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HP, Inc. (HPQ)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Second Quarter 2022 HP Inc. Earnings Conference Call. My name is Josh, 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 Orit Keinan-Nahon, Head of Investor Relations. Please go ahead.

Orit Keinan-Nahon
Global Head - Investor Relations, HP, Inc.

Good afternoon, everyone, and welcome to HP's Second Quarter 2022 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 a webcast, and a replay will be available on our website shortly after the call for approximately 1 year.

We posted the earnings release and accompanying slide presentation on our Investor Relations web page at investor.hp.com. As always, elements of this presentation are forward-looking and are based on our best view of the world and our businesses as we see them today. For more detailed information, please see disclaimers in the earnings materials relating to forward-looking statements that involve risks, uncertainties and assumptions.

For a discussion of some of these risks, uncertainties and assumptions, please refer to HP's SEC reports, including our most recent Form 10-K and Form 10-Q. HP assumes no obligation and does not intend to update any such forward-looking statements. We also note that the financial information discussed on this call reflects 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, 2022, 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 now like to turn the call over to Enrique.

Enrique Lores

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

Thanks, Orit. And thank you to everyone joining our call today. We are now halfway through our 2022 fiscal year, and I am proud of the results our teams have delivered as we continue building a stronger HP. But before I talk about our performance, I want to acknowledge the tragic events of the past few weeks.

Last Tuesday, 19 children and 2 of their teachers were senselessly killed at a Texas elementary school. About a week earlier, 10 people were killed in a racially motivated attack in Buffalo. These horrific events and others like them are deeply disturbing and our hearts are with the communities who are bearing unimaginable loss right now.

At the same time, we're also thinking about the people of Ukraine. More than three months into the war with Russia, the devastation and suffering across Ukraine is difficult to comprehend. So too, is the situation facing the 6 million Ukrainian refugees, we continue to mobilize resources to support them.

The HP Foundation has provided additional funding to support humanitarian relief across Central Europe and we are donating a significant number of PCs to help refugees and their families, consistent with our global efforts to promote digital equity and education. Times like this are a painful reminder of how much work is still needed to create a more just future.

And I believe it's incumbent upon companies to lead with purpose. These values have long been core to HP brand, and they will continue to guide us. Let me now turn to our results. When we held our Investor Day last October, I discussed our plans to continue our push to advance our leadership in our core markets, while creating our growth-oriented portfolio by expanding into adjacencies and creating new businesses.

I also highlighted the long-term secular trends we see propelling us forward, especially the rise of hybrid work and the exciting opportunities it creates across our broad portfolio. Our second quarter results show strong momentum in each of these areas. In the face of a volatile and dynamic macro environment, we executed well and grew revenue and non-GAAP EPS while returning capital to our shareholders. We are delivering on our commitments and our business is well positioned for sustainable long-term growth.

For the quarter, revenue grew 4% year-over-year to $16.5 billion as we continue to see strong demand for HP technology and services. Non-GAAP EPS grew 16% year-over-year to $1.08, that's at the high end of our previously provided outlook. We generated $0.4 billion of free cash flow, and we returned $1.3 billion to shareholders through share repurchases and dividends. We remain committed to building a more growth-oriented portfolio.

Our key growth businesses, which includes: Gaming, Peripherals, Instant Ink, Workforce Solutions and Industrial Graphics & 3D collectively grew double digits and delivered total revenue of $5.6 billion in the first half of fiscal 2022 and we are well on track to deliver on our $10 billion full year revenue target that we announced last October.

We feel very good about these results. We mitigated the impact of higher commodity costs by implementing effective pricing strategies in both print and personal systems while maintaining strong demand. And as we navigate the macro environment, we are making consistent progress on our strategic priorities and bringing strong innovation to market. This is reflected in our business unit performance.

In personal systems, revenue grew 9% to $11.5 billion. This was our highest Q2 revenue ever, reflecting the durability of PC demand. We also delivered operating profit margin of 6.9% at the high end of our target range. We are managing our PS portfolio with great discipline, focused on driving profitable revenue growth more than units.

Our continued mix shift towards commercial and premium combined with our pricing strategy allowed us to more than offset fewer unit shipments in the quarter. Increased spending on hybrid work solutions is driving strong commercial PC demand. Commercial revenue grew 18%, driven by double-digit growth in Windows-based notebooks, desktops and workstations. And commercial was trending up to 65% of our peer revenue mix in the quarter.

In consumer, while the market has seen some signs of softening demand, it still exceeded pre-pandemic levels. There are pockets of growth in areas like premium and gaming that we are most focused on. And we are driving continued growth in peripherals, which grew more than 40% this quarter.

Our supply chain actions also continue to have a positive impact. We reduced our backlog quarter-over-quarter. While the backlog remains elevated, particularly in commercial, we believe the actions we are taking will drive continued improvement. And as we prioritize operational execution, we are equally focused on strengthening our portfolio.

During the quarter, we entered into an agreement to acquire Poly. Once completed, we expect this transaction will strengthen our position in hybrid work solutions and accelerate our growth in peripherals and workforce solutions. Since the announcement was made, we have received very positive feedback from reseller and partners and commercial customers about the opportunity ahead.

Our integration planning efforts are well underway. And we are working closely with the Poly team to prepare for a smooth transition upon deal close. We look forward to welcoming the Poly team to HP later this year. Turning to print, we continue to operate in a components and logistics constrained environment, and performance was also impacted by the macro events this quarter. As a result, print revenue declined 7% in the quarter, and our order backlog remained elevated in Q2. We expect supply chain dynamics to improve but continued shortages, especially in application-specific integrated circuits will impact print for the remainder of the year.

We are actively working with our partners to mitigate the risks by executing on dual sourcing whenever possible and redesigning circuit boards and components in our printers. We are also managing prices with great discipline, and we delivered another quarter of solid profitability.

Our print operating profit margin was 19.3%, our second consecutive quarter above our target range. Print consumer demand remained solid despite some softening in Europe. And we made important progress on two strategic objectives: rebalancing system profitability and growing our subscription business. We have seen strong acceleration with HP+ and increased adoption in developed markets since launching last spring.

In addition, we see strong growth on our profit up front units, including our Big Tank model, especially in emerging markets. Big Tank revenue and units grew double-digits year-over-year. We plan to continue expanding the Big Tank portfolio with new product launches of high-end platforms in the rest of our markets. Overall, HP+ and Big Tank printers have become a larger portion of our portfolio mix, representing 48% of printer shipments in the quarter.

In consumer subscriptions, Instant Ink delivered another quarter of double-digit growth in revenue and cumulative subscribers. In commercial print, the office segment continued to be impacted by supply availability as well as uncertainty around the timing of offices reopening. This was partially offset by our industrial graphics and 3D business growth.

In industrial graphics, we delivered solid revenue growth and built a strong funnel continuing the positive trajectory we have seen in recent quarters. We had significant new installations of our latest Indigo digital presence. And I am particularly proud of the team's work for our customer, Hershey, as we created customized packaging to support the International Women's month campaign.

We also delivered double-digit revenue growth in 3D printing. This quarter, we announced a partnership with Legor Group, a leader in metal science and production for the luxury jewelry and fashion accessories market. This is an important milestone as we prepare to make metal jet more broadly available later this year.

The progress we made in our first half of 2022 gives us confidence to raise our full year non-GAAP EPS outlook. And as we enter the second half, we will remain focused on disciplined execution in today's challenging and volatile macro environment.

From a demand perspective, we expect to continue to see strong commercial demand with some softening of the consumer businesses. From a supply perspective, we see two causes of constraints. First is the industry-wide component shortages that we expect will continue through fiscal 2022; second, are the COVID-related disruptions in China, which we expect will primarily impact fiscal Q3.

We will also see an impact from the Russia-Ukraine war. Last February, we suspended shipments to Russia and Belarus across our portfolio and closed all marketing and advertising activities. Considering the current environment and long-term outlook for Russia, we have decided to stop our Russia activity and have begun the process of fully winding down our operations. Business there accounted for approximately $1 billion in revenue in fiscal year 2021. Marie will talk more about the financial aspects of our Russia plans.

We remain committed to taking structural cost out of the business, and we are on track to meet our transformation cost targets. These actions combined with top line growth and effective working capital management give us confidence in achieving our free cash flow target. And we remain committed to our share repurchase plan of at least $4 billion in fiscal year 2022.

The final point I'd like to make is that we are delivering on our financial commitments, while making progress against our sustainable impact strategy. Later this week, we will release our annual Sustainable Impact Report, outlining progress against climate action, human rights and digital equity goals.

Let me give you a few examples. From 2019 to 2021, we achieved a 9% absolute reduction in our greenhouse gas emissions across HP's value chain. I am proud that we continue to decrease absolute emissions, while our net revenue increased by 8% during the same period.

We have reduced single-use plastic packaging by 44% compared to 2018. And we have enabled better learning outcomes for over 74 million people globally since 2015 by providing curriculum, training and technology.

I am inspired by the progress we are making toward becoming the world's most sustainable and just technology company. Not only are these the right things to do, they are also differentiating our brand and helping to drive our business.

To sum up, this quarter caps off a strong first half of 2022. We are building a more growth-oriented portfolio, while also operating with great discipline and agility in the face of macro challenges. The environment will remain dynamic in the second half.

We are not immune to these challenges, but our strong performance and momentum through the first two quarters gives us confidence to increase our full year non-GAAP EPS outlook. We are equally confident in our free cash flow outlook for the year, and we remain committed to our capital allocation strategy and continuing to return capital to shareholders, while investing in the business to build a stronger HP.

I will stop here and let Marie provide a closer look into our financial outlook.

Marie E Myers

Chief Financial Officer, HP, Inc.

Thank you, and good afternoon, everyone. It's great to connect with you again. As Enrique highlighted, we have continued to build on our progress here in Q2, executing on our strategy, delivering solid results, returning significant capital to shareholders and investing both organically and inorganically to drive long-term value creation.

Overall demand remained solid, driven by the strong secular tailwinds we see propelling our businesses forward, and we continue to execute on our objectives despite ongoing supply chain and logistics challenges and new macro impacts from the recent round of COVID-related lockdowns in China and the Russia-Ukraine war. Overall, I am pleased with how our teams are meeting these challenges head on and remain confident in our execution, as we navigate this evolving macro environment.

Let's take a closer look at the details of the quarter. Net revenue was $16.5 billion in the quarter, up 4% nominally and 5% in constant currency. Regionally, in constant currency, Americas increased 1%, EMEA increased 7% and APJ increased 10%. Gross margin was 20.2% in the quarter, down 1.5 points year-on-year. The decrease was primarily driven by proportionally higher personal systems mix and higher costs, including commodities, partially offset by favorable pricing net of currency.

Non-GAAP operating expenses were $1.9 billion or 11.4% of revenue, down 5%. The decrease in operating expenses was primarily driven by lower R&D due to last year's ramp up in investments and lower variable compensation, including sales commission. Non-GAAP operating profit was $1.4 billion, and non-GAAP net OI&E expense was $74 million for the quarter. At the key segment level, operating profit grew 6%.

Non-GAAP diluted net earnings per share increased $0.15 or 16% to $1.08 with a diluted share count of approximately 1.1 billion shares. Non-GAAP diluted net earnings per share excludes a net expense totaling $152 million, primarily related to restructuring and other charges, amortization of intangibles, acquisition-related charges and other tax adjustments, partially offset by non-operating retirement-related credits. As a result, Q2 GAAP diluted net earnings per share was $0.94.

Now let's turn to segment performance. In Q2, personal systems revenue was $11.5 billion, up 9% and up 11% in constant currency. Total units were down 17%, driven by ongoing supply chain challenges, lower Chrome units and the overall macro environment. Despite this, we grew revenue, reflecting the strength of Windows demand, our mix shift towards higher-value commercial categories; like mainstream premium, and mobile workstation, and favorable pricing.

Furthermore, to highlight some of the secular tailwinds we have seen in personal systems versus pre-pandemic, our commercial notebook mix, excluding Chrome, now represents over 60% of our commercial unit mix, up 15 points versus Q2 2019. And in gaming, revenue has grown by over 140% versus Q2 2019. These are significant structural changes in our business.

Drilling into the details, commercial revenue was up 18% year-on-year and consumer revenue was down 6% year-on-year. By product category, revenue was up 3% for notebooks, 28% for desktops and 21% for workstations. We also continue to see strong performance across our key growth areas; including peripherals, gaming and workforce solutions with even more opportunities to drive growth ahead of us.

Personal systems delivered almost $800 million of operating profit with operating margins of 6.9%. Our personal systems business has grown operating profit dollars in 17 of the last 18 quarters. This consistent performance is indicative of our strong portfolio, the strong secular tailwinds we continue to see and our ability to deliver results in very different environments.

Operating margin improved 0.2 points, primarily due to product mix, favorable pricing and lower OpEx; including lower R&D spend due to last year's investments ramp up, partially offset by higher commodity costs in currency. Sequentially, operating margin declined 0.9 points, driven by higher OpEx due to R&D investment, more competitive pricing in several segments of consumer, partially offset by lower commodity and logistics costs.

In print, our results reflected our focus on execution and the strength of our portfolio as we navigate the current environment. In Q2, total print revenue was $5 billion, down 7% and down 6% in constant currency, driven by lower print hardware units and lower supplies revenue. This was partially offset by higher hardware ASPs and growth in industrial graphics and services. Total hardware units declined 23%, largely due to continued component and logistics constraints, which we now expect to extend at least through 2022.

By customer segment, commercial revenue declined 4% on a decrease of 17% in units and consumer revenue was down 12% with units down 24%. Home printer demand remains solid. However, revenue across both home and office was again constrained by available supply. In Q2, the commercial recovery, particularly in the office segment, continued to be impacted by the slower than expected return to the office. We did see, however, solid growth in industrial graphics and 3D as Enrique mentioned. We continue to expect a gradual and uneven recovery in commercial over time, with the overall office market returning to approximately 80% of its pre-pandemic TAM, as we have discussed previously.

Supplies revenue was $3.1 billion, declining 6% in constant currency year-on-year. We continue to expect for FY 2022 and over the long-term, supplies will decline in the mid to low single-digit range, consistent with the outlook provided at our Analyst Day.

In Q2, the decline was driven primarily by continued normalization in home printing as expected, partially offset by the gradual recovery in both office and industrial print. Supplies revenue was also impacted by the China lockdowns and the Russia-Ukraine war. Adjusting for these impacts, supplies revenue was down approximately 4% in constant currency.

As part of our contractual business, our Instant Ink services continued its momentum, once again delivering double-digit increases in both cumulative subscriber growth and revenue, while monthly churn continues to remain low at approximately 1%.

Print operating profit was approximately $1 billion, up $7 million and operating margin was strong at 19.3%. Operating margin increased 1.4 points, driven by favorable mix and pricing, combined with lower OpEx as a result of lower variable compensation, including sales commission, partially offset by lower volumes.

Now, let's move to our transformation efforts where we have made strong progress and are on track to deliver $1.2 billion in gross run rate structural cost reductions by year-end. Our transformation continues to create new capabilities and long-term value creation. For our sales teams and partners, we have accelerated the selling cycle by transforming the way we configure, price and quote HP Solutions for our customers worldwide.

Utilizing advanced analytical pricing capabilities with a cloud-based platform, we have enabled the delivery of competitive quotes for HP Solutions in a quarter of the time, delivering a faster and more efficient customer sales experience.

Lastly, we continue to optimize our real estate footprint, including 15 real estate actions in the first half of 2022. We are rebuilding and modernizing our key locations, focusing on collaboration hybrid work for our employees. A great example of this is our accelerated actions in Korea to both consolidate our sites and open a new state-of-the-art office and R&D facility, bringing together most of our employees in Korea.

Now, let's move to cash flow and capital allocation. Q2 cash flow from operations and free cash flow was $0.5 billion and $0.4 billion, respectively. The cash conversion cycle was minus 26 days in the quarter, a sequential decline of seven days. Both free cash flow and the sequential decline in cash conversion days were driven primarily by the decrease in personal systems volume and back-end loaded revenue linearity, driven by supply chain delays.

Looking ahead to the second half of 2022, we expect to improve our cash conversion cycle by fiscal year-end. Driving our outlook is our expectations for personal systems volumes to recover in Q4, which I will provide more color on in a moment. And other operational improvements in our cash conversion cycle, including reduced inventory. As a result, we remain confident in our ability to deliver on our free cash flow guidance of at least $4.5 billion for 2022.

Strong capital returns remain a key part of our capital allocation strategy. In Q2, we returned approximately $1.3 billion to shareholders. This included approximately $1 billion in share repurchases and $262 million in cash dividends, and we remain on track to exceed our $16 billion return of capital target by year-end.

Looking forward to Q3 and the rest of FY 2022, we continue to navigate supply availability, logistics constraints, inflation, pricing dynamics and the evolving macro environment, while continuing to deliver on our commitments. In particular, keep the following in mind related to our Q3 and overall financial outlook. We are once again raising our full year non-GAAP outlook for FY 2022 as we navigate through a challenging macro environment. We expect currency to be about a 2% year-over-year headwind in both Q3 and for FY 2022, reflecting the recent strength of the US dollar.

With regard to the financial impact of the Russia-Ukraine war and the recent lockdowns in China, we are factoring in our best assumptions at this time, recognizing that conditions remain fluid and highly uncertain, with impacts to our top and bottom line results.

Regarding Russia, as Enrique mentioned, we have made the decision to stop our activity there and have begun the process of fully winding down our operations. In FY 2021, Russia accounted for approximately $1 billion in revenue. In China, we expect to see a reopening and easing of restrictions from the recent lockdowns beginning in June.

For personal systems, we continue to see solid demand and pricing for our PCs and commercial with some softening of demand in consumer, driven in part by the macro factors I mentioned earlier, including currency. We expect year-over-year personal systems revenue growth through the second half of 2022 with a continued shift towards higher value categories, including commercial, premium and peripherals.

With regard to our personal systems supply chain, while we expect to see a gradual improvement in the supply environment, we did experience a supplier-specific disruption late in Q2 that we expect will resolve by the end of Q3, resulting in a sequential decline in personal systems revenue in Q3 and a rebound in Q4, more in keeping with typical seasonality. We expect PS margins to remain near the high end of our 5% to 7% long-term range, particularly in Q3.

In print, we expect solid demand in consumer, favorable pricing, disciplined cost management and further normalization and mix as commercial gradually improves through 2022. With regard to print supply chain, we expect similar to Q2, component shortages and logistics delays to constrain revenues. We expect these conditions to continue at least through 2022, but with some improvement into the latter part of the year. We expect print margins to be at the high end of our 16% to 18% range for FY 2022. For Q3 specifically, given continued hardware constraints, we expect print margin to be above our 16% to 18% range.

Taking these considerations into account, we are providing the following outlook. We expect third quarter non-GAAP diluted net earnings per share to be in the range of $1.03 to $1.08. And third quarter GAAP diluted net earnings per share to be in the range of $0.91 to $0.96, which includes an incremental GAAP-only charge of approximately $0.04 related to the wind-down of operations in Russia.

We expect FY 2022 non-GAAP diluted net earnings per share to be in the range of $4.24 to $4.38. And FY 2022 GAAP diluted net earnings per share to be in the range of $3.79 to $3.93. For FY 2022, we expect our free cash flow to be at least $4.5 billion. We have made excellent progress against our priorities in the first half of fiscal 2022. And I am confident in our ability to continue to deliver on our second half outlook while investing for long-term sustainable growth.

I'll stop here so we can take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] And our first question today will be from Krish Sankar with Cowen & Company. Your line is open.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Yeah, hi, thanks for taking my question and congrats on the strong results and execution in a tough environment. My first question is for Enrique, and then I had a follow-up for Marie. Enrique, on the PC business, it makes sense, commercial is strong. But it looks like desktop did much better than notebooks, both in terms of revenue and units. Can you just help us understand what's happening in commercial between desktop and notebook? And any view on PC TAM, unit TAM for this year? Your competitors spoke about 330 million units, kind of curious what your view is. And then I had a quick follow-up for Marie on inventory. Thank you.

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

A

Sure. Thank you. Hey, let me start with desktops and actually the same thing happened with workstations. The growth this quarter is really helped from an easy compare last year. If you remember last year, not many companies were investing in equipment for the office. This drove the sales of desktops and workstations down. And now we are seeing the opposite effect as some of this investment is coming back.

I think on the overall PC market, the important thing to have in mind is a strength of the demand on the commercial side. We are seeing this across the board, across all geographies, and this is especially true on high configurations given the new use models that PCs are going to have. And this is why even if for the year, going now to the second part of your question, we expect the overall PC market in terms of units to decline slightly. This is very similar to what other analysts and other companies have shared. From a revenue perspective, we see growth really driven by mix as commercial will become bigger, as premium categories within commercial will be bigger. And also as premium consumer and gaming will become a more relevant part of the market.

Krish Sankar
Analyst, Cowen & Co. LLC

Q

Got it, Enrique. Follow-up for Marie on inventory. On last call, you said you're not planning to decrease inventory, and it's kind of elevated in terms of inventory days. Can you give us some color on how much of it is finished goods or raw materials and components? How much of it is actually buildup of materials versus cost inflation? Any kind of color on inventory would be very helpful. Thank you very much.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Sure, and good afternoon, Krish, and thanks for your question. So from a sequential perspective, our inventory actually declined and that was due to in-transit offset by higher commodity costs due to supply constraints. Now in terms of both print and PS, a couple of different dynamics. So let me give you some color. So on the print side, it's really driven by the assurance of supply, given the ongoing supply constraints that we're seeing on the print side and also just the longer lead and transit times.

And then in PS, what's going on there is really the shift in mode of transport. So as you might recall, I think we made this comment in our last call that we stopped using the train that we have used extensively from China to Europe, and we shifted a lot more of PS onto the ocean, so we've seen that shift from air to ocean. So that's what you're seeing. And then obviously, sea shipments are really for economic value and really drive much better pass-through a lot better cost for us. So that's hopefully the perspective on inventory for you.

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

We have said in the past, our medium-term plan is to continue to reduce owned inventory, we think we have an opportunity there. And with the components situation getting better, we really think that this is going to be our plan during the next quarter.

Operator: Your next question comes from the line of Aaron Rakers with Wells Fargo. Your line is open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC Q

Yeah. Thank you very much for taking the questions and congrats on the good execution in the quarter. Two questions, one and one follow-up. First, I'm just curious, Enrique and Marie, if you could kind of dive a little bit deeper into the commercial backlog in the PC segment. What's your expectations of working that backlog down? Is your guidance assuming that you continue to have an elevated backlog? Any kind of commentary on how we should think about the trajectory of that backlog through the back half of this fiscal year?

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

Thank you. So as we said in the prepared remarks, commercial backlog – commercial PC backlog and especially commercial continues to be elevated. Our plan is to review that during the coming quarters, and we will continue to improve the situation from a supply chain perspective. And by the end of the year or early next year, we should be done with that.

Aaron Rakers
Analyst, Wells Fargo Securities LLC Q

Okay. Yeah, that's helpful. And then the follow-up question is just looking at the pricing trends you're seeing within PSG. Could you help us appreciate how much of it is being mix driven versus your ability to pass through increased pricing from components and logistics? I'm just curious if you can help us understand the effects of pricing.

Marie E Myers
Chief Financial Officer, HP, Inc. A

Yeah. No, I'd say, first of all, we definitely benefited from favorable pricing. And I think we've made those comments over the last couple of quarters. And really, it's due to that supply and demand imbalance that we've been experiencing. And I'd say particularly on the PS side, we've been able to actually pass-through a lot of that inflationary pricing straight through into our products.

Now, I would just add, if the supply and demand starts to come back into closer alignment, we'll start to see some of that pricing normalize. But right now, in terms of just the current outlook, we really expect pricing to remain strong in the second half of the year.

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

A

And in terms of your comment about mix, mix has also a significant impact on pricing. And really, when we – if you need to think about mix, you need to think about the new use models for PCs.

PCs are more and more used as communication tools, which means customers need more memory, better cameras, better audio. And this is really driving demand towards the richer categories and the more premium products and is really having a significant impact on the overall price – on pricing.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yeah. I should add just on the mix comment actually, this quarter, around 65% of our PS portfolio is commercial, which obviously, as you know, has higher ASPs. So it's a combination of both, the mix and the rate, which is really driving that favorability in pricing.

Operator: Your next question comes from the line of Amit Daryanani with Evercore. Your line is open.

Amit Daryanani
Analyst, Evercore ISI

Q

Thanks for taking my question. And congrats on a good quarter of mine as well. I guess I have two as well. The first one is, just on the print side, and I think your operating margin performance there was really impressive in the April quarter. So, maybe you could just talk about, what is enabling this really strong 19% plus operating margin performance in April, despite the supplies headwind that you had?

And then, as you think about the back half, it doesn't seem like mix is getting any different versus what you have in April. So, why would margins dip down based on what you said on the print side?

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

A

Yeah. So performance of the print business this quarter was really driven by supply. We continue to see demand significantly above supply. And in supply, we are impacted mostly by component availability.

And therefore, our focus was on really profit optimization through pricing, through allocation of units. And this is why profitability this quarter was so strong. As we shared before, we expect the supply situation to improve through the end of the year. And as we – this will happen we also expect that pricing will be normalized, as Marie just explained.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yeah. Maybe I'll just add some comments then on Q3 on the print rate and what we expect to happen. As we said for the full year, that would be at the high-end of that range. And in fact, actually, what we're expecting in Q3, it actually would be slightly above that. And really what that's driven by is a combination of the supply constraints that Enrique spoke about, some of the mix that we're starting to see as the office reopens.

And then given that backdrop, we're still seeing the impact of that favorable pricing, I just spoke about a moment ago, so we'll expect some of that to come through. And obviously, we're doing all of that, while we're offsetting currency headwinds as well. So overall, we would expect the rate for print to certainly in the year be at the high-end of that long-term range.

Amit Daryanani
Analyst, Evercore ISI

Q

Understood. And then if I could just ask you on the non-GAAP adjustments that are being made for the fiscal 2022 guide. I understand you're raising the non-GAAP numbers, but the GAAP numbers I think are coming down.

So I think the adjustments are $0.45 this time, 90 days ago, that was $0.31. Maybe I don't understand this enough, but could you just talk about what is resulting or what are the incremental adjustments that are being made? Is it restructuring? Is it Russia? And if you could just break that down, that would be helpful.

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Sure, happy to do so. So, we actually revised our FY 2022 GAAP guidance. And we actually have $0.11 just to clarify at the midpoint. So let me walk you through these really four key items that are driving it, which you captured a couple in your comments. So first of all, with the acquisition-related charges, related to Poly. As you know, we announced that just a little while ago, so that wasn't included in our prior GAAP guidance. Secondly, there are charges with Russia, which we actually – I spoke about I think in my prepared remarks. And then we also have the timing acceleration of some real estate actions related to our transformation. And then finally, we've got some onetime related tax adjustments as well. So that's basically the construct for the revised GAAP guide.

Operator: Your next question comes from the line of Toni Sacconaghi with Bernstein. Your line is open.

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

Q

Yes. Thank you for taking the question. I have two as well. I just want to understand the backlog dynamics that happened in the quarter and what you're expecting going forward. So, I think you said you drew down backlog in PCs. Was book-to-bill and revenues positive in the quarter? Can you give us some sense of how much backlog draw down there was in PCs?

And was there any backlog draw down in printing? And when we think about the remainder of the year, if there's a supplier disruption in PCs, why would you expect to be able to continue to draw down backlog in Q3? And I have a follow-up, please.

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

A

Sure. So, as I commented before, Toni, we saw a reduction of backlog Q1 to Q2, this is driven by the ability to ship some of the units at the – and increase some of the volumes in some specific areas. As we look out through the end of the year, we expect the supply situation to improve, and therefore, we expect to continue to reduce backlog in the rest of the year.

In the case of print, we continue to operate also with a high level of backlog. The reduction there was smaller. And we expect that we will be able to start reducing that more significantly in the Q4 timeframe, which is where we have visibility of some of the actions we have taken in supply chain to take more impact.

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

Q

Okay. Thank you. But I'm still not quite clear why, if you have a supplier constraint and you're expecting lower revenues in Q3 from PCs, why you think you'll draw down backlog? And can I also just get you to clarify typically, seasonally, printing is down Q2 to Q3. I think you're saying PCs will be down Q2 to Q3. Is that what we should expect?

And again, if we – if you're drawing down backlog, that feels a lot lower. Typically, you're up 4% sequentially from Q2 to Q3. So again, I'm just trying to square the circle with your anticipated backlog draw downs and the dynamics of having weaker than seasonal PC revenues in Q3? Thank you.

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

A

Yeah. So, the comment about drawing backlog is more via second half quarter – second half comment. Specifically in Q3, we have identified a very specific problem with one of our PC component supplier that is having some special issues on yield in one of their factory. This is going to be impacting our shipments in Q3 for PC. We have line of sight for this to be recovered in Q4. And this is why from a seasonality perspective, revenue in personal systems – in PCs in Q3 will be below Q2. And again, the backlog comment is a second half comment, not a quarter-over-quarter comment. Thank you.

Operator: Your next question comes from the line of Erik Woodring with Morgan Stanley. Your line is open.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Awesome. Thank you for the quarter – excuse me, thank you for the question. Congrats on the quarter. If we take a step back, it's been a pretty unique time in the market, kind of the best PC growth in the decade plus short supply, which has allowed you to hold pricing.

And then at the same time, you've been able to work through a multiyear cost cutting kind of transformation program, and it's clearly showing up in your margin profile, right, pre kind of COVID period operating margins were around 7% to 7.5%. Right now, they're running around 9% consistently.

So, just curious kind of – is there a way that you can break down the margin uplift between kind of mix and kind of the permanency of the changes that you've made versus temporary factors like pricing that you expect to potentially normalize in the back half of the year and into next year? And then I have a follow-up. Thanks.

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

A

Sure. Probably the best way to answer, Erik, is to go back to the guidance we provided in our Investor Day in October, where we shared what is our perspective for both businesses.

In the case of personal systems, we expect margins to be between 5% and 7% going forward. We raised that in October from what we had before to reflect, especially the impact of the cost activities that we have put in place, and also the focus that we had in higher margin categories. And I like to remind you that several of our growth areas like gaming, peripheral and services in the case of PC will help us to sustain these higher margins.

In the case of print, our margins – our projection is that margins will stay in the 16% to 18% range. And again, our long-term strategy is really focused on those categories where we think we can drive both growth and sustainable margins. While at the same time, we expect that some of the pricing benefits we have experienced during the last two years will fade over time.

Erik W. Woodring
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's really helpful. Thank you, Enrique. And then maybe a question on print. Go back to SAM 2019, you laid out this business model pivot for the printing business to collect more profits upfront from the sale of printing hardware, while at the same time introducing programs like HP+ to make supplies stickier in certain situations. So, we're now more than two years away from that announcement.

Can you just kind of give us an update on where we are on this pivot? How much is left to do, kind of what inning we're in? And then, really how a normalization in kind of supply and demand and pricing dynamics could change or alter your ability to kind of capture some of these higher hardware prices that you've been able to do over the last, call it, two years and change. Thanks.

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

A

Sure. Thank you. We are very pleased with the program that we are doing in the pivot of the business model. We shared today that today, in Q2, around 48% of the units are either what we call profit upfront, so customers get a printer and the ink or toner when they get the unit or HP+ units. So this gives you an idea of the progress that we have made in the last two years, and we expect this percentage to continue to increase as the adoption for HP+ will continue to grow.

Another important element of our strategy is the growth of our subscription model. And also, we shared today that in Q2 that business both from subscribers and from a revenue perspective, we grew double digit. So this also shows the momentum that we have in that part of the company.

Operator: Your next question comes from the line Jim Suva with Citigroup. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. I have some pretty easy specific questions, one for Enrique and one for Marie. Enrique, I believe it was a year ago you highlighted the strength in Chromebooks from HP. Now where we sit, can you help us kind of quantify how much exposure you have to PC because now the world, of course, is opposite of the view of strength for Chromebooks. Just want to see the risk there.

And then for Marie, is the reason why we're not increasing free cash flow is that as a function of those four items that you mentioned on kind of adjustments of the Russia, the closing costs, non-GAAP tax adjustments and things like that? Thank you.

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

A

Yeah. Thank you, Jim. So the exposure – the size of the overall Chromebook business is relatively small in our Personal Systems business, it lends us 10% from a revenue perspective and much smaller from an operating profit or margin perspective. So the exposure that we have is relatively small. Shipments of Chromebook this quarter were also small. So this shows that we can really perform in a very strong way of personal systems even in there – we have very small Chromebook market.

What we have seen during this year, and we started to see it a few quarters ago and we have talked about this before is a significant slowdown of the Chromebook business in the US in the education segment, we are starting to see some signs of recovery, but the market has continued to be significantly below where it was a year ago.

Marie E Myers A
Chief Financial Officer, HP, Inc.

Hey, Jim and good morning. Just on your comments on free cash flow, just to clarify. So as I mentioned in my prepared remarks, we do expect to generate at least $4.5 billion in free cash flow this year. So we remain very much on track. And with respect to the items that I explained on the GAAP guide in terms of their impact on cash flow, the impacts that we had in the quarter were really much more related to PS volumes in the back-end loaded revenue linearity. As you heard Enrique say earlier, we expect that to course correct in Q4. So at this point, we expect our cash flow to remain on track for our guide.

Operator: Your next question comes from the line of Ananda Baruah with Loop Capital. Your line is open.

Ananda Baruah Q
Analyst, Loop Capital Markets LLC

Yeah. Hey, good afternoon guys. Congrats on the results and strong execution in an increasingly challenging environment. Two, if I could, have you guys seen any impact to any of your commercial business for macro? And are you getting any feedback yet – if you've not seen any impact yet, are you getting any feedback yet from customers about what they're thinking? And then I have a follow-up as well. Thanks.

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

Thank you, Ananda. So the answer is not yet. We haven't and we continue to see strong demand on the commercial side. We have a strong funnel. So we don't see any signals of weakening of the demand on the commercial side. And this is one of the key drivers of the guide that we have provided for the rest of the year.

Ananda Baruah Q
Analyst, Loop Capital Markets LLC

Enrique, that's really helpful. And then, Enrique, just moving over to the PC business quickly. How much – I believe that 90 days ago – sort of, 90 days ago, 180 days ago, you guys were thinking that the market – PC market would be up kind of flat to slightly up for the year. So now sounds like slightly down for the year. Is that accurate by recollection? And if it is, is the change – how much is supply chain related coming out of China with the lockdown? And how much of it is demand related?

And then the second part to that is you gave us your view on the market. How are you expecting HP to perform unit-wise this year as well? Thanks. And that's it for me.

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

Yeah. So two things. One is, from a unit perspective, we expect this year to see a small decline from where the market was in 2021, but to stay at a very elevated level compared to 2019. In terms of unit, we expect the market to be in the 320 million, 330 million units in line with what many of the analysts and other companies have published. From a revenue perspective, though, we expect to see growth. We expect the market to grow in the 3% to 4%, really driven by many of the things we have been discussing today, mix between consumer and commercial and a mix shift towards more premium units in both segments. And that's really what is driving the growth that we expect to see in personal systems through the rest of the year.

Operator: Your next question comes from the line of David Vogt with UBS. Your line is open.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thank you. I have two quick questions, one for Enrique and then a quick follow-up for Marie. So Enrique, both you and your competitors have noted that you're focused on higher-end PCs, including commercial, gaming and high-end consumer as a reason for sustainable growth and better ASPs and mix going forward. But I guess the question I have is the supply chains have started the typical buying pattern and the pricing backdrop, how do we know that there is not risk to incremental buyers of PCs coming online when supply normalizes targeting more lower end devices, lower spec PCs given that there might have been some people lining up early in the queue for more richer configurations? And then I have a follow-up for Marie on margins.

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

A

Well, I think the demand of both is fairly independent. We -- because of – as I mentioned before, because of the use model in commercial consumer – customers need higher and better configurations because of a growth in gaming. We see growth in that category, which in general has also higher average selling prices and this is driving the demand of this category. We continue to have a very strong growing portfolio and if we see more demand on that side, we will be happy to serve it, but at this point, we really see demand on the more premium categories both in commercial and in consumer.

David Vogt
Analyst, UBS Securities LLC

Q

Great. And then a quick follow up for Marie. Marie, thanks for all the color on the margin. But just to follow-up on margin. So you're well above your 16% to 18% range, not only this quarter but in the prior quarter, and then the guide for the third quarter. But if I just sort of analyze the full year guidance, are you intimating that by Q4 of this fiscal year, print margins return back towards the lower end of your long-term range if I'm doing the math correctly and if so is that sort of the way to think about the profitability of that segment going forward that this is sort of a onetime above the range period and that 16% to 18% is more likely the stable environment that we're going to be operating in for the foreseeable future?

Marie E Myers
Chief Financial Officer, HP, Inc.

A

Yeah. No, David. Good afternoon. So I think the way to think about it for the full year is really that we expect to be at the high-end. As I mentioned a bit earlier, we expect it to be above for Q3 due to the supply chain constraints. But overall, just to kind of give you a little extra context here, we've seen that favorable pricing impact, and we believe the durability around that is there, plus you've seen us very successfully manage through the headwinds in the business, whether that was currency, was commodities, et cetera.

And then Enrique talked today about the growth businesses and how we're driving that in terms of just the flow through factor from a longer term perspective. So that's the right way to think about our margin construct going forward. It's a combination of all of those factors coming together. But for the year, I really want you to leave with the thought that we're going to be at the high end of 2016 to 2018.

Enrique Lores

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

Thank you, Marie, and thank you, everybody, for your questions today and for joining the call. I think the first six months of fiscal year 2022 show that our business continues to perform well and that we are entering the second half from a position of strength.

I want to especially highlight the performance that we have had in our growth businesses. As I said at the beginning of the call, they represented $5.6 billion of business, well on track to deliver on the $10 billion goal that we shared with all of you in October. At the same time, we really show this gives us strong confidence as we enter in the second half. This is why we decided to raise our EPS guide for the year to reflect that confidence and we are really well positioned to deliver sustained revenue, operating profit, EPS and free cash flow. So really, thank you for joining today and looking forward to continue to speak to all of you soon. Thank you.

Operator: This concludes today's conference call. You may now disconnect.