Hewlett Packard Enterprise Company

First Quarter Fiscal 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Andrew Simanek - *Investor Relations*

PRESENTATION

Operator
Good day, and welcome to the First Quarter Fiscal 2022 Hewlett Packard Enterprise Earnings Conference Call. My name is Chuck and I'll be your conference moderator for today's call. At this time all participants will be in a listen only mode. We will be facilitating a quest ion-and-answer session towards the end of our 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 conference over to your host for today's call, Mr. Andrew Simanek, Vice President of Investor Relations. Please go ahead.

Andrew Simanek
Thank you. Good afternoon. I'm Andy Simanek of investor relations for Hewlett Packard Enterprise. I'd like to welcome you to our fiscal 2022 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 in 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 and Form 10-Q. HPE 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 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 31, 2022. 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. Throughout this conference call all revenue growth rates unless noted otherwise are presented on a year-over-year basis and adjusted to exclude the impact of currency.

Finally, after Antonio provides his high-level remarks, Tarek will be referencing the slides in 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. And good afternoon, everyone. Thank you for joining us today. Before I discuss our results, I would like to address the evolving situation in the Ukraine and how we are

responding. Our first priority in the region is the safety of our team members, our contingent workers and their immediate families. We are conducting regular proactive outreach to our workforce in Ukraine to offer emergency assistance, making our security team available 24/7 to help.

The HPE Foundation has established a special giving campaign for our team members to support humanitarian efforts in Ukraine, which has already raised $150,000 in just over 24 hours. And we are expanding the time off we offer team members to volunteer so those in the regions can care for their families and participate in humanitarian relief activities. From the business perspective, we have suspended all shipments into Russia at this time, and we'll continue to adhere to all relevant sanctions and export controls.

Now, let me review our results for the first quarter of fiscal 2022. Hewlett Packard Enterprise delivered a solid performance. The quarter was characterized by robust customer demand and profitability, demonstrating the strength of our differentiated edge-to-cloud strategy and our portfolio innovation. Our business pivot is further strengthening our growth and operating margins. As a result of our overall performance this quarter, we are increasing our outlook for non-GAAP diluted net earnings per share for the full fiscal year 2022.

In Q1 we saw order growth of 20% from the prior year period, including 136% rise in other service orders. We increased total HPE revenue by 2% year-over-year to $7 billion, despite continued industry wide supply constraints, which slowed our ability to convert orders and record-breaking backlog to revenue.

We generated non-GAAP gross profit margins of 33.9% - higher than the prior quarter and prior year. I'm particularly pleased that we delivered 11% non-GAAP operating margin. Free cash flow was negative $577 million in the quarter, reflecting normal seasonality and proactive actions we continue to take to further buffer inventories in order to meet robust customer demand and forward-looking growth. The performance we delivered this quarter was noteworthy in a macro environment that continues to be defined industry wide by supply shortages and overloaded logistic channels.

Our global operations team is mitigating the impact by prudently building inventory where appropriate and leaning on our long-standing supplier relationships. We continue to utilize our world class supply chain engineering capabilities to adjust the type of components we use, shifting to those that are more readily available.

We've not seen any noticeable order cancellations from customers due to elongated delivery times. And we continue to take pricing actions in this inflationary environment. As we discussed previously, we expect supply constraints will likely last well into the second half of calendar year 2022.

Demand for our differentiated edge-to-cloud products and solutions continues to be very strong, with Q1 marking the third consecutive quarter we have generated year-over-year order growth above 20%. This was also the second consecutive quarter that our as-a-service orders more than doubled year-over-year.

Customers are turning to HP for a differentiated portfolio, adopting our solutions to drive their transformation at a faster and faster pace. Several key technology trends that are shaping the IT industry are aligned directly with our strategy to become the edge-to-cloud company through our HPE GreenLake platform offering. The edge is creating new sources of data. Our customers need secure connectivity to power the emerging distributed enterprise with remote workforces while delivering new digital experience to their stakeholders.

The world is hybrid. Cloud is an experience that customers increasingly expect to have wherever their workloads live. The result is a growing demand for multi-cloud experiences including clouds that live on premises, at the edge, in colocations or in a public cloud. We have entered the age of insight and data is the most precious asset. Digital transformation is creating new possibilities for enterprises, and customer need solution to extract insights from the data to accelerate business outcomes.

And when customers tell us they want to address this market shift, they are increasingly looking to do so through a flexible as-a-service consumption model that enables them to pay only for the IT they use. Customers seeking to capitalize on these market trends opportunities are turning to HPE GreenLake as the platform of choice.

As always, Tarek will provide details about the business results for each of our segments. I will note a few highlights that underscore our performance this quarter, as well as our innovation and interaction with customers.

Customer's requirement for a unified operating experience across edge-to-cloud and the desire to consume IT in a flexible way, is fueling the tremendous orders growth of our HPE GreenLake edge-to-cloud platform, which saw record demand in Q1 with as-a-service orders up 136% year-over-year.

During the quarter, we added more than 100 new HPE GreenLake customers, bringing the total count to more than now 1,350 customers who have adopted the HPE GreenLake platform because of its compelling value proposition. Among the new HPE GreenLake customers we announced in Q1 was Barclays, which is using HPE GreenLake to deliver its private cloud platform as a part of the bank's hybrid multi-cloud strategy and digital transformation across its global banking businesses.

The traction we are seeing in the market for HPE GreenLake is driving us to further accelerate the transformation of HPE into edge-to-cloud company. On March 22, we will unveil significant new innovations and enhancements to our HPE GreenLake platform to help customers manage their hybrid clouds more easily, protect and get more value from that data and securely connect at the edge.

Our as-a-service transformation is my number one priority, and it is already delivering results for our shareholders as evidenced in our Q1 performance and increased non-GAAP diluted net earnings per share guidance for the full fiscal year 2022.

Our as-a-service pivot is accelerating our momentum in key growth businesses. Our Intelligent Edge business segment grew revenues 11% year-over-year and for the fourth consecutive quarter, saw year-over-year orders growth of over 35%, driven by the very strong demand in secure connectivity from edge-to-cloud. Our Aruba Edge cloud offerings continue to garner new customers. The Aruba Central Cloud native platform now manages more than 120,000 customers and more than 1.9 million network devices.

In Q1, we announced that our Aruba Cloud managed branch offering is being adopted by Brasfield & Gorrie, one of the largest privately held construction companies in the United States.

The company is using our networking portfolio to elevate their construction site innovation with impressive tools like virtual reality views of projects before they are built.

Also in the quarter, we introduced the Aruba EdgeConnect Microbranch, an industry leading home office cloud-based networking solution that lets remote personnel work seamlessly and securely wherever they are located. Our High-Performance Compute and AI business also generated a noteworthy product order growth of more than 20% year-over-year, which has increased our total order book to a record of approximately $2.7 billion.

During the quarter we announced a win with the United States Department of Energy, National Renewable Energy Laboratory to build a new supercomputer that will advance R&D for tomorrow's clean energy systems.

Our Computer and Storage businesses experienced robust order growth and outstanding profitability. In Q1, nearly 10% of Compute and Storage orders were sold as-a-service. Compute generated more than 20% order growth year-over-year, expanded gross margins and attractive operating margins up 240 basis points year-over-year, driven by strong pricing discipline.

Storage drove product order growth of more than 15% year-over-year for the fourth consecutive quarter. Innovation is unrelenting, as we transform this segment into a data services business. For example, in Q1 our venture arm Hewlett Packard Pathfinder invested in BigID. This is a leading data intelligent platform that helps organizations realize detailed insights in their sensitive personal and critical data and then act on it.

Our HPE Pointnext Services team is helping customers navigate through their multi-generational IT journey while modernizing, building and running the new hybrid IT estates. In Q1 HPE Pointnext Services orders increased mid single-digits year-over-year.

Turning to our workforce, we reopened all of our United States offices last month to those who wish to return after careful analysis of information and guidance from the public health officials. I was very pleased to meet team members in-person at our new cutting-edge Houston headquarters. You may have caught a glimpse of our Houston campus innovations in the video that ran before this call. We look forward to the official grand opening in April.

Alongside advancing a rewarding workplace, I also believe that HPE has a responsibility to become a more climate resilient company. And we know it is a priority for our customers and shareholders. HPE Financial Services plays an important role in our sustainability strategy, providing asset up-cycling to customers, which means reuse of millions of technology assets while freeing up capital for customers to reinvest in their businesses. Customers are choosing HPE in part because of our portfolio sustainability attributes. In fact, in fiscal year 2021, we drove nearly $900 million in revenue from sustainability related customers engagements.

I am proud of our team members not just for bringing breakthrough customer centric innovation, but for how they're bringing it to market. We are making bold moves to maximize what we can do for our customers and shareholders. It is this type of collaboration and engagement that's propelling our business transformation. It is clear from strong customer feedback and momentum across our businesses that HPE is increasingly well positioned to capitalize on the edge-to-cloud mega trends that define our IT industry.

HPE GreenLake is at the center of our strategy to pivot the company and it is generating record breaking demand with impressive profitability across our business. These continue to be uncertain times. As we monitor the dynamic global stage, I am more confident than ever about our future and our ability to drive long term sustainable profitable growth for our shareholders because of our strategy and differentiated innovation.

Now, I would like Tarek to take you through the quarter's performance in detail. Tarek?

Tarek Robbiati
Thank you very much, Antonio. I'll start with a summary of our financial results for the first quarter of fiscal year 2022. As usual, I'll be referencing the slides from our earnings presentation to guide you through our performance. Antonio discussed the key highlights on slide one. So now let me discuss our Q1 performance details starting with slide two.

We're off to a good start delivering against our commitments for fiscal year '22 with strong momentum continuing to build across the business. The demand continues to be robust for our differentiated edge-to-cloud portfolio with order growth up 20% year-over-year, marking our third quarter in a row with order growth at or above 20% year-over-year. This bolsters our confidence in achieving both our fiscal year '22 revenue outlook of 3% to 4%, adjusted for currency, and our longer term 2% to 4% revenue CAGR outlook provided at our 2021 Securities Analyst Meeting.

We delivered Q1 revenues of $7 billion, up 2% year-over-year and in-line with our outlook of normal sequential seasonality, despite a continuously challenging supply environment. As a result, our backlog further increased to record levels with a firm order book that shows no signs of double ordering or any noticeable cancellations. We were particularly pleased with the quality of our earnings including the resiliency of our gross margins, despite the ongoing supply constraints that are driving up material and logistics costs.

We delivered non-GAAP gross margin of 33.9%, up 90 basis points sequentially and 20 basis points year-over-year, driven primarily by strong pricing discipline and our continued mix shift towards higher-margin, software rich offerings.

Non-GAAP operating margin has also been resilient at 11%, slightly down 30 basis points year-over-year, but up 130 basis points sequentially. We're achieving all of the expected savings from our cost actions announced mid-pandemic while continuing to make investments in our high growth, margin rich areas of our portfolio to fuel further revenue and profitability.

Within other income and expense, we benefited from further strong gains related to increased valuations in our investment portfolio and robust operational performance in H3C. As a result, we now expect non-GAAP other income and expense for fiscal year '22 to be an income of approximately $25 million versus prior guidance of a $20 (million) to $40 million expense.

As a result of our strength in margins that more than offset the continued supply challenges, we delivered non-GAAP EPS of $0.53, well above the high-end of our outlook range of $0.42 to $0.50 for Q1.

As previously indicated, we expect the free cash flow to be in-line with our typical seasonality that is lowest in Q1, with the use of cash of $577 million for this quarter. We also continue to take strategic inventory actions to navigate the current supply environment. Our inventory is now up $2.5 billion year-over-year to $5.3 billion in support of the substantial order book that we have. This will better position us to convert orders into future revenue and cash flow.

Finally, we continued to return substantial capital to our shareholders. We paid $155 million of dividends in the current quarter and are declaring a Q2 dividend today of $0.12 per share payable in April. We also repurchased $129 million in shares during Q1, reflecting our confidence in future cash flow generation.

Slide three highlights key metrics of our growing as-a-service business. We made meaningful progress during Q1. We added more than 100 customers and well over $500 million of total contract value that brings the current total TCV to more than $6.5 billion. Total as-a-service orders were up 136% year-over-year. As a proof point of our as-a-service pivot momentum as-a-service order growth has accelerated every quarter going back to Q1 of last year.

Our ARR was up 23% year-over-year to $798 million with supply constraints limiting some installations. While our ARR growth might be somewhat volatile in the current supply environment, the strong accelerating order growth over the last several quarters is the best indicator of long-term health of this business. This gives us confidence in delivering our 35% to 45% CAGR target from fiscal year '21 to fiscal year '24, with increasing margins as our mix of both software and services continues to increase to 64% in Q1, up more than 4 points year-over-year.

Now, let's turn to our segment highlights on slide four. Our growth businesses continue to show improving top line momentum and record levels of backlog fueled by strong demand. In the Intelligent Edge, demand for our secure connectivity solutions continued unabated with orders growing more than 35% year-over-year, the fourth consecutive quarter.

Despite increasing supply constraints, revenue grew 11% year-over-year with strength across the portfolio. Both wired switching and wireless LAN grew approximately 10% with Aruba Services up even stronger driven by our Edge-as-a-Service offerings up strong double digits.

We also delivered strong operating margins of 17.4%. This is a 650 basis point sequential improvement despite higher component and logistics costs, demonstrating that our price actions are sticking. In HPC and AI, demand remains robust with product order growth of more than 20% year-over-year, driving our awarded contracts total to another record level of approximately $2.7 billion.

Revenue grew 4% year-over-year but was impacted by two large customer acceptance delays that impacted growth by more than 10 points in Q1 and are now on track to be delivered in Q2. Our Q1 operating profit was obviously also impacted by these pushouts, and we expect operating margins to return to more in range with historical levels going forward.

In Compute, order growth was up over 20% year-over-year for the third consecutive quarter, while revenue growth was flat, reflecting the difficult supply environment.

We have been very focused on executing a dynamic pricing strategy that has been effective in managing the increased supply and logistic costs. The results are showing up in our operating margin performance at 13.8%, up 240 basis points year-over-year and 440 basis points sequentially, well above our long-term target of 11% to 13%.

Within Storage, product order growth was up in the high-teens year-over-year. This was the fourth quarter in a row of 15% or better year-over-year product order growth. Revenue was down 3%, reflecting increasing supply constraints, particularly for our owned IP products. As a result, we had an unfavorable revenue mix that pressured our margins this quarter. We expect both our revenue growth rates and margins to improve over the next few quarters as we continue to shift our portfolio towards higher margin products and supply constraints ease.

With respect to Pointnext Operational Services, including storage services, orders grew mid single-digits year-over-year as reported similar to levels for total fiscal year '21. As you know, this is very important for the long-term health of our most profitable business.

Within HPE Financial Services, volume increased 11% year-over-year, and revenue was down 1%. Our write-offs as a percentage of assets, excluding the impact of two frauds in the UK and Asia Pacific was 47 basis points, which is below pre-pandemic levels. Our profitability also continues to benefit from higher residual value's realization and lower borrowing costs as we continue to securitize our US portfolio via the ABS market. Our operating margin was 12.4%, up 260 basis points from the prior year, and our return on equity at 19.7% remains well above the 18% plus target set at SAM 2021.

Slide five highlights our revenue and EPS performance where you can clearly see the strong rebound from last year and sustained momentum entering fiscal year '22, and this despite a more supply-constrained environment versus a year ago. We are also delivering a better quality of earnings with our portfolio mix continuing to shift to our higher growth and higher margin businesses as we execute our edge-to-cloud strategy.

Turning to slide six. We delivered non-GAAP gross margins in Q1 of 33.9%, up both year-over-year and sequentially despite all of the increased component and logistic costs. This was driven by both strong pricing discipline and the favorable mix shift we've been driving towards edge and our as-a-service business.

Moving to slide seven. You can see our non-GAAP operating margin this quarter of 11%, representing a 130 basis point sequential increase. We also delivered roughly the same operating profit versus last year despite a more challenging supply environment while continuing to invest significantly more in both R&D and our go-to-market for the future, thanks to a much better quality of earnings and gross margins.

Turning to slide eight. Our free cash flow was a use of cash of $577 million. This is more aligned to our typical pre-pandemic seasonality if you look at Q1 in fiscal year '20 or the prior years. Cash flow in Q1 of this year has also been uniquely impacted by the supply chain environment as we have strategically continued building inventory levels. This will better position us to begin converting orders and generate healthy amounts of cash in the back half of the year, reflecting also our typical seasonality. We therefore continue to expect to deliver fiscal year '22 free cash flow of $1.8 billion to $2 billion.

Now turning to our outlook on slide nine. Given our strong performance in Q1 and building momentum across the business, I am pleased to announce that we are raising our full year non-GAAP diluted net EPS outlook range for fiscal year '22 by $0.07 at the midpoint to $2.03 to $2.17.

From a top-line perspective, we were very pleased with the continued strength in orders and growing backlog that gives us confidence in future revenue growth in fiscal year '22 and beyond.

We do also want to remain prudent in the short term given the ongoing supply challenges that we continue to believe will likely last well into the second half of the calendar year.

As a result, we still have strong confidence in our fiscal year '22 revenue outlook of growth of 3% to 4% and expect to end the year with elevated levels of backlog, which bodes well for fiscal year '23. More specifically, for Q2, 2022, we expect revenue to be in line with our normal sequential seasonality of down low to mid single-digits and are comfortable with current consensus. As a result, for Q2, '22, we expect GAAP diluted net EPS of $0.18 to $0.26 and non-GAAP diluted net EPS of $0.41 to $0.49.

So overall, I am very pleased with our first quarter of fiscal year '22. Our edge-to-cloud strategy is resonating with customers and driving strong demand across our portfolio. This enables us to deliver a good start to the fiscal year with increasing momentum and a raised outlook. We are very well positioned to capitalize on the ongoing opportunity and deliver against all of our financial commitments set at SAM 2021.

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

QUESTION AND ANSWER

Operator
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 pickup your handset before pressing the keys. And to withdraw your question, please press "*" then "2." We also request that you only ask one question.

And our first question will come from Shannon Cross with Cross Research. Please go ahead.

Shannon Cross
Thank you very much. I wanted to maybe dig a little bit more into linearity during the quarter and what you're hearing from customers in terms of demand given all the geopolitical challenges. You talked about backlog increasing to record levels. I'm wondering, how much of that do you think are customers planning ahead or thinking about longer lead times versus near term demand that's not just being able to be met right now? And just what are you hearing because are customers shifting the way that they think about how they're buying at this point in time? And just the final question within that is, how does this benefit, or does it benefit your GreenLake and your as-a-service strategy? Thank you.

Antonio Neri
Well, thanks, Shannon. So, as you can imagine, I spend a lot of time talking to customers. In fact, 50% of my time is with customers and partners. And the one consistent theme is that I always said our quarter has 13 weeks and every week has been super strong. We put specific goals for our sales force every week that we track very closely. Tarek runs a very tight process on that. And we have always exceeded every week's forecast. And the feedback is driven by the following.

Number one, obviously, we know digital transformation is getting stronger and stronger out there, and it's driven by the fact that you've got to digitize your process to be competitive. And number two, data continues to explode everywhere, and that means that they need more capacity to store the data, but most importantly, process that data at the pace we haven't seen before. And that's a combination of AI, analytics, deep learning at scale and obviously, a lot of compute power. The third piece, obviously, as I said in my remarks, is that the edge continues to grow very, very rapidly.

And in order to transform in a digital environment, you need connectivity. Without being connected, you don't have the on-ramp in through this digital transformation. Of course, customers are concerned about inflationary costs going forward. They are monitoring what's happening out there. And…but in the end, I think all of this, when you balance the demand for these trends, and I talk about the trends, right, in the megatrends. And then the fact that customers want to consume more flexibly and don't want to put all that CAPEX to work, GreenLake is getting significant attention.

And that's why I said when I think about the future of this company, the product is HPE GreenLake. Everything gets delivered to HPE GreenLake, whether it's a connectivity through a subscription model, whether it's computer storage that you can consume elastically with data services running on top of it, whether it's the services to operate in a hybrid world, HPE GreenLake is becoming a platform of choice for many customers because it offers that flexibility and in an architecture that's edge-to-cloud. And that's inclusive, by the way, of the public cloud. And that's why when you see the innovation, we're going to bring in the next two weeks, it includes the public cloud in the way we manage that. So overall, I will say, great execution by our team. Customers need more IT now more than ever. And obviously, we are doing a good job, I will say, in the quality of earnings, pricing elasticity and everything we have done, which is the results of the profitability you saw in Q1.

Andrew Simanek
Great. Thank you, Shannon. Appreciate the question. Operator, can we have the next one, please?

Operator
The next question will come from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Yes, thank you. Congrats on the really solid gross margin performance in a very tough environment where others are really seeing a lot of pressure on their GP dollars and gross margins. I was hoping you can talk about the sustainability of these gross margins through the rest of the year, especially in light of the increasing DRAM and NAND cost? And it seems as though some of the logistics are really not letting up so far? And maybe you can share some color on your ability to take incremental price actions and maybe share some color on what you've already been able to pass through in terms of pricing? Thank you.

Tarek Robbiati
Wamsi, thank you for the questions. Yes, indeed, I'm very pleased with our gross margin performance this quarter, and we outperformed our competitors. It's pretty obvious when you look at what they have reported. And the resiliency of our gross margin is there for everyone to see and this despite the ongoing supply constraints that everyone has been facing with. So we feel that this performance can be sustained, but you have to adopt different pricing strategies across different segments. So, we have to be incredibly dynamic in our compute segment that we have been, and this translates into significant operating profit margins at 13.8%, which is even higher than the long-term outlook that we put forward for that segment at SAM 2021. And in the rest of our portfolio, we have significant differentiation at the Edge, in storage also in HPE Financial Services and HPC. So there, the pricing strategy is different. We take a harder look

at how much value can be extracted given that our portfolio there is more differentiated. But everyone is contributing here to making sure that the gross margins are sustainable.

Finally, I want to highlight to you that as-a-service contributes and will continue to contribute in the long run to enhance gross margins. That's why we highlighted to you all in the slide presentation, the mix shift in the composition of the ARR. The more we continue to drive as-a-service growth, the better it is for gross margins ultimately. But it's a dynamic environment. And to your point, you will see some pressure on some commodities. We feel we are well equipped with our inventory levels to withstand the pressure from these commodities. And this is why we buffered up inventory to the levels that we reported knowing that this is obviously to meet a substantial order book that is much higher than what we have experienced in prior years. As Antonio said, the demand in the quarter has been extremely strong every week and it continues to surprise us from a…from its strength and resiliency standpoint.

Andrew Simanek
Great. Thank you Wamsi for the question. Operator, can we have the next one, please?

Operator
Your next question will come from Tim Long with Barclays. Please go ahead.

Tim Long
Thank you. Yes, I was hoping to just follow up on some of the as-a-service business and deals. You mentioned getting some large deals and more backlog building there. Can you talk a little bit about the complexion of what you're seeing from a solution set or a customer base driving that? And maybe a little bit on kind of what you see from pipeline on some of the customers looking to more take on the as-a-service type of offering as opposed to just kind of the standard of the build and buy? Thanks.

Antonio Neri
Sure. Well, one of the marquee customers is actually your bank, Barclays, quite interesting. They needed a partner to take them to this hybrid journey. And in their case, they have tens and tens of thousands of VMs. So, in their case, they wanted flexibility to scale up and down in a private cloud environment and yet integrate the public cloud as they go forward. So they felt that, obviously, with GreenLake, they get the best of both words, an experience and a cost on-prem that's very competitive and ability to move VMs back and forth as they need. But the reality is that that is driven by many factors. Number one, let's start with the edge, right? So obviously, a lot of the as-a-service now at the edge is done in a subscription model. You subscribe to the Aruba Cloud Platform now inside GreenLake. And then basically, you can provision connectivity with a few clicks.

But now we are seeing growth in what we call the NaaS environment, the Network-as-a-Service, where customers don't just want the subscription, but they want the full consumption, including the hardware and services in a managed services approach. They don't want to be in what I call the day two of the run part. So that comes with a lot of services. And that's why Tarek mentioned the combination of software and services is increasing.

If you look at the colocation or the edge, where the cloud is moving as well, or the datacenter, obviously, private cloud is one aspect, is that infrastructure-as-a-service component. But a lot is also workload optimized solutions, what else like VDI or whether it's SAP-as-a-service, or Machine Learning as-a-service. So, we see existing workloads and new loads also being consumed as-a-service in these locations. So those are the types of deals we are seeing. And remember, it's not just the hardware and software, it's the services that comes with it, because what we're seeing from customers, and we talked about some of the previous customers as well, they want HPE to run their solution end-to-end, which the managed services piece comes as well with it. So, it's a combination of Infrastructure-as-a-Service, connectivity and then as well, this workload optimization with more and more management as well as the hybrid estate, which includes the public cloud.

And last but not least, obviously, if you think about data. Data is a major component. Data has a gravitational force. And at the same time, they want to apply these new techniques. That's why we see a lot of growth in the AI machine learning space, both in the enterprise space and at scale through HPC. And that's why on the HPC side, we are very, very pleased with the momentum. As we know that business becomes a little bit lumpy because of the customer acceptances. But this year, we're going to deliver some of the most amazing systems you can imagine at massive scale, where customers can process data, we have not imagined before. So it's a combination of all things that's what resulted in 136% growth. And that's why we are very excited about the momentum. But what excites me the most, honestly, is the innovation we're going to continue to bring in the platform called HPE GreenLake. And to the question that Shannon asked me earlier, that's why it's my priority number one, because it's working, it's driving more growth in the bookings and better profitability.

Andrew Simanek
Great. Thanks, Tim for the question. Operator, next one, please?

Operator
The next question will come from Meta Marshall with Morgan Stanley. Please go ahead.

Meta Marshall
Great. Thanks. I wanted to dig into the Intelligent Edge upside. You noted that order growth was still stronger than the revenue growth that you guys were able to post. And so kind of two parts of the question are just, if some of the order growth that you're seeing still kind of return to office plans, or are we really starting to kind of move past this return to office-driven growth? And then on the second piece, just on the revenue upside that you were able to post, is that some kind of loosening of availability for networking chips? Or is there anything that led to kind of of outperformance in that segment or loosening of the supply chain in that segment more than others? Thanks.

Antonio Neri
Sure. Well, thank you for the question. And I will start, and Tarek can add on. If you go back to 2018, when I became CEO, I said that the edge is the next frontier, and we will invest in innovation over the next 40 years. We are now seeing the results of that investment because we have a unique value proposition in as-a-service model that actually is accelerating our momentum there.

And you saw the numbers, right, 35% growth for the fourth consecutive quarter. This is not just a data point in the chart, there is four of them in the data in the chart that they are driving strong demand. I think the pandemic has accelerated the need for that distributed connectivity. In fact, this quarter, we announced a new offer, the Edge Connect offer, which basically gives the customer the ability to manage their workforce wherever they are in a seamless, secure, integrated way and provision their connectivity wherever they are. But listen, the scale or the platform we have, I think is unmatched. We already have more than 120,000 customers, which are consuming more and more services. They may start with Wi-Fi. They are in LAN, now they're in WAN. That's why we made the acquisition of Silver Peak more than 15 months ago. And soon, we're going to add 5G too.

So in my view, this is just a buildup momentum. And the architecture of that business is about unification of the connectivity, which makes it simpler to run, the operations, the network operations, whatever that connectivity is, the security layer, which obviously is super important and then the analytics, because ultimately what customers like about our offer is the ability to use the data that we actually can provide through the network on performance and characteristics that allows them to deliver a better experience.

And when you have almost 2 million devices, there is a lot of data points. In fact, so you know the scale every hour, we process almost 2 billion data points. And that's done around the globe in 13 different geos. And that gives the ability of the customer to provide these unique experiences. But again, that comes also with an improvement in operating margins, which is 17.4%, which is actually sequentially at 650 basis points. I think on the supply, obviously, we have been working for some time. I can tell you we are…we continue to place orders at least four, if not five quarters ahead of demand because we are so confident about this business to continue to grow. And, we have to work it through sometimes, we get a little bit better matching to what we have, sometimes we may leave some orders unconverted. But on a long term, this is going to continue to be a shiny story for us.

Andrew Simanek
Great. Thank you for the question, Meta. Can we go to the next one, please, operator?

Operator
The next question will come from Sidney Ho with Deutsche Bank. Please go ahead.

Sidney Ho
Thanks for taking my question. I have a couple of questions on the ARR side, ARR didn't grow on a sequential basis for the first time in a while. I know you talked about supply challenges, limiting some of the installations. Is there a seasonality element to the ARR growth? That's question number one.

And secondly, GreenLake Services growth continued to accelerate more than double for the second consecutive quarter. Can you walk us through how long it takes for GreenLake orders to flow into the ARR calculation? I assume it's different for every business segment. Thanks.

Antonio Neri
So let me start, and I'm sure the last part of the question, Tarek will answer how long it takes. No, I don't think there's any seasonality. This is up to the right. And it's just a matter of getting those installations completed. Sometimes it's the supply, sometimes it's the customer readiness in some cases. But the reality is all driven by the availability of the systems for us to install. So that's the answer on that. But again, because of the momentum we have there, we are very confident on that 35% to 45% CAGR that we committed. And obviously, over time, this takes care of itself. So that's on that part of the question. I don't see an issue at all.

The services piece I think you just mentioned…I mentioned it before, right. As with GreenLake, the one important part is it comes with 100%, attach rates of Pointnext Services. And as we go forward, obviously, that momentum continued to build a bigger, kind of deferred aspect of it. And at the same time, we also added the managed services piece of it, because many of the new deals we have been engaging, there was a question earlier about the pipeline, the pipeline looks amazingly strong, in some very large marquee deals in the making. But with that said, the managed services piece is an additive to the attach because customers don't want to be in the in the round time anymore. So, they are aligned to the GreenLake as a platform plus the services underneath to run their operations.

So maybe, Tarek, you want to talk about the conversion into ARR, I think it is, right?

Tarek Robbiati
Yes. So, the simple answer to your question on how long does it take to see an order flow into the ARR and revenue terms is this. Our GreenLake model is an appliance-driven model, where effectively you have a complete stack from standard hardware platforms with services and software on top. And so, to the extent that we have to deliver that complete stack solution, it takes…obviously, it's important that we deliver the right hardware to be able to start to recognize the revenue. By the moment we deliver the appliance and the revenue flows based on the contract duration, and we have flagged to you and possibly too in prior occasions that the services revenue, which makes the bulk of the ARR with the software is recognized overtime over the duration of the contract. And the contract duration varies between 36 and up to 55-58 months, in some cases, 60 months.

And so this is why it takes time to develop the ARR. But the really important thing to note is the size of the total contract value that we have on the balance sheet. So if you really look at the contract value that we have on the balance sheet, we increased it by $500 million in this quarter, taking the total to $6.5 billion of revenue that will unwind in the upcoming, say, 60 months at the worst, right. So that's the dynamic that you have here in terms of orders versus revenue and ARR recognition.

Antonio Neri
Which is a great question because, obviously, if you look at our ARR, again, at $800 million this quarter, and our total contract value $6.5 billion and more than 64% now is software and services. Overtime, you will see the impact it has on our results, both quality of the revenue mix and quality of the earnings because as Tarek said, obviously, everything we do through GreenLake is accretive. And so that's why we are excited about the momentum we have on GreenLake.

Andrew Simanek
Great. Thanks, Sidney for the question. Operator, next one, please?

Operator
The next question will come from Aaron Rakers with Wells Fargo. Please go ahead.

Aaron Rakers
Yes, thanks for taking the question, and congrats on the results. I wanted to frame you…how you're thinking about the full year revenue guidance at 3% to 4% relative to the backlog build. So, if I look at the revenue guidance at the midpoint, it would seem to suggest you expect a stronger second half relative to what we've seen over the past few years, second half versus first half.

So, my question is this, what's your assumption around backlog build? And when maybe we see that peak and you start to ship against that backlog, is that factored into your revenue growth expectation from this year?

Antonio Neri
Great question. And I think if you think about it in Q1, right? So we grew orders 20% and revenue 2%. It means that we're growing orders ten times faster than the revenue. And so that's the simple message there. But the reality is that, obviously, we said that the supply will challenge what we see in by the way, logistics, which obviously comes with other issues will be well into the second half of '22. So, this is a matter of timing more than anything else.

And definitely, we said we feel very good about the 3% to 4% revenue, but it's going to depend to that ability to get the supply that we need in the right time, in the right mix. Remember, we have a very large portfolio. Not all orders are created equal to the point that Tarek made earlier. And then we'll see. Obviously, as we go through, we're going to assess what else may happen there. But definitely, it's just a timing issue at this point in time, more than anything else. And we expect that to get better as we go along. But your message is you imply that second half will be higher, absolutely. There is no question about it. The question is how high depending on the ability to convert the backlog.

I will say the backlog right now in Q1 is bigger than Q4. And Tarek and I believe that backlog has not peaked. And also remember on the backlog, we have a lot of HPC systems, which, in some cases, by the way, have already been built and delivered. But it takes several months to get it running, which basically until you run the payload and the workload and some of them need to go through what I call the top 100 HCL…HPL testing. You are now going to get the acceptance. So that's why, maybe a quarter, you're going to have a huge acceptance, and this will happen. Well, what will happen is the acceptance of some of the system. And Tarek talked about two systems that slipped from Q1 into Q2. So, you got all these dynamics. But definitely, second half will be better and then hopefully carries on into '23 because the demand is still super strong.

Tarek Robbiati
Yes. Aaron, if I can add to Antonio's answer. When we gave guidance at SAM, we told you all that we are targeting 3% to 4% revenue growth in fiscal year '22 with the second half of the year counting for more than the first half of the year. Nothing has changed to that picture. If anything, the order strength is greater than what we anticipated at SAM, and it surprised us somewhat in Q1 because…and I just want to remind you what Antonio said in his first answer to the first question, orders have been strong for 13 weeks in Q1.

And so when you really look at what's happening on two fronts: first, on our inventory levels, we are acquiring substantial amounts of inventory to cater for the strength of the order demand. And so if you also look at what the delta is between order growth and revenue growth, as Antonio said, we're clearly not at peak backlog. That is going to continue. It bodes well for our fiscal year '22 and for fiscal year '23 as well.

Finally, the thing I want to highlight to you is the impact of foreign exchange rates. When we were together at SAM in October, we mentioned that we were expecting 50 basis points of headwind due to foreign exchange rates. Now obviously, the situation is slightly different. The dollar is stronger, and we expect a full point headwind, not 50 basis points. But yes, we are comfortable reiterating the 3% to 4% top line revenue growth, because of the strength of the order book. So hopefully, you can see the link between orders…in revenue, the orders backlog inventory built up and ultimate revenue guidance that we give on a constant currency basis.

Andrew Simanek
Great, thanks. Appreciate the question. Operator, next one, please?

Operator
The next question will come from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani
Thanks for taking my question. I guess I have to ask a free cash flow question now. I guess, Tarek, down $600 million free cash flow or thereabouts, it's somewhat more severe than what I would think normal seasonality should be. So maybe you can just flesh out how much of this you think is seasonal versus perhaps things driven by working capital inefficiencies and there's a big spike or drop in these other assets and liabilities, maybe you can just start what happened there as well. And then importantly, as I go through the year, do I think about April being somewhat more muted in free cash flow as well and in the back half being better? Or what does that cadence look like?

Antonio Neri
Okay. So, Tarek?

Tarek Robbiati
Okay. So, a couple of things on your question. First of all, the negative $577 million free cash flow is mainly driven by working capital. If you really look at the buildup in inventory, we now have $5.3 billion of inventory. This has had an adverse impact on the cash flow conversion cycle. And so our cash flow conversion cycle is a positive 20 days, which is an increase of 17 days relative to the prior quarter because we're stocking up inventory given the order demand and the order book that we have.

So that's a main driver. Is it seasonal relative to the prior years? Yes, but not fiscal year '21. You have to go back to the first quarter of fiscal year '20 and prior years to determine free cash flow seasonality moving forward. But we feel good about our ability to generate free cash flow as we work through the backlog and reduce the inventory levels. And this is why we reaffirmed the free cash flow guide of $1.8 (billion) to $2 billion for fiscal year '22.

There was another part of your question, which I forgot, I think you were talking about the movement in other assets and liabilities. Andy would want to take that one, please?

Andrew Simanek
Yes, so that's generally related to our comp plans where we pay out our bonus in the first quarter. So that's one of the reasons why if you look at our typical seasonality, as Tarek said, going back to fiscal year '20 or before, you'll generally see Q1 is always a use of cash. Great. Well, thank you, Amit. I appreciate the question. I think operator, we have time for one more, please.

Operator
Our final question will come from Kyle McNeely with Jefferies. Please go ahead.

Kyle McNealy
Hi, thanks for squeezing me in. Great job on the results in such a difficult environment for everyone else. We have some recent survey work that we did that shows enterprises are expecting a higher-than-normal level of refresh activity in the coming year, specifically for servers and storage. We assume that some of that might be catch-up on upgrading aging

infrastructure coming out of the pandemic. But are you seeing that type of activity come through in helping the results? And what would be your expectation for refresh and upgrade activity for the balance of the year 2022?

Antonio Neri
Sure, Kyle. Yes. Of course, customers are now thinking about what else they need to succeed in this new environment. Definitely, the pandemic put a halt on their expenses because, obviously, at the beginning of pandemic, everybody was in preservation mode, on liquidity. But at the same time, I think there is a component of modernization, which I call it better than refresh, and also the need to deploy these new technologies. It's not anymore about a cloud mandate. It's about what they're going to do with that data. Because cloud is just a means to the end. It's all about accelerating speed and agility. But what customers are looking also is what type of things they need to do with that data.

So, it's a combination of data exploring, connectivity required in this digital world and the fact that you need to stay up to these new ways to deliver IT, while the transition to this journey to the multigenerational IT because many of these customers have a lot of complexity. They have legacy assets; there they have a lot of data with applications that are not really re-platform. They cannot re-platform. They are older ones that, honestly, they need to do what I call, cloudify, but most importantly, we need to deploy these new technologies around data.

So that's why our vision to become the edge-to-cloud platform company is so spot on because it's aligned to those megatrends of connectivity, cloud and data that you can consume as-a-service. And that's why the future of the company long-term is GreenLake, it's that product that drives the rest of the portfolio with higher margins and obviously, more recurring revenues for us and for our shareholders.

Andrew Simanek
Well, great. Thank you, Kyle for the question and everybody else participating. And Antonio maybe I'll turn it back to you for some closing remarks.

CONCLUSION

Antonio Neri
Yes. So obviously, very pleased with the Q1 performance, solid start. Again, the quarter was characterized by the customer demand, right, very robust customer demand and very strong profitability. I think it's showing the strength of our strategy and differentiated portfolio innovation.

I think we're very well positioned against these strengths, as Kyle just asked at the end. But obviously, we live in interesting times, so right now, we have to be vigilant about that. Our priority is to continue to execute on our commitments and also make sure we can contribute to the society as a whole because this company has a unique value and culture. So proud of not only what we deliver, but how we deliver. So, I hope you stay safe and well. And hope to speak to you soon. Thank you for your time today.

Operator
Ladies and gentlemen, this concludes our call for today. Thank you.