Hewlett Packard Enterprise Company

Second Quarter Fiscal 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Antonio Neri - *President, Chief Executive Officer*

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

Andrew Simanek - *Vice President, Investor Relations*

PRESENTATION

Operator
Good day, and welcome to the Second Quarter Fiscal 2022 Hewlett Packard Enterprise Earnings Conference Call. My name is Chuck, and I'll be your conference moderator for today's call. At this time, all participants will be in a listen-only mode. We will be facilitating a 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 call 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, Vice President of Investor Relations. Please proceed, sir.

Andrew Simanek
Great, thank you. Good afternoon, everyone. I'm Andy Simanek, Head of Investor Relations for Hewlett Packard Enterprise. I'd like to welcome you to our fiscal 2022 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 and Form 10-Q. HPE assumes no obligation and does not intend to update any such forward-looking statements.

We also note that the financial information discussed on this call reflects estimates based on information available at this time, and could differ materially from the amounts ultimately reported in HPE's quarterly report on Form 10-Q for the fiscal quarter ended April 30th, 2022.

Also, for financial information that has been expressed on a non-GAAP basis, we have provided reconciliations to the comparable GAAP information on our website. Please refer to the tables and slide presentation accompanying today's earnings release on our website for details. Throughout this conference call, all revenue growth rates, unless noted otherwise, are presented on a year-over-year basis and adjusted to exclude the impact of currency.

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

With that, let me turn it over to Antonio.

Antonio Neri
Well, thank you, Andy and good afternoon, everyone. Thanks for joining today's earnings call. HPE's second quarter results reflect significant customer traction for our differentiated portfolio and underscore our progress in becoming the edge-to-cloud company. The macroeconomic environment of the last few months has presented enterprises around the world with strategic challenges that are usually not confronted all at once. The market shifts have certainly created a dynamic backdrop for our global customers and have made it harder for them to realize their goals in the short-term. But more than ever, organizations need technology partners to help them weather challenges, while successfully digitizing and transforming their businesses in order to increase their market competitiveness.

HPE's ability to address these customer needs was key to our performance in the second quarter. Once again, HPE generated significant orders growth, steady revenue, and sustained profitability, even as tight supply conditions continued across global industries. We are seeing persistent demand from our customers, underscoring both their IT spending prioritization and their attraction to our compelling portfolio. Very strong customer demand in the second quarter drove orders growth higher, rising 20% year-over-year, which makes this the fourth quarter in a row that HP has logged year-over-year orders growth of 20% or better.

Our HPE GreenLake edge-to-cloud platform contributed to as-a-service orders doubling year-over-year, the third straight quarter of triple-digit growth. We continue to see a great deal of customer interest in our platform, which is evident in our sales pipeline.

Our orders backlog across the business is high quality and we are now…and we are seeing particular strength in our intelligent edge and compute segments, with orders climbing 45% and 23%, respectively. HPC and AI orders grew more than 18%, bringing backlog there to an impressive record of approximately $3 billion.

Total HPE revenue rose 1.5% year-over-year to $6.7 billion against a record breaking backlog of orders in the midst of industry supply constraints. ARR climbed 25%.

We have momentum across the portfolio with our as-a-service model differentiating us. This quarter, though, through a combination of supply constraints, limiting our ability to fulfill orders, as well as some areas where we could have executed better, we did not fully translate the strong customer orders into higher revenue growth. I am confident that we have identified where we can strengthen and expect continued improvement as we move into the back half of the year.

Importantly, the quarter's biggest standout, even if we were somewhat limited by supply chain, is that we maintained non-GAAP gross margins of 34%, thanks to disciplined execution and timely pricing actions. Non-GAAP diluted net earnings per share was $0.44, which together with our Q1 results, makes the first half of 2022, the second strongest EPS half year performance at HPE on a continuing operations basis.

As Tarek will detail for you, we are reaffirming our full year outlook of revenue growth of 3% to 4% and our long-term 2024 revenue CAGR outlook. We are also reaffirming our full fiscal year free cash flow guidance of $1.8 billion to $2 billion.

As announced in February, we suspended all shipments to and sales in Russia and Belarus. We have now determined that it's no longer tenable for us to maintain operations in these countries. Therefore, today, we are announcing the closing of our operations in both countries, and we'll proceed with an orderly managed exit. Our business in these countries represents less than 2% of HPE's total revenue in fiscal year 2021.

We have booked a $126 million pre-tax charge related to the impact of Russia to our business, which is included in our second quarter GAAP earnings per share results. We expect less significant additional charges in the third quarter related to winding down these operations, partially to reflect this necessary action and partially to unfavorable foreign exchange movement, we are updating our full fiscal year non-GAAP diluted net earnings per share to between $1.96 to $2.10, which is the guidance we provided at our Securities Analyst Meeting last October.

In the short term, we recognize the supply and logistics constraints, rising inflation and evolving economic and geopolitical conditions are all contributing to a dynamic environment. However, enterprise demand continues to persist across our entire portfolio. We are focused on translating the demand we see in the market and a high-quality backlog into profitable growth, while continuing to closely manage our inventory position. When even the supply of low-value components can be hard to secure in today's environment, we will continue to be disciplined and prudent in our decision-making to deliver on our commitments.

As we look to the future, we are strengthening the scale and resilience of our supply chain, including opening a new factory in the Czech Republic for next generation HPC and AI technologies, which will help us address the very solid demand we have for these specialized solutions.

There is no question that we have positioned HPE well to help our customers double down on digital transformation. HPE GreenLake is at the center of our strategy to deliver edge-to-cloud solutions to enable customer's data first modernization strategies. I hope many of you will join us later this month to see firsthand how our strategy comes to life when we host HPE Discover live in Las Vegas for the first time in three years. We will have a lot to show you as it has been an exciting few months for our customers and for HPE.

In March, we announced features on HPE GreenLake that deliver greater choice and simplicity. We added 12 new cloud native services with now more than a total of 50 cloud native services available through the platform. We also continue to expand our partner ecosystem, increasing the number of partners actively selling HPE GreenLake this quarter by more than 50% from the same period last year. In addition, partners who sold multiple HPE GreenLake deals in the quarter increased by 2.5 times year-over-year.

At the edge, our capabilities are in high demand as organizations need to securely connect distributed workforces and create engaging experiences. We are focused on delivering cloud-native services that can more easily be embed into an automated network to absorb evolving networking configurations. And with the convergence of Aruba Central and HPE GreenLake, more than 120,000 Aruba customers now have access to the HPE GreenLake platform.

As customers adopt hybrid multi class solutions, we know they also need a secure and flexible on-premises cloud solution. We were recently selected as the prime provider for Google's Distributed Cloud Hosted solution. HPE GreenLake will enable Google to deliver an on-premises cloud experience for organizations with strict data residency, security, and privacy requirements.

Our hybrid cloud offerings have attracted nearly 150 new customers in Q2, including BMW Group, who is using HPE GreenLake to streamline and unify the company's data management across its global locations in the cloud and Worldline, the world's fourth largest payment provider who chose HPE GreenLake to implement their major performance upgrade to its payment platform as it continues to deliver against a cashless economy vision. HPE Financial Services had a unique hand in the Worldline upgrade to HPE GreenLake, with our asset renewal program funding approximately 25% of the refresh.

From a data perspective, we continue to make meaningful enhancement that allow customers to extract more insights from their data to accelerate business outcomes. For instance, we are creating sophisticated AI models to generate and share insights in distributed environments.

In April, we introduced HPE Swarm Learning, which enables users to share learning's through an AI model at the edge and from distinct sites without compromising data privacy. One University in Germany is already using HPE Swarm Learning to more accurately diagnose colon cancer by applying AI learning's that can predict cancerous genetic alterations.

And early this week, Frontier, an HPE designed and built system became the world's first and the fastest exascale supercomputer, taking the number one ranking on the world's top 500 list of supercomputers, exceeding the one exaflop performance threshold for the first time. To put this in perspective, this performance is three time faster than the number two supercomputer. HPE has deployed four of the top 10 supercomputers and ranked first, second, third and fourth, on the Green 500 list of the most energy-efficient supercomputers in the world.

Our as-a-service pivot is also innovative in the way it helps our customers meet their sustainability goals. HPE Greenlake helps customers reduce their carbon footprint by more than 30% versus traditional IT models. Later this month, when we release our living progress report, we will share more about our efforts to support our customers' goals, while pushing ourselves in the industry to improve our own.

Few of us could have predicted that the challenges of the last several years would require enterprises to adopt so dramatically. I spend at least 50% of my time with customers around the world and I can tell you that when they think about how they are going to re-imagine their futures, they see HPE as an even more relevant and essential partner than ever before.

As I reflect on Q2, and look ahead to the future, I am confident in our ability to deliver on our commitments. We have the right strategy to capitalize on market trends with an expansive edge-to-cloud portfolio that's connected through our market-leading HPE GreenLake platform. We have significant momentum with our customers. And perhaps most importantly, we have a truly stellar team. I am proud of the 60,000 team members who make our results possible, and who help us deliver on our purpose as a company. This team will continue to innovate and execute in ways that will further set us apart and continue to create value for our shareholders.

With that, let me turn it over to Tarek to walk you through the details of our business segment results and overall performance.

Tarek Robbiati
Thank you very much, Antonio. I'll start with a summary of our financial results for the second quarter of fiscal year 2022. As usual, I'll be referencing the slides from our earnings presentation to guide you through our performance. Antonio discussed the key highlights on slide one and two. So now, let me discuss our Q2 performance details, starting with slide three.

We continue to see robust demand across our differentiated edge-to-cloud portfolio with order growth up 20% year-over-year, the same as last quarter. This marks our fourth quarter in a row with order growth of 20% or better year-over-year. This maintains our confidence in achieving both our fiscal year 2022 revenue outlook of 3% to 4% growth adjusted for currency and our longer term 2% to 4% revenue CAGR outlook provided at our 2021 Securities Analyst Meeting.

We delivered Q2 revenues of $6.7 billion, up 1.5% year-over-year, and in line with our outlook of normal sequential seasonality, despite a more challenging supply environment that limited upside. The unexpected COVID-related shutdowns in China and ceasing the support of Russia services contracts impacted our revenue by more than $250 million in the quarter, our total operating margins by more than one point and EPS by approximately $0.06. Given the delta between our order and revenue growth rates, our backlog further increased to new record levels and yet remains very high quality. The order book is firm and most importantly, has been priced to preserve gross margins.

We are particularly pleased with the resiliency of our non-GAAP gross margins despite the inflationary environment and ongoing supply chain disruptions that are driving up material and logistics costs. We delivered non-GAAP gross margin of 34.2%, up 30 basis points sequentially and down just 10 basis points year-over-year, driven primarily by strong pricing discipline and our continued mix shift towards higher margin software-rich offerings.

Non-GAAP operating margins were 9.3%, reflecting the revenue impact from incremental supply constraints and our exit from Russia that reduced operating leverage. We expect operating margins to expand in the short term as we drive more leverage from revenue growth and benefit from investments in the high growth, margin rich areas of our portfolio.

Within other income and expense, we benefited from robust operational performance in H3C and further gains related to increased valuations in our pathfinder investment portfolio. As a result, we now expect non-GAAP other income and expense for fiscal year 2022 to be an income of approximately $75 million versus prior guidance of an approximately $25 million income.

Given our strength in gross margin and despite the approximately $0.06 impact from China and Russia, we delivered non-GAAP diluted net earnings per share of $0.44, near the midpoint of our outlook range of $0.41 to $0.49 for Q2. We also delivered GAAP earnings per share of $0.19, this includes $126 million of disaster charges related to Russia, primarily consisting of an increased reserve for financing lease assets. With the decision to orderly exit Russia that we have announced today, we expect to record an additional and less significant GAAP-only charge in Q3 that has been factored into our updated outlook already.

As previously indicated, we expected free cash flow to be in line with our normal seasonality that is a use of cash in the first half and Q2 was a use of cash of $211 million. We have made significant investments in working capital during the first half, reflecting our strategic inventory actions to navigate the current supply environment. This will better position us to convert orders into future revenue and cash flow, while working capital is expected to become a tailwind in the second half.

Finally, we continue to return substantial capital to our shareholders. We paid $156 million of dividends in the current quarter and are declaring a Q2 dividend today of $0.12 per share payable in July. We also repurchased $58 million in shares, bringing our year-to-date total capital returns to $498 million, reflecting our confidence in future cash flow generation.

Slide four highlights key metrics of our growing as-a-service business. We continue to see very strong momentum across our as-a-service portfolio, where we introduced 12 new cloud services this quarter and converged Aruba Central with the HPE GreenLake platform to create a unified operational experience for all users. Total as-a-service orders were up 107% year-over-year, marking the third quarter in a row with orders more than doubling.

Our ARR was up 25% year-over-year to $829 million, with supply constraints continuing to limit some installations. While our ARR growth is somewhat volatile in the current supply environment, the strong order growth over the last several quarters is the best indicator of the long term health of this business. This gives us confidence in delivering our 35% to 45% CAGR target from fiscal year 2021 to fiscal year 2024 with increasing margins as our mix of both software and services continues to increase to 64% in Q2, up more than 5 points year-over-year with our expanding cloud and SaaS offerings.

Let's now turn to our segment highlights on slide five. Our growth businesses continue to show improving top line momentum and record levels of backlog fueled by strong demand. In the Intelligent Edge, demand for our secure connectivity solutions accelerated with orders growing 45% year-over-year, the fifth consecutive quarter with growth of more than 35%. Despite increased supply disruptions in China, revenue grew 9% year-over-year, outperforming the competition and demonstrating particular strength in Silver Peak and our Edge-as-a-Service offerings, both up strong double-digits.

We delivered operating margins of 12.6%, reflecting higher component and logistics costs, resulting in lower operating leverage. We expect margins to improve next quarter with higher levels of revenue that also benefit from previous price actions that are sticking.

In HPC and AI, demand remains robust with order growth of 18% year-over-year, driving our awarded contracts total to another record level of just under $3 billion. Revenue grew 5% year-over-year and was impacted by one large customer acceptance delay that impacted growth by more than 6 points and has now been delivered in Q3.

Importantly, our Q2 operating profit was impacted by the ramp in project costs for a couple of mega deals expected to close by the end of the year that will return operating margins to more in range with historical levels.

In Compute, order growth remained robust and was up over 20% year-over-year for the fourth consecutive quarter, while revenue growth was up 1%, reflecting a more difficult supply environment. We continue to be very focused on executing a dynamic pricing strategy that has been effective in managing the increased supply and logistics cost and gives us a very high-quality backlog. The results are showing up in our operating margin performance at 13.9%, up 270 basis points year-over-year and 10 basis points sequentially, well above our long-term target set at SAM 2021 of 11% to 13%.

Within storage, we achieved another record level of product backlog that is skewed towards our owned IP margin-rich products. Revenue was down 2%, reflecting supply constraints for our own IP products. As a result, we continue to have unfavorable revenue mix that pressured our margins this quarter. We expect both our revenue growth rates and margins to improve over the next few quarters as we work through our favorable backlog mix and steer more demand towards our new Alletra and Block Storage offerings.

With respect to Pointnext operational services, including storage services, orders again grew mid single-digits year-over-year as reported, similar to levels for total fiscal year 2021. As you know, this is very important for the long-term health of our most profitable business.

Within HPE Financial Services, volume increased 2% year-over-year with strong performance in GreenLake and revenue was flat. Our profitability continues to benefit from higher residual value realization as customers tend to extend the use of their systems in a supply constrained environment. Our operating margin was 12.6%, up 180 basis points from the prior year, and our return on equity at 20.4% remains well above the 18% plus target set at SAM 2021.

Slide six highlights our revenue and EPS performance where you can see we've maintained relatively constant levels from last year despite incremental supply constraints, in particular, from the China shutdowns and also ceasing to support services contracts in Russia. As a reminder, this combines for more than a $250 million impact to revenue and a one-point impact to total operating margins and an approximately $0.06 impact to EPS in Q2. In spite of these headwinds, we delivered a better quality of earnings across our portfolio as we continue to execute our edge-to-cloud strategy.

The improved quality of earnings can be seen on slide seven, where we delivered non-GAAP gross margins in Q2 of 34.2% showing their resilience in spite of the increased component and logistics costs. This was driven by both our strategic pricing actions and the favorable mix shift we've been driving towards edge and our as-a-service business.

Moving to slide eight, you can see our non-GAAP operating margin this quarter of 9.3%, reflecting the reduced operating leverage from supply challenges and our exit from Russia. However, we are achieving much better efficiency in our sales and opex investments when measuring productivity on an orders basis. Given our high-quality backlog, we are also continuing to invest more in both R&D and our go-to-market for future growth.

On slide nine, let's spend some time reminding everyone about our unique setup in China through H3C. As disclosed in an 8-K in late April, we have extended our existing put option that is struck at 15 times trailing twelve months earnings through to October 31st, 2022. We did this to enable the new investors at the Unigroup level to complete their restructuring, which is proceeding as planned before determining a longer-term path forward for our stake.

We value our presence in China, the second largest and fastest growing IT market, although we will balance prior to execution of any extension, the strategic and financial benefits of a continuous involvement in China with rising risks, including geopolitical risk. H3C makes up a significant portion of our P&L and cash flow and you can see that we are generating growing value to shareholders with our unique setup. Our equity interest rose 21% in fiscal year 2021 and has grown 32% in this Q2 of fiscal year 2022. We will keep you up to-date as we arrive at a longer-term solution for this valuable asset.

Turning to slide 10, our free cash flow was a use of cash of $211 million. This is aligned to our normal pre-pandemic seasonality with the first half being a use of cash followed by strong generation of free cash flow in the second half. The first half of this year has also been uniquely impacted by the supply chain environment as we strategically built inventory levels in Q1 that were flat in Q2.

We are taking further strategic actions to improve supply chain visibility and attain operational and financial benefits. This will put us in a better position to begin converting orders and generate healthy amounts of cash as working capital will turn into a tailwind in the back half of the year. We will need to demonstrate strong execution in the second half, but we have a path forward and expect to deliver fiscal year 2022 free cash flow of $1.8 (billion) to $2 billion.

Now, turning to our outlook on slide 11. We are revising our fiscal year 2022 non-GAAP outlook range back to our original outlook provided at SAM of $1.96 to $2.10. This reflects the impacts of more unfavorable currency movements since last October, the exit of the business in Russia, the COVID-related disruptions in China to this date, offset by the other income and expense benefit we've received in the first half.

From a top line perspective, we are very pleased with the continued strength in orders and growing backlog that gives us confidence in future revenue growth in fiscal year 2022 and beyond. We do want to remain prudent in the short term, given the ongoing supply challenges that we believe will likely last well into next year.

Currency is also expected to now be a two-point headwind to revenue for the full year as opposed to the 50 basis points at the start of our fiscal year. As a result, we still have strong confidence in our fiscal year 2022 revenue growth outlook of 3% to 4% adjusted for currency and expect to end the year with elevated levels of backlog, which bodes well for fiscal year 2023. More specifically, for Q3, 2022, we expect revenue to be up low single-digits sequentially. This is slightly below our normal seasonality to reflect our expectations that the China shutdowns will have a lingering impact in the short term. As a result, for Q3, 2022, we expect GAAP diluted net EPS of $0.22 to $0.32 and non-GAAP diluted net EPS of $0.44 to $0.54.

So overall, I'm pleased with how we are executing in a strong demand but challenging supply environment during the first half of fiscal year 2022. With our high-quality backlog, we are very well positioned to capitalize on the ongoing edge-to-cloud opportunity and deliver against all of our financial commitments set at SAM 2021.

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

QUESTION AND ANSWER

Operator
We will now begin the question-and-answer session. To ask a question, you may press "*" then "1" on your touchtone phone, if you are using a speakerphone, please pick up your handset before pressing the keys, and to withdraw your question, please press "*" then "2." We also request that you only ask one question. We will pause momentarily while we assemble our roster.

And the first question will come from Aaron Rakers with Wells Fargo. Please go ahead.

Andrew Simanek
Aaron are you there?

Aaron Rakers
Yes, I am. Sorry about that, guys. Can you hear me?

Andrew Simanek
Yes, we can, Aaron.

Antonio Neri
We can.

Aaron Rakers
Yes. Sorry about that. So, I'll start with just the question on the backlog. As you thought about the guidance for the full year and obviously, some moving parts around FX and China, et cetera, but how has your assumptions changed at all with regard to the backlog build? Are you assuming any kind of backlog reduction through the course of this fiscal year, and if not, what's your current views on peaking levels of backlog at this point? Thank you.

Tarek Robbiati
Yes. Good afternoon, Aaron. Thank you for the question. With regard to our backlog, I would say our backlog has not peaked yet. When you have four consecutive quarters of 20% growth and the delta between the order growth and the revenue being what it is, the backlog has not peaked and will probably peak toward the end of this fiscal year. Our assumptions on converting that backlog into revenue are contained in the guidance that we gave for this fiscal year of 3% to 4% revenue growth adjusted for currency. I want to reiterate to you that the FX impact in that guidance is a 2% headwind as opposed to a 50 basis point headwind that we originally forecast.

Antonio Neri
I would say, Aaron, obviously, we're going to enter 2023 with an elevated backlog, which bodes well for the future revenue growth of the company. As I said in my remarks, we continue to be very confident in our CAGR outlook that we provided at SAM for the next three years. But obviously, as we go forward, the backlog will be reduced as supply and other issues alleviate. And if you think about the 3% to 4% guidance for the year, which is the guidance we provide at SAM versus the 1.5% we just reported, obviously, there will be low single digit growth sequentially on that revenue.

Aaron Rakers
Thank you.

Andrew Simanek
Great. Thanks for the question, Aaron. Chuck, can we go to the next one, please?

Operator
Yes, sir. The next question will come from Simon Leopold with Raymond James. Please go ahead.

Simon Leopold
Thanks for taking the question. I wanted to see if you could help me get a little bit better insight into what allowed you to basically do better on gross margin than we expected given the input costs and the foreign exchange. What I'm looking for in this question is an understanding of how much of this is about mix? How much of it is about your ability to raise prices and pass that on to customers? And how are you thinking about the outlook for the gross margin given what you've done so far in terms of price increases and what you're thinking about on foreign exchange? Thank you.

Tarek Robbiati
Sure. So let me try and unpack this for you. So first of all, when you really look at our business across the various segments, Aruba is continuing to do extremely well and we outperformed the competition, specifically Cisco in the second quarter. And the order book in Aruba is absolutely substantial. As you can observe, Aruba growth…and you know Aruba comes with higher gross margin, has a favorable impact on the mix.

The second thing I would point out to you is with respect to Compute. The disciplined pricing actions that we've taken now for several quarters with Compute continue to bear fruit. Compute operating profit margins at well above 13%, well above our long-term guidance, have also been better than what our main competitor in that space, Dell, has delivered for their total ISG margins that include Compute, Storage, and Networking. So, Compute is performing much, much better than the rest of the industry.

Third, when you relook at the gross margin mix again across the other segments, particularly Storage and HPC, there are two different stories there. With respect to Storage, you have a mix between our own IP product and third-party product that has been unfavorable to us, meaning that there were more third-party product revenues than own IP revenue. And you can see, therefore, that this has had a detrimental impact to gross margins for Storage.

Finally, HPC, the story there is a story that is what we've always been saying, it's a lumpy business, and it's a matter of revenue scale. We had one slippage of a deal that has affected growth by six points in the quarter. That deal has closed into Q3. And really, the fundamental question for HPC is the delivery of substantial mega deals that we have planned for the second half.

And so, if you take all of this into account and you look at overall gross margins for the company, the story is different by segments. But it is the result of a number of actions that we have taken in Aruba and in Compute, offset by product mix shift in Storage and revenue delays in HPC. On the whole, very pleased to have our gross margins where they are at 34.2%, up sequentially and better than last year.

And finally, let me add to this, the performance of HPEFS. The performance of HPEFS is outstanding. You can see that while there is not much revenue growth, and this is not a gross margin business, it's a business that delivers substantial amounts of profit by way of operating profit margins. And the return on equity there in HPEFS is very, very strong, north of 20%, which is better than our long-term outlook of 18-plus percent that we gave you at SAM 2021. So, I hope this gave you color and I got back things f or you the way you want it, Simon. But if not, we're welcome to take the conversation offline with you again.

Simon Leopold
Thank you. I'll hop offline.

Andrew Simanek
Thanks, Simon. Appreciate it. Operator, can we have the next one, please?

Operator
The next question will come from Samik Chatterjee with JP Morgan. Please go ahead.

Samik Chatterjee
Hi. Thanks for taking my question. I guess I just wanted to ask more on the demand side here and you had another quarter of strong orders, maybe if you can give us a bit more color on what you're seeing on a geographic basis, particularly, I think investors have been concerned about the momentum in enterprise in Europe and ex-Russia, if you can give any color on what you're seeing in that region? And also, I don't know if you sort of pointed out what the order…impact on the order number was from the Russia exit as well? Thank you.

Antonio Neri
Yes. Thank you. Thank you for the question. As I said in my remarks, we continue to see ongoing persistent demand from our customers. I think it's a combination of them prioritizing IT spend. And honestly, their attraction to our portfolio. We have a very comprehensive portfolio from edge-to-cloud that is resonating in the market. And Tarek just talked a little bit about the strength of the Edge, which grew now in excess of 40% for four consecutive quarters. That's simply remarkable. And yet, we just delivered 9% revenue growth. So that tells you the strength of the demand. As you think about this distributor enterprise, there isn't just new ways to work. I think the other area, obviously, as customers continue to assess their hybrid multi-cloud journeys, which is now here to stay, they see HPE GreenLake as a very solid alternative to what I call flexibility, choice and control. And the fact that one of the major clouds is leveraging HPE GreenLake to basically deliver their managed hosted distributor cloud, is a testament of that differentiation.

The other thing, obviously, anything related to data is simply very strong. I think the demand for big data, analytics, AI, machine learning will continue to grow. And that's because customers need to extract insights from the data, which I think is the most valuable thing they have. Obviously, cybersecurity, Aruba with our SD-WAN and our SASE approach also provides an alternative to that. So, I think as I look forward, I personally believe and being at the World Economic Forum for the last week and listening, I think the potential slowdown is more a consumer issue more than an enterprise issue. And the reason why I said that is because every customer we talked to, they are prioritizing digitizing their businesses, modernizing their businesses, deploying cloud as an experience in this multi-cloud approach because it's all about speed and agility, and obviously, as I said before, extract every bit of insight from the data. And that's our strategy against the trends we see with HPE GreenLake, which is a data first modernization approach.

Our demand is super strong, 20%, four consecutive quarters for HPE, it's pretty remarkable and our order backlog, as we said early on, is high quality, which means the order book is firm. We don't see any major cancellation that will concern us at all. And last but not least, to Tarek's point, we priced the backlog to preserve gross margins. And that's what gives us the confidence not only to grow revenue but continue to deliver our operating margin commitments and ultimately EPS commitments. The impact of Russia and Belarus, because you have to combine these two, is less than 2% of the revenue on a continuous basis. If you look at 2021, in terms of EPS, Tarek explained it and unpacked it for you, which we were able to kind of offset in many ways with the over performance in Q1.

So, Tarek, any comments you want to say?

Tarek Robbiati
Yes. So let me add on the last part of your question. So, the impact from Russia on orders was negligible. This was not something that has affected our orders. China and Russia together,

obviously, with Belarus, impacted our revenue by $250 million, the majority of that impact relates to China. And the Russia impact specifically is related to the fact that we cannot operate any more in the country and serve existing customers with our services contracts, and therefore, this has been factored into the impact. I've described the totals for China and Russia, 1% impact on total operating profit margins and $0.06 on EPS overall. But again, the majority of these impacts were driven by the China disruptions on the supply side of the equation. And yes, I agree with Antonio on the...totally agree on the resiliency of the demand. I simply want to add the fact that even though there could be a slowdown in the EU, the European governments are ramping up a number of initiatives that are all in our favor in the digital space, which gives us confidence for the medium to long-term.

Antonio Neri
And I will say our diversification of our coverage around the globe also is a good positive thing for us.

Andrew Simanek
Great. Thanks for that, Samik. Can we get the next one, please?

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

Wamsi Mohan
Yes. Thank you. I hear your comments about the confidence around the demand trajectory and that orders continue to be very strong. But as you look into the second half, can you talk about how those demand trends are breaking out across regions, if you're seeing any variability from 90 days ago? And you also maintained your free cash flow guide, but EPS, you alluded to some of these impacts, the $0.06 that you alluded to, Tarek, but you're maintaining your free cash flow. What are some of the offsets that are allowing you to do that? And when you look at the second half free cash flow that needs to come in extremely strong. So, can you talk about what levers we should expect within those free cash flow moving pieces that gets you to your guide across the second half? Thank you.

Antonio Neri
Yes. Let me start and I would like Tarek to talk about the free cash flow, Wamsi. Listen, so far, and I can only talk so far, I have not seen any major deviation from 90 days ago, and demand continued to be very strong. And that's why we use the word persistent. Persistent meaning is there. And then I think it depends on what happens here in the back half of the year with some of the other policies, Tarek mentioned some of them in Europe. But obviously, as we think about inflation, interest rates and whatnot, that may or may not have an impact. But as I said earlier, Wamsi, I think it's mostly on the consumer side than the enterprise side. If anything, I will argue, it will have a positive impact to our GreenLake because customers want to maybe preserve some CAPEX and then would use more of the as-a-service model.

And still, deal with the reality that this is a hybrid multi-cloud journey, and therefore, for those workloads and data that cannot move outside their premises or a colocation or even moving from the edge for that matter, GreenLake is perfectly suited for that. And that's why it's a combination of our solutions, now 50-plus cloud native services, the fact that Google is going to use our solution is a very strong endorsement. But I think we are positioned to capture either way. And I think our backlog gives us a very strong foundation to build from there as we look forward.

Tarek, you want to talk about the free cash flow question?

Tarek Robbiati
Yes. Sure. So first, Wamsi, if you want a rough rule of thumb when you're looking at EPS changes and how these EPS dollars translate or cents translates into free cash flow, every cent of EPS is essentially $13 (million) to $15 million. So when you look at the lowering of our guidance it's very much contained in the guidance we gave at the free cash flow level. So the lowering of our guidance back to the SAM 2021 guide is very much contained in the free cash flow guide that we gave you. And the reason why we gave you this free cash flow guide was because of the working capital assumptions that we had made at the beginning of our fiscal year. So, I feel comfortable that we are within the free cash flow guide.

Now the second part of your question is what makes you confident that in the second half, you can generate this quantity of free cash flow given where you are at the end of the first half. I would simply say to you that we expect, first and foremost, working capital to become a tailwind in the second half as opposed to the first, where it was a headwind because of the inventory actions that we've taken. And by the way, we've done this before. In fiscal year '19, I want to remind everybody, we generated in the first half, $200 million of free cash flow and in the second half, we generated $2.2 billion. So 10 times more than what we generated in the first half. This was offset by $666 million that we had to pay for an arbitration case that we lost at the time in fiscal year 2019.And we had very little time to turn around and offset the impact of that arbitration case, and yet we came into our guide that we gave at the time.

And really look also at the trends on operating free cash flow that we highlighted to you as part of this call, you will observe that our seasonality is very much in line with fiscal year '19 and fiscal year '20. Fiscal year '21 was a different story because in fiscal year '21, you add the impact of restructuring costs that were affecting free cash flow. And if you will observe the detail of our press release with the tables that we provided you, you will see that our restructuring costs are coming down overall relative to fiscal year '21.So lots of puts and takes there, but we are happy to reaffirm the free cash flow guide of $1.8 (billion) to $2 billion.

Antonio Neri
This way, one thing for me to say is that we are exactly where we were at the October securities analyst meeting, where we guided 3% to 4% revenue growth, the EPS guidance we just provided today, which is $1.96 to $2.10; and a free cash flow of $1.8 (billion) to $2 billion. And knowing the seasonality of our business, we said at the time this year will be a normal seasonality business as you take the two years of COVID out of the way, we are very confident to deliver that number. It's exactly what Tarek said, it's the working capital is going to turn favorable to us. And as we continue to drive the backlog down over time, that will help us as well. So, the earning correlation to the free cash flow is the same we provided at SAM.

And in terms of restructuring, just to be clear on that one, we are very pleased with the progress we've made, which obviously was there, we refer at the time reallocating resources to the areas of growth. You can see the areas of growth being HPC, AI, Edge, and GreenLake, obviously, which are paying off to us and on track to deliver the $800 million net savings that we committed at the time.

Andrew Simanek

Great. Thanks, Wamsi, for the question. Appreciate it. Can we go to the next one please, Chuck?

Operator
Yes. The next question will come from Rod Hall with Goldman Sachs. Please go ahead.

Rod Hall
Yes. Hi, guys. Thanks for the question. In the ongoing spirit of trying to make sense of an incredibly complicated supply situation, I wanted to come back and maybe juxtapose your performance here against a couple of other companies. So, if I look at Cisco, they, I would say, objectively performed quite a bit worse on supply than you guys did. You had some a middle of the road impact, not too bad of an impact from what I can tell in the numbers. And then if I look at Dell, they had almost no impact. Although Dell did call out some looking forward issues with server supply. So, I just wonder if you could dig into that a little bit for us and help us to understand some of the puts and takes around supply, maybe why those differences of performance emerged? And then I have a follow-up.

Antonio Neri
Sure. I'm going to start. But I don't think you can look quarter-by-quarter. Honestly, you have to look at the half and then the second half. If you look at our performance in Q1, we did very well. And on the balance, I think we are pleased with the first half. Listen, and then there is a lot of puts and takes here because factory locations plays a role. So sometimes, you're in the right side of the location, sometimes, you're not. And obviously, for us, the impact of Shenzhen and Shanghai was there in April, and Tarek quantified that for you. That impacted not just the compute business, but every line of business because other products come from that side. Some of our vendors did not have the same impact. So that's why it's important.

The other one is that you make strategic choices about components two to three years ago. And there are some suppliers more impacted than other ones. And therefore, you need to go into the details of the product itself and configurations and whatnot. And last but not least, when you look at our performance, let's remind ourselves, we have a unique setup in China. And that set up basically says we cannot consolidate the China revenue that our partner today delivers.

And when you look at the China growth, I can tell you, our H3C business is performing exceptionally well in China. However, the only thing we recognize on that is the dividend that we collect, but not the revenue. And then when you look at the segment, call it, the server category, it is Compute plus HPC plus H3C, as the way market share gets reported. So that's why I look at this from a half performance. We made it better in Q1, maybe a little bit less so in Q2. Against some of our competitors, namely Dell, as you said, on some aspects. But on a balance, not that far off, again, Cisco definitely did well on every metric you want to look at it. And...but in the end, we are focused on the full year to deliver that guidance of 3% to 4% and obviously exit the year with still quite a large backlog, which bodes well for 2023.

Tarek Robbiati
Yes. I want to add also, Rod, that in what you said, it's really important to look at what happens at the bottom line and at the margin level. And when you really look at how we've outperformed Dell on the margin level, Q1 and Q2, considering it simply the compute margins alone compared to the ISG margins it's very telling.

Antonio Neri

Yes. I think on that note, delivering 13.9% on what people refer as a commoditized business compared to 10.2%, which includes server, storage and networking, I think it's pretty remarkable. But I think it also shows our strategy to drive profitable revenue growth, not just revenue for the sake of revenue.

Rod Hall
Great. Okay, guys. So, I am going to leave it there. Thank you very much for the answers.

Andrew Simanek
Sure. Thanks, Rod. Next question, please?

Operator
The next question will come from Irvin Liu with Evercore ISI. Please go ahead.

Irvin Liu
Hi. Thank you for the question. So, the large delta between your orders growth and revenue trajectory suggests that there still remains a large amount of unfulfilled demand. Given this dynamic, do you envision a scenario where customers begin to perhaps re-architect their infrastructure so that a larger mix of their IT workloads whether that's compute, storage, networking, HPC are delivered via cloud native GreenLake as-a-service models?

Antonio Neri
That's a great question. We see that more and more. Obviously, I think what customers are battling is the fact they are going through a multigenerational IT journey here. That they have to modernize. The fact that data has gravity and obviously, some industries are more regulated than others. Then you talk about latency and experience that really matters. Cost, obviously, is another big component because at scale, they need to comprehend the cost aspect of it. And GreenLake is an amazing platform we have developed over the years to give them access, flexibility, and control against all the needs.

In a way, they are moving away from running IT to more innovating on IT and that's why this data-first modernization approach is so relevant. And that's why we already have more than $6 billion in the balance sheet related to the HPE GreenLake business, which again grew 107% in Q2. And obviously, those bookings eventually will unwind from the balance sheet and through the P&L. And the other important fact here that Tarek showed in one of his slides, is the fact that our mix of GreenLake is shifting every single quarter to more software and services, which obviously comes with a significant higher margin than just the hardware.

So that's why I think about the order momentum is super strong, the marquee type of customers across events is super strong. The fact that we keep adding capabilities, the mix is shifting. And that's totally accretive to our gross margin as we go forward. And this is one of the key moments of our company, transforming into a relevant platform that customers can use as they go through this journey that we just...that you just highlighted.

Andrew Simanek
Great. Thanks, Irvin, for the question. Operator let's go to the last one, please.

Operator
Our last question will come from Kyle McNealy with Jefferies. Please go ahead.

Kyle McNealy
Hi. Thanks very much for the question. Can you give us a sense for the deferred revenue position in HPC and AI with the business you already have lined up and scheduled to deliver? You obviously already have one that was reached acceptance in Q3 already. And maybe give us a sense for the operating margin level that, that revenue is expected to come in at. Do you expect, given the project costs at times are taking in advance of revenue recognition, how much catch-up profitability might you get? And what does the margin profile look like for a business that's expected for the back half of the year? Thanks.

Antonio Neri
Sure. Listen, I'm continuing to be incredibly bullish about this business. Supercomputing is necessary to advance AI and deep learning solutions to solve some of the biggest societal challenges and honestly, climate and other. As I think about the current situation we are in, we have almost $3 billion in backlog. A couple of quarters ago, we were talking about $2.5 billion and maybe a year, $1 (billion), $1.5 billion. So, we have been continuing to grow the momentum with customers. By the way, it's all over the world. If you look at the wins, including the number three supercomputer called Lumi, that's in Europe.

We also have supercomputers in France, in Germany and so forth. So, we are clearly the market leader there. However, this business is lumpy, as we said. From the time you book the order to time you recognize revenue, it can be several quarters. And the reason that's the case is because there are large installations and customers need to go through their own process to validate the workload. And over time, we're going to have a quarter, you're going to see a massive growth in revenue, which is not linear in many ways as many of those customer systems gets accepted. So...but in terms of margins, I will let Tarek comment on this. Obviously, you have to look at long-term, not just quarter by quarter because that's not how this business works.

Tarek Robbiati
Yes. That's right. You said it very well, Antonio. I'll add to the margin part of the question saying, our Q2 operating profit margin was affected by the ramp in project-related costs, and they were recognized ahead of revenue for a couple of very large mega deals that we're expecting to close by year end. And therefore, as a result of that, we expect operating margins to return to more in range with historical levels on this business, and we feel pretty good about these prospects.

Andrew Simanek
Great. Thanks, Kyle, for the last question. Antonio, I'll turn it over to you for some closing remarks.

CONCLUSION

Antonio Neri
Well, thanks, everyone. I know there's a lot going on, a lot of news today to cover, but I appreciate you making the time. Again, we walk away from this quarter feeling good about the momentum we have with the persistent demand that we see in the market with an amazing set of solutions that are attracting customers. A testament of that is 20%, again, bookings with a backlog that gives us the confidence to deliver on our commitments. And honestly, I'm optimistic about the future, about the opportunity to innovate for our customers and to deliver the value to our shareholders. So again, thanks for your time today. I know there will be follow-up calls after this call, and I appreciate you making the time.

Andrew Simanek
Thanks, everyone.

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