Hewlett Packard Enterprise

Q2 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Antonio Neri - *President, Chief Executive Officer*

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Sonalee Parekh - *Senior Vice President of Corporate Development and Investor Relations*

PRESENTATION

Operator
Good afternoon, and welcome to the Second Quarter 2020 Hewlett Packard Enterprise Earnings Conference Call. My name is Eilee, and I will be your conference moderator for today's call. At this time all participants will be in listen-only mode. We will be facilitating a question-and-answer session 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." 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, Ms. Sonalee Parekh, Senior Vice President of Corporate Development and Investor Relations. Please proceed.

Sonalee Parekh
Thank you and good afternoon, everyone. This is Sonalee Parekh, SVP of Corporate development and Investor Relations for Hewlett Packard Enterprise. I would like to welcome you to our Fiscal 2020 Second Quarter Earnings Conference Call with Antonio Neri, HPE's President and Chief Executive Officer and Tarek Robbiati, HPE's Executive Vice President and Chief Financial Officer.

Before handing the call over to Antonio, let me remind you that this call is being webcast. A replay of the webcast will be made available shortly after the call for approximately one year. We posted the press release and the slide presentation accompanying today's earnings release on our HPE Investor Relations' web page at investors.hpe.com.

As always, elements of this presentation are forward-looking and are based on our best view of the world and our businesses as we see them today. For more detailed information, please see the disclaimers on the earnings materials relating to forward-looking statements that involve risks, uncertainties, and assumptions. For a discussion of some of these risks, uncertainties, and assumptions please refer to HPE's filings with the SEC, including its most recent Form 10-K. HPE assumes no obligations and does not intend to update any such forward-looking statements.

We also note that the financial information discussed on this call reflects estimates based on information available at this time and could differ materially from the amounts ultimately reported in HPE's quarterly report on Form 10-Q for the fiscal quarter ended April 30th, 2020. 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, please note that after Antonio provides his high-level remarks, Tarek will be referencing the slides and our earnings presentation throughout his prepared remarks. As mentioned, the earnings presentation can be found posted to our website and is also embedded within the webcast player for this earnings call.

With that, let me turn it over to Antonio.

Antonio Neri
Thanks, Sonalee. Good afternoon, everyone. Thank you for joining us today. I hope everyone is safe and healthy.

Operator
Pardon me. Ladies and gentlemen, we seem to be experiencing some technical difficulties. Antonio, your line may be on mute.

Antonio Neri
Yes. Thank you. Sorry. I had a problem with my phone. So, thanks Sonalee. Good afternoon, everyone. Thank you for joining us today. And I hope everyone is safe and healthy. Our fiscal Q2 results represent a full quarter of operating during the Coronavirus-19 crisis. This pandemic is unlike any other crisis we faced. And it has brought significant economic disruption.

Businesses and communities are struggling, supply chain productivity continues to be significantly constrained, and the demand environment is uneven. The market for capabilities like remote connectivity and virtual desktop solutions is stronger than pre-crisis in certain segments and we are well-positioned in those areas. But overall, customers are understandably cautious, given so much uncertainty. These dynamics had a significant impact on our financial performance this quarter, given the economic lockdown since February.

Our overall Q2 revenue declined by 15% to $6 billion, which led to a 42% decline in our non-GAAP operating profit. This was a tough quarter by every measure, and I'm of course disappointed in the results. But I do not view our Q2 performance as a reflection of our capabilities nor of the opportunity ahead of us.

Through this unsettling time, I have been really proud of our response that is aligned to our purpose to advance the way people live and work. We consider it our responsibility to help the world navigate this pandemic. We have prioritized protecting the health and safety of our team members and supporting our customers and partners as we weather the storm together.

At the outset, we moved quickly to mobilize crisis management teams around the world. We took decisive steps to ensure our team members' safety and wellbeing. We closed all of our sites and rapidly moved team members to work-from-home except for those are performing mission critical roles. We expanded team members' benefits to cover Coronavirus-19 testing and treatment, enhanced mental health support, and provided tools and resources to keep people connected and productive.

We also responded with important initiatives to address key needs created by the pandemic. We made substantial donations through HPE's Foundation and designated $2 billion in financing through HPE Financial Services to help customers and partners with financial hardships.

Our Aruba networking capabilities have been deployed in drive-up and virtual healthcare clinics and in schools that are facilitating distance learning. And our High Performance Computing solutions are helping scientists at leading research institutions to speed up drug discovery with complex modeling, simulation, AI, and machine-learning capabilities.

We joined forces with the US government and other high tech companies to form the White House High Performance Computing Consortium, giving Coronavirus-19 researchers access to

HPC resources. HPE also signed the open COVID pledge, granting free access to all of our patented technologies for the purpose of diagnosing, preventing, and treating the virus.

We have also adapted to deliver much needed capabilities and experiences to aid our customers' transformations as they navigate this difficult time. Through an improved sales coverage model aligned to market segments, our intelligent edge business continued to outperform the market while expanding operating margins and demonstrated 12% year-over-year growth in North America.

In addition, we gained traction in our HPE GreenLake business. We continued to see acceleration in this very profitable strategic business and are seeing large deals come in, underscoring a growing interest in our as-a-service offerings. In fact, our annualized revenue run rate or ARR increased 17% to $520 million.

While these are healthy signs of the needs that customers will continue to have coming out of the crisis, there continues to be significant supply constraints and delays in customer acceptance. This has impacted our ability to make deliveries to our customers.

Across our portfolio, we exited Q2 with more than $1.5 billion in backlog in compute, storage, HPC, and mission-critical systems, as well as Aruba, which represents two times the historical backlog. Our team is doing everything we can to deliver on these customer orders.

Tarek will take you through our Q2 results in more detail. But before he does that, I want to take the time to align actions we will take to address the near term uncertainty and ensure HPE is well-positioned to emerge stronger, more agile, and digitally enabled for a post-Coronavirus-19 world.

While the world is starting to envision what the recovery might look like, we need to be prepared for different scenarios. We know there is no going back to what used to be, there is only preparing for and building what comes next.

We need to adapt in order to keep our strategic momentum, even as the world has changed dramatically. We have taken a deliberate set of actions to protect our financial foundation, become a more agile organization, and align our resources to critical core businesses in areas of growth that accelerate our edge-to-cloud platform as-a-service strategy.

We continue to analyze financial forecasts and customer trends to better understand when and how global economies will recover. In the meantime, we have taken some immediate steps to reduce operating expenses that will protect our financial profile.

Effective July 1st, we will implement a short term pay reduction for all team members where it is legally permitted through October 31st, 2020. My executive team and I will take the highest percentage of reduction. Beyond us, the amount of reduction will vary by level. For team members who live in countries where pay reductions cannot be mandatory, due to local laws and regulations, we are implementing unpaid leaves.

In addition, we have implemented cost containment measures across the company, restricted external hiring through the end of our fiscal year, and put salary increases on hold. Additionally, our Board of Directors have voluntary decided to forgo a percentage of its cash compensation for the remainder of the fiscal year 2020 to demonstrate its commitment to Hewlett Packard

Enterprise, as we focus on preserving liquidity and improve our position to deliver for our customers now and in the future.

In addition to those short-term measures, today we are announcing a cost optimization and prioritization plan. This plan will help us focus our investments and realign our workforce to areas of growth that will accelerate our strategy. Some of the measures in the plan include: continue to streamline our product portfolio, implement a new digital customer engagement models, and optimizing a workplace site strategy and experiences.

HPE expects the plan will be implemented through fiscal year of 2022. And as a result of the changes to the company's workforce, real estate model and for the business process improvements, we estimate gross savings of at least $1 billion and annualized net run-rate savings of at least $800 million by fiscal ‘22 year end. In order to achieve this level of cost savings, HPE estimates cash funding payments between $1 billion to $1.3 billion over the next three years. Tarek will provide further details in his remarks.

While we take the steps to secure our financial foundation and strengthen our operations, we have simplified our operating model and have aligned them to the financial segmentation we introduced earlier this year. Each of HPE’s businesses is critical to our go-forward success, each carries an important part of the mission.

And as our customers demand new and different products and services from us, we must deliver. I’m personally committed to delivering to help each of our businesses leverage its existing strengths and evolve. Each of our business groups now report directly to me.

As part of the new organizational model, we created a GreenLake Cloud Services group to accelerate our other service capabilities. We also added a new software team that will architect our software strategy and portfolio that power our as-a-service platform. This new structure will provide further accountability and improve our execution and transformation.

As the world emerges from the global pandemic, business continuity will depend on solutions that advance IT resiliency, empower remote workforces securely, extend connectivity, reinvigorate customer engagement, and enable business model evolution. These realities mean that digital transformation will be more critical than ever. This is why we must accelerate our strategy to deliver everything as-a-service, edge to cloud.

We see data growth in the cloud, on and off-premises and increasingly at the edge, where we are uniquely positioned. Edge customers need persistent connectivity to bridge the digital and physical worlds.

HPE Aruba Central is at the core of our edge strategy. It is the only cloud-native, simple to use and secure platform that unifies network management for wired, wireless, and WAN networks, and soon 5G and Edge computing. In Q2, the number of unique customers using Aruba Central increased to 65,000.

Customers will also continue to need capabilities to harness the power of their data, wherever it lives--at the edge, across public and private clouds, in co-locations or in the traditional data center. We continue to believe the cloud is an experience, not a destination. And as-a-service business models will extend the cloud experience everywhere for all apps and data.

Earlier this month, we announced the general availability of HPE GreenLake Central, our advanced cloud-native platform that provides customers with a consistent cloud experience for all their applications and data, through an online operations console that runs, manages, and optimizes their entire hybrid cloud estate.

And in Q2, we made HPE Container Platform generally available. Our new cloud-native, software-defined stack is built using technologies from HPE's acquisition of BlueData and MapR, and delivers greater flexibility and lower cost for Kubernetes deployments of cloud-native and non-cloud native applications with persistent storage connectivity.

Next month, at our first-ever Discover Virtual Experience, we will showcase how HPE will help organizations ensure seamless business continuity through new technology capabilities, greater business intelligence, and enhanced financial flexibility, joined by thousands of customers and partners who will discuss how we should think differently about transformation in the future. And we'll introduce new innovation to bring agility to customers' apps and data…apps and data everywhere.

There is a great promise in what we can accomplish when we increase the speed of innovation and continue to bring to market differentiated capabilities from edge-to-cloud. Our customers, partners and communities need what HPE can provide. Our ability to execute our strategic pivot to offering our entire portfolio as-a-service by 2022, while we continue to re-architect and strengthen our core businesses, is critical. As we drive increased performance in our core businesses, we will be able to further align resources to new growth segments that will accelerate our strategy and pave the way to sustainable, profitable growth.

One of our core beliefs at HPE is the power of "Yes We Can." And I'm confident in our ability to execute because I believe we have the right strategy, the right leadership team, and the right mindset to adapt and deliver in bold new ways. We are focused and we are making the necessary tradeoffs, so we can continue to invest in the future. We are undertaking it with a sense of urgency and conviction in our strategy.

With that, let me turn to Tarek to review the quarter's results. Tarek.

Tarek Robbiati
Thank you very much, Antonio. Hope you can all hear me and are all safe and well.

I'll start with a summary of our financial results for the second quarter of fiscal year 2020. As I've done before, I'll be referencing the slides from our earnings presentation to highlight our performance in the quarter. Also, please note, since last quarter, we're now reporting results according to our new segmentation. Antonio discussed some of the key highlights of this quarter on Slide one. Now, let me discuss our financial performance, starting Slide two.

Our Q2 results were heavily impacted by the global COVID-19 crisis. As Antonio mentioned, our Q2 represented a full quarter of operating under COVID-19. Our revenues of $6 billion were down 15% year-over-year, primarily driven by supply chain disruption, which resulted in significantly higher levels of backlog, particularly in Compute, HPC MCS, and Storage.

We also saw uneven demand with customers pushing out business activity as they navigated through the current economic crisis and lockdown. At the edge, the market for capabilities like remote cloud connectivity and virtual desktop solutions was stronger than pre-crisis in certain

segments. And we're well-positioned in those areas, offsetting the decline in campus switching that resulted from lower business activity.

Despite the challenging backdrop, we managed to maintain relatively stable non-GAAP gross margins, which were down by 20 basis points year-over-year. Our non-GAAP operating profit, however, was down 42% year-over-year to 6.1% in operating margin terms and then our non-GAAP EPS of $0.22 was down 48% year-over-year.

Our GAAP EPS was a loss of $0.64, primarily due to an $865 million non-cash goodwill impairment charge associated with legacy goodwill allocated to the HPC and MCS business segment, which impacted GAAP net EPS by $0.67. This impairment was not driven by the Cray business, which continues to perform consistent with our expectations.

Cash flow from operations this quarter was $100 million, impacted by reduced profitability and inventory build-up. Free cash flow was negative $402 million compared to a positive $402 million for the prior year period, which was impacted by higher financing volumes.

Taking all the previous into account, we're taking decisive and prudent actions to manage our costs and expenses, further improve our liquidity, and focus on opportunities to emerge stronger in the post-COVID-19 world.

Turning to Slide three, Antonio outlined for you some of the near-term cost takeout measures we're implementing, including reductions in pay across our workforce, unpaid leave in places where pay reductions are not legally permitted, and hiring restrictions. He also mentioned the actions we're committing to today to further strengthen our financial profile in the medium and long term and accelerate our strategy. Today, we are announcing a cost optimization and prioritization plan to reflect the current revenue environment and to position ourselves as a more resilient company, ready to address the needs of our customers in a post COVID-19 world.

We remain confident that we have the right strategy and are taking the right actions to secure our financial foundation and support our path to sustainable, profitable growth. More specifically, our plan is designed to right-size our cost structure to the new normal, to allocate resources in alignment with our new segmentation and growth areas, to drive increased efficiencies through investments in digitization and automation, and finally, to accelerate our pivot to as-a-service to drive long term sustainable, profitable growth.

Overall, these new cost efficiencies will be captured from simplifying and evolving our product portfolio strategy and go-to-market, cost saving from supply chain optimization, increased penetration of remote customer support, new initiatives to leverage digital marketing, and consolidating our real estate footprint.

In terms of the timeline, we expect that the plan will be implemented through fiscal year 2022 and estimate that it will deliver annualized net run-rate savings of at least $800 million by fiscal year 2022 end. Having said that, we expect to achieve the majority of the savings by the end of fiscal year 2021. In order to achieve this level of cost savings, we estimate cumulative cash funding payments of between $1 billion to $1.3 billion over the next three years.

We'll now move to Slide four that shows our performance in the quarter in accordance with our new segmentation. Let me hit a few key points. In the Intelligent Edge segment, we declined 2%. However, we saw over 12% year-over-year growth in North America, showing that the changes we made to our North America sales leadership and go-to-market segmentation are

paying off, even in the midst of a challenging business environment. While campus switching declined single digits due to increased emphasis on working from home, we grew the wireless LAN product business 7% year-over-year due to high demand for our remote access solutions and WiFi6-certified access points with 35% year-over-year growth in North America. Furthermore, we expanded gross margins and also grew operating margins by 570 basis points year-over-year to 11%. The bottom line is that we gained share in both campus switching and wireless LAN markets, while significantly improving profit margins.

In Compute, revenue declined 19% this quarter, driven by lower conversion rates, even as order backlog grew to two times our average historical backlog, and lower unit growth, which was negative double-digits this quarter. Our ability to fulfill orders was impacted by component shortages, with supply chain logistics further disrupting our ability to fulfill demand, due to the coronavirus pandemic. As the supply chain constraints alleviate, we expect to execute against our high backlog.

In High Performance Compute and Mission Critical Systems, revenue declined 18%, primarily as a result of delayed installation and customer acceptance on account of COVID 19. Similar to Compute, this resulted in an elevated backlog, but we expect to see a stronger uptick in revenues in the second half of the year as we execute against the order book.

Our HPC business has been actively involved in COVID-related research activity and is providing COVID-19 researchers worldwide with access to the world's most powerful HPC resources to advance the pace of scientific discovery in the fight to stop the virus.

Furthermore, we announced the 2023 delivery of the world's fastest exascale supercomputer, El Capitan, for the United States Department of Energy at a record-breaking speed of two Exa-flops, 10 times faster than today's most powerful supercomputer. Most importantly, the Cray integration remains on track to deliver the FY20 revenue targets and triple-digit run rate synergies by fiscal year 2021.

Within Storage, we declined 16% year-over-year due to higher backlog, similar to Compute, but had notable strength in Big Data, showing a growth of 61% year-over-year. Nimble Services revenues grew 20% year-over-year with services intensity at record highs as customers add high-margin value-added services.

For Operational Services which are included across Compute, HPC-MCS and Storage, revenue declined by less than 1% year-over-year while orders were down 5% year-over-year, driven by the drop-in Compute units.

On the positive side, our services intensity, which is the ratio of attach revenue per hardware units sold, continued to be strong with double-digit growth in Storage and HPC-MCS services driven by Cray. This demonstrates that the underlying profitability of the units we sell and the attach rates continues to be robust.

In Advisory and Professional Services, revenue was down 8%, but we significantly improved operating margins by 6.2 points year-over-year due to our re-entry in select countries combined with an increase in remote delivery of projects from 65% to 90%, which helped to control costs and drive an improvement in chargeability levels of staff.

Within HPE Financial Services, financing volume grew 10% year-over-year, despite the impact of COVID-19, and our net portfolio of assets was up 4% this quarter with longer contract terms

supporting GreenLake. We maintained a solid return on equity of approximately 15% again this quarter.

Our bad-debt loss ratio this quarter was 0.5%, which is best-in-class in this industry. We will obviously continue to closely monitor the impairment losses as liquidity constraints could affect some of our customers' ability to pay in upcoming quarters. We will tighten our underwriting guidelines as necessary to ensure we can manage through this crisis, and any impairment losses remain within our level of comfort.

Our Communications and Media Solutions business that is included in our Corporate Investment segment is a strategically important business to us, providing software and services capabilities to telco service providers. CMS is showing improved momentum. We saw a strong double-digit software order growth with EMEA growing 45% and Japan growing 70% this quarter.

Revenue gained momentum, growing 2% sequentially. We also expanded operating margins by 170 basis points year-over-year this quarter. We also recorded our first 5G core win with a tier 1 carrier in the United States. This strategic win validates our 5G strategy with multi-vendor integration and true cloud-native telco network solutions.

Slide five shows our growing ARR profile I introduced at our securities analyst meeting in October 2019. I'm pleased to report that our Q2 2020 ARR came in at $520 million, representing 17% year-over-year growth and in line with our expectations.

Our HPE Aruba Central SaaS platform continued to grow revenue triple digits year-over-year this quarter. As we progress towards building our go-to-market as-a-service motion and remain focused on offering a full suite of differentiated solutions that can be consumed as-a-service, we are reiterating our ARR growth guidance of 30% to 40% compounded annual growth rate from FY19 to FY22.

Slide six highlights our EPS performance to-date. Non-GAAP diluted net earnings per share was $0.22 in Q2 with headwinds from reduced operating leverage, suspension of our share buybacks, and a lower but expected contribution from OI&E. Consistent with our guidance at SAM, we expect OI&E to be approximately negative $100 million for fiscal year 2020.

Turning to gross margin on slide seven, we delivered non-GAAP gross margin of 32% in Q2 of fiscal year 2020 which was down 20%... which was down 20 basis points year-over-year. Commodity costs were a tailwind to gross margin this quarter, even as the supply-demand balance turned into a more inflationary commodities environment at the start of the quarter.

Moving to Slide eight, non-GAAP operating margin was 6.1% in Q2 of fiscal year 2020 and non-GAAP operating income was down 42% year-over-year. This clearly demonstrates the imperative to right size our business to reflect the new revenue profile we are facing as a result of the COVID-19 impact.

Turning to Slide nine, our cash flow from operations was $100 million, impacted by reduced profitability from the Compute and Storage businesses, which were heavily impacted this quarter and higher than normal working capital. Free cash flow was a use of $402 million for the quarter, driven by year-over-year growth, which was impacted by financing volumes.

Higher than normal backlog and resulting inventory build-up triggered a reduction in our cash conversion cycle from minus 17 days in the prior quarter to minus 5 days this quarter. We expect our cash conversion cycle to improve through the rest of the year as we execute against the backlog and supply chain constraints alleviate, both of which help us reduce our high inventory levels.

Now, moving on to Slide 10, I want to spend a moment on the strength of our balance sheet and investment-grade credit rating, which is a competitive advantage in this environment. As of our April 30th quarter end, we had approximately $5.1 billion of cash and cash equivalents, having successfully raised $2.25 billion in senior notes in April 2020 at a low cost of capital. We also have an undrawn revolving credit facility of $4.75 billion at our disposal. So, in total, we have approximately $10 billion of liquidity. We remain committed to maintaining our investment-grade rating, which was reaffirmed by the rating agencies in April 2020. Bottom-line, we have a strong cash position and ample credit available during these uncertain times to support and invest in our business.

Let me recap for you our key takeaways for this quarter on Slide 11. But before I do that, it's worth spending a couple of minutes on capital allocation. In Q2, we returned $305 million to shareholders in the form of share repurchases and dividends. We repurchased $151 million in shares and paid a cash dividend of $154 million. In April 2020, we took the decision to suspend share buybacks in the light of the current environment, where liquidity is of paramount importance. Subsequently, in April, we announced our regular dividend payment for Q3 2020, payable in July.

Finally, let me summarize the key takeaway for you this quarter. Our fiscal Q2 results represent a full quarter of operating under the COVID-19 crisis and we're heavily impacted by the crisis, both on the demand and supply side. As a result, we have enacted short term actions and long term cost optimization and prioritization plans to reflect the current revenue environment and to position ourselves as a more resilient company in a post-COVID world.

Our robust balance sheet with approximately $10 billion of liquidity and investment-grade credit rating gives us flexibility not only to weather the current storm, but to continue to invest in key growth initiatives. We remain confident that we have the right strategy and are taking the right actions to secure our financial foundation and support our path to sustainable profitable growth.

Now, turning to outlook. Since the crisis began, we've been stress testing our model and running scenarios based on various assumptions, just like everybody else does. Given the level of uncertainty around the duration of the crisis and the rate and the shape of the recovery, there's a wide range of possible outcomes for the year. We have taken prudent and decisive steps with the latest being our cost optimization and prioritization plan, so that we are prepared for the different outcomes.

Due to the uncertainty and consistent with our April 6, 2020, 8-K filing, where we withdrew our fiscal year 2020 financial guidance, we will not be providing any Q3 or fiscal year 2020 guidance.

Now with that, let me hand over to Antonio and open it up for questions. Antonio.

Antonio Neri
So, thank you, Tarek. And I know Nancy is going to operate this. So, Nancy, why we don't get started?

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 speakerphone, please pickup your handset before pressing the keys, to withdraw your question please press "*", then "2." We also request that you only ask one question and one follow-up question.

Our first question comes from Katy Huberty with Morgan Stanley.

Katy Huberty
Thank you. Good afternoon. The color on backlog is helpful, but I wonder whether you could also give some color on how orders trended through the fiscal second quarter and what you've seen from an order perspective in the month of May. And then, just related to that, you specifically said that the HPC business and conversion rates would tick up in the second half, but you stopped short of giving a similar timeline for Compute and Storage. So, just any color as to when you think orders will begin to convert in those two segments as well?

Antonio Neri
Yes. Hi, Katy. Thanks for the question. So, the order intake or what I referred as the order linearity was fairly steady, I have to say. We normally plan a quarter in 13 weeks. The first week is the previous backlog from the previous quarter...the backlog from the previous quarter and then 12 weeks, right? And we planned the linearity early on. And I will say, we hit or exceeded our order linearity intake every week of the quarter. And so, this really came down to our ability to convert the order book into revenue.

And in the case of HPC, High Performance Computing, let me remind everyone that in order for us to convert that order into revenue, we have to build it, obviously, we have to ship it, but we have to install it and we have to turn it on. And once the customer accepts that installation, which in many cases is fairly large installations, you're talking about number of clusters, that's when only we can recognize revenue. And so, the impact on HPC was two-fold, was not being able to go to customer sites, because customers were locked down like we are, and not be able to install and deliver and turn it on. And obviously, the same challenge we have in Compute and Storage with supply chain constraints and capacity, because of the social distancing, and obviously, in the components level that we saw obviously a major disruption. And as a reminder, we ship pretty much three servers every minute. And so, when that supply chain stops, it’s pretty significant.

So, in terms of going forward, our priority one, two, and three continues to be: clear the backlog. And that's how I think about it. Throughout Q2, we made progress in the recovery, I’ll say China is pretty much back to normal, but obviously they are cleaning the backlog themselves, because they had to first recover the labor and then obviously, they depend also on sub-suppliers for the components. Think about cables, connectors, transistors, you name it.

And so, for us, the majority of the backlog right now is in the bucket. And then, in the regional factories, for the vast majority, all are performing…at capacity except one or two, where, the rules and the regulations or the shelter-in-place are demanding that there is a stringent process on social distancing, which obviously impact the capacity in the factory lines. But the factories are all up and running. So, I am optimistic about the weeks to come. So, I take this a week at a time, obviously we continue to focus on the order intake, I cannot comment in May, because I

think you asked the question on May, because we're in Q3 right now. But in Q2, the order linearity was fairly steady. And we expect not just HPC but Compute and Storage to continue to make progress and that's why Q3 will be different than Q2.

Operator
Our next question comes from Wamsi Mohan with Bank of America Merrill Lynch.

Wamsi Mohan
Yes. Thank you. Antonio, you commented on rightsizing the cost structure to a new normal. A few years ago, HPE Next was supposed to be the last restructuring program. And I know no one could have anticipated COVID-19. But, is it your view that you will not get back to pre-COVID levels because of secular end-market challenges, or is there a different interpretation to that?

Antonio Neri
Yes. Thanks, Wamsi. Great question. So, since you mentioned HPE Next, let me start with that. I mean, I was the architect of HPE Next in the 2017 year. As you know, we launched it in the fall of 2017. And I will say HPE Next was a great success story, because it allowed us to re-architect the company in the key areas in terms of simplification of processes, streamlining our go-to-market model. Remember, we went from a worldwide geo to country, to more a geo model, where we removed layers. And honestly, it allowed us to reinvest back in innovation. And that's where I announced the investment of $4 billion at the Edge. And now, we start seeing the results of that with great numbers, despite the challenges. So, that was a success. And remember, we committed to deliver $800 million in net savings, in which we did and we did ahead of schedule.

Now, to your point, this is a crisis unlike anyone we have faced. And I will say, in 2017, I said, listen, we don't envision another cost optimization plan, but this is a cost optimization driven by the pandemic. But honestly, I see an opportunity to go faster in our pivot to our strategy, which is to offer everything as-a-service.

It is very unfortunate that we have this pandemic just causing tremendous economic disruption and obviously a huge impact to communities. But, from a business perspective, we are more convicted than ever in our strategy. And we see it. The demand for pervasive, ubiquity connectivity. That's why access points are very strong for us. All cloud...the cloud experience deployed everywhere from the edge to cloud and the ability to consume it as-a-service, and this is where we see tremendous momentum with HPE GreenLake.

So, for me, its right-size our cost structure to the new normal. And we don't know exactly what the new normal is at this point in time, because we don't know what the recovery looks like. It's about allocating resources for the areas of growth we see in the future and also increasing efficiency, because we learned a lot.

Remember, in Q1, I talked about it. We learned quite a lot and we extended the HPE Next, which is now part of this cost optimization and prioritization plan and digitize everything. I believe this will cause incredible structural impacts in the way people are going to work. And my expectation is at least 50% of our employees will never come back to an office. And the office will look completely different, which means our offices will be more center of innovation and collaboration, not where you come to do your regular work every day. And that requires resizing our real estate footprint. But even, as you resize the footprint, also requires new experiences and, therefore, investment associated with that. But, when you bring it all together and the need

to rescale and upscale and allocate resources in the right place, I believe we have an opportunity to accelerate the strategy and drive to that long-term sustainable, profitable growth.

Wamsi Mohan
Okay. Thanks, Antonio. And the negative operating leverage on Compute was quite significant in the quarter. How much of that would you say was a supply-driven issue versus demand-driven issue? And how do you think investors should think about the trajectory of that, given that you also have the significant cost actions starting to kick in? Thank you.

Antonio Neri
Sure. It definitely was a supply chain-driven, although demand continued to be uneven, as we discussed before, particularly in Compute. And I will say the...you have to look at it this way. The shortfall on the revenue is pretty much all supply chain-driven. Because I made the comment early on that our linearity in the order intake was pretty steady. But, in the order linearity, you have to look at the customer segments. Obviously, when you sell to, I call it Cloud companies, which are more software companies that deliver their value through the cloud, those are continuing to be steady. If you think about enterprise, I will say those were pretty steady. SMB obviously was the biggest challenge in the transactional business. Because fundamentally, that segment of the market was significantly disruptive.

As I think about the future, right, obviously, we already were under a macro situation. But, let's remind ourselves that the Compute platform goes through an innovation cycle themselves, even though it's commoditized. And as I think about the Gen10, if you remember the Gen10, we actually told everyone that we said that two-thirds of the structural change was permanent, because of the ability to attach richer configuration.

As we go to what we call Gen10.5 and Gen11, which is happening in the next 18 months, you're going to see more of that. You're going to see, again, the same cycle where the density of these products, the amount of memory and storage, you can put inside this Compute platform will continue to increase. And that's good for us, because obviously it drives AUP. But right now, our focus is really around, clear the backlog, both on the Compute side and on the HPC side--both finish installation and obviously clear the backlog there as well.

Operator
Our next question comes from Toni Sacconaghi with Bernstein.

Toni Sacconaghi
Yes, thank you. I have two questions as well. First, it sounds like you're saying there was really a de minimis impact from coronavirus on demand and this was largely supply chain driven. And if you have the supply and you kept backlog at normal levels, you would have done $700 million more in revenue in Q2. And it sounds like if production is up and running, if you are able to bring down your backlog to normal levels, that should boost Q3 revenues $700 million relative to normal seasonality. So, am I thinking about that correctly? And how much progress do you think you can make on bringing your backlog down to normal levels over the course of Q3? And then, I have a follow-up.

Antonio Neri
Yes. Thanks, Toni. Hope all is well. Yes. I think, you're thinking in the right parameters. The only thing I will say is that definitely the vast majority was supply chain. And as I said in my early comment in the previous question, there was some demand, obviously, but particularly in SMB and some elements of the mid-market, where enterprise was a little steadier. And we saw

uptick in demand, for example, that consumes Compute for example solutions like VDI, which was in high demand, or even big data storage, which at the end, Toni, is a Compute platform with a level of hard disk attached to it or SSDs attached to it

So, in that context, you are asking absolutely the right question, and this is what I'm maniacally focused with the team, and which as I said, my priority one, two, and three is to clear the backlog. And as I said earlier, we focus the quarter in 13 weeks, where we enter the backlog, which was the $1.5 billion on May 1st and where we're going to exit on July 31st as the new orders come in. Because fundamentally, we expect the orders to come in. And we have a linearity plan associated with that recovery. So, I feel pretty optimistic about it. But, however, it's going to come down to our ability to get the supply in the right place and the ability to execute in the cycle times that we need. And obviously, as you know, we have a very global diversified supply chain, and we have made some series of moves to move products built around the globe, even if they are for other regions. So, we can accelerate that backlog.

And so, this is going to be the name of the game. But generally, as I think about the last four weeks, and I think about the next four weeks, and then the next four weeks after that, we continue to see progress. But, there's a lot of things, who knows, there is a restart of coronavirus. I'm more concerned right now, Toni, to be honest with you, if something happens in one of these locations where we have the factory and you go into a resheltering of the social distancing--that could have an impact. In terms of the velocity behind with components from China, I will say that's where the vast majority is going absolutely in the right direction. And obviously, the logistics side, as we reopen countries and flights across the globe that will help as well.

Toni Sacconaghi
Okay. Thank you for that. Maybe you could...I mean, is it unrealistic to think you could close, you could get backlog to normal levels? And then, my second question is, if you're really saying that this was largely the supply, not demand disruption, I'm still a little...I'm having difficulty reconciling the new sort of HPE Next too, because on your Q4 call, you were pretty unequivocal there wouldn't be another HPE Next. You felt you were in the right place on cost. You said last quarter, you were doing a little bit more on cost, but it wasn't structural, it wasn't another HPE Next. And now, you are undertaking a significant multiyear structural change. And, a) that doesn't feel consistent with the statement that this was really a supply issue; and b) it makes me wonder like, are you more worried about your competitive position, or are you worried that the IT environment is going to be weaker for a while?

Antonio Neri
Yes. Thanks, Toni. So, my remarks about what happened in Q2 was about the supply chain and lesser so on the demand. I cannot forecast right now what the demand is on the back end. And this is where in our remarks we said we are looking at the pipeline; we're looking at the economic indicators, which obviously all of you provide; and others. And so, I will not make any further comment because on the demand in... I don't know in October or November; I don't know what that will look like. But I'm just replying to your question about what happened in Q2 definitely was based on the order intake we had. It was...the vast majority was the supply chain problem.

And there were pockets of uneven demand, which obviously were accentuated in the SMB space, which was quite significant. But remember, we serve global customers, we serve large enterprise, mid-market and SMB, and in that a lower vertical. So, we have to look at this from multiple perspectives. But definitely in Q2 was...the vast majority was a definitely a supply

chain, and in that demand, we saw pockets of growth, despite the dynamic of the coronavirus, which Aruba definitely was...despite the 2% decline year-over-year, we saw bright spots in wireless LAN up 7%, North America as a geo 12%. The remote access points we couldn't ship enough of it. I mean, we didn't have all of it. VDI was another one. So, I think that was Q2.

As I think about Q3, it's all about cleaning the backlog. And in a reasonable way, I feel more confident in Q3 than obviously in the results in Q2, because we should expect continuous improvement. As for the demand, I don't know what to tell you, Toni, right now, because obviously it depends also in the global recovery of the economy. And then, ultimately, customers are going to assess where they want to spend their money, but right now, that's where we are.

And then, in terms of HPE Next, I made that comment at the beginning of HPE Next. Now, let's be clear. I mean, nobody expected a Coronavirus 19. But as I said in one of my comments, I think to Katy's question...actually, Wamsi's question was, I believe this is...in a downturn, this is where you go double down your strategy. And this is where investing in the right place now. So, when the recovery takes place, you come out on the other end stronger.

And so, that's fundamentally what we're doing is really obviously addressing the cost resizing for the situation we are in. And in the short-term, we have taken some painful action. For me, as a CEO, telling our employees we're going to cut salaries, not an easy thing to do. I don't take that lightly. But in the other end, allocating the right people, the right resources, the right investment into the future, now that we're in the downturn, is the biggest opportunity. Because I think the strategy is absolutely spot on. And I'm more convicted than ever.

Thanks, Toni. Okay. Operator, next question?

Operator
Our next question comes from Shannon Cross with Cross Research.

Shannon Cross
Thank you very much for taking my questions. My first one is, I realize you're not giving guidance, but can you provide some parameters for us to consider thinking about OPEX, how much is variable, how material do you think the salary reductions would be relative to sort of the overall base run-rate of OPEX? And, is there a significant amount of revenue that's sort of just sitting out there waiting to be recognized as soon as customers come back and can be trained and can accept?

And I don't know maybe something about backlog in terms of your confidence level that you're not going to lose those orders to competitors or that they are pretty firm orders? Just anything you can give us to have some idea of how to think about it? Was this the trough quarter for instance? Thank you.

Antonio Neri
Sure. Let me start, and then, I will ask Tarek talk about more the first part of your question. Obviously, again, it goes back to Toni's question, the confidence to clear the backlog. And this is where again we are focusing. I feel better about it than six weeks ago. But, as I said earlier, right, we're taking it day-by-day, week by week. It looks promising. And we continue to make progress every day, every week.

In terms of what is the size of revenue, I cannot give you it right now, but I will tell you, remember, HPC deals are normally multimillion dollar deals, sometimes mid-double-digit deals. And those are all waiting to be deployed and installed. And they are all over the world. And so, obviously, we have a fantastic services organization ready to go as soon as the customers let us in. So, those are the things you need to think about it. But I hope everybody appreciates, we've given you a complete direction of what was the backlog and what we are doing about it.

I think, I'm going to give it back to Tarek to talk about the first part of the question. So, Tarek...

Tarek Robbiati
Thank you, Antonio. It's quite difficult to call the bottom or trough quarter, given the level of uncertainty that is currently visible. There's one thing that we know is that the uncertainty is high. And it's everyone's guess what the shape of the recovery will be. So, please bear that in mind. And most people and economists we talk to, and I've spent a lot of time talking to many experts, as I'm sure you did, are not thinking in terms of a V-shape recovery, more in terms of a U-shaped recovery. And that's what we are modeling. And this is why we have come up with the cost prioritization plan that Antonio mentioned. And as he said, we need to take every day as it comes.

So, in terms of cost take out, there is...as part of our plan, the goal is to achieve the vast majority of the $800 million net run rate savings by fiscal year 2021, although we said this number will be visible by fiscal year '22. And the reason why we said this is because of this level of uncertainty that exists in the shape of the economic recovery that I was referring to you before. So, what we are doing is, we're supplementing run rate reductions with temporary pay cuts and actions that we can take otherwise to protect the financial profile of the company and enhance our liquidity moving forward. Back to you Antonio.

Antonio Neri
Thanks, Tarek. So next question, please.

Operator
Our next question comes from Jeriel Ong from Deutsche Bank.

Jeriel Ong
Thanks for letting me ask a question. And, I guess, first of all, I'd like to ask a little about GreenLake. Obviously, it was nice that the business still grew, year-on-year. But I'm wondering why you're confident in an acceleration in that growth. It seems like, as the business gets bigger, it'd be hard seeing growth rate, but it seems like you're kind of back ending more of that growth to get to that 30% to 40% compound annual growth rate.

Antonio Neri
Sure. Thank you, Jeriel. I think we have a unique differentiated value proposition with the HPE GreenLake. And with the introduction of the HPE GreenLake Central, which is a true cloud-native platform where you can deploy the right mix from edge to cloud and consume it as-a-service and deliver the workload optimized solutions in a standardized way, it is a true differentiation for us. And what we have seen in the last several months is a continuous growth in our pipeline and the ability to convert the pipeline into larger deals, larger deals. Some of these deals, in particular two or three, which are triple digits, to give a sense.

And so, for us...and also, they are multiyear, right? So, for us, that's an exciting, because remember, we said many times, when we sign a GreenLake deal, we work with a customer in a

multiyear deal. And the pull-through for infrastructure that goes with it and services attached is higher. The services attached through Pointnext... Pointnext operational service is 100% by the way, attach. And the margins are higher. So, fundamentally, we are confident in reaffirming the annualized run rate revenue of 30% to 40% that Tarek talked earlier, because it's a function of getting these continuous momentum and larger deals for many large cap companies. So, I think that's what we see. And now, we are tailored more for the mid-market as well for SMB. And what the customers are looking for is the ability to scale up and down, based on their needs, and also more and more have someone else run it for them. They don't want to be in the run side, they want to be more in the innovation side.

Jeriel Ong
I appreciate that. And just one more for me. I think, I get a sense from the cash spend for the cost realignment that fiscal year 2021 is going to be...it seems like the bulk of the spending. But, I guess, I'd like to get an idea for whether it's going to be cost of goods sold or OPEX-driven, if it is going to represent the general mix on your costs generally, or if it's going to be weighted one way or another. Thanks.

Antonio Neri
I'm going to give that to Tarek.

Tarek Robbiati
Yes. Thank you, Antonio. With respect to cash and cash flow and I'd like also to ask you a question for clarification purposes. With respect to cash flow, what has driven our cash flow performance in Q2, is the increase in inventory levels and the change in the cash conversion cycle. We've stocked up a lot of inventory. And the backlog is also a reflection of the fact that we stocked up a lot of inventory. And our cash flow conversion cycle, which was a favorable minus 17 days, dropped to a less favorable minus five days, because of our stocking up in inventory terms. Could you please, for my benefit, repeat your question on costs and what you were trying to get to here? I did not quite understand it. Thank you.

Jeriel Ong
Yes. So, in terms of your annualized net run rate savings, what areas of your business are those going to come from?

Tarek Robbiati
Okay. So, by and large, we're going to leave no stone unturned. That's the message. But, effectively, if you look at what the plan is about, it’s fundamentally around realigning resources to the segments that we started to report back in the first quarter and areas of growth that we see driving better productivity levels across those segments; changing fundamentally the way we engage with customers from a marketing and sales standpoint; rethinking our supply chain to create it in such a way that is more resilient than before, yet agile and efficient; rethinking also our workforce management practices.

Because quite frankly, I don't know what your situation is like, but we've been working very effectively from home for the past three months almost. And so, this is pointing to us the need to think about this new normal and what does it mean from a workforce management standpoint, and our real estate footprint. So, you can rethink your real estate footprint now that the world is much more distributed and connected than ever before. So, I hope I have provided sufficient color to answer your question. Back to you, Antonio.

Antonio Neri
Yes. Thanks, Tarek. Next question? I know, we got into the top of the hour where we are 5 minutes over. Do we have any more questions on the line, operator?

Operator
Our next question comes from Aaron Rakers with Wells Fargo.

Jake
Hi. This is Jake on for Aaron. I was wondering if you could go into a little bit about how we should think about portfolio simplification in regard to the cost optimization plan.

Antonio Neri
Yes. So, obviously, from the portfolio optimization, I think about the work we have done under HPE Next and continued that work to streamline number of platforms and options. We have done a phenomenal job there. But to Tarek's point, it's all about where we build these products and fundamentally, where we also design these products. So, there is an opportunity to continue to drive that optimization.

And fundamentally, I think about our portfolio as a way to accelerate that as-a-service model. Obviously, on one end, at the edge, we have a fantastic cloud platform called HP Aruba that we continue to invest...Aruba Central, that we continue to invest and it's 100% software, right, with access points and switching that comes with it, think that way, and obviously through the subscription model.

The other thing is, obviously in the core business is how we drive the best workload optimized solutions that they are fully automated and provisioned from the cloud using HPE GreenLake Central. So, that's another component of that. So, that's how we think about it. And obviously, there is a lot of the work we do even in the core businesses. While people may think its hardware...and I want to give an example. The recent introduction of a distributed hyperconverged infrastructure is actually all software. It's 100% software in many ways. And as I think about the future, how the world will evolve, we're going to live in a more distributed model.

Today, it's very centralized in the sense you have your mobile phone or your mobile device connected to some sort of cloud. That cloud can be your datacenter, can be somebody else's cloud. But fundamentally, the cloud experience will extend...will be extended all the way to the edge. And that's why we have plan in that portfolio to continue to invest in the Aruba Central with integration of 5G and the integration of edge compute. So, it's a combination of freeing up resources in the traditional businesses, reallocate those resources in those areas that will drive the long-term sustainable, profitable growth, based on the work we have done in HPE Next and also continue to digitize everything we have and we can.

Okay. So, next question, please?

Operator
Our next question comes from Simon Leopold with Raymond James.

Simon Leopold
Thanks for taking the question. My sense is, is that the quarter you just reported was primarily supply and the uncertainty you're expressing about the outlook maybe reflects more of a shift towards demand. So, I thought it would be helpful, if you could give us a better understanding

of what your customer verticals typically look like? In other words, how much is federal government, how much is the SMB market, and how much is Financial Services? Because I think, even if we can't make predictions, I think all of us have some sense of which verticals are healthier than others. I appreciate it. Thank you.

Antonio Neri
Sure. Thanks, Simon. I think, I will say...let me start with the bad. SMB obviously has been a significant challenge we all witness every day. That's what has driven a big chunk of the unemployment that we see here in the United States. So, obviously, that will take time to recover. And generally, that market gets served through what we call a transactional engine, and it's a high velocity engine. In the enterprise, if you take it by vertical, I think telco has been fairly steady. Tarek talked about a portfolio that we have called Communications & Media Solutions. You heard some of the numbers, in some areas growing 40% and 70%. It's all software and services, and obviously drags infrastructure, because eventually you have to virtualized, whatever infrastructure put there.

Financial Services actually was fairly steady and strong. We have a very large footprint. And this is where the diversification of our geo and verticals actually is helping us a little bit. Generally, FSI and telco are very large for us, where retail not so much, and I think retail obviously was more impacted. But I will say, telco or communications, media and entertainment, Financial Services was strong. Obviously, oil and gas not so much, because we know the pricing of the oil. And then, as I think about transportation, obviously impacted as well.

But I will say the number of deals and the size of the deals were generally the same. The elongated sales cycles were consistent. But we align our plans based on the linearity I talked earlier. And Q2 was fairly steady so far.

So, whether the first half was supply chain and the second half is demand is to be seen. Again, Tarek talked early on about the shape of the recovery. And I agree with Tarek, I totally subscribe to the U recovery. The question is how far the two sides of the U are and how deep the U is. But right now, it feels steady in those areas. And as I said earlier, our focus is the backlog.

Okay. Next question? I think, this is the last...one more question. I think, this is the last question. I think we have another question on the line.

Operator
Our final question comes from Amit Daryanani with Evercore ISI.

Irvin Liu
Thanks. Hi. This is Irvin Liu dialing in for Amit. As I look at your cost optimization and prioritization plan that was announced today, that will result in a $1 billion to $1.3 billion total cash payment through fiscal 2022. Now, is it fair to say that the cost savings plan will essentially push back the timing related to the achievement of your normalized free cash flow target of $2 billion by let's say another two-to-three years?

Antonio Neri
Yes. Thanks for the question. I'm going to pass it to Tarek.

Tarek Robbiati
Thank you, Antonio. So, the most important thing in our cost optimization and prioritization plan is to achieve those $800 million of net run rate savings and hold them as long as possible in the cost structure, so that we can effectively see more margins in our business. With respect to free flow, last year, if it were not for a legal settlement that we paid, we would have exceeded $2 billion free cash flow mark. So, that was what that business was capable back then with a certain revenue base. And, what you've heard from Antonio is that we are rightsizing the business to what is potentially a new revenue base. And it's too early to tell whether that new revenue base will come back to the pre-pandemic revenue levels, moving forward. But, what's very important right now is our focus is to ensure that we rightsize our business and deliver those run rate savings, so that we can emerge stronger after this crisis subsides. Thank you

CONCLUSION

Antonio Neri
Yes. Thanks, Tarek. And again, I just want to...last year was a unique year in the sense that we were pretty much on track. And actually, I would argue, we delivered the normalized free cash flow, because we were able to take care of unique circumstances with the settlement in arbitration. So, when you add it all up, it was in excess of $2 billion. And again, it comes down to our ability to drive the operating cash, the cash from operations, which generally tends to be very strong. Obviously, this quarter, because we couldn't convert, we couldn't deliver that.

But, let me remind again that the cost optimization and prioritization is not just about resizing, but it's about shifting investments to the strategy, which I answered earlier to Toni, I think is the opportunity we have now and therefore, making that happen in the lower part of this, whatever the lower is, is the right strategy, so you become stronger on the other end.

So, to wrap it up, thanks again for joining us today and for your questions. Let me make a few comments to wrap the call. As I said earlier, these are unprecedented and challenging times for all of us, not just the business, but obviously the economy and the communities. Technology and digital transformation, in my view, are more critical than ever, to enable what I think is going to be new world, the new distributed world where workforces would be located in different ways. And honestly, there will be new ways to run businesses.

I think, our strategy to deliver a cloud experience from the edge to the cloud is more relevant than ever. And at the core of that is to securely connect people and things as we see more than 50 million devices being connected to the network every single day. But, at the same time, we need to analyze data faster and to accelerate the business outcomes for our customers. I think, the measure we announced today will allow us to protect not only our balance sheet and continue to preserve the liquidity, which as you saw, in one of the slides, we have a very robust balance sheet with capacity up to $10 billion. So, that's not the issue. But fundamentally, my goal is to adapt the organization to be more agile, to align our resources to the critical core business areas of growth, and ultimately to accelerate the strategy, which I'm very convicted which will result in a long-term sustainable, profitable growth.

And I want you to take away that this work is being done with sense of urgency. Whether we are the first to announce it than other people doesn't matter, we believe that this is the right thing to do, and the time is important.

So, again, thank you for joining the call today. And I hope you stay safe with you and your family. And we'll talk soon. Take care.

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