COVID-related supply chain cost that we had in Q4.

And then that was partially offset by higher consumer mix, and lower supplies mix. So that in all is what contributed to the rate and then overall we're seeing the strength and resiliency of our broad Print portfolio and leadership across customer segments, and that's really positioned us very well against our competition.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: Our next question will come from David Vogt with UBS.

David Vogt
Analyst, UBS

Q

Great. Thank you. Maybe just going back to the component shortages issue for a second. It's been persistent for some time now and there's been commentary across different industries that lead times are lengthening across the board. I know inventory is up this quarter, 49 days versus 43 last quarter, but can you give us more qualitative discussion on how you're thinking about remediation going forward in your future procurement plans in case there's a greater disruption and what that might mean for your top line going forward? Thanks.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

So as I said before, the shortages that we are seeing are really driven by the very strong demand that we're getting across the full portfolio. We of course are taking any action we can to mitigate the impact and make sure that we can deliver even more than what we have in the plan. One of the big things that we have decided, as Marie mentioned before, is to increase the amount of inventory that we have on hand. It will help us not only to increase the delivery of the Humana product, but also to be able to ship more products in case some components are made available during the quarter.

We are also building direct connection with suppliers that until now were being managed from our ODMs, usually suppliers of low-cost components, because we have seen that it is important to really establish a direct connection with them and in some cases even buy products directly from them. And these I would say are the two big things that we have already done and that we expect will help us to manage the situation during the coming quarters.

David Vogt
Analyst, UBS

Q

Yeah. And maybe just a quick follow-up on that. So when you think about sort of the inventory that you're taking in and that you're going to procure going forward, is there any sort of commentary or guidance you can give us in terms of what the margin impact might look like from that inventory today going forward as you burn through that inventory maybe later this year into next fiscal year?

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

I think given how strong our demand is, if you are concerned about obsolescence of several of the inventory, I think the risk is extremely low, because we really have very strong demand and we expect it to continue during the coming quarters. In terms of cost of component, we are expecting that in some cases, cost will be increasing during the coming quarters, but all of this is built into our guidance and built into the comments that Marie made before in terms of operating margin during the coming quarters.

Marie Myers
Chief Financial Officer, HP, Inc.

A

And just to follow-up on Enrique's comment, as a result then we would expect from an overall basket of commodity pricing perspective for those prices to be higher than what we've seen in Q1 going forward as well.

Operator: Our next question will come from Jim Suva with Citigroup.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much. And congratulations on the very strong results and outlook. When we dive – I only have one question. When we dive into the results on PCs, yes, you are growing but it seems like some of your competitors, especially your North America competitors, growing much stronger than you. You did highlight that you grew a lot in Chromebook so I'm wondering, is the strategy there to really focus on education and Chromebooks? Or profit share gains? Or market share maintaining, even if you lose some share? I just wanted to revisit your strategy in the PC side when we look at the data versus the industry. Thank you.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

A

Sure. Let me be very clear, Jim. So we had a very strong quarter in absolute terms on PCs, revenue growth, unit growth, profit growth, but we did it on relative terms. And being as competitive as we are, this is not something that we are satisfied about. As I explained before, we are looking at what can we do and what will we do to improve our relative performance. We have already taken some actions to do that by increasing inventory and changing how the connections that we have with certain component providers, and this will be helping us to improve our performance going forward. We are really using this as a catalyst to optimize even further our operational capabilities. And this is what great companies do and what we will continue to do, because again, we like to win and this is what we will do, continue to do going forward.

Enrique Lores
President, Chief Executive Officer & Director, HP, Inc.

So having said that, I think we are close to time, so let me use this as an opportunity to wrap up.

First of all, I want to repeat some of the comments I made during the prepared remarks. We are doing what we said we would do, and our strategy is working. We have had a very strong start of the year and we are confident in the projections that we have for 2021 and beyond. We see growth opportunities in our core market, in the adjacencies, and also in the new businesses that we are creating, and we are really leveraging the opportunities that we see to accelerate our strategy, accelerate our growth, which gives us great confidence in the future of the company.

So again, thank you for joining us today, and looking forward to continuing to talk to all of you in the future. Thank you.

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