Hewlett Packard Enterprise

Second Quarter Fiscal 2023 Earnings Conference Call

Tuesday, May 30, 2023, 6:00 PM Eastern

CORPORATE PARTICIPANTS

Antonio Neri - *President*, *Chief Executive Officer*

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

Kirt Karros - *Senior Vice President, Treasurer and Investor Relations*

PRESENTATION

Operator
Good evening and welcome to the Second Quarter Fiscal 2023 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 is being recorded for replay purposes.

I would like to turn the conference over to your host for today's call, Mr. Kirt Karros, Senior Vice President, Treasurer and Investor Relations. Please proceed, sir.

Kirt Karros
Thank you, Chuck and good afternoon, good evening, everyone. I'm Kirt Karros, Senior Vice President, Treasurer and Investor Relations for Hewlett Packard Enterprise. I'd like to welcome you to our fiscal 2023 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 to Antonio, let me remind you that this call is being webcast. A replay of the webcast will be available shortly after the call concludes. We have posted the press release and the slide presentation accompanying the release on our HPE Investor Relations web page. Elements of the financial information referenced on the call are forward-looking and are based on our best view of the world and our businesses as we see them today. 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 the 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, 2023. For more detailed information, please see the disclaimers on the earnings materials related to forward-looking statements that involve risks, uncertainties and assumptions. Please refer to HPE's filings with the SEC for a discussion of these risks.

For financial information, we've 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 otherwise noted, are presented on a year-over-year basis and are adjusted to exclude the impact of currency. Finally, after Antonio provides his high-level remarks, Tarek will be referencing the slides and our earnings presentation throughout his prepared remarks.

With that, let me turn it over to you, Antonio.

Antonio Neri
Well, thanks, Kirt, and good afternoon. Thank you everyone for joining today. In the second quarter, HPE increased total revenues, drove larger contributions from recurring revenues and expanded overall profitability. I attribute this gain to two primary factors. First, our strategy to build our portfolio to higher growth, higher margin areas is working. And second, we are operating with strong discipline.

In a market that continues to be dynamic, we grew our revenue 9% year-over-year to $7 billion. Our annualized revenue run rate or ARR increased 38% year-over-year to $1.1 billion. We grew year-over-year revenue across our key segments except in Compute. With our Intelligent Edge and High Performance Computing and AI segments delivering particularly standout growth even though the potential in our HPC and AI segment was somewhat impacted by customer acceptance of certain large deals.

HPE achieved exceptional profitability in the second quarter, increasing our non-GAAP gross margins a full 200 basis points to 36.2%, a new record. Our deliberate portfolio mix shift strategy supported by our operating discipline helped us generate a non-GAAP operating margin of 11.5%, up 220 basis points from a year ago.

Non-GAAP diluted net earnings per share rose 18% year-over-year to $0.52 at the high end of our second quarter outlook. Free cash flow generated in the quarter was nearly $290 million, an increase of about $500 million from the prior year.

As a result of our second quarter performance and our expectations that profitability will increase this fiscal year, we are raising our full-year GAAP and non-GAAP diluted net earnings per share guidance. Tarek will share further details about our full-year updated guidance, including operating profit expectations later in our call.

Our portfolio diversification is a clear strength in winning the business of customers who are taking a data first approach to modernize their IT updates. The relevance of our strategy at the edge in hybrid cloud and in AI delivered through our HPE GreenLake edge-to-cloud platform, is enabling us to navigate the dynamic macroeconomic environment.

In the second quarter, we saw some decline in the health of macroeconomic conditions, causing unevenness in customer demand, particularly in general purpose Compute. We also see unevenness when comparing customer size, industry, or geography. European, Asian, and mid-sized company deals are holding up better than expected, while large enterprise businesses and customers in certain sectors such as financial services and manufacturing in North America have been more conservative with their spend.

In the last few months, sales cycles have elongated because customers are more reluctant to quickly commit to large projects or some will seek additional internal approvals at the time of the order. We continue to focus on our sales processes to accelerate closing deals wherever possible.

Our order book at the end of Q2 remains elevated at more than 1.5 times the size of normalized historical levels. In the area of high growth, Intelligent Edge, HPC and AI, and HPE GreenLake business, order books are especially large.

Before I provide some business highlights, I want to be sure you saw the announcement we made last Friday related to our relationship with H3C Technologies. After successfully closing negotiations, we announced that UNIS will purchase all our shares in H3C for $3.5 billion in cash, subject to certain required regulatory approvals and closing conditions.

Importantly, from the China market perspective, we are pleased that we have agreed to the terms of a new go-forward commercial agreement that we will enter with H3C. Tarek will share more in his remarks.

Our HPE GreenLake platform continues to power the growth of our software, infrastructure, and services, capturing more than $10 billion dollars in total contract value for the first time this quarter. HPE GreenLake also drove our ARR to $1.1 billion dollars in the second quarter – with an increasing portion coming from margin-rich software and services, which now is 66 percent of our total ARR mix.

Our as-a-service business continues to expand our opportunities pipeline, though orders this quarter dipped slightly 8 percent year-over-year. This was driven by a very tough comparison to fiscal Q2-2022, when orders more than doubled. We have had a great ramp with our HPE GreenLake for Private Cloud Enterprise offering, which advances customers' hybrid cloud environments with a consistent, intuitive cloud operating experience. Global engineering company Danfoss selected HPE GreenLake for Private Cloud Enterprise as part of an effort to transform its global IT strategy. With HPE GreenLake for Private Cloud Enterprise, the company evolved its IT to an agile, sprint-based environment that aligns the right workload on the right platform – all while significantly reducing their carbon footprint.

We continue to innovate on the HPE GreenLake edge-to-cloud platform. To complement our organic innovation, earlier this month we completed our acquisition of OpsRamp, whose hybrid digital operations management solutions have enhanced our HPE GreenLake platform by providing visibility, observability and control across multi-vendor and multi-cloud IT environments. We are already getting very positive feedback from customers and partners. With the integration of OpsRamp technology into HPE GreenLake in Q3, we entered a $39 billion dollar IT Operations Management market. HPE GreenLake is a performance driver across our portfolio, and we are seeing its value across our business segments. Let me provide a few segment highlights …

Intelligent Edge had a stand-out quarter. HPE Aruba Networking has exceeded our expectations in revenue and margin terms, in part because customers are adding more cloud software services to recently delivered infrastructure, which will add to recurring revenue in future quarters. This is the second consecutive quarter of more than $1 billion dollars in revenue in this segment, and the eleventh consecutive quarter of year-over-year revenue growth. We continue to drive innovation and expand our addressable market at the edge. Through our acquisition of cloud-security provider Axis Security, we have expanded our SASE – Secure Access Service Edge offering – and with the soon-to-close purchase of Athonet, we are doubling down on private 5G. The combination of Axis Security, Athonet, and our world-class HPE Aruba Networking intelligent edge capabilities, gives HPE one of the most comprehensive, connected edge portfolios in the market. We expect this business to continue to grow in the quarters ahead.

In our HPC & AI business, we saw a significant sequential increase in orders this quarter, with a noteworthy uptick across customer segments – from Fortune 500 companies, including a large cloud provider – to digital-native start-ups, looking for optimized AI supercomputing solutions. HPE is winning in AI because we deliver an end-to-end portfolio designed for the full spectrum of enterprise AI workloads and use cases – spanning large-scale model development, training and inferencing. Customers are attracted to HPE's market-leading supercomputing capabilities, differentiated interconnect IP, AI-specific software, and services expertise.

Since the start of the second quarter, we have won multiple large contracts totaling more than $800 million dollars from large cloud providers and enterprise customers that will develop, train and run AI models. Most of these contracts exceed $100 million dollars each. We expect this pipeline to continue to grow and anticipate these deals will generate significant revenue in later quarters.

For example, in Q2, HPE won an AI-focused deal with Crusoe Energy, a cloud provider pioneering infrastructure that taps into stranded energy – like wasted methane or trapped renewable energy – to power compute resources. Using HPE Cray supercomputers as its generative AI foundation, Crusoe will enable customers to train and run large-scale AI models in a sustainable way. Crusoe's mission is to align the future of computing with the future of the climate, and this deal enables a significant offering of a climate-aligned supercomputing service solution.

Just last week, the Top 500 supercomputer list was released, and HPE systems comprised more than one-third of the Top 100 most powerful systems in the world, including Frontier in the number one spot. In this latest evaluation, the performance of Frontier, the world's first exascale supercomputer jumped by another 8%.

In the quarter, we recognized a portion of the total revenue of our second exascale system called Aurora for Argonne National Laboratory. Aurora will develop a series of generative AI models to run on HPE Cray EX supercomputer, which includes HPE Slingshot, a proven Ethernet Interconnect that can scale to the system's more than 60,000 GPUs and more than 21,000 CPUs. Aurora is expected to deliver more than two exa-flops of peak compute performance. Argonne plans to open the generative AI models to the scientific community for a range of research, including an initial focus on accelerating drug discovery and cancer research.

AI is a significant profitable growth opportunity for HPE and our shareholders in a space where HPE has unique differentiation evident in the momentum of our business. In just few weeks, we will host our annual customer event HPE Discover, where we will make breakthrough announcements in HPE GreenLake, hybrid cloud and AI solutions that we anticipate will accelerate the demand for a differentiated portfolio. We hope many of you will join us in Las Vegas to see our strategy and diverse offerings come to life firsthand.

In our **Storage** segment, our pivot to IP-owned products continues to get traction in the market, shown by the impressive ramp up of HPE Alletra offerings. HPE Alletra revenue increased more than 100 percent year-over year. In April, we announced new storage services – HPE GreenLake for Block Storage and HPE GreenLake for File Storage. The new services leverage HPE Alletra storage to simplify data lifecycle management with intuitive cloud operations -- to store, manage, and protect customer data, wherever it resides. In the month between launch and the close of the quarter, customer orders for the solutions were strong.

For example, the Dallas Cowboys selected HPE GreenLake for Block Storage because they believe the simple management, efficient scale and high performance delivered by a new solution will add even more value to their IT operations that customer experience.

In Compute, our continued focus on pricing discipline has added to the segment's profit contribution. We continue to see some sluggishness from large accounts, many of which have placed large orders when industry supply was more constrained. As we look ahead, we are focused on unit growth in other segment of the market.

We are executing our strategy and delivering strong results, including year-over-year revenue growth, record gross margin, and expanded earnings. HPE's year-over-year revenue growth, earnings per share expansion, and consistent increase in ARR contribution over the last two plus years demonstrate the effectiveness of our strategy and shift in our portfolio to higher growth, higher margin areas, rich in software and services. Our strong operational discipline continues to drive operating leverage across the company.

I'm personally proud of the 60,000 team members whose commitment to bold thinking and innovation is helping our customers achieve their goals. Our customers are counting on HPE as a key partner to help them capture opportunities ahead from the edge to hybrid cloud to AI.

While the macroeconomic environment may introduce more uncertainty in the short-term, I am confident that our winning strategy, diverse portfolio, and continued innovation position us well to deliver for our customers and shareholders.

I now would like Tarek to provide business segment details and specifics about our progress. So, Tarek, over to you.

Tarek Robbiati
Thank you very much Antonio. I will start with a summary of our financial results for the second quarter of FY2023. As usual, I will reference slides from our earnings presentation to guide you through our performance.

Antonio discussed key highlights for Q2'23 on slide 4. Let me discuss our Q2 performance details starting with slide 5. I would characterize this quarter as solid overall, despite the uneven demand indicators across our portfolio particularly in Compute, with continued demand and outstanding performance in our Intelligent Edge business as a standout.

We are very pleased that we are successfully driving further diversification of our business mix towards our higher growth, higher margin portfolio of Intelligent Edge, HPC & AI, and HPE GreenLake solutions. During the quarter, net revenues grew 56% year-over year in Edge, 22% year-over-year in HPC & AI, and the HPE GreenLake ARR grew 38% year-over-year, all in constant currency. The pivot of our portfolio towards higher growth, higher margin markets is clearly visible in the expansion of gross margins and our strategy is working.

While we remain confident about our FY23 and beyond, we are also realistic. Demand through much of the past two years has been above trend as attested by our growing order book over the FY2020-2022 period throughout our business, including Compute which is very cyclical in nature. Demand shifted from FY22-end to uneven in Q1 and was even more uneven in Q2 across our portfolio. While Q2 revenue of $7.0 billion equates to healthy 4% year-over-year growth and 9% year-over-year growth in constant currency, revenues were below our prior guidance range of $7.1-$7.5 billion. Deal velocity has slowed, particularly in North America and in Compute and, to a lesser extent, in Storage. Deal cycles have elongated as customers, primarily our larger Compute customers, digest their investments of the past two years. This trend has been particularly pronounced for Compute in the manufacturing and financial services verticals in North America in part as a result of the loss of confidence in the banking sector. In addition, HPC & AI was affected by several customer acceptances that slipped out of Q2.

Despite this, we see several promising indicators. Demand in Q2 grew sequentially led by HPC & AI and our Intelligent Edge business Aruba. Aruba continues to grow revenues both on a year-over-year and sequential basis. Overall demand in Compute in the mid-market is stable, including direct enterprise and the channel. Our overall order book at the start of Q3 remains elevated at more than 1.5x normalized historical levels, and we expect the strong momentum in Intelligent Edge to continue. And finally, AI demand is solid and materializing in our pipeline and our order book with several very large deals.

We also continue to take action to strengthen the portfolio mix shift inorganically across our businesses. We have closed the acquisitions of Axis Security and OpsRamp and are already winning deals with these assets as part of the broader HPE. I am particularly proud that we have finalized an agreement with our partners at UNIS for the sale of our 49% stake through the exercise of our Put option for an amount of $3.5 billion. More on that later.

In recognition of the Compute weakness, we are adjusting our previously communicated guidance of 5-7% revenue growth to 4-6%, in constant currency. Nevertheless, the combination of our order book, ongoing strength and momentum in Edge and HPC & AI give us confidence that we will deliver solid FY23 revenue growth and we remain confident in the 2-4% revenue CAGR outlook over the FY22-25 period that we provided at our 2022 Securities Analyst Meeting in October. More on this later.

Our non-GAAP gross margins reached a high-water mark of 36.2%. This is up 200 basis points both year over year and sequentially. Our margin structure reflects the pivot of our business mix to higher margin, and software intensive recurring revenue. Our Intelligent Edge business Aruba was 19% of total revenue in Q2, up 580bps year-over-year, and with Q2 sequential revenue growth in Aruba at 15%, we expect Aruba to represent a larger proportion of the company’s gross and operating profits by the end of FY23.

As a result, our Q2’23 non-GAAP operating margin reached 11.5%. This is 220 basis points ahead of Q2’22 and down just 30 basis points from our record performance in Q1’23. In addition to the portfolio mix-shift towards high margin businesses, we remain focused on cost control and productivity. Antonio and I remain determined to maintain this focus and to grow revenues faster than opex over time.

Our Q2 margin strength drove GAAP diluted net EPS to $0.32 and non-GAAP diluted net EPS to $0.52 at the high end of our guidance range of $0.44-$0.52.

Our Q2 2023 FCF was positive $288 million, an improvement of nearly $500 million over Q2 2022 and $1.6 billion over Q1 2023. We will discuss cash flow in more detail later. We remain on track to generate between $1.9 and $2.1 billion in FCF in FY23. Finally, we are continuing to return substantial capital to our shareholders. We paid $155 million in dividends and repurchased $106 million in stock this quarter and are on track to buy back at least $500 million worth of shares in FY23. Our year-to-date total capital returns are $490 million, which reflects our confidence in future cash flow generation.

Moving on to slide 6, we are very pleased to announce our pivot to as-a-service revenue continues to show strong momentum as ARR surpassed $1.1 billion in Q2’23. The benefits of easing supply challenges are appearing in our results as ARR growth in constant currency accelerated from 25% in Q4’22 to 31% in Q1’23 and now 38% in Q2’23. Our Edge and Storage SaaS offerings are the fastest growth components of our as-as-Service portfolio.

Our as-a-service order decline of 8% in Q2’23 is a function of a tough compare to Q2’22, in which orders grew 107% on strength from several large deals. We are comfortable with our robust pipeline, which includes large enterprise AI wins we recently closed, and our current view of the sales funnel and reiterate our 3-year ARR target of a 35-45% CAGR from FY22 to FY25.

Most importantly, we continue to make our as-a-Service business more valuable with a growing mix of higher margin, software and services recurring revenue. In Q2 2023 our mix of software and services increased another 220-basis points year-over-year to 66% and we have attained a total TCV well in excess of $10bn.

Let's now turn to our segment highlights on the next slide. I would like to remind you that all revenue growth rates on this slide are in constant currency.

In the Intelligent Edge, we grew our revenues 56% year-over-year and exceeded the Rule of 40 for a second consecutive quarter. Most importantly, we grew revenues 15% sequentially and delivered record revenues for a fourth consecutive quarter. We are outgrowing our main competitors and are taking share in some of the largest enterprise customers who are increasingly adopting our software-centric solutions, such as Edge Connect SD-WAN software and our Aruba Central management platform. We have now closed our acquisition of Axis Security and are already generating SD-WAN and SASE wins in combination. Our acquisition of private 5G player Athonet is still pending but already contributing to our pipeline of business. Our operating margin of 26.9% was up more than 1400 basis points year-over-year and 500 basis points sequentially. We are benefiting from scale and a solid order book that continues to grow and as a result, we are optimistic about the prospects of our Intelligent Edge business in FY23 and beyond.

In HPC & AI, revenue grew 22% year-over-year. The emergence of Large Language Models and generative AI has prompted many inquiries from our customer base during the past quarter which are turning into pipeline and orders. In the past few months, we have multiple large enterprise AI wins totaling more than $800 million dollars. This includes large AI as-a-Service deals under the GreenLake model. We believe building and operating large AI models requires unique computational capabilities including silicon and software that our Cray supercomputers and HPC & AI solutions are extremely well positioned to enable. We expect AI demand to drive healthy revenue growth in the future and intend to invest organically and inorganically to fully grasp this opportunity as our acquisitions of Determined AI and Pachyderm attest. The early stage of the AI market, tightness in certain key components, and long lead times in this business means that operating margins in the business unit will continue to fluctuate.

Storage revenue grew 2% year-over-year. HPE Alletra revenue grew triple digits in Q2 for the fourth consecutive quarter lifting our total AFA growth to 20% year-over-year. HPE Alletra is driving a long-term mix shift to higher margin, software-intensive, as-a-service revenue. We will continue to invest in R&D for our owned-IP products in this business unit, such as our new File as-a-Service and Alletra MP offerings. Our Q2'23 operating margin of 7.9% is down 390 basis points year-over-year as we navigate uneven demand and migrate to our software-defined HPE Alletra which includes a significant component of SaaS ratable revenue.

Compute revenue was down 3% year-over-year to $2.8 billion and down 20% sequentially. The deal elongation and demand softness I discussed previously was most prevalent in the Compute business as our largest customers – particularly in manufacturing and financial services and in North America – digest the investments they have made in recent years. Our Compute operating margin of 15.2% exceeded our long-term outlook of 11-13% for the sixth consecutive quarter, which attests to the quality of our historical book of business. While we are seeing decreasing commodities costs leading to increased competitive price pressure, we are selling 3 differentiated platforms in the market: Gen10, Gen10+ and Gen 11 which should allow a gradual management of margins over time.

In HPE Services which is within our Compute, HPC-AI and Storage segments, and excluding HPE GreenLake, orders were down low-single digits and revenues were flat year-over year.

HPE Financial Services revenues rose 7% year-over-year and financing volume of $1.7 billion grew 17% in constant currency driven by HPE GreenLake. Our operating margins were down 280 basis points year-over-year reflecting rapid interest hikes and higher cost of funds that we will gradually offset over time through pricing. Time and time again, our business has proven resilient in a downturn thanks to the quality of the underwriting of the book of business. Throughout the pandemic, our annual loss ratio never exceeded 1%. Our Q2 loss ratio of 0.50% was below full year 2019, or pre-pandemic levels.

Slide 8 highlights our revenue and non-GAAP diluted net EPS performance. We are very pleased that the progress we are making against our edge-to-cloud strategy is evident in the financial results we have delivered on both the top and bottom lines. We have again grown both our revenue and non-GAAP diluted net EPS in Q2'23 year-over-year despite our transition towards a recurring revenue model, an uneven spending environment and FX rates remaining a significant headwind that impacted revenue growth by 480 basis points in Q2'23.

Slide 9 illustrates the progress we have made in our gross margin structure. Our Q2'23 non-GAAP gross margin is up 200 basis points year-over-year. Our growing gross profit and margin are a testament to the success of our strategic pivot of our portfolio and the pricing actions we have taken. With 56% year-on-year growth in constant currency our Intelligent Edge business was a standout and is now representing 19% of total sales in Q2'23, up 580 basis points from a year ago...

Slide 10 illustrates our non-GAAP operating margin progress, which reached 11.5% in Q2'23. This is up 220 basis points year-over-year. It also represents a high-water mark for non-GAAP operating margin for a Q2 in any year.

Again, our deliberate portfolio mix shift, pricing strategies and productivity focus are the primary drivers of our operating margin expansion. The Intelligent Edge business not only represented 19% of revenue in the quarter but did so with a record 26.9% operating margin.

As you know, we have chosen to exercise our put option on our shares in H3C. We are pleased to have announced earlier that we and our partner Unisplendour have come to an agreement and signed a Put Share Purchase Agreement that values our 49% stake in H3C at $3.5 billion USD.

The next step in the process is to obtain the necessary regulatory approvals and to complete certain conditions necessary for closing. We anticipate that the process to close will require a further 6-12 months to complete, however this timeline could be further extended pursuant to the terms of our agreement.

We intend to update our plans for the use of proceeds once the transaction closes. You can assume that we will use the same disciplined, returns-based framework for evaluating investments, capital returns and maintaining an investment grade credit-rating we have outlined in the past. As part of this framework, we may consider a range of allocation activities, including but not limited to both organic and strategic investments, return of capital to shareholders, repayment and/or redemption of outstanding debt, and general corporate purposes.

We have also negotiated the terms of a new go-forward Strategic Sales Agreement to be entered into with H3C that covers the commercial sales, service and reseller arrangements between the companies. We are firmly committed to serving our customers and to continuing to do business in China through both direct sales and our partner H3C.

Finally, as you see on this slide, we are continuing to benefit from H3C dividends in FY23 and will provide a more detailed update at SAM in October 2023 as to our go-forward expectations in this area.

In Q2'23, we are pleased to have generated a positive $889 million in cash flow from operations and $288 million in free cash flow. Our free cash flow improved by $1.6 billion sequentially from a seasonally low Q1'23 and was also nearly $500 million above our Q2'22 free cash flow. We expect to generate significant free cash flow in the remainder of FY23 and reiterate our guidance of $1.9 to $2.1 billion in free cash flow in FY23.

Net income was the primary driver of our positive free cash flow. Working capital continued to be a use of cash in the quarter. The timing of receipts and payments plus continued inventory investments have lifted our Cash Conversion Cycle to a positive 24 days in Q2'23. We expect to exit the year with a neutral Cash Conversion Cycle. Also, please remember, we have made significant capex investments in HPEFS volumes to drive future revenue growth in subsequent quarters.

Now let's turn to our outlook on Slide 13. As we have mentioned, demand for our products and services was more uneven in Q2'23 across our business than it was in Q1'23. Macro uncertainty is affecting some of our end markets, yet customer investment is rising in other end markets such as Edge and HPC & AI. We believe our portfolio differentiation will continue to drive market share gains in key markets. We are also entering Q3'23 still carrying a substantial order book relative to pre-pandemic levels.

Let me reiterate that our guidance incorporates our current thinking on the macro-economic picture, inflationary pressure, and FX risk which represented a 480bps headwind to revenue growth in Q2'23. I would like to remind you that approximately 50% of our revenue is generated in foreign currencies.

We had indicated at our last earnings announcement that our financial performance in FY23 is likely to be more weighted to the first half of the year than is typical. We continue to view that as the proper lens for FY23. For Q3'23, we expect revenues in the range of $6.7 billion to $7.2 billion. At the midpoint of the range, this represents revenues that are stable year-over-year, and most importantly, flat sequentially, in reported $. We expect GAAP diluted net EPS of $0.34 to $0.38 and non-GAAP diluted net EPS of $0.44 to $0.48. This outlook assumes the current levels of demand we have been experiencing remain relatively unchanged, that we continue to make progress on the delivery of our order book and no further deterioration from FX rates.

Given the weakness in Compute demand, we are adjusting our previously communicated FY2023 guidance of 5-7% revenue growth to 4-6% in constant currency and expect FX to be a 250-300 basis point revenue headwind. In parallel, we also expect our margin strength from portfolio mix-shift to deliver non-GAAP operating profit growth of 6-7%, which is up from our prior 5-6% view. We are lifting our GAAP diluted net EPS guidance from $1.40 to $1.48 to

$1.42 to $1.50 and raising our non-GAAP diluted net EPS guidance from $2.02 to $2.10 to $2.06-$2.14. We reiterate our guidance for free cash flow of $1.9 to $2.1 billion.

For OI&E, we have benefited in 1H23 from FX hedging costs lower than we originally forecasted. A combination of this plus other anticipated benefits in 2H23, now leads us to expect OI&E to be neutral on a full-year basis vs our prior expectation of a $20-$40 million expense.

In terms of capital returns, we expect to return approximately 60% of free cash flow to shareholders via dividends and repurchases. We are maintaining our dividend and expect to repurchase at least $500 million worth of shares in FY23.

So…to conclude. We see the uneven end market demand in FY23 as an opportunity for HPE to showcase our differentiated portfolio, particularly in Edge and in HPC&AI, and to accelerate our portfolio pivot to faster growth, higher margin, recurring revenues. Antonio and I look forward to continuing our execution momentum through FY23 and beyond. Now with that, let’s open it up for questions.

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 key and to withdraw your question, please press "*" then "2." We also request that you only ask one question.

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

Shannon Cross
Thank you very much. Antonio, can you dig a bit more into the significant outperformance you continue to see in Intelligent Edge? You're gaining share, the market remains strong. I know there's some backlog but it seems as if end demand is also remaining pretty solid. Also, as you look at this business, how should we think about seasonality over the coming quarters because it's been so strong in the first half? How do you think about a more normalized growth rate in the business? And just any more color you can give because it has been such a strong performer. Thank you.

Antonio Neri
Well, thank you, Shannon. We are incredibly pleased about the performance of Intelligent Edge. If you recall, this has been a story in the making since the acquisition of Aruba in 2015, which I completed. And then in 2018, I committed to invest $4 billion over the next four years. And the result of this growth is a combination of many things; number one, a very differentiated portfolio, which is cloud driven, a lot of what we do is SaaS subscription, which drives a lot of infrastructure in the campus and branch, but now more and more at the edge of the data center. Second is the fact that our team has executed extremely well in targeting growth areas in the market by customer segment and verticals and used cases.

And then after that, I will say, the cloud AI experience that we built in the portfolio with the simplicity of use is one of the reasons why customers prefer the HPE Intelligent Edge now delivered to HPE GreenLake offering. And over time, we have added more and more functionality, both organic and inorganically. I think organically, the AI-Ops is a point of differentiation for us. We talk about AI these days, but we embedded AI in our HPE Aruba Central, now part of the GreenLake several years ago. We added, obviously, the SD-WAN component of our portfolio through the acquisition of Silver Peak. And now as Tarek said, we have closed Axis Security. And think about it this way, for every $1 of SD-WAN, it should be $1 of SASE attached to it. That's why it was fundamental for us to bolster that type of capability. And then we are very bullish about the opportunity to provide private 5G as an extension of the connectivity layer with Wi-Fi, LAN, and SD-WAN.

And then over time, we're going to continue to grow our data center footprint because of the organic investments we've made over a number of years, which actually, the differentiation comes from the silicon side and, as well as from the software side. 80% plus of our portfolio in the campus and branch has our own silicon. We use our own chipsets. And obviously, the software we deliver to ArubaOS-CX, is programmable to that silicon.

So those are the reasons, I think the use cases continue to be very evident in hospitality. Obviously, as the services sector continue to do well, customers want a connected experience. We see that in health care, I see that as a part of my engagement into healthcare, since I'm a director in an insurance company. We see that in manufacturing through automation and robotics. If you're not connected, obviously, you can't deliver any of that. But in the end, it's all about the digitization of enterprise and the first step to digitize in a data first approach is the connectivity.

So that's why we are very bullish about this. I think the business will continue to grow double-digits. That's why we laid out a few quarters back the Rule of 40, whatever is the mix of growth and profit. But so far, we have blown through the Rule of 40. If you add 56 and the 27, that's a pretty much a Rule of 80 plus. And so, that obviously is not sustainable, but we're gaining share and that's what really matters.

Shannon Cross
Great. Thank you.

Kirt Karros
Thank you, Shannon. We'll take our next question, please.

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

Samik Chatterjee
Hi, thanks for taking my question. Maybe I can ask you on the AI pipeline that you discussed a few times on the call. How are you thinking about the land and expand opportunities as you engage with these customers, I know you referenced $800 million pipeline that you booked recently. And any insights into how competitive are these deals versus some of your traditional supercomputer wins that you have, completed for wins around?

And just finally a quick follow-up, Slingshot and Interconnect technology, how do you see that sort of evolving as becoming maybe a secondary source to NVIDIA in the Interconnect technology? Thank you.

Antonio Neri

Thank you. Obviously, what have been experienced in AI is simply amazing, breathtaking in some cases. I consider AI a massive inflection point, no different than Web 1.0 or mobile in different decades. But obviously, the potential to disrupt every industry through advance many of the challenges we all face every day through data insights, it's just astonishing.

And HPE has a unique opportunity in that market because ultimately, you need what I call a hybrid AI strategy. You need strong inference at the edge. And that really comes by being able to connect and process data, whatever is created with very efficient and low carbon footprint, meaning sustainable solutions with lower power consumption. And then on the other side, you need a training environment where you take some part of the data, where you can train for different needs, different models for different type of used cases. And HPE has a unique portfolio from the inference side all the way to the training side. So, our HPE ProLiant has already some very powerful cost-efficient solutions at the inference.

The amount of computational power, we can put in one of these, what I call, 2U servers is simply amazing. And there are different types of configurations that we need to go through to accelerate the GPUs and the like and sometimes, CPUs, by the way. And on the other side, obviously on the training side, you need a scale type of models with very specialized stacks, and that's where HPE, through organic and inorganic acquisition, really excel because delivering this large amount of GPUs as a coherent system requires enormous expertise. And that's where HPE has unique differentiation in delivering AI at scale through supercomputing. Think about the old tech become the new tech in many ways.

Second is unique IP and you named HPE Slingshot. HPE Slingshot is the true Ethernet fabric that's very efficient from both cost and power consumption to chain up to, in this case, like Aurora, 60,000 GPUs. And by the way, it's open because we can support any type of GPUs. Obviously, NVIDIA right now is a hot commodity, but think about Frontier, it was all AMD. And in the case of Aurora, it's all Intel. And we are building a lot of NVIDIA systems in partnership with NVIDIA. So, we can support that in an open environment. The other piece of this is the fact that HPE has unique software. In order to present the system in a coherent way, you need software to manage contention of resources because the most important metric for developers is the starting and the completion of the model. And many developers we have been working with, not the traditional run type, but people are developing these large language models are telling us, 'sometimes, we try systems in an open cloud environment, it doesn't start for us. Sometimes we can't complete the model.' Is that's the unique expertise that we bring, because we now have to do that at scale.

And then last, but not least, it's very important. Our aspiration is not just AI in the system infrastructure level. We already have, through the acquisition of HPE Cray today, a lot of software that actually provides the packages to train these models. And then in addition to the acquisition of Pachyderm and Determined AI, where we focus on the simplicity to prepare the data, to automate the data pipeline and eventually to train that data. And I think you will hear more about this in a couple of weeks when we go to HPE Discovery in Las Vegas. So, I would recommend you follow us because you will see some breakthrough announcements in the way we provide this AI solution from edge or inference all the way to the training model in a way that every type of customer can get access to our HPE GreenLake platform.

Samik Chatterjee
Thank you.

Kirt Karros

Thank you, Samik. We'll take our next question, please.

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

Simon Leopold
Thanks for taking the question. I wanted to just get a better understanding about how you're thinking about the server cycle. And what I'm pondering here is, some of the third-party market researchers are predicting a rebound in server sales in calendar 2024, particularly coming from enterprise and Telco operators. And that's been, I think, strong verticals for you. How are you thinking about how this cycle that you highlighted the demand absorption that's occurring now, how do you see this playing out over multiple quarters?

Antonio Neri
Well, Simon, we will be there. I mean, obviously, we have a large footprint. We participate in many of the verticals you described. In the short-term, obviously, we see a significant challenge in financial services. Tarek talked about that, call it the crisis of the financial services where the large deals that normally happen are now elongated or waiting to get longer approvals and the like. But there is also a lot of digestion and deflationary that's taking place on the commodity space as well, but there is no supply chain challenges. So, maybe just in time, orders works fine because now we can deliver servers in what I call pre-pandemic SLAs. So, that's positive news.

Now, it's hard to predict, to be honest with you. We commented that Europe and Asia and mid-market, things seems to be holding up. I agree with you the Telco should be a growing opportunity. And listen, we have a very optimized compute platform for virtualization and round deployments. We have very strong partnerships with the equipment providers. We have a platform called HPE ProLiant 110 that's really very specialized for the virtualization of the brand. So…and as 5G deployments take hold, we expect to capture a size of that. But right now, it's a little bit blurry, and that's why with Tarek, we felt prudent and pragmatic, in many ways, to readjust that guidance for the short term.

Ultimately, I think, I believe long term, there is a growth opportunity driven by the growth of data we see in the market. That data needs to be processed. The world is hybrid, so the balance between the public cloud and on-prem of colocations and now the edge continues to be there. I think form factors are evolving at the same time. But I think it comes down to the unit growth and the unit growth of what average unit price. These systems are becoming well more dense and more intelligent in many ways. But at the same time, think about units and then attach rates and then what happened with the cost of commodity. So, there will be unit growth. I think there will be segments that will drive unit growth, but we have to see a little bit more before we can call that growth at this point in time.

Simon Leopold
Thank you.

Kirt Karros
Thank you, Simon. We'll take our next question please.

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

Amit Daryanani
Thanks for taking my question. I wanted to go back to the Intelligent Edge discussion, if I may. And I think your growth and margin are both obviously very impressive here. I think the growth rate is higher than what Arista is doing. So, maybe just spend a little bit of time on how much of this growth is really end demand driven versus perhaps backlog liquidation driven? Just anything on the backlog and what's happening over there would be helpful? And then I guess, Antonio, as you think about Intelligent Edge, your stock price clearly is not reflecting all the value that this segment is creating for your customers. So, I'm wondering, have you looked at a thought about different ways to unlock the potential value over time? Thank you.

Antonio Neri
Well, thank you for the question. I hope you will be writing about this because to your point, right, we are not getting credit for the stellar performance. And honestly, a story in the making for a number of quarters. So, this was the 11th consecutive quarters of growth for that business, which is very impressive in my mind. And I think Tarek had a little bit of challenge saying 1,400 basis points. I mean, normally, 100 plus or 200 plus, but 1,400, it was a little bit awkward to say it. And I think it's because A), we have that unique differentiation and the software that makes the portfolio so special in many ways, and that's what customers are attracted to.

Now, as I think about what is driving, I think it's basically demand rolling through that very large order book. And as I said in my remarks, the order book for both the Intelligent Edge and AI remains very, very large, and that demand improved sequentially, as Tarek said. And so, we keep trying to work that order book, but we keep feeding our order book with sequential growth in that demand. We don't believe the demand is poised to go down significantly from here. In fact, we believe it's going to be somewhat steady. But that's why we need to keep innovating and keep adding functionalities and capability to that portfolio. As Tarek said, 19%, almost of the revenue now is coming from this portfolio.

And this portfolio enables us to build scale, also and allows us to build the as-a-service model because a lot of what we have done with GreenLake came from the extraction of the cloud coming from this business that we expanded in the rest of the portfolio in Hybrid Cloud and AI. So, it's a very important critical business. I think the market is starting to see a sizing increase before they give us credit, but I think now everybody has to take notice of that.

Tarek Robbiati
And Amit, if I can add to what Antonio said. This market is healthy, and it will continue to grow in the upper single-digits for several years to come. We're very comfortable with this. We're also investing in adjacent TAMs. Antonio spoke about SASE, private 5G, but also data center networking, for us is a massive opportunity that we're going after. We're generating already a lot of revenues in there.

Aruba today represented 19% of total revenues in Q2. If you really look at where we were at the end of fiscal year 2022, to put things in perspective we were only at 13% of total revenues. So, we believe we now will be stably in the high teens as a percentage of revenues for the whole of the company. And then I'll let you do the math with regards to how much Aruba will represent as a percentage of total operating profit of the company. So, Aruba is absolutely core. And you know that when we pass the 15% mark of total revenue, the stock market should take notice about that. And by way of comparison, if you compare Aruba in size to its next competitor, Juniper, it has roughly the same revenue at the end of the second quarter, but

Juniper has 14% operating profit margin and Aruba is at 26.9%. That speaks volumes about the performance of Aruba.

Antonio Neri
And I would say, you asked a question, how you consider unlocking the value? As you can expect, I mean, we really review with our board strategy to maximize value for our shareholder. But we believe the edge is critical to our strategy, because it's aligned to the customer need. You need the connectivity to drive the digital transformation. Without that is incomplete. At the same time, I now I talked about the leverage of the edge portfolio and the cloud for the rest of the company. And also, let's remind ourselves, we have cross-selling opportunities because once we land the customer on HPE GreenLake, whether it's through the edge or through the hybrid cloud and now through the AI as we go forward, you will see the opportunity to cross-sell, which benefit Aruba and the Intelligent Edge as a whole and the rest of the company as well.

Kirt Karros
Thank you, Amit. We'll take our next question please.

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

Wamsi Mohan
Yes, thank you. I was wondering if you could maybe share some color on your comments regarding deal velocity slowdown both in Compute and Storage, and you noted manufacturing and financial services verticals, in particular for Compute. Can you share some color on how linearity was in the quarter? And are you baking in an increased deceleration in other verticals as you look at your back half of the year? Thank you.

Antonio Neri
Thanks, Wamsi. I think Tarek mentioned that we assume in our guidance current level of demand and no further deterioration. Demand on Compute was slightly down from the previous quarter, compared to everything else that was up sequentially. And so, from our vantage point, we believe we have covered this in the guidance.

I think from the deterioration, I think it was clear when the financial crisis started sometime in March. We saw a deceleration and that was very evident in the financial sector, the financial vertical, I will say. But that said, it is the most uneven parts of the portfolio, as we commented. I think it's driven by the digestion of our customers' order last year. The fact that today, they are maybe prioritizing investments in the edge or prioritizing investment in AI, which clearly we are a benefactor of it from that perspective.

I think customers are looking for resilience as well, considering everything that's happening around the globe. And then also understanding what's happening with the cost of the commodities as we go to this transition. And ultimately, at some point, right, we see what the consumer market is going to do because the consumer is a driver of data as well. And so, we need to understand those trends. But I will say from that vantage point, I think clearly the Compute market as a whole, and this is important we segment this because sometimes people refer to Compute as servers. We don't refer that as servers. We refer that as a specific general purpose compute. The servers include, obviously, high-performance computing and other form factors. But in that space, clearly, is the most uneven at this time.

Kirt Karros

Thank you, Wamsi. And operator, we have time for one more question, please.

Operator
Our final question will come from Toni Sacconaghi with Bernstein. Please go ahead.

Toni Sacconaghi
Yes, thank you for taking my question. I'm just wondering if you can just help triangulate some of the numbers around backlog that were highlighted on the call. So, I think backlog exiting last quarter was two times normal. Exiting this quarter was 1.5 times normal, so it came down quite a bit, but you added $800 million in orders in the Intelligent Edge business. So that would suggest there was like really dramatic drawdown, like $1 billion plus of backlog, in other businesses. So, is that the right way to think about it or am I triangulating it incorrectly? And also, you keep saying that demand improved this quarter versus last quarter, but revenue was down, and you drew down a lot of backlog. So, I'm also just trying to reconcile that. Thank you.

Antonio Neri
Sure. So, a couple of things I'll correct. So, last quarter, right, we exited with an order book that was two times historical levels, and we refer to historical levels to pre-pandemic, Toni. And then this quarter, we're exiting 1.5. What is different is that the mix of that order book is different, because obviously, the growth we have in Intelligent Edge and AI is substantial, obviously. But the $800 million, I want to clarify that for you, Toni. The $800 million was just in the AI space. And every segment grew orders sequentially, except Compute, which was low single-digits demand decline.

And so clearly, when you want to isolate, it's Compute, it's Compute particularly in North America, it's Compute particularly in these two segments we described, financial services and manufacturing. But the mix of the order book has shifted because now the larger of the book is actually in the Intelligent Edge and it is in AI. And the $800 million I described early on are all 100% orders that we got in the AI space because we saw a significant uptick, and that came from Fortune 500 companies, some of these digital-native large language models companies and a large cloud provider. But ultimately, that's what's happening. And the Compute...that's why we are readjusting that guidance on revenue because of the unevenness in Compute. But overall, we are, as a total company, 1.5 times where normally we should be.

Toni Sacconaghi
Thank you.

CONCLUSION

Antonio Neri
Yes. Well, thank you for all your comments, and we appreciate you attending today the call. I mean, I will leave with a simple message. So, I think overall, HPE had a very solid quarter. Obviously, we were not at the total revenue consensus as people put out there. But the fact of the matter, we grew revenues. We significantly grew our recurring revenues, and we had an exceptional profitability for the quarter. And this was driven by our pivot, and you can see the pivot and the meaningful impact that Intelligent Edge and AI is having to our business. We didn't speak a lot about Storage, but Storage grew 2%. And at the same time, the HPE Alletra platform, which is a software-defined platform, grew in excess of 100% and a big portion of that revenue is actually deferred.

So, I think in the short-term, we're going to navigate this uneven demand in Compute, but we are very pleased about the momentum we have in Hybrid Cloud with GreenLake, AI and which is a massive, massive opportunity for the company with a unique differentiation and obviously, the Intelligent Edge, which is delivering a standout performance this quarter-after-quarter-after-quarter.

So, with that, I hope to see you at HPE Discovery in Vegas in three weeks because we have some amazing announcements that we want to share with you that will continue to drive momentum in our business. So, thank you very much.

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