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HP, Inc. (HPQ)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to the HP, Inc. Third Quarter 2021 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference 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 third 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. We posted the earnings release and the accompanying slide presentation on our Investor Relations webpage at investor.hp.com. As always, elements of this presentation are forward-looking and are based on our best view of the world and our businesses as we see them today.

For more detailed information, please see disclaimers in the earnings materials related 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 July 31, 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 the call 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 hope that you and your families are safe and well. It's an important time for us to connect. The hybrid world taking shape is expanding our addressable market and creating new opportunities to drive profitable growth. We have already started to capitalize on this and have a long runway ahead.

This is evident in our Q3 performance. We delivered another quarter of top and bottom line growth with EPS growing substantially faster than revenue. This reflects continued progress against our strategic priorities and strong and sustained demand for our products and services. In Q3, we delivered revenue of $15.3 billion, an increase of 7%. Our non-GAAP net earnings increased 71% to $1.2 billion. Non-GAAP EPS increased to $1 compared to $0.49 in Q3 last year. And we generated $1 billion of free cash flow, returning $1.7 billion to shareholders.

Before I take you through the highlights, I want to first share three key points of context as you think about our performance and outlook. First, as I mentioned, we continued to see strong demand for our products and services. The hybrid world is accelerating trends in our segments and our leadership across Commercial and Consumer categories, positions us well, even as demand continues to outpace supply.

The second point is that we continue to ship as much product as we can, while navigating a complex operational environment. We are managing through component shortages, COVID-related factory lockdowns in Southeast Asia, and congested ports and transportation disruptions. Even under these conditions, we delivered solid financial results.

And third, we are performing while transforming our business models and service offerings to capitalize on emerging growth opportunities. We have continued to make progress reducing our fixed cost structure, evolving our business models, and creating new growth businesses, and we are expanding our TAM in key segments to drive additional top and bottom line growth. In Personal Systems, it will be driven by our focus on peripherals and new compute models. In Printing, we are expanding our services and subscription offerings. I will talk about all of this in more detail by looking at the progress we are making across our portfolio.

In Personal Systems, demand for our products continue to be strong with our backlog increasing again quarter-on-quarter. PC penetration rates are growing across our market as devices become increasingly essential in today's hybrid world. While we delivered strong operating profit, PS revenue was less than we expected primarily because of our supply chain constraints. We expect industry-wide supply shortages, particularly in ICs to continue into 2022.

Given this, we have identified the necessary improvements we need to make and are accelerating their execution to drive stronger top line performance. We expect that it will take more than one quarter to show results. As we ramp supply, our PS portfolio is extremely well positioned for the hybrid world, and we see significant opportunities for market expansion. And our leading share in Commercial PCs positions us well as more businesses reopen.

In the Commercial market, we launched a new all-in-one and expanded our ZBook portfolio of high-performance PCs for creative professionals. This includes the ZBook Studio G8, the world's most powerful mobile workstation of its size. And our new ZBook Power brings ZBook performance to students, SMB, and the public sector. In Q3, we also launched a new Pavilion lineup that brings premium computing experiences into the mainstream with a lot of series of new displays that are purpose-built for home office and entertainment setups.

And we continued to drive momentum outside of our core hardware businesses. This quarter, we completed our acquisition of HyperX, giving us a leading position in gaming peripherals and a platform from which to accelerate our peripherals leadership more broadly. We also continued to advance our Device as a Service business, which grew 32% in the quarter.

And we are investing to meet emerging customers' needs in the commercial space. This is highlighted by our recent agreement to acquire Teradici Corporation. Teradici's software is widely used by leading organizations around the world to deliver superior remote computing solutions. We expect this deal will accelerate new compute models and services tailored for high-risk work environments.

In Printing, revenue was up 24% driven by recovery in Commercial and strength in Consumer. As in Personal Systems, the rise of all things hybrid plays to our strength and is creating new opportunities for print innovation and growth. Specifically, we are expanding our services and subscription offering, each of which delivered double-digit growth this quarter.

We continued to scale HP+ and Instant Ink across North America and Europe, including the addition of HP+ on the ENVY and DeskJet product families. We have seen positive response to HP+ to date, and HP's Instant Ink hit a major milestone by surpassing 10 million subscribers. Our subscription services are providing a simple and seamless experience for today's hybrid workers, paving the way for new offerings in the future.

We also continued to evolve our hardware portfolio with success in our award-winning HP LaserJet 400 and 500 series. HP continues to be recognized as a best managed print vendor, helping SMB solution providers thrive in a competitive market where quality and security are essential. The strength of our position in the Commercial market is significant as more people return to the office.

In our industrial businesses, we drove very strong hardware revenue growth in the quarter. Importantly, our number of pages printed is at or above 2019 levels. We once again saw double-digit growth in print impressions and square meters as well as strength in key categories like labels and packaging.

And in 3D, we remain focused on driving high-value end-to-end applications in strategic vertical markets. This quarter, we launched the new Arize Orthotic Solution. It leverages HP 3D Printing and cloud-based software to help the millions of patients who suffer from foot pain. This is a great example of the opportunity we see to disrupt industries with highly personalized solutions. Our combination of innovation and execution enables us to continue making progress across our business and portfolio. And we remain committed to generating strong cash flow and to value-creating capital allocation. This includes our robust share repurchase and dividend program and disciplined organic and inorganic investment.

In Q3, we returned $1.7 billion to shareholders and have returned $6.8 billion over the past 12 months. We believe our shares remain undervalued and are committed to aggressive repurchase levels of at least $1.5 billion in Q4. As part of our value-creation strategy, we also remain focused on M&A that can accelerate our growth in strategic areas. HyperX and Teradici are two great examples. We will continue using our rigorous returns-based framework to evaluate and pursue deals that complement our strategy and accelerate new sources of value creation.

As we drive our portfolio strategy and transformation agenda, we continue to prioritize making a sustainable impact. This quarter, we released our 20th annual Sustainable Impact Report that highlights the work we are doing in climate action, human rights, and digital equity and outlines new 2030 goals. Not only is it the right thing to do, it's also driving business success. In 2020, our Sustainable Impact initiative helped us win more than $1 billion in new sales for the second consecutive year. Aligned with this, we recently issued $1 billion in sustainability bonds. We are allocating these proceeds to ESG related initiatives consistent with our strategy and values.

Looking ahead to Q4, our backlog remains significantly elevated. We expect robust demand to continue, and we are taking decisive steps to address operational headwinds. Our portfolio is strong and resilient, and we remain on track to significantly exceed the full year EPS target we set in February. And today, we are raising our Q4 outlook. And more importantly, we plan to build on this performance and expect to grow full year EPS in fiscal year 2022. Longer-term, the hybrid world plays to our strengths and creates attractive opportunities across our categories. We are well-positioned to drive sustained performance as we innovate, improve, and continue to reinvent for our customers, partners, and shareholders. I look forward to our upcoming October Analyst Meeting to discuss our strategy and our plans to drive continued business success.

Let me now 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 E Myers

Chief Financial Officer, HP, Inc.

Thanks, Enrique. Looking at our third quarter financial results, we delivered another solid quarter of revenue growth with operating profit and EPS growing substantially faster. We are continuing our transformation journey, while generating strong free cash flow, returning significant capital to shareholders and investing for long-term value creation.

Looking at the details of Q3, net revenue was $15.3 billion, up 7% nominally and 4% in constant currency. Regionally in constant currency, Americas increased 12%, EMEA increased 1%, and APJ declined 6%. Supply chain constraints affected both Print and Personal Systems revenue, and this was particularly impactful in EMEA and APJ in Personal Systems. Across Personal Systems and Print, we continued to see strong demand for our products and solutions, capitalizing on opportunities we see as the hybrid world takes shape.

The gross margin was 22.2%, up 5.5 points year-on-year. The increase was primarily driven by continued favorable pricing including lower promotions as well as a reduction to previously estimated sales and marketing program incentives as well as currency partially offset by higher costs. Non-GAAP operating expenses were $1.9 billion, or 12.4% of revenue. The increase in operating expenses was primarily driven by increased investments in go-to-market and innovation as well as higher variable compensation due to the very strong performance this fiscal year as compared to 2020. Non-GAAP net OI&E expense was $78 million for the quarter.

Non-GAAP diluted net earnings per share increased $0.51 to $1, including $0.25 related to the reduction in previously estimated incentives of which $0.12 were reinvested during the quarter primarily in accelerating R&D, incremental marketing, and a hybrid work strategy. Non-GAAP diluted net earnings per share excludes net expense totaling $90 million primarily related to restructuring and other charges, amortization of intangibles, acquisition-related charges, debt extinguishment costs, other tax adjustments, partially offset by non-operating retirement-related credits. As a result, Q3 GAAP diluted net earnings per share was $0.92.

Before I get into the details of the segments, let me briefly address the reduction in previously estimated sales and marketing program incentives. Consistent with our policies, we review these estimates every quarter. We estimate incentives based on a number of factors like historical experience, customer behavior, and market conditions. The change in estimate is a result of lower-than-expected incentives due to increased supply constraints, shifts in customer behavior, and the evolving impact of the COVID-19 pandemic. As a result, it became clear that we had to make an usually large change in estimate in Q3.

Now, let me turn to segment performance. In Q3, Personal Systems revenue was $10.4 billion, flat year-over-year as supply chain challenges continued to constrain our growth. Demand for our products remained strong with backlog increasing again sequentially, despite substantially clearing the Chrome backlog.

Drilling into the details, Consumer and Commercial revenue was up 3% and down 1%, respectively. By product category, revenue was flat for Notebooks, up 1% for Desktops, and down 9% for Workstations. Total units was flat year-over-year. We also drove double-digit growth in both consumer peripherals and services attach across Consumer and Commercial.

Personal Systems delivered $869 million in operating profit and operating margins of 8.4%. The operating margin improved 2.9 points primarily due to favorable pricing, including the reduction in estimated incentives and currency partially offset by higher costs including commodity costs, investment in innovation and go-to-market, and variable compensation.

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. Q3 total Print revenue was $4.9 billion, up 24% driven by strong growth in supplies, hardware, and services. Total hardware units declined 4% due to manufacturing and component constraints primarily in Consumer printers. We expect these Q3 constraints to impact Q4 as well.

By customer segment, Consumer revenue was up 15% with units down 8%, and Commercial revenue and units were up 46% and 29%, respectively. Consumer demand remained strong. However, revenue, particularly A4 laser, was constrained by supply and factory disruptions. The Commercial recovery continued with double-digit hardware revenue growth in office and triple-digit increases in industrial printing hardware. Given what we're seeing with the Delta variant and evolving hybrid model, we still expect the recovery to be gradual and uneven at times across segments and geographies.

Supplies revenue was $3.1 billion. The 20% year-on-year growth was driven by inventory replenishment, stronger commercial demand, and favorable pricing. Our contractual business is a key element of our print strategy in both Consumer and Commercial printing. In Consumer, our Instant Ink business model continued to resonate well with customers with strong double-digit revenue and subscriber growth. On the Commercial side, we drove growth in Managed Print Services revenue and total contract value with particular strength in new TCV bookings.

Print operating profit increased $377 million to $857 million and operating margins were 17.6%. Operating margin grew 5.4 points driven primarily by favorable pricing, including the reduction in estimated incentives, higher volumes in commercial hardware, including graphics and 3D, partially offset by unfavorable mix and higher costs, including commodity costs, investments in innovation and go-to-market, and variable compensation.

Let me now turn to our transformation efforts and 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. Our hybrid work strategy is one example. It has enabled us to accelerate a location strategy, while providing a more flexible workspace. Going forward, we are enabling HP's hybrid work strategy by modernizing our sites to be critical hubs for collaboration and innovation. This will also deliver savings in our real estate portfolio.

In addition to our progress in our location strategy, we are making progress in our digital transformation. We are enhancing and leveraging our digital capabilities to transform the ways we operate and deliver value to our customers. In the third quarter, we completed the initial deployment of our SAP S/4HANA system, one of the largest ERP implementations. Also, as part of our end-to-end business planning and forecasting efforts, we also went live with our new cloud-based platform, which we believe will improve our forecasting agility as part of our digital transformation. The structural cost savings from our transformation efforts are a key enabler of reinvesting in our business for long-term growth and profitability.

Shifting to cash flow and capital allocation, third quarter cash flow from operations and free cash flow were $1.1 billion and $1 billion, respectively. In Q3, the cash conversion cycle was minus 29 days. Sequentially, the cash conversion cycle improved 1 day as higher days payable outstanding more than offset the increased days of inventory due to growth in inventory across PS and Print and the 1-day increase in days sales outstanding. For the quarter, we returned a total of $1.7 billion to shareholders, which represented 178% of free cash flow. This included $1.5 billion in share repurchase and $230 million in cash dividends.

Looking forward, we expect to continue to aggressively buy back shares at elevated levels of at least $1.5 billion in Q4. Looking forward to the fourth quarter, we continue to navigate supply availability and logistics constraints, pricing dynamics, and the pace of economic reopening. In particular, keep the following in mind related to our overall financial outlook.

For Personal Systems, we continue to see strong demand for our PCs, particularly in Commercial. In Print, we expect solid demand in Consumer and a mix shift as Commercial continues to improve. For both Personal Systems and Print, we expect that component shortages as well as some manufacturing, port and transit disruptions will continue to constrain revenue due to the ongoing pandemic and resurgence driven by the Delta variant.

Taking these considerations into account, we are increasing our Q4 and FY 2021 EPS. We expect fourth quarter non-GAAP diluted net earnings per share to be in the range of $0.84 to $0.90 and fourth quarter GAAP diluted net earnings per share to be in the range of $0.82 to $0.88. We expect full year non-GAAP diluted net earnings per share to be in the range of $3.69 to $3.75, and FY 2021 GAAP diluted net earnings per share to be in the range of $3.56 to $3.62. 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: We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Matt Cabral with Credit Suisse. Please go ahead.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah, thank you very much. I wanted to start off on the PC side. So really strong operating margins, especially relative to just how you were talking about that business 90 days ago. It sounds like a lot of that was the reduction in estimated incentives. Curious if there's any way to quantify that impact and just if there's any other swing factors to call out. And then going forward, just curious for your perspective on sustainability of margins at or above the longer-term range versus the need for some normalization beyond that point?

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Hey, Matt, good afternoon, and thanks for the opportunity. So why don't I hit up – unpack your question. I'll start on the outlook for PS for Q4, and then I'll flip over and give you an update on the change in estimated incentive impact on margin.

So with respect to our PS rate outlook, we have strong confidence in our Q4 operating profit and margin outlook. So far to-date, we're really pleased with our PS operating margins to-date and overall, we expect that PS will be well above our long-term range of 3.5% to 5.5% in Q4. So think about it in terms of being similar to half one levels, and we'll talk more about that when we get to SAM.

Now, to address your question with respect to the change in incentives, in terms of the impact on PS margin with respect to OP quarter-on-quarter, the net impact of the reduction in the previously estimated sales and marketing incentive was approximately about 1.5 points, and we're talking about that net of investments.

And I'll turn it to Enrique now.

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

A

Thank you, Marie. Let me address your question about sustainability. I think a very important thing to understand about this quarter is the strength of the demand that we are seeing. Demand continues to be significantly stronger than our supply chain capacity. Backlog grew quarter-over-quarter, and this is really driven by the trends that we have been describing before. The hybrid world is opening and driving opportunities for us to continue to build PCs. There is a very strong demand for PCs for people working from home and we expect that to continue. So as we saw strong demand in Q3, we expect to see strong demand in Q4 and to continue through 2022.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Perfect. And then maybe building on that last answer, Enrique, you mentioned confidence in EPS growth next year. I'm sure we'll hear a lot more at SAM, but just curious if you can give us a preview of the biggest drivers underneath there and just how dependent it is on that sustainability of demand or your revenue trajectory versus maybe other levers you have to pull?

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

So, we continue to see a lot of opportunities across the company both in PCs, in printing, in the new businesses we are creating, and as you said, we will be having our Investor Day in a few weeks from now and we will be sharing all the details about next year at that point.

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

James Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you very much. Could I just ask one question, and that's kind of on the PC side. There's a lot of investor questions about the peaking of the PC cycle and what we're starting to see post the big boost on year-over-year – a year ago big sales. Can you give us some color about your orders, your outlook? It sounds like there's a hand-off going on from consumer to enterprise strength, if I heard you correctly, and therefore, probably less strength in Chromebooks. Am I getting that right, the install base has been stealthily way above 300 million units per year kind of on this run rate. Do you think we're going to stay up there or go down quite a bit? That's kind of the big debate. Thank you so much.

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

So let me try to go one by one. So first of all, as I was mentioning before during the quarter we continued to see very strong demand for PC driven by the trends that I described. What we saw was that, when we finished the quarter, our backlog order that we had that customers wanted us to ship was significantly larger than what it was at the beginning of the quarter, and what we saw is very strong demand from both Commercial and Consumer categories. In both cases, we saw increase of demand.

The areas you were mentioning where we saw some weakness was on the Chromebook space because many – and it was mostly in the US because many school districts decided to stop their purchase activity until they had clarity on what type of new funds they were going to be getting from the federal government and the timing of those funds. As now this has been clarified we expect that now demand from the education space on Chromebooks will pick up at the end of this quarter or at the beginning of next quarter. But in any case, very strong demand from the PC side, faster growth from the Commercial, but very strong growth were from Consumer.

Operator: The next question is from Toni Sacconaghi with Bernstein. Please go ahead.

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

Yes, thank you. I also wanted to just follow up on PCs with the question being why do you appear to be facing supply and logistics constraints that are significantly more pronounced than your competitors? Dell just reported PC growth of 27%. Yours was zero. Lenovo had very strong growth. HP had been a perennial share gainer, and I think has lost share in PCs three out of the last five quarters or four out of the last five quarters. Why are these constraints so unique to HP?

And then related to that, you expressed confidence in the backlog but the Chromebook backlog was enormous one or two quarters ago, and it's completely gone. And so what makes the certainty of your conviction in the sustainability of your backlog in PCs for Commercial and Consumer different from Chromebook?

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

A

So, hi, Toni, and let me also go one by one. On the PC side, what we saw is, we clearly have some areas where we need to improve operationally to be able to optimize our performance given the delta between supply and demand. And there are three areas where specifically we are working and we need to do some more work.

First of all, as you know, we have an outsource model where the majority of our production is managed by ODMs. This means that also ODMs were managing until now, the relationship with the providers of the components that we are missing. We have been changing that, signing now direct relationship and direct supply agreements with them, so this is addressing that gap.

Second important factor is, one of the key things of our PC business is the breadth of our portfolio. We lead both in Consumer and Commercial. But this portfolio had not been designed to optimize for low cost components, which is what we are missing now. We have been changing that, and as we will introduce our new products going forward, you will see an increase of leverage of components across multiple products so we can really optimize our digitalization of components.

And third, as Marie mentioned during the prepared remarks, we have been working to deploy a new ERP system. The ERP system is now in place, and now we have the ability to create tools that will help us to optimize the location of orders not only based on business priorities, but also on component availability. And this is something that until now because we were in the middle of the ERP change we had to do manually. So when I look at all these three areas, explain kind of the improvement that you are going to see on this side and give us confidence on how we will continue to optimize how we manage the current situation.

Then the second part of your question around Chromebooks, I think that an important factor to realize is that during the quarter, we closed the backlog because the shipments of Chromebooks were 100% higher than shipments that we made before. When we look at the backlog that is left, we analyze it customer-by-customer, retailer-by-retailer, partner-by-partner, and this gives us very strong confidence on the value and the solidity of that backlog. If we look at cancelations, with the exception of Chromebooks coming from some of the changes in the US school districts, we are not seeing cancellations of the backlog and as we mentioned before, it is more than one full quarter of demand what we have in backlog.

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

Q

Thank you. Just my final question is you did say you were going to grow revenues in fiscal 2022. You did not say you were going to grow revenues in fiscal 2022. Are you confident you will grow revenues in fiscal 2022?

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

A

As I said before, we are going to be having our Investor Day in a few weeks from now, and that will be the right time to have all the conversations about fiscal year 2022. Thank you, Toni.

Operator: The next question is from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani
Analyst, Evercore ISI

Q

Good afternoon. Thanks for taking my questions. I have two as well. I guess the first one, Enrique, maybe you could talk about the Print business a little bit. It continues to perform really well. I think supplies was up 19%, 20%. I think the struggle everyone is having though is what does profit normalization look like as supplies growth starts to moderate back to the long-term averages. So I'd love to understand, do you think there are structural changes in place within supplies, within Print actually, that ensure that even if supplies starts to slow down you can sustain the high-teens margins that you've been seeing over the last few quarters?

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

A

Thank you. So first of all in terms of the supplies performance, we are really pleased with the performance that we saw this quarter, though we need to accept that the 20% growth is also coming because we had an easy compare to last year. But, again, we are pleased with the performance of our supplies.

In terms of what do we see happening, basically the trends that we shared before as offices are reopening, we are starting to see an increase and growth on the toner side, on the office side and at the same time we are starting to see some slight slowdown on the Consumer side which again is what we were expecting, and in any case the Consumer business today continues to be above the projections that we had for this time before the pandemic started. And this is a structural change that has happened.

Additionally to that, we have been able to accelerate the transition of our business model both rebalancing profitability but also significantly growing our subscription businesses and this gives us strong confidence about the evolution of the business going forward, but also in terms of protecting our supply share because as more and more customers are part of the subscription program we will make sure that they continue to use HP supplies.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

To add to Enrique's comments, right now, our channel is where we want it to be, so going into Q4, we're not expecting any channel replenishment at this stage either, Amit.

Amit Daryanani
Analyst, Evercore ISI

Q

Perfect. Thank you very much. And then, Marie, maybe I'll follow-up with you. On the free cash flow dynamics, inventory maybe you talked on that a little bit, why it ramped up so much. How do you see that normalizing back into the October quarter? Does it normalize in October? Does it stay elevated I guess longer-term? And what do you need to see as a company to take leverage back up to I think two times debt-to-EBITDA that you talked about a year ago or so to [ph] accelerate (40:10) the buybacks even further?

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yes, look, no worries, Amit, and I think I got the first part of your question. I'll address your comments on inventory. And quite rightly, so you said that inventory is elevated this quarter, and that's really due to strategic assurance of supply. Look, we expect that it's frankly going to remain higher than pre-COVID levels, but, look, we might see some adjustments quarter-on-quarter as we drive and meet customers' needs. We're in a pretty dynamic environment as we speak here.

Now to address the second part of your question on leverage, right now our gross debt-to-EBITDA is about 1.17 times, which is – it's below our stated goal of getting towards 1.5 to 2 times and, look, we continue – we expect to reach that lower end of the range over time, but right now given our strong earnings and free cash flow performance, it's going to be a couple of quarters.

But I might just add that we are really proud of the job that we've done around capital allocation. I think you heard in my prepared remarks that we said we plan to purchase back at least $1.5 billion in shares in the quarter. And, Enrique, I might just turn it over to you for any closing comments.

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

A

Well, maybe a couple of comments. I think it is important to remember that we are really and we stay very committed to aggressively return capital to our shareholders and our actions within the last quarters reflect that.

As we mentioned, we have returned this quarter $1.7 billion to shareholders, which is 178% of free cash flow. And since the value plan started, we have bought 20% of our outstanding shares. So, really, strong commitment to that. During Q4, we are going to be buying at least $1.5 billion, so we are continuing with that. And during the Analyst Day, we will share what our plans for 2022 are, but you all can expect from us very strong focus on continued buying back and dividends.

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

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

Q

Yes, thank you. Marie, can you help us understand what the catalyst was to change the sales and marketing incentives in the quarter? Because that was a big surprise, and at face value, it almost looks like it was a reaction to operational execution and shortfalls, but maybe that wasn't the case.

And specifically, is this an accrual change or is it an actual change in the level of payments that you were making in the quarter? And should we think about this new level as a new structural level or will this recover as you come out of COVID? And then I have a follow-up.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yes, and good afternoon, Katy. So why don't I explain to you, just walk you through this change in estimate, then I'll address your question specifically around the accrual and the reserves.

So we typically look at these estimates every quarter. So we estimate our sales and marketing incentives based on a number of different factors. So, for example, historical experience, expected customer behavior, acceptance rates and a very important driver is market conditions, which as you know we've experienced a lot of volatility since the COVID-19 pandemic began.

It's also worth noting that some of these programs take several months, from 6 to 12 months for partners to claim. So with the impact of these market dynamics combined with the lower claims that we've seen from our partners, it became clear that we had to make this unusually large change in estimate in Q3. And, frankly, we don't expect future changes of this size, but if it changes, we'll make the appropriate disclosures.

Now, typically reserves just to answer your question you asked me about the reserve and then I'll address your structural component, reserves are typically liabilities for estimated future payments. So a reserve can occur for a variety of reasons. One of those can actually be a change in estimate. And in terms of structural, as you know, we have in place a transformation plan.

We are expecting to be at 75% of our $1.2 billion plan and we're always looking for opportunities to drive efficiency in our pricing and we've been very effective actually in pricing for the current market environment as you see in the results that we've delivered. So certainly in terms of structural, we're looking for opportunities to continually improve our pricing and our ability to price effectively in this dynamic period.

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

Thank you for that color. And just as a follow-up, historically revenue increases 5% to 7% sequentially in October. Is normal seasonality a reasonable expectation given that you're coming from the lower base of revenue in 3Q given some of the execution issues that need to be addressed? Or will it take longer to fix, for instance, the shortfall you saw on PCs in international markets and we shouldn't necessarily be assuming normal seasonality? Thank you.

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

Yeah. Let me take that question, Katy. And I think we need to realize that we are in a very different situation than before the pandemic. Usually, our business is demand-driven and, therefore, there is some seasonality driven by buying patterns. Today, our business is totally driven by supply.

As I said before, orders exceed significantly what we can produce and, therefore, normal seasonality doesn't apply to a year like this, because what we will be shipping is not what we will be getting orders for. It's going to be what is the maximum amount of product that we can produce every day, every week, every month.

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

Shannon Cross
Analyst, Cross Research Q

Thank you very much. My first question is just with regard to underlying trends in print volumes, and if you can talk about what you're seeing consumer SOHO in the office and maybe if you can talk about within regions that are either, I guess, returning to the office or reversing course just to get some idea of what you're seeing with the data that you get. Thank you.

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

Thank you, Shannon. The trends that we are seeing are aligned to the trends that we were expecting to see a quarter ago. We are starting to see recovery in the office side, though I have to say that that recovery is uneven and it is impacted by the evolution of the pandemic, and certain countries when they are hit we see offices close again and then we see an impact there. But the trend is positive in terms of office growth, and we see faster growth from the SMB side than on the Enterprise side. When I say growth I mean recovery.

On the other side, on the home side, again, as we were expecting we are starting to see a slowdown as kids are starting to go back to schools in many countries and the balance of work between home and office is also changing. Again, it is what we were expecting, and in any case what we see today and the projections that we have now continue to be above the projections that we had before the pandemic.

Shannon Cross
Analyst, Cross Research

Q

And as a clarification, can you say you're at 80% or 85% of where you were printing? And then my – just I'll jump it in, my second question is with regard to acquisitions especially if you're going to start to see some revenue pressure next year given some of the strength you've seen in PCs this year. Where are you at with regard to acquisitions? Thank you.

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

A

Sure. In terms of deviations as to number of pages printed, I guess your question is in the office. It goes between minus 15% and minus 25% or minus 20-something between SMB and Enterprise, so we are still below where we want to be, but this gives you some ranges.

And then in terms of acquisitions, M&A continues to be part of our plan. We have a rigorous framework to analyze the opportunities that we see based on returns, based on alignment and strategy, based on our ability to execute. We are constantly evaluating opportunities in our core businesses, in adjacencies to support our new growth strategies, and this quarter we had two great examples that show how do we approach and how do we think about M&A.

We closed the HyperX deal that is really allowing us to accelerate our growth into the peripheral space and now we have a leading position in peripherals for gaming. And we did also a very exciting opportunity on the services space with acquisition of Teradici Corporation that will allow us to integrate into our services, remote compute for highly complex environments which many of our customers are utilizing today. So M&A is part of our plan and we are executing on that when we see the right opportunity.

Operator: The next question is from David Vogt with UBS. Please go ahead.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thank you, guys, for squeezing me in. so I just wanted to go back, Enrique, to the backlog. Can you give us a little bit more granularity on sort of the mix? I know you mentioned that the Chromebook part of the backlog could come down pretty dramatically. But any more color on what that mix might look like given where the margin strength came in in the quarter. So it's a little bit surprising.

And then obviously it sounds like you think Chromebooks are going to come back a little bit into the mix. How do you think about sort of order growth from a Chromebook perspective relative to where the backlog is today? So what I mean by that is when we think about the October quarter, should backlog given supply constraints tick up again given your commentary or do you think we're at reasonable equilibrium despite the supply chain constraints from a demand perspective? And then I have a follow-up.

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

A

Sure. Let me address some of your points. So first of all, first important factor is backlog grew during the quarter. So we ended the quarter we have higher backlog than what we had when the quarter started. The mix of the backlog was different. As I said before, we basically fulfill all the orders that we had with Chromebook, but the rest of the commercial business and consumer grew significantly. And today when we closed the quarter, more than 60% of the backlog was coming from commercial customers, which is where margins are higher and where we – and this is really an important factor to have in mind.

As we look at the future, we expect the Chromebook business to accelerate again at the end of Q3 and at the end of Q4, but I think it's important to have in mind that Chromebook represents around 10% of our total PC business, even slightly below that, so it's a relatively small business for us. What I really want to highlight is the strength of the commercial business which really is driven by companies reopening, offices being reopened and investments that corporations are doing and SMBs are doing in improving their work and experience for their employees.

David Vogt
Analyst, UBS Securities LLC

Q

And then – that's helpful. I appreciate that. Maybe just a follow-up for Marie along those lines. So I know you mentioned Q4 margins will be more likely resembling kind of one half margins in Personal Systems Group. Is that the right way to think about it in terms of commercial margins are above where we are now and Chromebook as it comes back into the mix into Q4 is slightly dilutive to margins and that's how we think about sort of that step-down from 3Q into 4Q, and then into 2022 if Enterprise or commercial is still relatively strong should we be expecting margins in PSG to be above sort of your normal historical 3.5% to 5.5% range. Thanks.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yeah, so going into Q4, as I mentioned earlier, we expect PS to be well above our long-term range of 3.5% to 5.5%. So just think about it in terms of being similar to the sort of half one levels. And to your comment about Chrome, yes, Chrome margins are usually more dilutive to PS. Now, in terms of 2022 and how to think about 2022 margins, we're going to talk more about that in terms of the mid and long-term at our Security Analyst Meeting in October, so we'll look forward to seeing you then.

Operator: And our last question today is from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Thanks, guys, for taking the question. Hey, two, if I could. Enrique, just to the remarks you made a few moments ago, if back to office gets meaningfully delayed as we go through the fall here, like how should we think about the impact of both the PC and the Printing business. And in that if the demand for back to office PCs is put on hold to any extent, do you think that there could be a switch back to – is there sort of PC demand still at the home that would need to be satiated. And then I have a follow-up as well. Thanks so much.

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

A

I think that the backlog that we have when the quarter started is so high, when I say backlog is close to one full quarter, this gives you the magnitude of the orders that we haven't able to fulfill. I think in the short term really we are very protected from many deviations as per the current plan.

So I don't think this will have any big impact from that perspective, Ananda. And what we are seeing is, especially on the PC side, we are not seeing a big implication of the offices reopening or not because more corporations realize that they need to invest in improving the experience for their employees and we are seeing very strong demand across the board.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's really helpful. And then I guess the second one is the actions that you described, Enrique, with regards to sort of the underutilized – sort of the comments about being under-indexed on share and you had talked about sort of executional dynamics, outsourced model, components being optimized across SKUs, ERP systems, when do you believe that those actions collectively can start to make an impact that will show up in the P&L, and I'm assuming that also you're suggesting that [ph] it leads to (55:27) share repurchase as well.

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

A

Well, I think in terms of the actions we have been working on them for a couple of quarters now and they will have impact gradually during the next month. This is really more about how do we optimize our performance within the current constrained environment. We shouldn't expect that with this we are going to be able to double our capacity because there are significant shortages of components, but this will have a gradual improvement in our performance, especially when we look at it competitively.

And I'm not sure if I understand your comment about share repurchase. We are fully committed to continue to repurchase stock. We announced that during Q4 we will be buying at least $1.5 billion of shares and during the Analyst Meeting, we will share what are the plans for 2022. Thank you.

Enrique Lores

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

And I think that was the last question. So let me close by saying thank you, everybody, for participating. As you have seen during the call we remain very optimistic about the opportunities that the new way of working that the hybrid world is opening for us and we are making very good progress executing our strategy.

We continue to see very strong demand and in the short term our results are going to be impacted by component availability. It's not a demand-driven world, it's a supply-driven world. In this world our ability to drive financial results is very strong. We are confident in the future, and this is why we raised guidance for the year and for Q4 to reflect the confidence that we have in the business. And as we said, we are looking forward to seeing all of you in our Investor Day in October. Thank you.

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