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HP, Inc. (HPQ)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Second 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 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
Vice President & Head-Investor Relations, HP, Inc.

Good afternoon, everyone, and welcome to HP's second quarter fiscal 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.

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.

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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. 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 April 30, 2021 and HP's other SEC filings.

During this webcast, unless otherwise specifically noted, all comparisons are year-over-year comparisons with 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.

With that, I'd like to turn it over to Enrique.

Enrique Lores

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

Thanks, Beth. Good afternoon, everyone, and thank you for joining the call. I want to start by acknowledging the state of the pandemic, particularly in countries such as India. We are doing everything we can for our employees, customers, and partners during this difficult time. While some parts of the world are beginning to improve and reopen, there is much more work to do.

Turning to our results, it was another exceptional quarter of double-digit top and bottom line growth, in which we delivered well above our guided range. Our performance reflects the relevance of our technology in an increasingly hybrid world, the resilience of our business model, and the operational excellence of our team.

In addition to summarizing our results, I also want to highlight secular trends driving sustained demand across our portfolio. HP technology and services are at the heart of hybrid work. We are accelerating our strategy to drive long-term sustainable growth. This includes continuing to transform the way we operate and deploy our substantial cash flow to maximize value creation.

But let me start with the quarter. In Q2, we saw exceptional demand for our products and delivered record revenue of $15.9 billion, an increase of 27%, with balanced growth across Print and Personal Systems. Our non-GAAP net earnings increased 56% to $1.2 billion, and we generated $1.3 billion of free cash flow, returning $1.8 billion to shareholders. These results reflect continued strong growth in Consumer, as well as improvement in our Commercial businesses as economic activity increased.

In our Consumer segment, we delivered 72% growth in Personal Systems and 77% growth in Print. Commercial PC revenue grew 10% and Commercial Print was up 34%, including 45% growth in our industrial printing businesses. It is important to note that these results are against the backdrop of industry-wide component shortages and supply chain challenges.

Currently, there is not enough supply to keep up with the robust demand, and the resurgence of COVID in Southeast Asia is creating additional pressure on our supply chain. We expect supply constraints to continue at least through the end of 2021. Although the environment will likely remain dynamic, we are taking actions to navigate through the challenges, enabling us to deliver strong results and increase our outlook for the second

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half. As we remain focused on delivering in the short term, we are equally focused on capitalizing on attractive long-term opportunities.

It is clear that the world will not simply go back to the way it was prior to COVID. There has been a fundamental shift in the way people work, learn, play and create, and this shift is here to stay. The future of work and education will be more hybrid. According to a recent survey, more than 60% of employees want flexibility in where and how they work. As this future emerges, it will open the opportunity to create new products and services for our customers. Unless consumers and businesses see greater mobility, convenience and value, this supports our strategy to accelerate new business models geared toward more services and subscriptions, enabled by the integration of our hardware and software.

Underpinning all of this is the growing importance of cybersecurity. 88% of IT decision makers tell us they worry their cyber risk has increased during the pandemic. This presents a huge opportunity for us to expand our security offerings and deliver the most secure and resilient PCs and printers. With our broad differentiated portfolio, HP is uniquely positioned to capitalize on this secular trend. And as I have said, this is a time for strong companies to get stronger, and we are innovating across our portfolio to strengthen and grow our businesses.

In Personal Systems, our innovation is driving growth in key segments, including remote work, education and gaming. The PC continues to be essential in daily life. We're already capitalizing on this trend in a number of ways. Our latest award-winning PC include features purpose built for hybrid work, and we are developing new services like HP Provisioning Connect that make it easier for IT teams to set up and support devices in employees' homes as well as in the office.

In the education market, where HP is the number one vendor, PC sales have more than doubled due to remote learning. At the same time, however, the number of PCs per 100 students remains in the single digits. As an industry, we still have a long way to go to close this digital divide, and as a company, we have a big opportunity to be part of the solution.

The importance of the PC extends far beyond work and school. In many cases, it has become the entertainment center of the home, from streaming and content creation to the rise of gaming and e-sports. In Q2, revenue growth in gaming outpaced overall Consumer PC growth. We are building on these trends to expand into attractive adjacencies, including peripheral. We are on track to close the HyperX acquisition in Q3, which we expect to be accretive in year one.

In Printing, we are leveraging our leadership across Consumer and Commercial markets to provide innovative solutions needed in today's hybrid world. This includes accelerating the evolution of our business model and subscription services. We recently announced the expansion of HP+ and Instant Ink, which are now in 35 countries across North America and Europe. We believe HP+ will help us to optimize system profitability and provide a better customer experience.

Additionally, employers are looking for a more distributed printing environment, which plays to HP's strength in A4 printers. The new LaserJet Enterprise 400 series is designed to deliver seamless remote management for both hybrid workers and new office configurations geared to our collaboration.

At the same time, greater workforce mobility is a catalyst for our print services portfolio. Within our Managed Print Services, we have introduced HP Flexworker Service to incorporate remote workers and branch offices into a company's MPS contract. This is allowing companies such as General Motors to have better visibility and manageability across their printer fleet.

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In our industrial businesses, new innovation is enabling production to be more agile and more personalized. In industrial graphics, we are seeing improvements in the market and growth in hardware installations. Among the customer wins this quarter were the installation of the 100th Indigo press at CCL, a world leader in label, security and packaging solutions. We also continue to see consistent double-digit growth in print impressions and square meters.

In 3D, we are creating more vertical go-to-market solutions, spanning equipment, software and services across industries, from industrial tooling to automotive to health and wellness. For example, our molded fiber tooling solution has strong customer engagement and adoption, including numerous prepaid purchases, and we enable them to achieve significant process and cost efficiencies. In addition, we are partnering with Ford Motor Company to extend the life of already used 3D printer parts by turning them into auto components for their F250 trucks, creating a closed loop on waste.

With our strong and diverse portfolio, we also continue to generate meaningful free cash flow, and we remain focused on deploying our cash to maximize value creation. We have the flexibility to return significant capital to shareholders and reinvest in our businesses while also exploring disciplined M&A. We will continue to look for opportunities to strengthen our core, expand into attractive adjacencies, and create additional growth engines.

As always, we will take a rigorous approach to evaluating M&A, requiring strategic fit, attractive financial returns that exceed those of buying our own stock and a strong operational plan to execute on the value proposition. And an important enabler of our strategy is continuing to transform the company to become leaner and more digitally enabled.

For HP, there is a continued focus on both reducing structural costs and reinvesting for the future. To help us accelerate our progress, we announced three new leadership appointments. Didier Deltort is joining HP as the President of Personalization & 3D Printing; Greg Baxter will be our next Chief Transformation Officer, and Kristen Ludgate is joining HP as our Chief People Officer.

Working together with our leadership team, they will strengthen our innovation capabilities and help drive our long-term strategy. And a key part of our strategy is to deliver strong results while staying true to HP's values. Last month, we announced an ambitious set of climate action goals. By 2025, we aim to achieve carbon neutrality, zero waste in HP operations and zero deforestation for HP paper and paper-based packaging. We are also committed to achieving net zero carbon emissions across our entire value chain by 2040.

And last week, we announced a new set of diversity and inclusion goals. This includes a pledge to achieve 50/50 gender equality in HP leadership by 2030, making us the first Fortune 100 tech company to make such a commitment. I am proud to say our partners are joining us in these efforts. Today, over 1,400 partners have signed the Amplify Impact Pledge to set their own long-term objective to drive a sustainable impact. This is where the size and scale of HP's ecosystem truly shines.

Overall, I am very pleased with our performance this quarter and excited for what lies ahead. We continue to drive our relentless focus on execution, while taking decisive actions to capitalize on attractive opportunities to advance our leadership in personal systems and print, expand into attractive adjacencies, disrupt new markets, and transform the way we operate. And I am confident that our strategy will continue to create significant shareholder value.

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I know I speak for our more than 50,000 employees when I say we are not content simply maintaining our current position. We have a much bigger ambition.

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

Marie Myers

Chief Financial Officer, HP, Inc.

Thanks, Enrique. HP's second quarter results highlights both our operational strength and the breadth of our portfolio. We are demonstrating our ability to meet customer needs and continuing on our transformation journey, all while growing operating profits, generating strong free cash flow and maintaining a robust capital return while continuing to make investments in the company for our future.

Turning to the details of the second quarter. Q2 net revenue was $15.9 billion, up 27% nominally and 25% in constant currency. Regionally, in constant currency, Americas increased 32%, EMEA increased 19% and APJ increased 23%. The year-on-year growth rate benefited from the prior year impact of COVID and supply chain disruptions. Demand continued to outpace supply and we ended the quarter with elevated backlog in both Personal Systems and Printing.

At the highest since the split, gross margin was 21.7%, up 1.7 points year-on-year. The increase was primarily driven by favorable pricing including historically low promotion expense and favorable currency partially offset by higher costs.

Non-GAAP operating expenses were $2 billion, up 12.6% of revenue, up 10 basis points year-on-year. The increase in operating expenses was primarily driven by higher variable compensation as a result of the very strong performance this year as compared to Q2 2020, as well as increased investments in innovation and go-to-market.

Non-GAAP net OI&E expense was $64 million for the quarter. Non-GAAP diluted net earnings per share increased 82% to $0.93, with a diluted share count of approximately 1.2 billion shares. Non-GAAP diluted net earnings per share excludes net benefits totaling $70 million primarily related to other tax adjustments and non-operating retirement-related credits, partially offset by restructuring and other charges as well as amortization of intangible assets. As a result, Q2 GAAP diluted net earnings per share was $0.98.

Turning to segment performance. In Q2, Personal Systems benefited from strong demand related to working and learning from home. Revenue was $10.6 billion, up 27% year-over-year. Demand for our products remained very strong with backlog increasing again quarter-on-quarter.

Drilling into the details, we saw strength across Consumer and Commercial with revenue up 72% and 10%, respectively. By product category, revenue was up 47% for Notebooks, down 8% for Desktops, and down 7% for Workstations. Strong demand for Notebooks drove total unit growth of 44% with Chromebooks representing 20% of our total Personal Systems units as the need for technology and education continue to grow.

We also saw solid services attached with particular strength in commercial and significant double-digit growth in consumer peripherals. Personal Systems delivered $710 million in operating profit and operating margins of 6.7%. The year-over-year improvement was primarily due to favorable pricing, including lower promotion expenses as well as currency, partially offset by unfavorable mix and higher costs, including variable compensation, commodity costs as well as investments in innovation and go-to-market.

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In Print, our results reflected continued focus on execution and the strength of our portfolio. We are uniquely positioned as leaders in both Consumer and Commercial and have the hardware supplies and services to deliver value in a hybrid world. Q2 total group revenue was $5.3 billion, up 28% and total hardware units grew 42% to $10.6 million. By Customer segment, Consumer revenue was up 77%, with units up 45%; and Commercial revenue and units were up 34% and 22%, respectively.

In Commercial, the recovery momentum continued with revenue up 13% sequentially, but we continue to expect the recovery to be gradual and uneven at times across segments and geographies. Supplies revenue was $3.3 billion, up 17%. The year-on-year growth was primarily driven by favorable pricing as well as ongoing Consumer demand and improving Commercial demand. Our contractual business is a key element of our print strategy in both Consumer and Commercial printing.

In Consumer, our Instant Ink business continued to resonate well with customers with cumulative enrollees growing 7% sequentially to $9.7 million. On the Commercial side, we drove growth in Managed Print Services revenue and new TCV bookings for the first time since the pandemic took hold and strong renewal TCV bookings again this quarter.

Print operating profit increased $403 million to $951 million and operating margins were 17.9%. This year-over-year increase was driven by increased volume and favorable pricing across hardware and supplies, including less promotional expense partially offset by unfavorable mix and higher costs.

Let me now turn to our transformation efforts and specifically our cost savings initiatives. In the second year of our program, we continue to look at new cost savings opportunities and remain ahead of our $1.2 billion gross run rate structural cost reduction plan. During the quarter, we continued our efforts to optimize our factory footprint to enable a best-in-class supply chain network and enhanced supply resiliency while reducing our cost structure.

In addition, we continue to enhance and leverage our digital capabilities to transform ways in which we operate and deliver value to our customers. The structural cost savings from our transformation efforts give us the flexibility to reinvest in our business for long-term growth and profitability.

Shifting to cash flow and capital allocation. Second quarter cash flow from operations and free cash flow were better than expected at $1.4 billion and $1.3 billion, respectively. In Q2, the cash conversion cycle was minus 28 days. Sequentially, the cash conversion cycle was up two days as growth in inventory, primarily due to strategic buys, drove increased days of inventory partially offset by a reduction in days sales outstanding and higher days payable outstanding.

For the quarter, we returned a total of $1.8 billion to shareholders, which represented 137% of free cash flow. This included $1.6 billion in share repurchases and $239 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 third quarter and the rest of fiscal 2021, we continue to model multiple scenarios related to supply availability, pricing dynamics, and the pace of economic reopening. In particular, keep the following in mind related to our overall financial outlook. From a demand perspective, we expect to continue to see strong demand for our PCs, particularly in Consumer.

In Print, we expect solid demand in consumer and continued improvement in commercial as offices reopen. While we expect year-on-year revenue growth in FY 2021 to reflect our continued progress on our strategy, it is also

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important to note that growth trends in Q3 will also reflect the tougher year-over-year comparisons particularly in Personal Systems.

We expect supply constraints to continue to negatively impact our ability to meet demand in PCs and printers at least through the end of calendar 2021. We expect gross margin pressure in the second half of the year in both Personal Systems and Print due to increased costs in commodities and logistics as compared to Q2 levels and as we expect to see some more normalization in the market and pricing environment. We expect operating expenses in the second half of the year to be more similar to Q1 run rate.

Finally, we continue to closely monitor the current COVID resurgence and its potential impact to our supply chain particularly in Southeast Asia. Taking these considerations into account, we are providing the following guidance for Q3 at FY 2021. We expect third quarter non-GAAP diluted net earnings per share to be in the range of $0.81 to $0.85. And third quarter GAAP diluted net earnings per share to be in the range of $0.77 to $0.81.

We expect FY 2021 non-GAAP diluted net earnings per share to be in the range of $3.40 to $3.50 and FY 2021 GAAP diluted net earnings per share to be in the range of $3.24 to $3.34. 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. And we will now begin the question-and-answer session. [Operator Instructions] Our first question today comes from Amit Daryanani with Evercore.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Good afternoon. Thanks for taking my question. I guess I have two. The first one, I guess, I was hoping if you could talk a little bit about the Print margins in the April quarter. I'm somewhat surprised they were down on a sequential basis by nearly 200 basis points even though the supplies mix, I think, was fairly stable in July versus April. So can you maybe just touch on what happened to the print margins and then in the April quarter? And how do we think about it in the back half of the year?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Sure. No. Thanks, Amit, and good afternoon. So the decline we saw in the Print operating rate was really driven by several factors. So first of all, some of the unfavorable costs in commodities, factory and logistics; and secondly, by investments that we made in OpEx across R&D, marketing to support future growth and higher variable comp.

And look, overall, I'd just say we have seen strength and resiliency in our broad – in our Print portfolio, which really positions us well against the competition. And as we look ahead into the future, we do expect our margins to be in the long-term range of 16% to 18%. And let me give you just a few things to think about as you think about the second half.

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So, obviously, the full year was very strong in the first half. So we expect to be towards the higher end of the range. And just a couple of other points I would add is some of the exceptional benefit that we saw in H1 particularly in favorable pricing will start to diminish. And so we would expect that our mix as well would normalize as the office reopens.

We're likely to see higher commodity costs, logistics costs, and that will potentially impact our ability to meet demand. And then finally, there is some seasonal mix headwinds in Q2 as in supplies as Q2 is typically our strongest quarter for supply. So just keep that in mind as you're thinking about the second half, and I would just conclude that we're in the business of generating incremental OP dollars.

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

A

I think a key point for our performance of Print this quarter is that we are really pleased of how the Print business did. Whether you look at year-on-year comparisons, whether you look at growth, it really aligned to the trends that we described last quarter, the rebalancing that we see happening between home and office, the growth that we are starting to see in some of the commercial and industrial categories. So Print had a very strong quarter, and we expect it to continue through the rest of the year.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Got it. That is really helpful. And then if I could just follow-up in a comparable dynamic, really, Enrique, I think a big focus for everyone is trying to understand what does steady-state EPS look like for HP over time especially given the strong performance you've had in the first half. And I think your back half guide sort of implies EPS will decline high single-digits, 10%-plus in Q3 and Q4. I'm curious, you touched on Print, but what are the other vectors that are driving the slowdown in EPS especially given the fact you have elevated backlog? And then do you think the $0.75, $0.80 implied EPS in October quarter is a representation of what normal EPS run rates would look like for HP?

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

A

Yeah. So first of all, let me talk about year-on-year comparison, so we put things in perspective. EPS for the second half is growing more than 40%, 40% from where we were a year ago. So we're really representing very solid growth. At the same time, as you are saying, we continue to see very strong demand across all of our portfolio. We expect this to continue to happen through the second half, but we're going to be limited by supply, given the shortages that we see in the market. And this is a fundamental part of what is driving our guide.

As we have done in the past, we are prudent when we guide. We have been in the past, and we will continue to be. If we can do better, we will, we could be better because of better pricing, because we could do better because of better capacity. So again, prudent guide. We have demonstrated that if we can do better, we will do better. And, therefore, given all the anomalies that we see and the supply constraint, I don't think we should be using the Q4 numbers to project the business in the future.

Operator: Our next question comes from Shannon Cross with Cross Research.

Shannon Cross
Analyst, Cross Research

Q

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Thank you very much. I had a question on inventory, both on your balance sheet and then within the channel, up about $800 million quarter-over-quarter. I'm curious how much of that was component buying or maybe some end product, just given supply chain hiccups. And then Lenovo said today, I think, that they see two to three weeks of inventory – or channel inventory on PCs. Usually, I can't remember, I think it was six to eight weeks is their normal. Can you talk a bit about what you're seeing in the channel and both on the PC and the printer side? And then I have a follow-up. Thank you.

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

A

Let me start. And I think maybe before Marie share some of the numbers, let me share some of the strategy that we have behind it. We shared last quarter that we were anticipating some of the supply challenges that we are seeing. We decided to operate with higher levels of HOI, and this is what you see reflected in the numbers.

So Marie, why don't you give some color on what are the increases in HOI?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yeah. No, absolutely, Enrique. So let me step back and set some context for you, Shannon. So obviously, we've seen that strong demand across PS and Print. And as you know, we're also lapping the factory closures and disruptions from those inventory drawdowns last year. And obviously that impacted the system all the way through. And then we're, obviously, trying to continue to navigate the supply chain challenges given the ongoing nature of the pandemic.

So to approve assurance of supply, we are carrying higher levels of owned inventory. And as we said, we do this to navigate during this time. So HOI at this point, is likely to stay elevated to support business growth. And that includes strategic buys to answer your question, where, particularly in CPUs.

And then going on to the second part of your question, around channel inventory, overall, CI in PS, Print, hardware and supplies is currently below historical levels. And our backlog is up, frankly, quarter-on-quarter, and that gives us confidence on the demand that we are seeing, Shannon.

Shannon Cross
Analyst, Cross Research

Q

Okay. Great. And then just a question on pricing, I think you noted you expect some normalization in pricing, but what we're hearing is prices are somewhat increasing. So is this more sort of an average price or mix impact? Or what are you seeing? Because if there's no supply out there and demand remains strong, I don't see where you might not have some pricing advantage. Thank you.

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

A

Thank you, Shannon. I think it's worth to go through the pricing discussion business-by-business. In the case of Print, we are having price increases across the board, and you have – you can see in our numbers an increase in the average price. In the case of PC, pricing rates are growing. So price in each category, almost in each category, are going up. But overall price is going down because of mix, because of where we are seeing the highest demand in the market. So prices are up. But because of mix, you may see the average price going down.

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Marie Myers
Chief Financial Officer, HP, Inc.

A

And, Shannon, just to add to Enrique's comments, some of the favorable pricing that we saw in the benefit in the first half is starting to abate in the second half as well.

Operator: Our next question comes from Toni Sacconaghi with Bernstein.

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

Q

Yes. Thank you for taking the question. I just want to just try and square the circle on a couple of things particularly around your guidance. So, seasonally, you're typically up in EPS and you're guiding for EPS to be down about 10% sequentially. Revenue is typically up 3% or 4%. Are you suggesting that revenue is going to be lower than normal seasonal or is this all margin pressure?

And the reason I struggle with the margin question is it sounds like your backlog is even bigger. You should be able to sell whatever you have, you have incremental inventory, so that should allow you to arguably meet demand better. So, if you're in a situation where people are chasing demand and the mix doesn't fundamentally change, why do you expect pricing to abate?

So, I guess a couple of questions in there. One, do you expect an impact to top line that's different from normal seasonal? Or is it all margin in terms of your way below normal seasonal EPS guidance? And then how do we square that margin pressure with the fact that there's really strong demand. You have better inventory to fulfill that demand and you should be able to continue to take price?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Hey, Toni. Good afternoon. It's Marie. So, let me walk you through how to think about our guide and, specifically, I'll give you a sense of what the headwinds and the tailwinds are looking like. So, first of all, with respect to your comments on revenue, we do expect that revenue will be driven more by available supply than demand, and there are increasing margin headwinds versus the first half.

With all that said, as Enrique said right at the onset of the call, we are guiding for double-digit operating profit and EPS growth in Q3. And frankly, we believe that this is a prudent guide in the context of the current environment. Obviously, if we can do better, we always will. But let me walk you through what we're seeing from the headwinds and tailwinds to give you some of that color.

So, on the headwinds, we're seeing component costs and logistics costs in both peers and print, and they will be an incremental headwind, both quarter-on-quarter and year-on-year. And those overall basket of commodities, particularly in panels, ICs, and PS and then ICs and resins and print. And then there are other tailwinds that we've had in the first half around those favorable pricing dynamics, they will start to dissipate as we lap the onset of those historically low promotion expenses.

Then getting into your comments on tailwinds and how we're thinking about it, demand in both PS and Print continue obviously to be very strong as you mentioned. We're seeing those trends of hybrid work continue. But obviously, they're constrained by supply. And in addition, just to kind of wrap up here, as we said, we're going to continue to return capital to shareholders. So, we expect that repo of at least about $1 billion a quarter.

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So, for the full year, we expect PS margins will be slightly above the high end of our longer term range of 3.5% to 5.5% and Print for the full year at the higher end of 16% to 18%. So at this point, we remain very confident of our guide. And if we can do better, like I said, we will.

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

A

And I think, Toni, is something important to have in consideration this year is really the business and the market is driven by supply, not by demand. So, therefore, comparing this year with other years based on seasonality, it will not work because, really, the dynamics behind the market are very different. But we continue to see very strong demand across our portfolio. And this is really the key driver is how much supply we can get.

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

Q

If I could just follow up on the pricing dynamics. So if I look at Consumer Print, ASPs last quarter were up 30%. This quarter, we're up 27%. If we went to something like zero pricing, it would basically put your operating margins dramatically down in the IPG group. So I want to understand what is driving this pricing. So is this purely an absent – an absence of discounting? Is this a we're not building lower-end SKUs with lower margin, and we're forcing people to take sort of more richly configured consumer printers that have better margin? Or is it we're actually raising price because we can, because demand is constrained? But obviously, 27% ASP growth this quarter, 30% last quarter is helping your economics enormously. As you suggested, it's going to be less. But I want to understand very specifically what is driving that ASP increase.

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

A

I think, Toni, in a situation like the one we are facing, we are doing anything we can to optimize our business. And therefore, we are driving all the actions that we were mentioning. We, of course, have reduced significantly our promotional discounts because of how strong the demand is. We are steering demand towards higher-margin products. And of course, in the cases where we can, also prices are going up. Because as we said before, we are seeing – we are living in an inflationary environment. And whenever we can, we will – we have increased prices.

Operator: Our next question comes from Katy Huberty with Morgan Stanley.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Thank you. Good afternoon. I heard you mention that PC backlog is up sequentially. Is your Print backlog also up versus the first quarter? And then can you talk about how the makeup of backlog is changing as you go through the year? Is there any shift from Consumer to Commercial, from Chromebook to other PCs and just mix between hardware and supplies? And then I have a follow-up.

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

A

Let me take that question. Hi, Katy. So the answer to the first question is, yes, we are seeing an increase in backlog across both PCs and Print. And in terms of how do we expect this to evolve, it's really aligned to where do we see demand coming during the next quarter. As we mentioned before, we expect through the end of the year an increase in the demand on the Commercial side both on the PC side and also on the Print side. And this

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is where this – because of that backlog, we'll be moving into this direction. But still, we continue to see strong demand on consumer, as I mentioned before.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you. And then PC margins this quarter were a bit lower than the flat sequential guidance. What were the surprises on costs or mix in the quarter? And then, should we expect with cost inflation that PC margins return to that roughly 5% range from a couple years ago?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yeah. Katy, it's Marie. Hey. Good afternoon. So, let me hit up your margin question. So yes, the margins were strong again at 6.7%, which, as you know, is above the high end of our long-term range. And some of that was obviously driven by that strong pricing discipline that we've spoken about, as well as some benefit from currency. But really, it was offset by mix and some of those commodity headwinds. And as we get into the full year, we do expect that margins to be slightly above the high end of our range of 3.5% to 5.5%. And it's going to be driven by the themes that you're hearing today, particularly around those continued shortages in commodities, and that's obviously sort of transforming into higher component costs and then knock-on costs and logistics. But – and then, I'd finally just add, we are starting to enter a period where the impact of favorable pricing is going to start to diminish as we start to lap that period in time.

Operator: Our next question comes from Tim Long with Barclays.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Thank you. Yeah. Two, if I could. First, on the Print side, could you talk a little bit about – you mentioned some of the user numbers for the out-of-service offering both for Consumer and Commercial. Seems like it's pretty steady growth there. Could you talk a little bit about some of the underlying drivers beyond that, maybe usage or anything else that's potentially showing the strength there other than just the user base?

And then, second, if – you talked about another quarter of very strong Chromebook. Could you talk a little bit about the impacts there on the model margin ASP? And then also, as you expect to see a little bit of normalization to PC growth, is the expectation that the rapid growth in Chromebook will be something that will pull back, or do you think that's something that could start replacing other mid and lower tiers of the PC segment? Thank you.

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

A

Sure. So many questions in one question, so I will try to go one by one. So starting from Print, where the dynamics we are seeing are very similar to what we explained a quarter ago and the evolution is what we were expecting. Before to pre-pandemic levels, we continue to see our home business to perform better than what we were projecting, and this is driving the demand that we see both on printers and also on supply. And on the office side, we are seeing the opposite effect. As many offices are still closed and people are not going back to the office, the overall office business continued to be below where it was before the pandemic.

Through the end of the year, we expect the situation to reverse. As offices will reopen, we expect our office business to perform better. And at the same time, more people will be – less people will be working from home.

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We expect that it will have also an impact – a negative impact on our home business. So, a similar trend to what we expected a quarter ago.

Then in terms of demand on the Chromebook side, we continue to see very strong demand from education. We have – this is what is driving the growth of Chromebooks and this is what also – when we were talking before about ASPs on the PC side and the mix there, this is what is having some of the impact in the pricing on the PC side because Chromebooks overall have lower prices than the rest of the PC portfolio.

Operator: Our next question comes from Aaron Rakers with Wells Fargo.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for taking the question and congratulations on another solid quarter. First question, and I have a follow-up, is when we look at the results, the Commercial business starting to recover, I think you reported 10% growth. I think your peer reported growth around that tonight. So, I'm curious of how you're thinking about the back-to-work, back-to-office trend on the Commercial PC side. Any thoughts on kind of the installed base, the age of the installed base, just how you think that demand shapes up through the course of the year?

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

A

Sure. So again, similar to what we shared a quarter ago, we expect the demand on the Commercial side to start to recover, and we are starting to see some recovery, as you are saying. But we – what we are seeing from our clients is that they are realizing of the need to invest in better equipment for their offices and employees come back, and this is really going to be helping both the Print and the PC business, as you were mentioning.

In terms of dynamics, we continue to see a shift from desktops into notebooks, because even if employees will be going back to the office, we still see the need for companies to offer a hybrid way of working and enabling their employees to work from home. And therefore, we expect the shift mix from desktops into notebooks to continue, which, as we have talked in the past, overall, has a positive impact for the business because of both pricing, but also because of the recycle time that PC – that notebooks have compared to desktops.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yes. And then, as a quick follow-up, just on the free cash flow, I think you've stuck with the $4 billion free cash flow or at least $4 billion for this year. You're raising EPS. So, I'm just trying to maybe understand why free cash flow wouldn't be stronger and trending higher with the EPS?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yeah. Sure, Aaron. Let me go ahead and hit that one up for you. So look, regarding future free cash flow, as you know, this is always driven by our strong net earnings. Look, for – what we're thinking is that working capital is going to be a headwind due to some of the decisions we're making to carry more inventory. So look, for 2021, we continue to remain confident obviously in our outlook and confident in our guide of at least $4 billion in free cash flow.

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

A

And I think – let me add one more comment. We are really pleased with the progress we have made in free cash flow in Q1 and Q2. And the guide that we have provided is of at least $4 billion for the year, and as Marie just mentioned, we are really expecting to be at that level.

Operator: Our next question comes from Ananda Baruah with Loop Capital.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Thanks, guys, for taking the question. Congrats on the strong results. Two quick ones, if I could. Enrique, based on conversations with corporate customers and given the backlog, do you get the sense that this momentum will actually continue into calendar 2022? Would love to get any updated context there, and then I just have a quick follow-up. Thanks.

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

A

So, thank you for the question. And we think that the changes that we have seen driven by the pandemic are going to be permanent and are going to continue to have an impact in 2021 and 2022. The – more and more people will have – will be working in a hybrid way. We think that more kids will continue to learn from home and from schools, and this is going to continue to have a positive impact on the overall size of the PC market. And therefore, we expect the size of the market to continue to be significantly larger than what we were expecting before of the pandemic.

Additionally to that, as we just described, we also expect to see strong Commercial demand through the end of the year. So, this will also help and put even more – drive even more growth on the PC side.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

And just sticking there, just going back to the questions about mix on the PC side, would – you talked about strength in Chromebook and how that is having a sort of softer mix impact on ASPs. Would that not reverse as Commercial sort of business continue to open up, should we not expect that to reverse and carry sort of into 2022, the mix?

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

A

So in terms of mix, yes, we expect the mix of Commercial to go up through during the next quarter. And this is why Marie was mentioning before that we expect the overall operating profit of Personal Systems to be slightly higher than our guided range through the end of the year.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great. Thanks so much.

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

A

Thank you.

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

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah. Thank you. On the Print side, I was wondering if you can give us an update on where you stand in trying to refill some of the Supplies channel inventory. Just talk about how big of a factor that was in the quarter and how we should think about the contribution from here. And maybe more broadly, just an update on your efforts to add visibility as we start thinking about getting below those tier 1, tier 2 distributors that you have out there?

Marie Myers
Chief Financial Officer, HP, Inc.

A

Yeah, no. Sure, Matt. So, maybe I'll just start it with a quick comment on where we see the channel right now relative to Supplies. And I think I mentioned earlier that overall, our channel inventory levels for the company are sort of below historic levels, and that includes Supplies. And obviously, we continue to monitor that very carefully so that we can maintain healthy and appropriate levels, but this quarter, given – if you wind it back a year ago, we had the sort of the onset of the pandemic. So, we've had that channel depletion that occurred last year. And so, we did see some benefit in the year-on-year compare. And from that impact of the inventory movements, we estimate that to be approximately 3% year-on-year. And as you know, we have a multi-tiered channel. So, this is our best estimate based on the data we have, including our channels for product across our channel and end-user stock.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

That's helpful. And then, I think it was last week that you guys announced the new Head of your 3D Printing business. Maybe just a broader update on how 3D has been ramping, where you guys stand with the push, and just maybe a bigger picture on when we should start to think about some more explicit disclosure just to think about the impact of that business more going forward.

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

A

Sure. Let me take that one. So first of all, this quarter, we started to see – we have seen the previous one – solid growth on the 3D side. Parts grew more than 30%, which is a very solid number. And I think these are – this shows kind of the potential that this business has in the long-term.

As we had announced before, we are complementing our strategy on 3D to also focus on some end-to-end applications where we think we can get even more value than just by selling printers or consumables. And we were mentioning on our prepared remarks the work that we are doing on molded fiber, as an example. But we really think that more and more, we will be focusing on applications to capture value in this business. And this is why we selected Didier Deltort to lead this business. He comes from the health and wellness industry. So he comes from an industry that will be disrupted by 3D, and we think this will be adding significant value to the definition of our strategy.

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And then, in terms of when we will be more transparent on the 3D business, I think as I have said before, there are two major things. One is we want the business to have higher scale. And second, and probably most important, we need to have a better defined business model. And this is where this combination of selling printers or supplies or going after end-to-end applications is so important. So once we will have a complete perspective of where this will be going longer term, it's when we will be providing more visibility.

Operator: Our final question today comes from Sidney Ho with Deutsche Bank.

Jeffrey Rand
Analyst, Deutsche Bank Securities, Inc.

Q

Hi. This is Jeff Rand on for Sidney. Can you give us an update on the competitive environment in your Personal Systems business and how this has changed through the pandemic and now a tight supply environment?

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

A

Yeah. I think that first of all, as we have discussed before, really, the performance of this business now is more driven by supply than by the strength of the portfolio. Now, having said that, we are really pleased with the progress we have made from a portfolio perspective. We – if you look at the innovation that we have introduced this quarter, we've won significant awards across both Consumer and Commercial products. We have one of the broadest portfolios in the market, covering from low-end education products to high-end Commercial products, and we are in a very solid position to continue to grow share as we did this quarter that show really the relevance of our portfolio.

Jeffrey Rand
Analyst, Deutsche Bank Securities, Inc.

Q

Great. And just for my follow-up, how should we think about your operating expenses trending in the near term as costs like business travel start to return?

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

A

Well, I think if you look at the projections that we have for the second half, we think we will be going back to a similar level to where we were in Q1.

Operator: This concludes our question-and-answer session. I'd like to turn the call back over to Enrique Lores for any closing remarks.

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

Okay. So let me close, and thank you, everybody, for having joining us today. I think the strong results of the quarter demonstrate the relevance of HP in this hybrid world and how our technology is going to be helping customers to really perform in a very different environment. We are really pleased with the growth opportunities that we see both in our core markets, in attractive adjacencies, and also in the new segments that we are creating. And we are going to continue to innovate across our technology to continue to create and drive differentiation.

Thank you for your time today and looking forward to meet in person sometime soon. Thank you.

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

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