

Hewlett Packard Enterprise Company

Q1 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Antonio Neri – *President and Chief Executive Officer*

Tarek Robbiati - *Executive Vice President and Chief Financial Officer*

Andrew Simanek – *Head of Investor Relations*

PRESENTATION

Operator

Good morning, good afternoon, and good evening and welcome to the First Quarter 2019 Hewlett Packard Enterprise Earnings Conference Call. My name is Denise, and I will be your conference moderator for today's call. At this time, all participants will be in listen-only mode. We will be facilitating a question-and-answer session toward the end of the conference. Should you need assistance during the call, please signal a conference specialist by pressing the "*" key followed by "0." As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Andrew Simanek, Head of Investor Relations. Please proceed.

Andrew Simanek

Good afternoon. I'm Andy Simanek, Head of Investor Relations for Hewlett Packard Enterprise. I'd like to welcome you to our fiscal 2019 first quarter earnings conference call with Antonio Neri, HPE's President and Chief Executive Officer and Tarek Robbiati, HPE's Executive Vice President and Chief Financial Officer.

Before handing the call over to Antonio, let me remind you that this call is being webcast. A replay of the webcast will be made available shortly after the call for approximately one year. We posted the press release and the slide presentation accompanying today's earnings release on our HPE Investor Relations webpage at investors.hpe.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 the disclaimers on 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 HPE's filings with the SEC including its most recent Form 10-K. HPE assumes no obligations 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 at this time and could differ materially from the amounts ultimately reported in HPE's quarterly report on Form 10-Q for the fiscal quarter ended January 31st, 2019. Also, for financial information that has been expressed on a non-GAAP basis, we have provided reconciliations to the comparable GAAP information on our website. Please refer to the tables and slide presentation accompanying today's earnings release on our website for details.

Finally, please note that after Antonio provides his high level remarks, Tarek will be referencing the slides and our earnings presentation throughout his prepared remarks. As mentioned, the earnings presentation can be found posted to our website and is also embedded within the webcast player for this earnings call.

With that, let me turn it over to Antonio.

Antonio Neri

Thanks Andy. Good afternoon everyone. Thank you for joining us.

Today, we reported another strong quarter for Hewlett Packard Enterprise providing further evidence that our strategy and disciplined execution are driving solid profitable growth. In Q1,

we continue to execute against our strategy of accelerating growth in Intelligent Edge and delivering profitable growth in Hybrid IT through innovation, exceptional customer experiences and a commitment to our team and culture. We are on track to exceed most of our fiscal year 2019 financial commitments that we laid out at our securities analyst meeting in October last year.

Q1 revenue grew 1% year-over-year, when adjusted for the tier 1 segment, in line with our guidance. Most importantly, we grew significantly in the high margin value categories like high performance compute, hyper-converged, and composable infrastructure. Our continued mix shift, as well as, the ongoing cost management and supply chain simplification helped us significantly improve our operating leverage. We improved gross margins by 280 basis points year-over-year. We grew non-GAAP operating profit by 19% year-over-year, well above our 6% to 8% guidance. And we grew non-GAAP earnings per share by 31% to \$0.42, well above our outlook of \$0.33 to \$0.37. All of these drove free cash flow growth of over \$200 million year-over-year, putting us well on our way to delivering our fiscal year 2019 outlook of \$1.4 billion to \$1.6 billion.

From a macro perspective, demand remains steady. We continue to monitor the economic uncertainties around the globe, but the overall IT spending environment remains healthy. Our customers tell us the IT investment they are making are critical to driving business outcomes as they look to harness the explosion of data that continues to grow.

While the demand environment is helpful, our performance largely reflects our sound strategy, focused execution, and software-defined portfolio that is resonating with our customers around the world.

Computing at the edge is the next frontier. HPE's unique ability to connect our customers' data between all their edges and all their clouds is a significant differentiator and opportunity for us. That is why we continue to prioritize strategic investments in the Intelligent Edge business. Our Aruba business performed well in Q1. We announced two important new solutions, the Aruba 510 campus access points designed for 802.11ax and the Aruba 8325 switches. The introduction of these new offerings should drive accelerated growth in future quarters. Finally, as you saw in our financial realignments last week, we made an operational change by consolidating our edge data center networking business under Aruba. This will help us even more effectively bring a complete networking portfolio to market. Investments like this will enable us to continue to be the leader in the edge.

Turning to our Hybrid IT business, we continue to approach this market in a targeted segmented way. That means streamlining our go-to-market approach for our volume solutions and investing in high-value software-defined solutions and services. Software is increasingly embedded across all of our value solutions and we continue to drive software innovation both through organic investments and acquisitions. For example, HPE OneView is a software foundation that delivers our composable hybrid cloud vision. It has over 1 million licenses in deployment and just won Software Product of the Year for one of the leading channel publications. So it is clearly resonating with our customers and partners. And HPE OneView is a key factor in synergy success in the market. HPE Synergy is now a \$1 billion run rate business since being introduced just two years ago.

Another good example is Plexxi, which is now incorporated into the composable fabric of our SimpliVity hyper-converged offering. Our hyper-converged portfolio with SimpliVity and synergy grew 70% in Q1. And thanks to our AI software from InfoSight and more recently, BlueData, we

are offering the most intelligent storage platform on the market. This software is what sets our storage portfolio apart and help drive the seventh straight quarter of growth.

Finally, innovative services like Pointnext GreenLake, which offers a consumption model that lets customers pay for what they use, continue to resonate with customers. GreenLake orders grew double-digits in Q1 and added to HPE's subscription services that drive our recurring revenue and profit. We have recently seen competitors compare their offerings to GreenLake, but the reality is that our solution enabled by software and backed by HPE financial services is the only on-prem consumption-driven offering in the market. Beyond GreenLake, Pointnext overall has a strong book-to-bill ratio of 110% in Q1. As we begin to recognize the full benefit of a higher attach rates on our value compute offerings, the go-to-market improvements we have been executing and the completion of the intentional country exit in advisory and professional services, we expect to see a positive inflection in revenue in the second half of fiscal year 2019.

The investments and focus in differentiated software-defined solutions and services is driving the right mix shift to deliver growth and expand margins in Hybrid IT. Tarek will get into the details, but I am very pleased with the progress we have made on improving profitability and believe there is still more room to grow.

Most importantly, our strategy and solutions are resonating with our customers and partners. In Q1, I continue to spend over 50% of my time with our customers and partners, and I consistently hear from them how our vision, portfolio, and strategy are perfectly suited to lead them through their digital transformation journeys. We continue to win competitive deals due to our differentiated experiences and ability to provide focused portfolio at scale. For example, in Q1 we won a significant new deal with Telefonica in Spain for a technology infrastructure refresh, including a transition from traditional storage to an all-flash storage solution. Indiana University selected Aruba for a complete network refresh to support their 109,000 students, including indoor and outdoor access points, wired switches, ClearPass for security, AirWave for network management, and Netinsight for analytics and assurance. And Tata Motors recently selected us for a significant technology upgrade, including 3PAR and Superdome Flex.

Finally, I believe to compete and win, we need the best innovation which is made possible by having the best talent. Our people are our future and in Q1 we continue to invest in making HPE a dynamic place where people are proud to work. With our executive leadership team in place, we focused on recruiting top talent to HPE and improving the engagement of our teams through new employee experiences, training, and professional development and community services opportunities. And as you may have seen, we have begun our move to a new state-of-the-art and custom-built headquarters in San Jose, California, two weeks ago. It showcases our innovative solutions while providing collaborative workspaces for our team. We will host a grand opening in April and I will be excited to welcome customers, partners, and all of you to our new home this year.

I am pleased with the important progress we have made to transform HPE and I remain incredibly optimistic about our future. Our strategy is on point. The enterprise of the future will be edge-centric, cloud enabled, and data-driven. And we are proud to be the company who can best help our customers connect all their data wherever it lives.

Near-term we expect the demand environment to remain healthy and our differentiated software-defined solutions to continue to gain traction with customers driving accelerated revenue growth starting in Q2. Tarek will provide the details, but our confidence in these areas has led us to raise our earnings per share forecast for fiscal year 2019.

Longer term, by continuing to execute on our strategy and make important investments in our customers, innovation, and our people, I am confident in our ability to deliver strong financial performance and shareholder returns. I look forward to what lies ahead and I hope you share my enthusiasm for both the opportunity and for how well positioned we are to capitalize on it.

And now, let me hand the call over to Tarek, who will provide additional details on the quarter. Tarek...

Tarek Robbiati

Thank you very much, Antonio. Now, let me share with you our financial results for the quarter. As I did before, I'll be referencing the slides from our earnings presentation to better highlight the solid start we had in our Q1 to our fiscal year.

Starting with slide one, you will see that we are already on track to exceed most of our key financial metrics that we committed to at our securities analyst meeting. Revenue grew in line with guidance, while we significantly expanded both gross and operating margins, enabling us to deliver non-GAAP earnings per share well above our quarterly outlook. This incremental profit and focus on working capital resulted in growing our free cash flow by over \$200 million versus the prior year, demonstrating that we are executing well and our strategy is resonating with customers.

From a macro perspective, despite some ongoing uncertainties around the globe, we continue to benefit from the underlying trends of ever-increasing amounts of data and the acceleration of digital transformations that our customers are undertaking. As a result, we have seen IT spending from our enterprise customers remain steady.

Looking at foreign exchange rates, they have continued to move unfavorably the last few quarters and we faced a modest headwind in Q1 of 30 basis points. We expect currency will be close to a 2 point headwind to revenue growth on a full year basis in FY 2019, based on our current spot rates.

Looking at slide 1, total revenue for the quarter was \$7.6 billion, down 2% year-over-year, 1% in constant currency. However, excluding the headwind from our exit of the low margin tier 1 business, revenue grew 1%.

Looking forward, we expect the impact from tier 1 to become less dilutive to revenue growth toward the end of the year. We also expect the solid enterprise demand environment to continue and our own execution to remain strong, all of which should drive accelerated year-over-year growth rates beginning in Q2.

Slide two, gives you a geographic breakdown for the quarter. Americas revenue was up 1% in constant currency. Core compute grew double-digits and storage grew approximately mid-single digits. Revenue growth in EMEA continued to be strong, up 2% in constant currency with double-digit growth in the U.K. and France. Asia Pacific was down 9% in constant currency, primarily driven by revenue declines in the China market. Our H3C partnership there continues to be strong and we are working to optimize the right mix of HPE product, which generates revenue on our P&L with H3C's local offerings to maximize the profit of the overall entity. As a reminder, we recognize our 49% equity interest in our P&L and receive dividends. In fiscal year 2018, we received cash dividends of \$164 million from our H3C joint venture and expect to continue to receive similar dividend payments going forward. Beyond H3C, we saw a double-

digit growth in the total Asia Pacific region in our Intelligent Edge and Financial Services business.

Slide 3 shows our performance in the quarter by segment. I won't take you through every number, but the key takeaway is that from a portfolio mix perspective, we are continuing to win where it matters.

We maintained robust growth in our strategically important Intelligent Edge segment with balanced growth across both wired and wireless LAN.

In Hybrid IT, our high margin value compute portfolio grew close to 20% driven by strength in the high performance compute, which grew over 50% and in hyper-converged offerings, which grew 70%. Within our storage portfolio, we saw notable strength in All Flash Arrays, which grew 20%. Our services business continues to show great potential with a Pointnext book-to-bill ratio of 110% and orders for Pointnext Operational Services including Nimble services growing 2% year-over-year in constant currency.

And within HPE Financial Services, we saw strong double-digit growth in our asset management business, which is key for unlocking value to our customers and higher margin for us.

Overall, we are confident that we can accelerate revenue growth as we continue pivoting our business towards higher margin software-defined offerings and improve our performance in our services business as fiscal year 2019 progresses.

Slide 4 shows our EPS performance to-date. Non-GAAP diluted net earnings per share of \$0.42 was up 31% year-over-year and well above our previously provided outlook of \$0.33 to \$0.37 due to strong operational performance, favorable other income and expense, and lower than expected tax rate, and a lower share count from opportunistic buybacks. This marks the fifth consecutive quarter we have exceeded the high end of our outlook range. This outperformance has been driven primarily by the significant improvements we are making in both gross and operating profit margins to drive increased operating leverage. I'll talk more about that in just a minute.

As outlined at our security analyst meeting in October, we report our non-GAAP earnings using a structural tax rate based on long term non-GAAP financial projections. At our analyst meeting, we had indicated that the rate was expected to be 13% beginning in fiscal year 2019. Having received further guidance from the US Treasury, we have now concluded our structural tax rate will be 12%, which will be our non-GAAP tax rate for future quarters, pending any structural change in our worldwide tax environment.

GAAP diluted net earnings per share was \$0.13, below our previously provided outlook range of \$0.19 to \$0.23 per share, primarily due to the impact of one-time, non-cash US Tax Reform adjustments as we received incremental guidance on how to apply the new regulations.

Turning to margins on slides 5 and 6, we continue to deliver significant margin expansion as a result of focusing on profitable growth in Hybrid IT, shifting our portfolio towards higher value, higher gross margin offerings, and continuing to drive HPE Next initiatives.

Gross margin of 31.1% was up 280 basis points year-over-year and up 40 basis points quarter-over-quarter, the fourth quarter of sequential expansion. Improvements were driven primarily by

portfolio mix, supply chain efficiencies, reducing manufacturing overhead, and to a much lesser extent, lower commodities cost. Expanding gross margins is very important, as it demonstrates that we have a rich portfolio of software-defined offerings of significant value to our customers.

Non-GAAP operating margin of 8.9% was up 160 basis points year-over-year. HPE Next has been a great success story for us this year. It has enabled us to make significant investments back into the business including a 20% increase year-over-year in R&D to drive organic innovation. We expect the benefits from HPE Next to continue well into the future, enabling investment opportunities and margin expansion benefits that will ultimately drive further cash flow growth.

Now turning to the segment and business units starting on slide 7, with the Intelligent Edge, revenue was up 5% year-over-year and 4% in constant currency led by growth in Aruba services. Operating margins of 1.3%, which are seasonally lowest in Q1, were down 390 basis points year-over-year due to ongoing significant investments in sales and R&D.

Aruba product grew 3% with balanced growth across both wired and wireless LAN. We expect share gains in wireless and wired, which has gained share for seven consecutive quarters. With the new product launches in both wireless and wired switching that Antonio mentioned, we expect to drive accelerated growth as the year progresses.

Aruba services went up 20% on a continued installed base growth. We will continue to push high-margin Aruba services to represent a higher portion of Aruba's total revenue.

Moving on to slide 8.

In Hybrid IT, revenue was down 3% year-over-year, both as reported and in constant currency, but grew excluding tier 1 sales. Operating margins were 11.3%, up 200 basis points year-over-year, almost at a two-year high level. We're executing well against our strategy of driving profitable growth by shifting to higher gross margin value offerings while improving operating margins across the portfolio with HPE Next.

Compute revenue was down 3% year-over-year, but up 3% excluding tier 1. Most importantly, our higher margin value compute business was up nearly 20%. Our hyper-converged portfolio, which includes Synergy and SimpliVity offerings, was up 70%. Our high performance compute category was again up over 50%. And our Edge Compute servers grew triple digits again this quarter. These trends are indicative that our focus on market segmentation is paying off and we are winning where it matters.

Storage revenue was up 3% year-over-year, which marks our seventh consecutive quarter of growth. This quarter we saw particular strength in All Flash Arrays, which grew 20% year-over-year driven by Nimble. Big data also had another strong quarter, growing at 25% year-over-year, and we expect it to further benefit from our recently announced acquisition of BlueData. We have also seen significant margin expansion as our customers embraced our intelligent storage offerings. Looking forward, we expect storage revenue to ramp, targeting \$1 billion per quarter.

HPE Pointnext revenue declined 6% year-over-year as expected due primarily to our continued intentional exit from low-margin countries in the Advisory and Professional Services business. This would become less dilutive as the year progresses. More importantly, Operational Services orders, including Nimble service orders, grew 2% in constant currency. Growth in new attached

to our higher-value offerings like Nimble and the increasing adoption of our flexible capacity offerings with GreenLake, which was up double-digits, drove the order growth and the strong book-to-bill ratio of 110% in the quarter. These leading indicators give us confidence in the long-term health of the business and we expect an inflection in revenue growth in the second half.

Moving to slide 9, HPE Financial Services revenue was up 3% year-over-year and 6% in constant currency on strength in our higher-margin asset management business. Financing volume was down 3% year-over-year and flat in constant currency with an ending net portfolio assets of \$13 billion. Loss ratios also continued to be best in class below 50 basis points. Operating margin increased 40 basis points year-over-year to 8.4% and return on equity was a robust 15.6%. Our Financial Services business continues to play a vital role, unlocking value for our customers through our traditional leasing offerings, asset management services, and flexible consumption offerings with GreenLake that we will look to accelerate for years to come.

Now, turning to cash flow on slide 10. Free cash flow was a negative \$190 million in Q1. This is an improvement of more than \$200 million versus the prior year driven by improved working capital management and higher profitability. Q1 is always our seasonally weakest quarter, so we are well on our way to achieve our full-year outlook of \$1.4 billion to \$1.6 billion of free cash flow. More importantly and on an annual basis, we expect working capital to be a contributor to free cash flow generation in the year, offsetting some of the restructuring costs of HPE Next, thanks to an improved cash conversion cycle. The cash conversion cycle was a negative 22 days in Q1, as working capital became a source of cash this year compared to the same period last year where it was a use of cash.

Moving to capital allocation, as part of our continued \$7 billion capital return plan through fiscal year 2019, we returned \$1 billion to shareholders during the quarter. We paid \$157 million in dividends and repurchased \$814 million worth of shares in the quarter that we intentionally accelerated to be opportunistic at lower trading prices throughout the quarter.

Finally, and as you can see from slide 11, our balance sheet remains strong and we ended the quarter with an operating company net cash balance of \$2.1 billion. Also, as a reminder, the vast majority of our debt is associated with a \$13 billion receivable book of our financing business. With less than 50 basis points of bad debt as a percentage of average net receivables, the underwriting performance of HPEFS is best in class. As a result, the level of cash support for HPEFS are minimal, which enables HPEFS to generate a high return on financial assets and double-digit return on equity, as I mentioned before.

Now turning to our outlook on slide 13.

As a reminder, we started the year with a fiscal year 2019 EPS non-GAAP outlook of \$1.51 to \$1.61 per share. Given our strong non-GAAP EPS performance in Q1 and continued confidence in achieving the full year plan, we are raising our EPS guidance for the full-year. We now expect to finish fiscal year 2019 with non-GAAP diluted net earnings per share of \$1.56 to \$1.66 and we expect our fiscal year 2019 GAAP diluted net earnings per share to be \$0.88 to \$0.98 per share.

This is now the fifth consecutive quarter that we are raising our non-GAAP EPS outlook. For Q2 fiscal year 2019, we expect non-GAAP diluted net earnings per share of \$0.34 to \$0.38, and we expect GAAP diluted net earnings per share to be \$0.19 to \$0.23.

So overall, I am very pleased with the performance in the quarter to start the year. We continue to execute well against our strategy and it's clearly resonating with customers as we are making the right bets and winning where it matters. This gives me a great confidence in our ability to accelerate revenue growth in the upcoming quarters with continued margin expansion that will drive our free cash flow and ultimately strong shareholder returns.

Now, with that, let's open it up for questions.

QUESTION AND ANSWER

Operator

Thank you. We will now begin the question-and-answer session. To ask a question you may press "*", then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press "*", then "2." We also request that you only ask one question and one follow-up question.

Your first question will be from Shannon Cross of Cross Research. Please go ahead.

Ashley Ellis

Hi, thank you. This is Ashley Ellis on for Shannon. Within Pointnext, I was wondering if you could quantify the drivers of the decline, I think you began exiting or maybe you completely exited several countries around the middle of last year. So I'm wondering what else drove the decline versus the prior two quarters, and how do you plan on stabilizing that business? And then I have a follow-up. Thank you.

Antonio Neri

Sure. Thank you for the question, this is Antonio. I'm going to start and I'm going to give it to Tarek. So first of all, let's recap Pointnext, which we are pleased with our bookings performance, which as Tarek said in the Operational Services business grew 2% year-over-year, but when you look at the book-to-bill ratio, which is the orders that we take now against the current revenue period or the current period revenue and you think about the future, which is basically translate those orders into revenue, that was 110%, which is very, very strong.

On the Advisory and Professional Services in your question, we started last year as a part of HPE Next, it will be done sometime at the latter part of this year, and we are...as I said earlier in my HPE Next commentary, is the fact that we are really refocusing Advisory and Professional Services in fewer countries, so we can make bigger investments where we can drive the pull through above our software-defined infrastructure, our Intelligent Edge and the attach that goes with it. So instead of being in 170 countries, we are going to be in fewer countries and that work is well under way and that's the declining revenue that we saw in Q1. But, as I said in my remarks, we see that inflection point to start happening in the second half of 2019.

Tarek, I'm not sure if you want to add anything on that.

Tarek Robbiati

Thank you, Antonio. I would simply add, by highlighting the fact that under the umbrella of Pointnext, we have essentially two types of businesses. We have the Pointnext Operational Services business, which is a maintenance business across all our installed base and our customers and we have also the A&PS business, which is by and large a consulting business that we run globally.

To answer your question, Ashley, most of the decline in revenue was driven by A&PS and this is the fruit of decisions we made with respect to country exits. The order book on Pointnext Operational Services is working well. We're very confident with the order levels that we've seen across Pointnext Operational Services and Nimble services in the quarter and the book-to-revenue ratio...the book-to-bill ratio...at 110% is pointing to long-term revenue generation by this business unit.

Antonio Neri

The only thing I will add, Ashley, since you asked the question, remember one of the key components of that Operational Services portfolio is also HPE GreenLake, which grew double-digits. And to give a size of that business for you to understand it, we already have more than 450 customers under that type of contract. The TCV value of that over the period of time is already over \$2 billion and this business is going to be close to \$1 billion run rate business for us in the year. So we are very excited about that because I made the comments in my remarks that it's the only on-prem true consumption-driven offering on the market.

Ashley Ellis

Thank you. That was very helpful. Maybe, we could go further into that thing. Could you detail the margin profile between the Operational business and the Advisory business and maybe how you see margin improving over time? And that's it from me. Thank you.

Tarek Robbiati

I'm glad you are asking the question. So the richest margin revenue stream is Pointnext Operational Services. A&PS is lower margin, but still very profitable for us compared to Operational Services.

Andrew Simanek

Perfect, thank you Ashley. Can we have the next question, please?

Operator

The next question will be from Simon Leopold of Raymond James. Please go ahead.

Simon Leopold

Great, thanks for taking the question. This may be a difficult one for you to answer, but I wanted to see if you had some thoughts on why one of the other peers within the IT space has talked about weakness in January following a decent close to calendar 2018. And it sounds like your view on the overall IT spending trends are fairly stable and no particular weakness apart from some of the international challenges that are on-going, not new. Can you, maybe shed some light on why you might see the world differently?

Antonio Neri

Sure, I mean I am going to comment for us, not for the other vendors. Listen, from a macro perspective, the demand remains steady, and obviously we continue to monitor the economic uncertainties driven by global trade and Brexit and others. But you know, our demand was very steady throughout the quarter. And people ask me questions like the government shut down had an impact to the US business, the answer is no, zero. In fact, one of the elements of the portfolio we serve to the government is high performance compute, and I can tell you our high performance compute, in that segment in the government grew triple digits. When you ask me about Brexit, our business in UK grew double-digits. And in China we have a unique set-up, which Tarek made the comments about our joint venture with Chinese partner in a company called new H3C.

We at this point in time, I always talk about this from the customer point of view, we see customers accelerating the digital transformation. I talk about all the time about the explosion of the data around that. That data is outpacing the compute power, but that compute is shifting. It's not just in the cloud, it's moving to the edge, and that's why I talk about the ability to provide the cloud computing at the edge and that's why our edge computing platforms grew triple digits this quarter. So we may have a different portfolio and maybe have different focus on the segments, but we saw no slowdown in our demand in Q1. And that's why, together with our portfolio and our sound strategy we are very confident to accelerate growth in revenue in Q2 and beyond and that's why we also raised the EPS guidance.

Simon Leopold

Great. Thank you very much.

Andrew Simanek

Great. Thank you, Simon. Can we move on to the next question, please?

Operator

The next question will be from Toni Sacconaghi of Bernstein. Please go ahead.

Toni Sacconaghi

Yes, thank you. I just want to reconcile the increase in guidance with what appeared to be some non-operating benefits. So I'm hoping you can just correct me if I'm misspoken and then reconcile it. So by my calculations, other income was a \$0.045 benefit this quarter relative to your prior guidance. Tax rate now at 12% for the year is about a \$0.02 benefit. So those two alone are \$0.065 and you raised guidance \$0.05. Additionally, relative to my model, unallocated stock-based compensation was down \$25 million year-over-year, that helped \$0.02. So if I add these three factors, it's \$0.085, which are all effectively non-operating and yet you are raising guidance by \$0.05, despite the fact they sound very positive on fundamentals. Am I misspeaking on any of the factors, and how do I reconcile that? And I have a follow-up, please.

Tarek Robbiati

Yes, I think Toni your math doesn't work. The improvements in operating profit is driving the vast majority of the growth that stands behind our guidance change. Yes, there is some benefits from tax, but the difference is not going to drive more than \$0.01, a little bit more potentially from our math. The OI&E improvement is also a function of two things. There is the interest expense side that we are managing and keeping under control, and there is also dividends from China that we explained and continue to foreshadow, that is responsible for \$0.01 or \$0.02.

On the whole, the real driver of operating performance is the expansion in gross margin. We expanded gross margins 280 basis points year-over-year and that is really the key acid test in my mind in the way we want to look at the business moving forward. With HPE Next also driving higher levels of efficiencies from an OPEX standpoint, and this is why you can see a pretty large improvement in overall operating margins, which are now at 8.9% in Q1, up from 7.3% in Q1 last year, once you've normalized for the pension adjustment. So it's 160 basis points improvement year-over-year in operating margin overall.

Toni Sacconaghi

Okay. Thank you, Tarek. Maybe you can just provide updated guidance for interest and other, it was minus \$250 million for the year. What's the updated guidance then? And then separately

for my follow-up, Edge Compute did extremely well, that's new to the segment. So I am trying to understand the growth trajectory of traditional compute. So I think traditional compute was probably minus five or minus six, if we exclude Edge Compute, maybe you could help us with what server units grew and what server ASPs did in the quarter? Thank you.

Tarek Robbiati

Okay. So let me take the first part of the question and I will ask Andy to shed some light on Edge Compute versus compute growth. And Antonio will add to that. Fair question on OI&E. We did...and you're correct in guide at the SAM meeting at the Securities Analyst Meeting to a \$250 million expense for the full year. We don't give specific new guidance at this stage on this line item, but it's true that we did have some outperformance relative to what we guided on a full year basis in the course of Q1. And we expect to beat on the \$250 million. But even if you were to take the \$250 million in terms of overall EPS impact, the impact will be relatively small relative to the original guidance that we gave at SAM. Andy and Antonio?

Antonio Neri

Yes. So on the server side, Toni, a couple of things, our value compute grew 20% in aggregate, and you saw some of the commentary around the software-defined infrastructure with hyper-converged growing 70% and high performance compute growing 50%. And obviously, we are exiting the tier 1 business, right, which...that continues to be now a less of an impact for us. But if you look at the growth of compute overall, it was minus 3, but if you excluded the tier 1, it's plus 3%. So we expect that headwind to continue to be less and less, because obviously we continue to deplete that specific segment.

On the edge side, it's still relatively small in overall basis, but we are very encouraged about the momentum, because we're growing triple digits, and that will continue to be the case. And the reason why that's the case, Toni, is because we see the growth of that cloud closer to where the data is created, and we see new use cases in manufacturing, transportation, and health care. And the embedded compute in those platforms, plus the cloud closer to where the data is, is a better economics for customers in many of the use cases. So that's what we see today.

From the AUP perspective, our AUP continue to grow, and that's a function of the fact that we said many times that two-third of the AUP is structural, because as you know the commodity cost base has been declining, and it takes longer time to pass that through, but the reality is we continue to grow AUPs roughly 20%, which is a function of what customers are buying, which is configurations related to AI and big data analytics and other software-defined infrastructure. So that's what we see Toni at this point in time.

Toni Sacconaghi

That's great, thank you, Antonio.

Andrew Simanek

Can we go to the next question, please?

Operator

The next question will be from Katy Huberty of Morgan Stanley. Please go ahead.

Katy Huberty

Thank you, good afternoon. Can I just come back to the guidance question, because you beat in the quarter by \$0.07, you're rising by \$0.05, which assumes that there is a \$0.02 headwind

that hits in the following quarters. Is that...what is that headwind? Or are we thinking about that wrong? Is there just conservatism baked into the guidance? Then I have a follow-up.

Tarek Robbiati

All right, it's true, Katy, we beat by \$0.07 and we gave back \$0.05 by way of guiding...guidance improvement. Look, this is only Q1, we have three quarters to go. We want to accelerate growth, and give me \$0.02 to be able to do that.

Katy Huberty

Okay. And then as a follow-up, R&D as you mentioned is up strong double digits year-on-year. Can you just talk through the projects that are receiving the most incremental investment? Is that all going to the Intelligent Edge investment over multiple years that you've talked about, or are there other areas of the business where you are seeing a significant step up in investment? Thanks.

Antonio Neri

Sure Katy. So one point I want to make on the previous question is the fact, listen, we need to manage the company for the long term, and obviously we continue to accelerate investment where we see the opportunity to grow and deliver shareholder value.

So to Tarek's point, this is just Q1 and we see opportunity to accelerate some investments. To that question that Toni asked the Intelligent Edge is absolutely an area that we continue to invest. And you saw in the numbers, right, that we are growing, but also reinvested significantly back into the business. And in that, think about the connectivity aspect of this as 5G comes online, there is an opportunity to integrate 5G into the overall control plane and data plane that we provide customers with our Aruba platforms. Think about the cloud computing and the edge we talked earlier, and then in the core business, right, for us it's all about software embedded in our solutions, because customers want a workload-optimized solution on-prem that they can connect through a cloud in a very efficient way. And all of that is going through software. And as you think about that, it's the private cloud on premises with the right consumption model, with the right simple aspects of the experience to provision and manage that infrastructure? And we feel very good about that. That's why Synergy is a billion-dollar run rate business for us.

And when you think about Synergy, 95% of that business or the platform is software. That's why HPE OneView now is the foundation to deliver that composable cloud and the hybrid cloud vision, and that's why there's already more than 1 million licenses deployed. So, think about core, all about software AI, machine learning to automate everything and to make that Hybrid IT experience simple, and on the edge, really the edge compute connectivity and security, and obviously services, services for us is very, very significant and the consumption model is one aspect of that.

Katy Huberty

That's perfect. Thank you so much.

Antonio Neri

Thank you, Katy.

Andrew Simanek

Could we go to the next question, please?

Operator

The next question will be from Jeff Kvaal of Nomura Instinet. Please go ahead.

Jeff Kvaal

Okay. I'm afraid I'm going to have to start with clarifying that guidance one step further. And that is, if I'm interpreting your remarks correctly, the gross margin improvement that you've got in this quarter is sustainable. But you may choose to increase your OPEX a little bit more to pursue some of these growth opportunities, and that's why the full-year guidance isn't going up. Is that right?

Tarek Robbiati

Jeff, look, the gross margin improvement of 280 basis points is sustainable. But in my speech I've explained the sources of that improvement, which have to do with supply chain efficiencies improvement, such as logistics costs, manufacturing overhead cost reductions, and also to a much lesser extent, the improvement in commodities cost. The mix is the fundamental point that drives the improvement in gross margins. It's not just the cost of sales, but the mix of the revenue drives the improvement in gross margins. This has caused us to beat guidance in this quarter by \$0.07. This is the first quarter of the fiscal year. We see potential, having talked to many customers, to continue to grow and accelerate growth starting Q2. And so, we are going to make limited amount of investments to go and pursue that growth moving forward.

Antonio Neri

And to be clear that investment is again in the areas I talked earlier before. It's all about accelerating innovation, accelerating innovation based on the customer feedback, which...the feedback is, our strategy is sound and it's resonating with them. Our HPE Next actually gives us the operating leverage together with our mix shift to make some of those choices.

Jeff Kvaal

Okay that makes so much sense. And your gross margin commentary, Tarek, was clear. It's more of an OPEX question. Could I also ask on the Aruba side of things your product seems like you got some new products there 11ax upgrade? Should we expect that to bring Aruba back towards its more traditional growth rates in next quarter or over a series of quarters? Or how should we think about that?

Antonio Neri

Yes, absolutely. We are incredibly excited about the new offering that Aruba brought to the market, the Aruba 510 access point that to your point now are going to deliver this new experience with the 802.11ax, which improves bandwidth and improve the overall experience. As you know, Aruba is the software platform that provides a mobile-first cloud-first approach. And these access points are actually going to enhance those experiences. And the 8325 switches are the next iteration of programmable switches that ultimately take advantage of these newer capabilities and we expect that to accelerate growth.

Listen, the Aruba portfolio, the wireless LAN, grew double digits and that's great. But as you know, when customers see this new technology, they also want to take advantage of it. And also in the United States you have programs like E-rate and all those that come to play. And so I know there was another question before that didn't come up, but since I'm here, I'm going to answer proactively. It was...was the Q4 deals had an impact to the Q1? The answer is, no. It's just normal seasonality and our bookings in Aruba products are incredibly strong. So this is just about converting the bookings to revenue and then take advantage of these new offerings, which are super, super bullish.

Jeff Kvaal

Great. Thank you both very much.

Antonio Neri

Thanks.

Andrew Simanek

Could we have the next question, please?

Operator

Next question will be from Rod Hall of Goldman Sachs. Please go ahead.

Rod Hall

Yes. Hi, guys, thanks for the question here. I just wanted to come back to the AUP comment. I think you had said that AUP is up about 20% for servers, and I wonder if you could give us the other side of that equation, the unit decline number.

And then, I have a follow-up and that relates to the geographical revenues in the guidance. We see this big deterioration in Asia Pacific which you called out as China. I wonder if you could talk about whether that, in your estimation, it's declining further. Or whether that's relatively stable at this point. And maybe simultaneously in EMEA, U.K, if you could just comment on what you think forward trends look like there. Thanks.

Andrew Simanek

Sure Rod. I'll take a quick grab at the units and AUP question. So, as Antonio mentioned, AUPs were up again about 20% or so this quarter. And so you can kind of back into the unit's numbers, but they were down similar to what we saw last quarter. So no major change in the dynamic, because obviously compute excluding tier 1 grew 3%. So I think the important thing that Antonio mentioned was we've got enough structural AUP uplift to continue to drive overall growth in core compute. So no major change from that dynamic perspective. And maybe, Antonio I'll let you take the...

Antonio Neri

Yes, I want to make a comment on that, because remember the units that have been declining, are the units that have no attach to Pointnext. That's what I really want to emphasize versus the units that are growing are the ones that drive the attach in Pointnext Operational Services, which are the value units whether it's high performance compute or hyper-converged and others. And that's why those businesses as they grow whether they're growing 50% or 70% with AUP of increase of 20%. The reality is that, that drives a nice attach and that's why our book-to-bill ratio was 110% and that's why our Operational Services business grew as well. So that's why I want to emphasize that because the two go hand-in-hand versus the volume commoditized part today, which a big chunk of the unit decline, was the tier 1 and no implication to Pointnext.

In terms of China, as I said before, we have a unique setup there. But Asia Pacific without China grew again, and that's what is important and it grew double digits. But in China because we have this set up they have a combination of our portfolio there, HPE products and Chinese products. As you can imagine selling in that market is not linear in uniform, because when you saw the government, right, they would like to have more Chinese products versus selling in the traditional commercial space. But in the end, we don't...are not concerned at all because in the

end we have a 49% stake that delivers very nice dividends. And we are driving that upside together with our shareholders, because we pass those dividends to our shareholders. And so I want the community to understand that that business as a whole is growing but the mix within that business is shifting. But the reality is we pass the benefit of that growing business to the dividend side.

Tarek Robbiati

Yes. If I can just add a commentary on this one, because it's really important to understand our setup in China. Look, most companies who set up a business in China, most Western companies typically set it up with a special purpose vehicle with a Chinese partner and both parties put their assets and know-how to work for the joint venture to succeed. Very few players across all sectors have a 49% stake in the substantial operation in China. We do. If you really want to look more at our Chinese business, you have to refer back to the parent company UNIS, which is listed in China, and see how much of the profit of our H3C joint venture contributes to the total profit pool of UNIS. So the setup for us is optimal and what we're trying to do is to manage the operations, as Antonio said, through the mix of products to maximize profits and dividend payouts.

Rod Hall

And maybe a comment on Europe?

Tarek Robbiati

Yes. Europe was actually the best-performing region I would say, when you think about that. And we have very strong growth in many of the geos within Europe. I mean I made a comment about Brexit early on about our U.K. business, it grew double digits. So France, so Germany, we have a very strong momentum in Europe. And I think our portfolio, considering how business is done there and how customers adopt new technologies, is incredibly suited for that market. So overall, we are very pleased with Europe. We grew 3% year-over-year. And in that you have obviously some of the exit in the Central European countries that we talked about, our Advisory and Professional Services. But the core business and the Operational Services business grew very nicely. And we see an expansion with Aruba too.

Rod Hall

Okay, thank you.

Andrew Simanek

Thank you Rod, I think we are running out of time, could we have one more question, please.

Operator

Thank you. It will be Ananda Baruah of Loop Capital. Please go ahead.

Ananda Baruah

Okay, thanks guys. I appreciate you taking the question. Look, congrats on a solid quarter. Hi, just going back to the revenue acceleration commentary, you guys mentioned revenue acceleration coming starting in the second quarter, a handful of times across a handful of segments using a handful of contexts. I know the growth you've kind of forecast for the fiscal year was really just for growth. But I would love context, we probably all would, just on how you want us to sort of think about revenue acceleration because that will sort of suggest something greater than just nominal growth. And so how should we think about that? It also sounds like you're talking about investing into upcoming growth opportunities too. I think the word "amplified" was used as well. So any context there would be fantastic. Thanks.

Tarek Robbiati

Okay. Let me try and add a little bit of color for all of you to understand this point. We did say and we guided that we would be growing revenue for the full year. There is no change to that. However, there were a couple of dynamics that we also flagged to you. Number one, currency. We still expect a 1%-to-2% of headwind from currency. It's closer to 2% rather than 1%. And there's also the tier 1 dynamic. The tier 1 revenue decline has diluted our growth profile. What gave us now more confidence that we can grow as of Q2 is because we have seen the tier 1 decline being sharper than what we originally anticipated, which reduces the dilution effect for the subsequent quarters.

And that's why we made a commentary overall that we can see acceleration of revenue from Q2, Q3, and Q4. And finally and most importantly, what really is driving this level of confidence is all the discussions we're having with our customers who are reiterating that their plans continue at pace. And that's why we qualified the macro environment by saying it is steady.

Antonio Neri

I will add one thing to that point here is that we see again the explosion of the data as a driver to drive growth. Our high performance compute portfolio is best in class and we see the momentum accelerating. Aruba will continue to accelerate starting Q2 and beyond because of our new offerings and also because how demand shapes throughout the year. And obviously, our software-defined portfolio clearly is resonating with customers.

That together with the comments that Tarek made about the tier 1, we are actually very, very confident that our Q2 and beyond our revenue will accelerate from the current levels. And that's why, together with our mix and together with our cost disciplined execution, we are confident to raise the guidance. And as I said in my comment, I think there are more opportunities here to continue to drive that shareholder value. And again, our innovation is the best we ever had. The employee morale in the company is the best we've ever had. We just moved to our new headquarters here, which is phenomenal. And we are winning in key segment of the markets where we decided to focus on. So that gives us the confidence that we can accelerate revenue.

Ananda Baruah

Okay, that's great, I appreciate it. And just a real quick follow-up. That...does that hold for your channel business as well which is a significant portion of your revenue? You mentioned enterprise. You gave some enterprise context earlier, but for your channel business as well.

Antonio Neri

Yes, absolutely, because if the channel doesn't grow we can't grow. So 70% of our business in the core Hybrid IT and up to 90% in Aruba are all driven by the channel. And in fact tomorrow, I will be talking to the channel partners about our momentum and our innovation to all the key CEOs and they are with us. So they like our predictable channel program, so they can understand how to make money with us. But ultimately they like our portfolio to serve our customers better. So our sellout in the channel has grown double digits and that's why we are confident.

Ananda Baruah

That's great. Okay, thanks a lot, I really appreciate it.

Antonio Neri

You're welcome.

CONCLUSION**Andrew Simanek**

Great. Thank you, Ananda. And thank you everyone else for joining the call today. With that, I think we can wrap things up. Thank you.

Operator

Thank you. Ladies and gentlemen, this concludes our call for today. Thank you for joining. And at this time, you may disconnect your lines.