Hewlett Packard Enterprise

Second Quarter Fiscal Year 2018 Earnings Conference Call

Tuesday, May 22, 2018, 5:00 PM Eastern

CORPORATE PARTICIPANTS

Antonio Neri - *President, Chief Executive Officer*

Tim Stonesifer - *Executive Vice President, Chief Financial Officer*

Andrew Simanek - *Head, Investor Relations*

PRESENTATION

Operator
Good afternoon everyone and welcome to the Second Quarter Fiscal Year 2018 Hewlett Packard Enterprise Earnings Conference Call. My name is William and I will 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 question and answer session towards the end of the conference. Should you need assistance during the call, please signal a conference specialist by pressing the "*" key followed by "0." And 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 am Andy Simanek, Head of Investor Relations for Hewlett Packard Enterprise. I would like to welcome you to our fiscal 2018 second quarter earnings conference call with Antonio Neri, HPE's President and Chief Executive Officer and Tim Stonesifer, 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 of risks, uncertainties and assumptions please refer to HPE's filings with the SEC, including its most recent Form 10-K.

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 April 30th, 2018.

Finally, 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.

With that, let me turn the call over to Antonio.

Antonio Neri
Thanks, Andy and good afternoon everyone. Thanks for joining us today. Let me begin by saying that I am very released with our strong performance in Q2. We continue to execute well across all business segments while delivering on a number of strategic initiatives.

Revenue of $7.5 billion was up 10% from the prior year period. We experienced solid revenue growth across each business segment with particular strength in intelligent edge, high performance compute, storage, hyper converge and composable infrastructure. From a macro perspective, the IT market remains robust. We saw growth in all regions with particular strength in both EMEA and APJ.

Currency was a larger year-over-year benefit, providing a three point tailwind this quarter. Given our strong execution, helped by a one-cent tax benefit, we delivered a non-GAAP EPS of $0.34, above our outlook range of $0.29 to $0.33.

Looking at cash flow, our free cash flow was negative $269 million in Q2. We remain confident in our full year outlook of approximately $1 billion in free cash flow. Tim will provide more color on this in a moment.

Finally in Q2, we began executing against our $7 billion capital return plan we announced last quarter. We returned $1 billion to shareholders, in form of share repurchases and dividends, and we announced that we are raising our dividend by approximately 50% starting in the current third quarter.

Looking forward, as a result of our outperformance in Q2, as well as a continued benefit from our lower tax rate; we are raising our fiscal year 2018 non-GAAP EPS outlook to $1.40 to $1.50 from our previously provided outlook of $1.35 to $1.45. Tim will provide more details in a minute.

Before I turn to the business segment performance, I want to give you an update on our progress with HPE Next. As a reminder, HPE Next is our company wide initiative to re-architect HPE to deliver on our strategy and drive new wave of shareholder value. It is all about simplification, execution and innovation.

Through this initiative, we are simplifying our operating model and the way we work. We are streamlining our offerings and business processes and modernizing our IT systems to improve our execution. And we are shifting our investments in innovations towards high growth and higher margin opportunities.

Over the first half of this year we have achieved some significant milestones across each of these areas. For example, we have we have reduced [indiscernible] and layers between the CEO and the customer. We have significant streamlined our sales structure empowering the front line to make key decisions and we have dramatically reduced SKUs and platforms across our volume and value segments, which simplifies our operation and makes us easier to work with.

Looking into the second half of the year, we will be concentrating our efforts on the next phase of the initiative, including building out our no-touch sales model for certain flow segments and accelerating our IT transformation to better service customers and partners. The changes we are making through HPE Next we not only improve our cost structure, it will also give us a significant long-term competitive advantage.

I am very proud of the work we are doing here and while the decisions we are making are for the long-term, you are already beginning to see the benefits in our financial results. In Q2, we delivered an operating margin of 8.6%, up 270 basis points from last year due in part to the effective execution of HPE Next.

Turning to our business segments, we saw solid performance across the board, while continuing to deliver innovation in key areas of our portfolio. In intelligent edge segment, revenue grew 17% year-over-year with strength in both product and services.

Q2 wireless LAN revenue rebounded as expected after a softer Q1 and wire switching remains strong. And while still a small portion of our overall products sales, we saw strong customer traction with our Edgeline IoT Systems, including a significant win with a global financial services company. These results bode well for our future.

Our customers tell us they want to take advantage of the exploding amount of the useful data being created at the edge. We heard them, and we continue to make investments to build out our intelligent edge portfolio. For example, in Q2, we strengthened our portfolio with the acquisition of Cape Networks. The Cape acquisition is the latest steps towards our vision of autonomous infrastructure enabled by artificial intelligence.

Cape expands Aruba AI powered networking capabilities with a sensor based network assurance solution that improves network performance, reduces disruptions and significantly simplifies IT management for our customers.

We also introduced NetInsight, another complementary AI-based analytics and a surer solution for optimizing network performance. NetInsight uses machine learning to continuously monitor the network and deliver insights in the event of anomalies. It also recommends how best to optimize the network from today's mobile first employees and workplace critical IoT devices. Looking forward, we see significant potential in intelligent edge and this will continue to be a key area of investment for us.

Turning to Hybrid IT, revenue was $6 billion, up 7% year-over-year with solid performance across all segments. Compute grew 6% year-over-year and 9% if you exclude Tier 1. We saw very strong growth in high performance compute, composable infrastructure and hyper converged, offset by the continued decline in our customized commodity server sales to Tier 1 vendors, a business we are moving away from.

Our focus continued to be on providing solutions that deliver high value differentiation to our customers and drive profitable share for HPE. And we continue to prioritize investment in those higher-margin, high-growth segments of the market.

For example, just last week, we announced the acquisition of Plexxi. Plexxi provides innovative software defined networking technology which we plan to integrate into both SimpliVity, our hyper converged offering and Synergy, our composable infrastructure offering. With Plexxi, we will enable customers to move and manage the data more quickly and effectively and also significantly reduce CAPEX and OPEX by up to 50% in some cases.

Storage performed very well, up 24% year-over-year with the Nimble acquisition, and up 14% organically. All-flash continue to perform well growing 20% year-over-year, as the market continues to transition and we benefit from our strong position with both 3PAR and Nimble.

And earlier this month, we introduced the next generation Nimble Storage platform, which is backed by guaranteed to deliver the best storage efficiency of any all-flash array on the market. Data center networking revenue was up 2% year-over-year with good execution within our existing installed base.

Finally, turning to services; HPE Pointnext revenue grew 1% year-over-year in Q2. We saw a pickup in orders from deals that slipped from Q1 and strong customer traction from our newest offering called HPE GreenLake. HPE GreenLake is a suite of pay-per-use solutions available for top customers' workloads like Big Data, SAP HANA and Edge computing.

The offering simplifies the IT experience and gives customers choice in where workload should live and how to flexibly consume them. This is an offering we will continue to expand, look for updates soon. And in Q2, we also continue to strengthen our advisory capabilities building on our acquisition of cloud technology partners with the acquisition of RedPixie.

RedPixie is a UK based cloud consulting company with deep Microsoft Azure expertise which perfectly complements CTPs strong AWS relationship. We are excited about the capabilities these two acquisitions bring to HPE and are already seeing them open doors to new and bigger deals.

HPE financial services also performed well in the quarter with revenue up 5% year-over-year, driven by strong growth in our asset management business.

Customers are responding well to the actions we are taking both from an operational and innovation perspective. They believe in our strategy and the powerful portfolio of products and services we are building and that confidence can be seen in some recent wins.

For example, in Q2, we won a major high performance compute deal with the US Department of Energy. This is just the latest example of the strength of HPE's HPC portfolio and the value it brings to the US government and the nation in international competition over computing power.

We also won a new project with Time Warner where Aruba was selected for the state-of-the-art Hudson Yards Smart Digital Workplace project in New York City. And we announced a new supercomputer installation of KU Leuven, a Flemish research university, consistently ranked as one of the top five most innovative universities in the world. We have collaborated with the university to develop and deploy a new supercomputer specifically built to run AI workloads.

It will be used to build applications that drive scientific breakthroughs, economic growth, and innovation in Belgium. And next month, we will host our Annual HP Discover Conference in Las Vegas, bringing together thousands of customers and partners from around the world. We will be making some exciting announcement at the event and I look forward to see many of you there.

So, as I said earlier, I am very pleased with our performance in the first half of fiscal year 2018. All of our business segments performed well. We made solid progress on HPE Next and continue to invest in innovation that will furthest strengthen and differentiate our company into the future.

Looking ahead to the rest of the year, as we indicated last quarter, we expect the growth rate to moderate given tougher compares, lapping acquisitions and a smaller currency tailwind. While we see a more challenging second half, we have got great momentum and I am confident that we will deliver on our annual fiscal year 2018 outlook.

And with that, I will turn it over to Tim.

Tim Stonesifer
Thanks, Antonio. Our Q2 financial results were strong with robust revenue growth, significantly improved operating margins and better than expected earnings.

Total revenue for the quarter was $7.5 billion, up 10% year-over-year and 6% in constant currency. Top line performance was driven by good market dynamics, solid execution and both favorable year-over-year compares and exchange rates.

From a portfolio mix perspective, we are seeing solid growth in our value offerings and our core volume business is growing better than expected. From a macro perspective, IT spending continues to be quite healthy with solid customer demand across all businesses and geographies. The pricing environment remains competitive, but has continued to be more rational and passing through elevated commodities costs.

DRAM cost increases have also started to flatten. Currency drove a 330 basis point tailwind of revenue year-over-year. With that said, rates have moved somewhat unfavorably in the last month, so currency will not be as large of a benefit in the second-half, if these rates hold. We now expect closer to a two point benefit to revenue in fiscal year 2018.

Regionally, HPE's performance in the Americas continue to be solid, growing 3% in constant currency. Most of the growth came from the US, Canada and Brazil with strength in storage and the Intelligent Edge.

Revenue growth in Europe continues to be strong, up 9% in constant currency, with double-digit growth in UK, France and Italy.

Performance in EMEA was strong across all business units with double-digit growth in compute, storage and Aruba products and services. Asia Pacific grew 9% in constant currency, with strong growth in China, Australia and Singapore.

Turning to margins; the gross margin of 30.4% was up 90 basis points year-over-year and 200 basis points sequentially. Non-GAAP operating profit of 8.6% was up 270 basis points year-over-year and 90 basis points sequentially. We continue to execute well this quarter with HPE Next savings driving most of the improvement.

DRAM was also less of a pressure point as compared to prior quarters and we continue to gain traction on the pricing front. Going forward, margin improvement will be driven primarily by delivering the cost savings from HPE Next and growing our value portfolio offerings which have higher margins.

Non-GAAP diluted net earnings per share of $0.34 is just above the high-end of our previous outlook of $0.29 to $0.33, due to strong operational performance and a tax rate benefit of approximately a $0.01. The Q2 non-GAAP tax rate was 9.6%, which is just below our previously provided tax range of 11% to 15%, due to various one-time reductions in non-US tax expense.

For the full year, we now expect our tax rate to be at the lower-end of the 11% to 15% range, but we are still working through many variables associated with tax reform.

GAAP diluted net earnings per share was $0.49, above our previously provided outlook range of $0.10 to $0.14, primarily due to releasing reserves we've been holding associated with HPQ tax risks that were part of our separation agreement, which has now been settled.

Now turning to the business units; in Hybrid IT, revenue was up 7% year-over-year and 4% in constant currency. Revenue performance was strong and balanced across all businesses in all regions. Operating margins were 10.3%, up 220 basis points year-over-year and 70 basis points sequentially and in line with our expectations.

Compute revenue was up 6% year-over-year and 9% excluding Tier 1. We continue to see higher AUPs, driven by passing through more DRAM costs, increasing our gen 10 mix and delivering richer attach configurations. We saw continued momentum in our value business with high performance compute growing over 20%, hyper converged up triple digits and synergy gaining increasing customer traction.

As mentioned earlier, revenue growth in our volume business was higher than planned, driven by strong growth in core rack.

Storage revenue was up 24% year-over-year with continued momentum in the organic business, up 14% year-over-year. We saw strong double-digit growth in converged storage, driven by Nimble and Big Data storage that has become a meaningful part of the portfolio.

All-flash arrays grew 20% year-over-year. While the overall storage market remains competitive, we like our current position and expect to take nearly 50 basis points of share this quarter, which will be the tenth time in the last 12 quarters, where we've gained or maintained share. Datacenter networking revenue was up 2% with good execution, primarily from our installed base in the Americas.

HPE Pointnext revenue was up 1% year-over-year, with operational growth for the seventh consecutive quarter. Overall, orders grew 1% with even better growth in operational services, which was driven by our new HPE GreenLake flexible capacity offerings. Service intensity remains strong but attach orders continue to be under pressure from lower unit growth and richer hardware configurations.

In the Intelligent Edge, revenue was up 17% year-over-year and 14% in constant currency. Operating margins of 6.5% were up 360 basis points sequentially due to the operating leverage from higher revenue, but were down 110 basis points year-over-year due to significant investments in sales and R&D.

Aligned to our strategy of pivoting to the Intelligent Edge, we've been making significant go-to-market and R&D investments that have given us a leadership position in this high-growth market opportunity.

Aruba Product grew 18%, with continued strong growth in campus switching and a rebound in wireless LAN, despite tough compares in the prior year. We've also started to see good traction in our edge compute business. Aruba Services was up 10% on an installed base growth due to strong attach of our software platform like ClearPass and AirWave.

HPE Financial Services revenue grew 5% year-over-year and 1% in constant currency, driven by strong residual sales and growth in our direct business that was somewhat offset by lower operating lease mix. Volume was flat, as growth in our direct business was offset by the

pressure in our indirect business. Operating profit declined 90 basis points year-over-year to 7.9% due to one-time items.

Now turning to cash flow, free cash flow was negative $269 million in Q2. The cash conversion cycle was in line with expectations and decreased sequentially by one day to negative 22 days, both inventory and payables were elevated in the quarter due to strategic positioning of key commodities and somewhat higher pricing. We also ended the quarter with an operating company net cash balance of $3.5 billion.

Looking forward, we are still on track to achieve our free cash flow outlook of approximately $1 billion in fiscal year 2018, as the second-half benefits from a few items.

First, we expect cash earnings to ramp aligned with normal seasonality and the cost savings from HPE Next.

Second, working capital will be a source of cash versus a use of cash in the first-half with the cash conversion cycle improving to the negative high 20-day range similar to our Q4 exit rate.

Last, we have fewer one-time payments and expect incremental real estate sales towards the end of the year.

Moving to capital allocation, as part of our $7 billion capital return plan through fiscal year 2019, which we announced in Q1, we returned $1 billion to shareholders during the quarter. This includes $907 million of share repurchases and $116 million of dividend payments.

As previously communicated, we raised our quarterly dividend by 50%, which will be payable in July. We also announced today that we'll be redeeming $1.6 billion of our bonds maturing in October at the end of June.

The bond redemption is consistent with our capital allocation approach, which includes maintaining an investment-grade credit rating. Going forward, we intend to run the operating company with net cash neutral or positive and will maintain financial flexibility through borrowing capacity as needed.

Now turning to our outlook, consistent with our approach in Q1, we are increasing our non-GAAP earnings outlook for fiscal year 2018 by $0.05, due to our operational performance in Q2 and a favorable tax rate that we now expect to be at the low end of our 11% to 15% guidance for the year. As a result, we expect fiscal year 2018 non-GAAP diluted net earnings per share of $1.40 to $1.50, and we expect our fiscal year 2018 GAAP diluted net earnings per share to be $1.70 to $1.80.

For Q3 2018, we expect non-GAAP diluted net earnings per share of $0.35 to $0.39 and we expect GAAP diluted net earnings per share to be $0.19 to $0.23. So overall, I'm pleased with the performance in the quarter and I'm looking forward to focusing on delivering our full-year commitments.

Before we open up the call for questions, as Antonio mentioned, I just wanted to remind everyone that we have our IR Summit coming up in June at our Discover customer event in Las Vegas, and I hope many of you will be able to join us.

Now, let's open it up for questions.

QUESTION AND ANSWER

Operator
Thank you. And we will now begin the question and answer session. To ask a question you may press "*" then "1" on your touchtone phone. And if you are using a speakerphone please pickup your handset before pressing the keys, to withdraw your question please press "*" then "2." And we do also request that you limit yourself to one question and a single follow-up question.

And our first questioner today will be Sherri Scribner with Deutsche Bank. Please go ahead.

Sherri Scribner
Thank you. I think, Antonio and Tim, you both mentioned that DRAM cost increases have started to flatten. Can you remind us how you are feeling about DRAM and NAND pricing and, generally, component pricing as we move into the second-half of the year? And I think when we talked about it last quarter that's going to be somewhat of a pressure on revenue. How are you thinking about that as we move into the second-half?

Antonio Neri
Yes, sure. Thanks, Sherri, for the question. So we start to see a flattening of the DRAM cost. We still see what I call nominal low single-digit cost increases, but we are able to pass those along for two reasons. One is stronger execution in our go-to-market, a more disciplined approach, and second is our competitors are becoming more rational about pricing in general. So it's going to be a very low cost increase and we feel confident we'll pass those along.

Listen, the AUPs obviously continue to be elevated for two reasons. One is the DRAM, we talked before, and two is the richer configurations. So the…particularly on the compute side, the compute side are really driving a significant rich configuration of memory, obviously, flash NAND, internal storage, and that's why we see the increased AUPs. And those are not going to change any time soon, also because customers are trying to reach more efficiencies in their data centers, particularly as they deploy the private cloud. And the other one is some of these workloads demand that level of configuration, particularly as you move to AI and Big Data analytics. So that's what we've seen so far.

Sherri Scribner
Okay, great. And then just looking at the storage business, it seems like you guys have definitely recovered in that business versus some issues you had last year. How are you feeling about the storage business as we move into the second-half? Do you think these revenue growth levels are sustainable, or do you expect them to come back in a bit? Thank you.

Antonio Neri
Sure. Storage performed very well, up 24% year-over-year with inclusion of Nimble and 14% organically, which is, to your point, we are actually executing way better than last year. Last year, we had some execution challenges, particularly in North America. We think we have addressed those issues. And when you think about the opportunity, the market, obviously, all-flash continue to be a significant opportunity. This quarter, we grew 20%. And we are really excited about our portfolio.

I have to say, on the combination of Nimble and 3PAR with the simplicity of our value proposition with cloud capabilities built into it and most importantly, with our AI technologies built

into it, both in Nimble and 3PAR, because now we scale that solution to 3PAR, actually it's something that's resonating with customers. And so, as I look forward, we expect to see solid organic growth in storage. But let's remind ourselves, right, like next quarter, right, we are going to have the lapping of the Nimble acquisition to the portfolio. So I think the growth rate would be a little bit more moderated, but we are very confident about our ability to execute with this portfolio, because we have true value differentiation.

Sherri Scribner
Thank you.

Andrew Simanek
Great. Thank you, Sherri. Can we have the next question, please?

Operator
And our next questioner today will be Katy Huberty with Morgan Stanley. Please go ahead.

Katy Huberty
Thank you. Good afternoon. You beat revenue in EPS two quarters in a row and yet the majority of the $0.05 full-year guidance increase is tax-related. So can you just comment on why you are not assuming that the strong operational trends continue for the remainder of the year? And then just as a related follow-up to that, when you talk about tough compares in the back-half of the fiscal year and lapping acquisitions, does that end in a company that's not growing top line, or do you think the top line can continue to grow in the back-half just at lower rates? Thanks.

Tim Stonesifer
Yes. So as far as the $0.05 goes, I'd say, $0.02 of the $0.05 was operational. Again, we continue to perform very well, particularly in the volume piece of the portfolio that's growing faster than we had expected. As far as why we aren't passing more through, again, we have quite a bit of execution left in the second-half. We still have six months to go. So we feel that it's just prudent to pass along the operational performance we are seeing. And then obviously, we are trying to be as transparent as we can on the tax front as we are still working through all those changes.

As far as the growth goes, yes, I think we can continue to grow. If you look at the 10% growth that we had in Q2, I'd say, about 3.5 points of that was tailwind from FX. We had a couple of points of tailwind from the compares with Nimble and SimpliVity and then we have 4.5 points of execution. And I think it's really a combination of execution, because I do think our go-to-market motion is working better. I do think that our geo model that we pivoted to this year is working very well. But we also have better markets. We have stronger customer demand. We have a better pricing environment, so that plays into it as well.

As I look forward into the second-half, rates have moved a little bit unfavorably for us. If those rates hold, we would get less of a tailwind. We obviously lose the favorable compares. The other point I would make out is, we are doing about half of the Tier 1 business in the second-half of the year that we did versus the first-half. So that's about 2.5 points of headwind, no margin impact and then we have tougher compares overall. So I think, going forward, we can certainly grow, but it's obviously not going to be at that 10% rate given the reason I just laid out.

Antonio Neri
So, Katy, this is Antonio. I want to add the couple of things here. One is, if you go back to what we guided at SAM, we said 0% to 1% growth. It's obvious we are going to grow faster than that full-year. I think that's one area. Second is that, we are very, very confident in our portfolio. And I think, as we continue to pivot from volume to value, we will see also an improvement there, because the growth areas we see are in hyper converged in areas like private clouds, high-performance compute, and so forth. So we believe this company absolutely can grow and definitely this year will be above the guidance we gave you for the full year.

Katy Huberty
Thank you.

Andrew Simanek
Great. Thank you, Katy. Can we go to the next question, please?

Operator
And our next questioner today will be Tony Sacconaghi with Bernstein. Please go ahead.

Tony Sacconaghi
Yes, thank you. You provided an update on HPE Next and some of the accomplishments so far. I think the target was to try and deliver $250 million in net savings for this year and ultimately $800 million over the next three years. Could you provide an update specifically on where you think you are in terms of the savings capture rate so far this year? And whether we should still be thinking about a $250 million savings for the year? And I have a follow-up, please.

Antonio Neri
Sure, Tony, this is Antonio. Thanks for the question. So we are confident we are on track to deliver the $250 million for the year. And now just as a reminder, HPE Next is the initiative I launched to re-architect the company to deliver on our vision and our strategy. And at the core of this was not just cost savings, right, it's all about simplification, innovation, and execution. We have made good progress on many fronts.

One is, listen, the operating model simplification. And go-to-market is paying off in terms of not just the savings, but actually improved execution. Second, we have reduced already quite significantly number of platforms and options, which translates into lower amounts of SKUs to our customers and partners, which allows us to better plan and execute in our supply chain. And then third is the culture of the company as well.

So from my standpoint, we are on track what we said we're going to do. And to me this is going to be the competitive advantage that Hewlett Packard Enterprise would have going forward. For me, this is not just the way to return shareholder value, but really to improve the way we execute our business every single day. The reality is that market is moving really fast. We need to react to those opportunities quickly, and having a lean mean end-to-end value chain is absolutely essential. So now we are going enter the second phase of this, which is the transformation in the processes and IT modernization, which actually will give us the incremental step forward on executing even better and more simply in front of the market opportunity. So, Tim, you want to add anything?

Tim Stonesifer
No, I think you nailed it.

Antonio Neri
Alright.

Tony Sacconaghi
So the follow-up, it still looks like, if we believe that Pointnext has about 30% operating margins, which is historically where it's been, it still looks like operating margins on servers, storage and the data center networking is in the 1% to 2% range right now, and that probably suggests that server margins are negative still. How should investors just think about what a normalized margin for these businesses are, or has the whole server market moved to a market where we shouldn't be thinking about it that way? And that you are really looking at a blended margin between support and servers are really becoming the vehicle to selling high-margin support and we shouldn't be thinking about discrete profitability for each of those?

Tim Stonesifer
Yes. So thanks for the question, Tony. I would just say this, I think your math is correct. You are here in the low single-digit range for the hardware businesses. I'm not really going to comment on where those are going. But again, I'll…to give you some color, if you look at our overall margin of 8.6%, as we've talked about all year, we do think that continues to improve over the course of the year. And that's really a combination of the increased cost savings from HPE Next. That's a combination of the acquisitions as they become more and more accretive as we continue to grow those businesses and right-size those cost envelops.

And then to Antonio's point, as we continue to pivot towards the value portion of our portfolio where we have higher margins and higher attach, that obviously gives us some great lift as well. So we'd expect those dynamics to continue through the course of the year. On a normalized, if you will, basis, two or three years down the road, I think, a couple calls ago, I said, I think there's a couple hundred points of improvement. And I still think that's true, because, again, even as we exit 2018, we are still going to have more HPE Next savings and we'll continue to pivot towards the value portion of the portfolio.

Antonio Neri
The other thing I will add, Tony, this is Antonio, is that when you look at our Q2 performers, we improved our Hybrid IT margins by 220 basis points in that business. And obviously, like I said before, the rationalization of platforms and options give us improved profitability on the hardware side. It is obvious that obviously a big chunk of our profitability comes from services. But let's remind ourselves that profitability of the services business is not just attach, it is what we call, services-led opportunities and we have pivoted our portfolio quite significantly in the last two to three years and we see now the momentum in the way customers want to consume more subscription-based model. And that's why things like HPE GreenLake are very important to us as well.

But to Tim's point, right, we will continue to drive that with rigor and discipline in our cost structure and ultimately, the simpler we innovate in our portfolio, the easiest to go sell it to improve that, the pull-through for services and as well for the rest of the HPE portfolio.

Andrew Simanek
Excellent, great. Thank you, Tony. Can we go to the next question, please?

Operator
And the next questioner today will be Simon Leopold with Raymond James. Please go ahead.

Victor Chiu
Hi, guys. This is Victor Chiu in for Simon Leopold. I wanted to ask about free cash flow. It seems like, FCF seems like, it will have to have a quite a sharp step up in the back-half of the year to get to your $1 billion target. So, I just was hoping you could give us a little more color around that, how much of the upside is coming from the proceeds from real estate? And what parts of working capital are you expecting will improve that will help drive the cash conversion in the second-half of the year?

Tim Stonesifer
Sure. So listen, we are still confident with $1 billion for fiscal year 2018. Q2 came in at negative $269 million, which to be honest with you, was lighter than we had expected. I think on the last call, I said Q2 would be flattish, and we basically had a higher mix of one-time payments along with some unfavorable movements in other assets and liabilities that was related to the VAT taxes. So those are more timing than anything else. But as you know, in this business, free cash flow is very seasonal. If you look at the last couple of years, we typically have negative free cash flow in the first-half of the year and then we generate a significant amount in the second-half of the year. And I don't think 2018 is going to be any different and it's really driven by four things.

First of all, you can look at the earnings ramp, that's reflected in our EPS guide, that's a combination of HPE Next savings, as well as typical seasonality. So that will obviously generate more free cash flow. From a working capital perspective, we actually had a cash usage in the first-half of the year. We are going to generate cash in the second half of the year. I think, the best indicator to look at there is our cash conversion cycle.

As we said in the prepared remarks, we'd expect that to end at the negative high 20-day range. That will be very consistent with where we exited Q4 of 2017 and that generates a significant amount of cash. Other assets and liabilities, we had some un-favorability in the first-half, I would expect that to come back in the second-half. Nothing has really structurally changed when you think about the balance sheet. I'll go back to the VAT example. We should be collecting on those receivables in the second half of the year.

And then lastly is, we are going to have fewer one-time payments. So if you look at the SAM presentation that we laid out, we had about $1.1 billion of one-time cash payments, roughly $800 [million] of that has been taken care of in the first-half of the year, so that provides us a tailwind in the back-half of the year. And then we will have, to your point, we will have some real estate gains in the second-half of the year. So, there's a lot of moving parts in free cash flow, that's why it's very difficult to forecast on a quarterly basis. But given those comments, we feel very good about the $1 billion for fiscal year 2018.

Victor Chiu
Great. Thank you. That's very helpful.

Andrew Simanek
Perfect. Thank you, Simon. Can we go to the next question, please?

Operator
And our next questioner today will be Shannon Cross with Cross Research. Please go ahead.

Shannon Cross
Thank you very much. My first question is with regard to AI. I'm just curious how you see some of the new offerings that you've launched and some of the acquisition fitting into this. And particularly, I'm curious as to how you are going to monetize them, because everybody talked about AI and what it's going to do to the industry, but I'm wondering how it helps you from a competitive standpoint over time. And I have a follow-up.

Antonio Neri
Sure. Thank you for the question, Shannon. I'm actually very excited about AI. We see this every single day. I spend 50% of my time talking to customers. And AI is interesting, because what they're looking for is to monetize that data faster and trying to understand what they should be doing with the data from the business perspective. So AI gives you the vehicle to accelerate outcomes from the data standpoint, and we already have very strong offerings, both in-memory solutions. If you think about our Superdome X and as well as HPE Apollo 6500, which is an AI design platform. And so how we monetize is very simple. We provide services upfront, which is basically the advisory capability how to implement AI in their environment.

And number two, how we design and implement the right solution for them. And at the core of this, we already have many, many platforms with AI embedded into it, into the most solution development kits that their data scientists can go and develop using whatever tools they want, whether its cloud data or Hortonworks or whatever it is. And so this is a good opportunity for us, and also we are using AI inside our portfolio. So we talk about the future of Hybrid IT being adaptive and autonomous. We are leveraging those AI technologies inside our own software-defined infrastructure. An example of that obviously is InfoSight, but you are going to see more and more of that embedded at the Edge and as well as in our cloud orchestration capabilities.

Shannon Cross
Thank you. And then can you talk about how we should think about the model changing as you move more and more to flexible capacity or flexible consumption models over time? How quickly do you think we make the shift? We saw it in software, obviously, to SaaS, and now we are seeing it into devices and services over time. Thanks.

Antonio Neri
I think you are asking the question from the business model perspective or the financial perspective? If it's financial, I will ask Tim here to comment. What we see right now is, customers like the ability to consume on-prem in a utility-based model. And what that means, they want a fully integrated solution with the hardware or the infrastructure that they need with the software and the services to be able to run at a most efficient way. In many ways, as you know, we talked before how we bring that public cloud experience and economics on prem, and that experience includes the consumption-based models. So depending on the scale, we already can provide customers a very competitive solution on premises. And it's not just infrastructure as a services, but also outcome as a services.

Think about backup recovery as a service, SAP HANA as a service and so forth. So we already have those solutions available and we see a significant interest and actually a significant uptick in that business. From the financial perspective, we have crafted what I think is a very strong and simple solution of our customers, leveraging our strength with our portfolio of financial services, which provide that embedded financing, but is a services-led orientation. And the way we financial treat them is not different than any subscription-based model. But Tim, maybe you want to comment on that.

Tim Stonesifer
No, I would just say that, over time it will improve our recurring revenue and will also improve our profitability.

Andrew Simanek
Great. Thank you, Shannon. Could we move out to the next question, please?

Operator
The next questioner today will be Jim Suva with Citigroup. Please go ahead.

Jim Suva
Thank you very much and good job on the results and execution. I have a question on the Hybrid IT reporting segment, specifically the Pointnext or the service revenues. If I do the math correctly, that is up about 1% year-over-year, but constant currency down 1% year-over-year. How should we think about why would revenues for Pointnext be down year-over-year when overall, your company results are so strong or how do we bridge the gap between those differences?

Tim Stonesifer
Yes, I just think that's a factor. Obviously, FX is a challenge. And I think that's just a factor of the contracts rolling off and given the fact that a lot of these are three-year contracts, you have some timing in there from a translation or FX perspective.

Jim Suva
Okay. So if that's the case, should we expect Pointnext to be challenged the next few quarters then with timing of contracts rolling off?

Antonio Neri
No, think about it, when we book the orders, we book at whatever the currency was at that time. But at the same time, we are booking the orders with, what I call more favorable currency. And the mix of this is going to dictate basically what the outcome is. But we are still confident that we'll continue to drive the growth in this portfolio, driven by this new offerings not just the attach. And that's why, we are very keen to continue to drive the consumption-based model that Shannon asked the question for, because that HPE GreenLake is growing significantly faster than what we have posted here as a whole segment.

Tim Stonesifer
I would say the other thing to look at in that business is the services intensity. So service intensity was up 35% in Q2, so we continue to have more attach dollars per unit.

Jim Suva
Thank you so much for the clarification and detail.

Andrew Simanek
Great. Thank you, Jim. Could we move on to the next question, please?

Operator
The next questioner today will be Steve Milunovich with UBS. Please go ahead.

Steve Milunovich

Thank you. First of all, on the tax rate for fiscal 2019, I think previously you said the tax rate would go up next year. We were thinking maybe 18%-ish, but does that come down a couple points now?

Tim Stonesifer
Yes, we'll give you guys more color at SAM, because we're still working through the impact in fiscal year 2018. But to your point, at the last time we guided, we said 16% to 20%. So you are right in the middle there. Again, I'm not going to give any guidance here for 2019, but we'll give you full transparency in October at SAM.

Steve Milunovich
Okay. And then I wonder if you could elaborate a little bit more on your private cloud opportunity, what some of the trends you are seeing is Azure Stack out there and some volume? How is your Microsoft relationship? And I think you actually need new servers if an account were to use Azure with your products. And maybe talk a little bit about your software offerings. I think, you have some fairly good orchestration software?

Antonio Neri
Yes, sure. Thanks for the question. So we see good traction in the private cloud segment. We offer a multi-cloud type of solution. Obviously, we have the VMware and we have now a very strong integration between the VMware stack and our HP Synergy. We see a significant traction of Synergy with VMware in particular segments like the financial sector, where they need large deployments of large VM farms, I call it, that ultimately, they can manage significant amount of workloads.

The other one is Azure stack. It's still a little bit early. But we see good traction with Microsoft in providing the true consumption-based model on-prem and off-prem with Azure Stack and Azure cloud. We have now slightly different implementation of that, because we have better engineering integration and we already provide different type solution whether it's HPE ProLiant or what is now with availability of HPE SimpliVity as well with the Hyper-V solution.

By the way, with our offering of HPE OneSphere, we also provide an OpenStack and Docker Kubernetes environment for those customers who wants to accelerate deployment of containers. So in the end, we have one platform called HPE OneView that manages any type of infrastructure, whether it's a traditional Tier 3 approach, converged, hyper converged and composable. And now with the inclusion of Plexxi, which we announced last week, we've actually now virtualized in a network and fully integrated natively that solution in all our offerings.

And then with HPE OneSphere, we provided through multi-cloud in a Hybrid IT environment, where you deploy VMs or you deploy a container or even a open source type of solution. So we see the traction across them. And I think, we wrap all of that with our consumption-based model, right? And we talked about the HPE GreenLake, and that's where the customers are very, very interested to work with us.

Steve Milunovich
Thank you. Perfect.

Andrew Simanek
Thanks, Steve. Can we go to the next question, please?

Operator

And our next questioner today will be Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah
Hi, thanks for taking the question, guys. Yes, two, if I could, now ask them both at the same time. The first is, with regard to long-term competitive advantages from Next, it makes sense as to how it would improve your processes and your get to market and like that. Could you speak specifically as to what you see is some of the competitive advantages relative to the marketplace and to your competition? And then the second question is, I believe there is a comment that the second-half will be more challenging. I was just wondering if you could tease out what some of the challenges specifically you see are in the second-half. Thanks.

Antonio Neri
Sure. As I said before, we truly believe, I believe that HPE Next will be a competitive differentiator for us, because one of the challenges we see in this industry with all the acquisition, mergers and whatnot is the ability to provide an integrated experience. With the hard work we have done over the last 6.5 years and position of Hewlett Packard Enterprise clearly in the space where we can compete and win, we have the opportunity to really deliver a whole integrated new experience. And it's an opportunity of a life time.

And so I've been in the company for 23 years. And unfortunately, I know every system, every process for good or bad, and I know we have tremendous upside, not only to improve our cost structure, but really improve our growth through better execution once we have these integrated experience. And let me give you example of that. We are going to have a simple, much better integrated partner experience with configurators. We are going to have a no-touch, low-touch model for more of the transactional side, particularly as you think about that market in the mid market and SME. We are going to have a streamlined one single platform for the supply chain, which actually improves not just the, what I call, quote to cash, but also the finance side of the execution. But all of this translates into value both for our customers and for our shareholders, because obviously, we will automate everything we can in that execution.

From the growth standpoint, again, like I said before, we are confident we will beat our guidance we gave at SAM, which was 0% to 1%. But obviously, we are going to have tougher compares. As we articulated before, the currency is not going to be as strong as a tailwind. We have the, what I call, the acquisitions now in the full run rate. But I'm very confident in our organic growth, because our portfolio is very, very strong. So it's going to come down to how well we are going to execute. And we are executing better and obviously, where we see the opportunity in terms of balancing growth with the profitability, which we just increased again on EPS.

Ananda Baruah
Both of those are very helpful. Thanks so much.

Andrew Simanek
Great, thanks Ananda. I think, we have time for one more question. The last question, please?

Operator
Yes, the question will be from Aaron Rakers with Wells Fargo. Please go ahead.

Aaron Rakers
Yes, thank you for taking the question. I do have a follow-up as well. I want to go back to Toni's earlier question on the progression of your savings that you expect to generate from HPE Next. I'm curious if you could just give us a framework of how much have you realized of the

$250 million thus far in the first-half of the year. And when you look at some of the progress of things that you are going to execute upon manufacturing facilities from 17 down to seven, going to one ERP system versus 10, 400 sales comp plans down to 25, et cetera, I'm just curious, can you help us understand what has been done and what maybe still or what you're planning to execute upon looking through the second-half of the year? And I do again have a follow-up.

Tim Stonesifer
Sure. So I'll answer the financial component then flip it over to Antonio. So if you look at the $250 million, I would say that probably a third of that is in the first-half and two-thirds will be coming in the back half of the year. And as Antonio mentioned, everything that we have seen so far, we are on track to deliver that.

Antonio Neri
Yes, in terms of what has been done, so we already initiated the platform simplification, to your point. We said 26 platforms down to seven and on the volume side and 27 down to nine. So we are well on our way. We are not completely done on that, but we are well on our way. In terms of the manufacturing side actually, we have not yet initiated the full transition, because part of this is dependant to the IT implementation. So in the back-half of this year, particularly in the latter part of the year, we are going to implement the new SAPs instance. And with that foundation with a common data master, we're going to move to the simplification of our supply chain in number of nodes, which the vast majority will happen in 2019.

In terms of core plans, we executed much of that. We entered 2018 in terms of sales core plans, which actually is also one of the reasons why we have executed better, because you're telling the sellers exactly what to focus on and how they are going to get paid. And so that actually is a motivator in many ways and that's why we have better execution. So very confident where we are today, but there's still a significant amount of work to be done. And it's a journey that we laid out for the next three years and much of this will also would be dependent on the IT transformation we are driving, particularly on the low-touch, no-touch, which is going to come in the latter part of 2019, and that will improve again our execution of go-to-market as we continue to pivot from volume to value growth.

Aaron Rakers
Yes, that's very helpful. And maybe this is somewhat tied to it and as the follow-up. When I look at the cash conversion cycle, one thing that stands out is you had about a 17% increase, 40% year-over-year in your inventory carried on the balance sheet coming out this last quarter. Is there strategic purchases being made in the inventory balance or you are holding more just than what you would naturally hold, given some of these initiatives, or what's really driving that increase in the inventory side?

Tim Stonesifer
Yes, it's a little bit of both. We were carrying some excess buffer stock just to make sure that we had enough inventory to meet customer demand. And then you have to remember that we have elevated DRAM costs in there as well, so that has a significant impact.

Aaron Rakers
Fair enough. Thank you very much.

Andrew Simanek
Great. Thank you, Aaron, and thanks, everyone, for joining us today. With that, I think, we can close up the call.

CONCLUSION

Operator
And ladies and gentlemen, this will conclude our call for today. Thank you for attending.