Hewlett Packard Enterprise Company

Third Quarter Fiscal 2023 Earnings Conference Call

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CORPORATE PARTICIPANTS

Antonio Neri - *President, Chief Executive Officer*

Jeremy Cox - *Interim Chief Financial Officer*

Jeff Kvaal - *Head, Investor Relations*

PRESENTATION

Operator
Good afternoon, and welcome to the Third Quarter Fiscal 2023 Hewlett Packard Enterprise Earnings Conference Call. My name is Gary, 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 now like to turn the presentation over to your host for today's call, Mr. Jeff Kvaal, Head of Investor Relations. Please go ahead.

Jeff Kvaal
Good afternoon, everyone. I'd like to welcome you to our fiscal 2023 third quarter earnings conference call with Antonio Neri, HPE's President and Chief Executive Officer, and Jeremy Cox, HPE's Interim 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 webpage. Elements of the financial information referenced on this 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 such forward-looking statements. We also note that the financial information discussed on the 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 ending July 31, 2023.

For more detailed information, please see the disclaimers on the earnings materials relating 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 have 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 adjusted to exclude the impact of currency.

Finally, after Antonio provides his remarks, Jeremy will reference our earnings presentation throughout his prepared comments.

Now with that, let me turn it to you, Antonio.

Antonio Neri
Alright. Thank you, Jeff, and good afternoon. Thank you, everyone, for joining today. HPE delivered another solid quarter. We again increased our revenue, gross margin and earnings per share year-over-year and delivered strong free cash flow.

Our results are being driven by our intentional ongoing mix shift to higher growth, higher margin parts of our portfolio that are critical priorities to customers. Our success in shifting the portfolio delivered a 120 basis points year-over-year non-GAAP gross margin expansion, driven by exceptional performance in areas like the Intelligent Edge, where revenue has set its fifth consecutive record quarter, and HPE GreenLake, which continue to accelerate our strategic pivot, generating higher recurring revenue and gross profit across our four product segments, driven by the increased mix of high margin software and services.

In Q3, our Intelligent Edge business contributed 20% of our total company revenue. It is now the largest source of HPE's operating profit at 49% of our total segment operating profit. Our HPE GreenLake hybrid cloud platform is accelerating our as-a-service pivots, delivering an annualized revenue run rate, or ARR, of $1.3 billion, a 48% increase year-over-year.

Our strategic shift towards edge, hybrid cloud and AI delivered through our HPE GreenLake cloud platform is working, and we are delivering on our financial commitments. Because of our momentum and strong execution throughout this fiscal year, we are once again raising our full year non-GAAP diluted net earnings per share guidance. GAAP for full-year diluted net earnings per share guidance will remain unchanged.

For non-GAAP, diluted net earnings per share we are increasing to $2.30 at the midpoint, while maintaining both our full-year constant currency revenue growth guidance of 4% to 6% and full year free cash flow guidance of $1.9 (billion) to $2.1 billion. We will provide more details later in our call today, including on a GAAP basis.

Our view of the macro environment remains unchanged from recent months. Customers continue to prioritize their data first digital transformation, despite some reservations about the macroeconomic environment for the future. While the broader IT market is still pressured, demand for our products and services grew sequentially in the third quarter across all key segments of our business, driven by high-growth areas like AI and HPE GreenLake.

We continue to see strong interest in our AI and supercomputing offerings from enterprise customers who are incorporating artificial intelligence into their businesses. This is translating into significantly higher demand for our HPC and AI business segment as customers discover HPE's unique capabilities to power unprecedented levels of performance for AI at scale, including using our market-leading supercomputers built with sustainability in mind to train and tune their AI models.

Total HPE revenue during the third quarter increased 3.5% year-over-year to $7 billion, which exceeded the midpoint of our guidance. Non-GAAP gross margin rose 120 basis points year-over-year to 35.9%, very close to the record level we achieved in the second quarter. Higher profitability in the third quarter compared to last year also corresponded to an increase in non-GAAP diluted net earnings per share, which was $0.49, up 2% year-over-year. And we generated $955 million in free cash flow, an increase of nearly $370 million.

The HPE GreenLake cloud platform is a key driver of financial performance, with our hybrid cloud offerings through the platform continuing to attract new customers and compel existing customers to expand their contracts.

HPE GreenLake orders rose 122% year-over-year, resulting in a nearly $1.5 billion increase in a as-a-service total contract value since last quarter. Our cumulative booked total contract value now stands at just under $12 billion. The scale and the strength of HPE GreenLake is evident; it supports 27,000 unique customer logos and 3.4 million connected devices, and more than

1,100 partners sell HPE GreenLake, one of the largest partner ecosystems selling as-a-service offerings in the industry.

As we grow our ARR, we are also increasing the share of high-margin software and services. Software and services increased 2 percentage points sequentially to 68% of the total ARR mix, compared to 66% in the second quarter, with ongoing contributions from SaaS offerings tied to our HPE Ezmeral Software, storage and HPE Aruba Networking, our operational Services and OpsRamp, our recent acquisition. We are well-positioned to continue to grow the software and services mix within our ARR.

For example, we saw a double-digit increase in demand with HPE operational services this quarter, which will contribute to future recurring revenues. The impressive gross margin in our as-a-service recurring revenues helped lift our already strong overall company gross margin this quarter. These results demonstrate the relevance of our differentiated HPE GreenLake value proposition of providing one-unified hybrid cloud experience to empower customers to access, analyze and extract value from their data, no matter where it lies, at the edge, in the colos or data center and in the public cloud.

Now, I would like to highlight a few important takeaways in our business segment results. First, as I said earlier, HPE's performance in the Intelligent Edge segment was particularly noteworthy in the quarter. Intelligent Edge revenue increased 53% year-over-year and operating profit more than doubled in another exceptional quarter for this business segment. I'm particularly pleased that our Intelligent Edge SaaS revenues continued to climb double-digits. We are gaining share, benefiting from improved availability of supply, high shipment volume and a strong response to our SaaS edge offerings in terms of both demand and revenue. Momentum in Intelligent Edge was consistent around the globe, with revenue increasing by double-digits in all regions in the third quarter.

One example is the University of Maryland, which wanted a stronger cloud-based policy driven wired and wireless network that could provide improved automation, better device visibility and easier and more secure access for students, faculty and staff as they are returning to campus. The University selected HPE Aruba Networking for a campus-wide refresh to enhance the flexibility, visibility and security of its network through HPE Aruba ClearPass, our SaaS platform to onboard new devices, grant varying access levels and keep network secure.

The HPC and AI business segments saw a wave of demand acceleration in the quarter, as we converted on AI deal opportunities and shipped orders that leverage our unique end-to-end AI value proposition, from training to tuning to inference.

As a result, we exited the quarter with the largest HPC and AI order book we have ever had. Our AI momentum also helped grow our total HPE order book, which is now at more than two times pre-pandemic levels, driven by exceptional customer demand for our AI solutions and sequential demand improvements across our four product segments.

Only HPE can combine our unique AI software and slingshot networking fabric. HPE services offerings and market-leading sustainable supercomputers. Our open ecosystem of AI suppliers is also an advantage for customers, who are turning to us for a full spectrum of enterprise AI workloads and use cases, spanning large-scale model development, training, tuning and inferencing.

Through the UK's GW4 Alliance of four UK research universities, HPE won a contract from the UK Research and Innovation to develop Isambard 3, a supercomputer that leverages the latest HPE Cray XD supercomputers, HPE Slingshot Interconnect and NVIDIA Grace CPU Superchip. The system will provide researchers, engineers and data scientists purpose-built capabilities to train AI models and accelerate research in clean energy, drug discovery, medical diagnosis and astrophysics.

In addition, we were selected by Tokyo Institute of Technology Global Scientific Information and Computing Center to build its next-generation supercomputer, which is called TSUBAME 4.0, which includes AMD CPUs and NVIDIA's GPUs to accelerate AI-driven scientific discovery in medicine, material science and climate research.

Recursion Pharmaceuticals is a leading public tech-bio company that uses advancement in AI to accelerate and industrialize the discovery of new drugs. Recursion turned to HPE's AI software to scale its foundation model efforts, significantly speed up training across its more than 25 petabytes of biological and chemical data and improve team collaboration.

We are seeing AI projects generate exciting results on our supercomputers. For example, the LUMI supercomputer built by HPE with AMD CPUs and GPUs is the fastest system in Europe and the third fastest in the world. It has enabled generative AI projects, such as creating the world's largest finished language model, and it has helped researchers apply AI for early detection of diagnosis of breast and prostate cancers. We continue to make progress in ushering in the era of exascale supercomputing, which enables unprecedented scale and performance for larger AI models, such as generative AI.

This quarter, HPE in collaboration with the Lawrence Livermore National Laboratory started to build and test El Capitan, one of the largest upcoming exascale supercomputers. El Capitan, which uses AMD CPUs and GPUs is expected to reach two exa-flops of peak performance, will allow researchers to apply AI to advance U.S. National Security and breakthroughs in medical and drug research initiatives.

We are seeing demand improving in both our Storage and Compute segments. Storage demand was solid year-over-year with our cloud-native HPE Alletra portfolio recording triple-digit revenue growth. Storage SaaS revenue also increased double-digits as we continue to intentionally drive more of HPE Alletra’s owned IP through HPE GreenLake. Compute performed well considering the sector ongoing cyclicality.

We saw sequential unit demand increase in the quarter. One area where we anticipate demand picking up in the coming quarters is customers seeking a solution to run AI inference workloads.

Our new HPE ProLiant Gen 11 servers optimized for AI workloads are well positioned for this growing customer need. During the third quarter, we started shipping these servers, which boost AI inference performance by more than five times over previous models. And just last week, we expanded our portfolio for enterprise tuning and inference solutions with NVIDIA and VMware to accelerate our customers' generative AI deployments.

To round out our major segments, in HPE Financial Services, revenue climbed 7% year-over-year and financing volume ticked up 6%. HPE Financial Services continues to be strategically important as we continue to ramp up our as-a-service volumes through HPE GreenLake.

We continue to strengthen our innovation from edge to cloud, positioning HPE well for the future. In June, we hosted more than 10,000 customers and partners at our annual HPE Discovery event, where we unveiled exciting new edge, hybrid cloud and AI solutions to help customers achieve their business goals and gain competitive advantage.

At HPE Discover, we announced we have entered the AI public cloud market with HPE GreenLake for Large Language Models. Available at the end of this calendar year, the offering will enable a wide variety of enterprise customers to privately train and tune their data, using our industry-leading AI sustainable supercomputer infrastructure and software. We also extended our hybrid cloud leadership at HPE Discover with new HPE GreenLake hybrid cloud services, including our new SaaS-based IT Operations Management solution from our recent acquisition of OpsRamp. And to drive faster, easier and more sustainable ways to deploy our HPE GreenLake hybrid cloud solutions outside of the data center, we expanded our partnership with colo market leader Equinix, which enables customers to go from quote to production in days by using our HPE GreenLake for private cloud enterprise stack.

Two new HPE GreenLake for Private Cloud Enterprise customers are global logistics solutions leader, Swisslog, and global media company Mediahuis. Swisslog chose HPE GreenLake for Private Cloud Enterprise to help accelerate the automation of its warehouse centers with a cutting-edge on-premises private cloud that could provide rapid, secure and controlled service delivery.

Mediahuis, which owns more than 30 different news brands in Europe, wanted a modern on-premise private cloud to accelerate its digital transformation and better leverage data to attract and retain subscribers with a more personalized customer experience. HPE GreenLake will help the company achieve operational agility, mitigate risk and address IT skills gap and advance its digital priorities.

At HPE Discover, we expanded our HPE GreenLake private cloud portfolio with HPE GreenLake for Private Cloud Business Edition, a new offering that allows customers to spin up virtual machine across hybrid clouds on demand. This new offer is an extension of our hyper-converged portfolio with automation and hybrid cloud software, built into the private cloud solution.

Earlier in the quarter, we previewed a new sustainability dashboard on the HPE GreenLake platform alongside a comprehensive portfolio of sustainability services designed to help organizations reduce the carbon footprint associated with their hybrid IT estates. Customers understand that the hybrid IT estate can be one of their biggest sources of operational emissions and have made measuring and reducing their carbon footprint business imperative.

Driving the steady drumbeat of innovation strengthens our HPE GreenLake hybrid cloud value proposition for customers, extends our industry leadership, expands our total addressable market and positions us well to accelerate our momentum across edge, hybrid cloud and AI in the future.

We have been advancing our strategy for the last several years. And even in a very dynamic market environment, it is clear that our strategy - combined with strong execution and a terrific team - set us apart.

Our third quarter performance demonstrates the progress we have made to shift our portfolio to higher growth, higher margin areas that are the most critical to customers as they continue to transform.

Our pivot to software and services rich businesses has led to new customer logos, greater recurring revenue, margin, earnings per share and free cash flow. This is why we are once again raising our non-GAAP diluted net earnings per share guidance. Despite a slowdown in some parts of the IT industry, our HPE team has executed our strategy, bringing differentiated innovation and a diverse portfolio to customers around the globe. This positions us to continue to win in the market and deliver for our shareholders.

I'm very pleased to pursue these priorities more closely with Jeremy Cox, whom I appointed as our Interim Chief Financial Officer earlier this month. Jeremy is an experienced finance leader whose customer centric approach, institutional knowledge, and track record of operational excellence, sets him up well to serve in this role while we conduct an internal and external search for a permanent CFO.

Jeremy will now discuss our quarter's financial results in greater detail. So, Jeremy, welcome. Over to you.

Jeremy Cox
Thank you very much, Antonio. I'm honored to take on the responsibility of interim CFO as we go through the process. I'll start with a summary of our financial results for the third quarter of FY 2023.

Antonio discussed key highlights on slide four. Let me begin with slide five, financial highlights. We're actively diversifying our business mix towards our higher growth, higher margin portfolio of Intelligent Edge, HPC and AI and HPE GreenLake solutions. This pivot is clearly visible in the 120 basis point year-over-year expansion of non-GAAP gross margins.

We delivered a solid quarter within an IT market still under some pressure. Cycle times remain elongated and digestion of prior orders will continue to have some near-term impact. This has been particularly true in Compute and to a lesser extent, in Storage.

Despite these challenges, we delivered 3.5% year-over-year revenue growth in constant currency to $7 billion, which exceeded the midpoint of our Q3 revenue guidance. This figure included a modest amount of AI revenue. We do see several promising indicators that suggest stabilization. Antonio mentioned the sequential improvement in demand across our four product segments. We're starting to see indicators that our largest customers are returning to the market. Intelligent Edge continues to increase revenues rapidly, both on a year-over-year and sequential basis, and robust AI demand is evident in our as-a-service orders.

Our non-GAAP gross margin rose 120 basis points year-over-year to 35.9%. This is off just 30 basis points from our high watermark of 36.2% last quarter. Our margin structure reflects the pivot of our business mix to higher margin, software intensive recurring revenue, such as Intelligent Edge. The edge mix was up 450 basis points year-over-year.

Our Q3 '23 non-GAAP operating margin reached 10.3%, this is down 120 basis points sequentially and 20 basis points year-over-year. Sequentially, the driver was largely return of Compute operating margins to just below long-term target range of 11% to 13% after six consecutive quarters above the range.

We expect the impact of Compute operating margin cyclicality on HPE's operating margins to decline over time, as our revenue mix shifts towards our higher growth, higher margin businesses. Our Intelligent Edge business reached a record-high 29.7% operating margin. We remain focused on productivity and continue to expect revenue growth to outpace OPEX growth over time.

Our solid Q3 revenue and margin performance led GAAP diluted net EPS to $0.35 and non-GAAP diluted net EPS to $0.49, which was up $0.01 year-over-year despite Compute cyclicality. It was also $0.01 above the high end of our Q3 guidance range of $0.44 to $0.48.

Our Q3 free cash flow was $955 million. We continue to return substantial capital to our shareholders, paying $154 million in dividends and repurchasing $187 million in stock this quarter. We have now returned $831 million in capital to shareholders this year.

Moving to slide six. Our as-a-service revenue pivot continues to show strong momentum. ARR reached $1.3 billion in Q3 '23. The benefits of as-a-service deals we won in prior quarters are now appearing in our results, though, the large AI as-a-service deals booked in Q3 have yet to reach revenues.

Year-over-year ARR growth in constant currency has accelerated from 25% in Q4 '22 to 31%...38% and now 48% in Q3 '23. The 48% growth is above our long-term 35% to 45% target and should be viewed as an indicator of our long-term momentum rather than as a new growth trajectory. The fastest-growing components within ARR year-over-year are Storage and Edge.

We continue to lift HPE GreenLake's value proposition with an increasing mix of higher-margin, recurring software and services revenue. Antonio mentioned that in Q3, our software and services mix rose to 68% and should continue to increase. While this mix has traditionally tilted to services, software is now half of the total. In the future, we expect software growth to exceed services growth and for as-a-service margins to rise over time.

To slide seven; our Q3 as-a-service order growth was robust. We're pleased to have delivered 122% year-over-year order growth which has raised our cumulative as-a-service TCV to nearly $12 billion. The driving factor was AI demand. A significant percentage of our AI orders have come under the as-a-service model and the strength this quarter should also provide confidence in our long-term 35% to 45% ARR growth outlook. Order growth will fluctuate given the volatility of large as-a-service deals.

Now, let's turn to our segment highlights on the next slide. And remember, all revenue growth rates on this slide are in constant currency. In Intelligent Edge, we grew revenues 53% year-over-year and 8% sequentially, delivering record revenues for a fifth consecutive quarter. Customers are increasingly adopting our software-centric solutions such as Edge Connect SD-WAN software and our Aruba Central management platform. We've expanded the Axis Security and SASE funnel to six times since the acquisition.

Our operating margin of 29.7% was up more than 1,300 basis points year-over-year and 280 basis points sequentially. We're benefiting from revenue scale and prior pricing actions, which are helping us build visibility into the durability of our mid 20% margin target over time. While we're making progress on our order book, we expect to carry an above-normal order book into FY '24.

In HPC and AI, revenue grew 3% year-over-year. Customer discussions on large language models and generative AI that began in Q1 turned to wins in Q2 and are now showing up as as-a-service orders in Q3. AI, the predominant driver of our 122% year-over-year growth in as-a-service dollars, has also driven sequential growth in our corporate total order book, which I'll discuss in a moment.

We expect AI deals to provide gross margin rates above historical levels. We believe building and operating large AI models requires unique computational capabilities, including silicon and software that our HPE Cray supercomputers and HPC and AI solutions are extremely well positioned to enable.

As for operating margin, our Q3 performance was just below breakeven. The early stage of the AI market, tightness in certain key components and long lead times in this segment mean that operating margins in HPC and AI will continue to fluctuate. We'll discuss our outlook for revenue growth, investment, and margin improvement at our Securities Analyst Meeting.

Storage revenue fell 2% year-over-year but rose 3% sequentially. HPE Alletra revenue grew triple-digits in Q3 for the fifth consecutive quarter. It is now one of our higher revenue products and thus growth rates may normalize. This product is shifting our mix within storage to higher-margin, software-intensive revenue and is a key driver of our ARR growth.

We'll continue to invest in R&D and our owned-IP products in this business unit, such as our new file-as-a-service and HPE Alletra MP offerings. Q3 '23 operating margin of 10.7% is down 360 basis points year-over-year as we transition to HPE Alletra. HPE Alletra includes a meaningful component of ratable revenue, which pushes revenue recognition out into future periods.

Compute revenue was down 10% year-over-year to $2.6 billion and down 5% sequentially. Deal elongation challenges we've discussed previously were most prevalent in the Compute business as some customers digest prior investments.

Declining AUPs from a record high in Q1 '23 was also a significant driver. But, as previously noted, we did see sequential demand improvement. And after six quarters of above plan operating margins in Compute, this quarter's 10.9% was a shade below our long-term margin target of 11% to 13%.

HPE Financial Services revenues rose 7% year-over-year and financing volume of $1.7 billion grew 6% in constant currency, driven by HPE GreenLake. Our operating margins were down 340 basis points year-over-year, reflecting rapid interest hikes and higher cost of funds that will gradually offset over time through pricing, as well as lower asset management margins as supply challenges ease.

Time and time again, HPEFS has proven resilient in a downturn, thanks to the quality underwriting of our book of business. Throughout the pandemic, our annual loss ratio never exceeded 1%, and our Q3 loss ratio of 0.48% was even lower than it was in the full year 2019 pre-pandemic.

Slide nine, highlights our revenue and non-GAAP diluted net EPS performance. The progress we're making against our edge-to-cloud strategy is evident in the financial results we delivered on both the top and bottom lines. We've held our revenue steady this quarter and expanded non-GAAP diluted net EPS year-over-year despite an uneven spending environment, our transition towards a recurring revenue model and FX rates remaining a significant headwind. FX was a 280-basis point headwind to revenue growth in Q3.

On slide 10, we've included a new depiction of our portfolio shift, which illustrates just how significant the Intelligent Edge business has become for HPE. Even three years ago, Intelligent Edge constituted just 10% of revenue, and this quarter it represents 20%. Operating profit trajectory is even more dramatic. Edge contributed just over 10% of operating profit three years ago and is now 49% of total segment operating profit. We will offer our forward-looking view at our Securities Analyst Meeting.

Slide 11 illustrates the progress we've made on our gross margin structure. Our Q3 non-GAAP gross margin is up 120 basis points year-over-year despite FX headwinds. Our year-over-year non-GAAP gross profit and margin growth show the success of our strategic portfolio pivot and the pricing actions HPE has taken.

Slide 12 illustrates our non-GAAP operating margin, which was 10.3% in Q3. This is down 20 basis points year-over-year, also inclusive of FX headwinds, and 120 basis points sequentially. While the primary driver of the sequential decline was the return of Compute operating margins to near our target range, we also made certain targeted investments in the quarter to further enable our pivot. Our deliberate portfolio mix shift, pricing strategies and productivity focus put us on track to increase operating margin in FY '23.

On slide 13, as previously announced, we exercised the put-option on our shares in H3C and signed a put share purchase agreement that values our 49% H3C stake at US $3.5 billion. The next step in the process is to obtain the necessary regulatory approvals and to conclude certain conditions necessary for closing. We expect to conclude this process in the first half of calendar year 2024, although this timeline could be further extended pursuant to the terms of our agreement.

We intend to update our plans for the user 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 that we've outlined in the past. Finally, we continue to benefit from H3C dividends in FY '23. We'll offer an update on our go-forward expectations for H3C dividend at SAM in October.

Now to slide 14. We generated $1.5 billion in cash flow from operations and $955 million in free cash flow. Our Q3 free cash flow improved by approximately $670 million sequentially and nearly $370 million year-over-year. Similar to our Q4 '22 performance, we expect to generate significant free cash flow in the remainder of FY '23 and are reiterating our guidance of $1.9 billion to $2.1 billion in free cash flow in FY '23.

The timing of receipts and payments plus inventory investments have held cash conversion cycle steady sequentially at 23 days. We expect to exit the year with a neutral cash conversion cycle.

Now, let's turn to outlook on slide 15. As we've mentioned, the broader IT market is still pressured. Macro uncertainty is affecting some of our end markets, yet customer investment is rising in others, such as Edge and HPC & AI. We believe our portfolio differentiation will continue to drive share gains in key markets.

We are also entering Q4 with an order book that is more than two times pre-pandemic levels. Our order book has increased from more than 1.5 times pre-pandemic levels entering Q3, primarily on the strength of AI orders.

The assumptions in our guidance, which incorporate our current thinking on the macroeconomic picture, demand, inflationary pressure, supply, and FX rates - remain relatively unchanged. We've indicated throughout the fiscal year that our financial performance is likely to be weighted to the first half of the year. We continue to view this as the proper framework for FY '23.

For Q4, we expect revenues in the range of $7.2 billion to $7.5 billion. We expect GAAP diluted net EPS between $0.36 and $0.40 and non-GAAP diluted net EPS between $0.48 and $0.52. We are reiterating our prior fiscal year 2023 guidance of 4% to 6% revenue growth in constant currency. We expect FX to be a 300-basis-point revenue headwind from our previously communicated 250 to 300 basis point headwind.

In parallel, we also reiterate our expectation that margin strength from our portfolio mix shift will deliver non-GAAP operating growth of 6% to 7%. We are reiterating our GAAP diluted net EPS guidance of between $1.42 and $1.46 due to tax rate differences and additional amortization of intangibles from our recent acquisitions. We are raising our non-GAAP diluted net EPS guidance from between $2.06 to $2.14 to between $2.11 and $2.15. We reiterate our guidance for free cash flow of between $1.9 (billion) and $2.1 billion.

For OI&E, we benefited this year from higher interest income and FX hedging costs lower than we originally forecasted. The combination of these and other anticipated benefits in the second half of this fiscal year leads us to expect OI&E to be a positive $50 million to $70 million on a full year basis. We had previously expected OI&E to be neutral for the full year.

In terms of capital returns, we are maintaining our dividend and expect to return approximately 60% of free cash flow to shareholders via dividends and repurchases.

So, to conclude, the uneven end market demand thus far in FY '23 is an opportunity for HPE to showcase our differentiated portfolio led by HPE GreenLake Hybrid Cloud, Intelligent Edge and HPC & AI, and we'll continue to take the steps required to further accelerate the pivot of our product portfolio and our company towards faster growth, higher margin recurring revenues. We look forward to updating you with HPE's outlook beyond FY '23 at our Securities Analyst Meeting in October.

Now, 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 keys. To withdraw your question, please press "*" then "2." We also request that you only ask one question.

The first question is from Simon Leopold with Raymond James. Please go ahead.

Simon Leopold

Great. Thanks for taking the question. I wanted to see if you could put the AI wins in the same terms you did at the analyst session you had in June, when you told us you had $1.6 billion in awards. That was a combination of CAPEX and recurring deals that would be spread out over a number of years. So, what I'm looking for is an update on that and how much of the AI are you expecting in that fourth quarter and what's the timeframe for seeing the benefits? Thank you.

Antonio Neri
Thanks Simon. Well, all those deals we talked through came through. They were booked and the pipeline continues to be super strong. In fact, I will say the pipeline we came in and we exit is pretty much the same. So that means throughout the quarter, we booked those deals, and we exit pretty much with the same pipeline we came in. So clearly, the momentum in the business is significant.

But as you can see, our progress is showing up in as-a-service, which you saw the 122% as-a-service order growth, which is very significant and that fuels our order book to be now more than two times than pre-pandemic levels, and we exit the HPC and AI quarter with the largest ever order book we ever had. Now, we start now shipping some of those orders, those wins, but it's a long way to go. And remember that there's two components related to that. Number one is availability supply, which obviously in the AI space is constrained. Number two is the fact that when you deploy these deals, you have to install it and then drive acceptances, which means elongated times for revenue recognition. And then maybe in a specific win or two, there are other conditions related to the contractual agreements.

So, the net of this is that what we discussed at the end of Q2 and then during the HPE Discover came all through and then what I am really pleased about is the quality of the deals we are getting. And I just referenced a half a dozen or so in my opening remarks to give a sense of the type of customers we are winning to make sure you understand the proof points associated with that. And so, as we go forward, we expect this momentum to accelerate, but the revenue recognition will be different than what I call the demand bookings in our systems because, obviously, that takes time. In any case, the other thing I will say is that one of the reasons why customers are coming to us is because we have a complete life cycle of solutions from training to tuning to inferencing.

So, on the training side, obviously, these are companies that develop their own language models, whether it's startups or large unique customers. On the tuning side, I believe one of the biggest opportunities will be when customers use these foundational models that you can get in the market. We're going to offer over time, five of them in our AI public cloud instance. So, they can tune those models with their data in a private, secure, responsible way. And then number three, which I'm really excited about because it would be an accelerator of both Compute and Edge, is going to be the AI inferencing. And so, all those three will move concurrently. And so, you have to look at this not just the next quarter, but on a mid to long-term basis, and I will call it, two, four and then eight quarters.

Jeff Kvaal
Thank you, Simon. Gary, could we have the next question, please?

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

Aaron Rakers

Yes. Thanks for taking the question and congrats on the results. I wanted to build on Simon's question a little bit. I think in the context of last quarter and what you had disclosed at the Analyst Event, you had also alluded to within that pipeline, large hyperscale cloud opportunities. I'm curious what are you seeing in that vertical, should we expect that to further expand? Just any context around the positioning within cloud where HPE Enterprise hasn't really historically had a material footprint. Why are you winning in those opportunities if they're expanding?

Antonio Neri
Yes, Aaron. So, one of the opportunities we won in Q3 was a large hyperscaler. We haven't even started building and shipping that. So that tells you the size of it. And we have further opportunities down as I look at '24. The reason why they come to us is; number one, is because we have a unique amount of intellectual property. Think about it as an open ecosystem with our networking fabric, which obviously supports NVIDIA. We have a fantastic relationship with NVIDIA, but also supports other types of accelerators. And depending on the AI workload, it can be a mix and match.

If you heard my comments, right, in some cases, we have NVIDIA GPUs with potentially AMD CPUs. In some cases, all NVIDIA. In the case, for example, of the Aurora system, the Argonne Laboratory is actually all Intel. So that provides flexibility for customers whether it's performance driven or supply driven over time. And the other one is, because we have unique expertise in AI. Remember, we have been in AI for a decade. It's just we have done it for unique discrete customers. That were building this system on a purpose base. But now this is why we entered the AI public cloud to democratize the AI for every enterprise...and that's why we saw the growth in the HPE GreenLake as-a-service AI bookings, because they cannot build that themselves. And the other piece of this is the ability to consume this in a sustainable way. I think sustainability is becoming a key component because customers deploy AI and want to make sure they control the carbon footprint with it. And then the data center services, which are essential to run this massive at-scale AI solutions.

And then for the large language model companies, one of the things that attract them to us it's not just all of the things I just said, it is the fact that working with us, they can get access to our route to market, so they can reach enterprises in ways potentially they couldn't by themselves. So, it's a combination of multiple things. That they are all coming our way, I will say. But ultimately, our strategy is a software-led strategy using our supercomputer as a cloud kind of experience and then wrapping around all the services and the software needed to provide that level of capability.

Jeff Kvaal
Thank you, Aaron. Gary, could we have the next question, please?

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

Meta Marshall
Great. Thanks. Maybe taking a second on the Intelligent Edge business. Can you just give a sense of what is the biggest forward driver that you're seeing, I think people understand the catch-up spend and the backlog release that has been done, but just what you're seeing in ongoing kind of orders today? And is that WiFi 6 or is it still return to work? Just what are the biggest drivers that you're seeing to help continue the growth of that business? Thanks.

Antonio Neri

Well, thank you for the question. I'm incredibly proud of the work we have done in the Intelligent Edge business segment. This is the opportunity I highlighted in 2018 [ph], where I said we will invest over the next four years to build the right solutions that ultimately will allow customers to drive what I call a data-first digital transformation. So, it's a combination of things; number one, return to work, obviously, you need to have the right connectivity. Number two, in order to process the data, you need to connect devices and things that are essential, in order to provide the right cloud experience on those types of workloads and applications. But our portfolio is unique because we provide edge to cloud networking capabilities. Our strength obviously has always been in campus and branch. We see that to transition to Wi-Fi 6. In fact, we shipped more than 30 million ports so far with Wi-Fi 6. By number of access points and ports, we are one of the largest, if not the largest, I will say. And also, now that drives the 26 million ports we drove in the switching side, which was the thesis when I acquired Aruba in 2015.

Over time, we have made these all cloud native and we have added to it. And so, as we look forward, what I'm excited about is that we are delivering more capabilities and expanding our time with the same experience. So, we added Software-Defined Wide Area Network. Three, four years ago it was a niche market, now it is a very large market more than $5 billion in the TAM, and that's why we did the acquisition of Silver Peak. Now that's integrating the same control plane with HPE GreenLake as a part of the Aruba experience. And now we just completed the acquisition of Axis Security. So, it takes Axis Security and Silver Peak. Now, we're going to offer the most comprehensive SSE framework at the edge. And then also we are integrating Athonet, which provides both core 5G software-defined solutions and private 5G at the edge.

All of this comes under a cloud native model in a subscription based model, which will continue to fuel growth as we think about '24 and '25. Bottom line, it is one of the most comprehensive portfolios out in the market and no surprise obviously with the growth we have, obviously, we are converting more of our order book. But we exited Q3 and we expect to exit Q4 with a significantly elevated order book as we enter '24. And you can see the results right now represent 20% of the company revenue and almost half of the company profit. And so, the mix shift had really worked for us in this particular part of the portfolio as it is now with GreenLake as well.

Jeff Kvaal
Thank you, Meta. Gary?

Operator
The next question is from Asiya Merchant with Citi. Please go ahead.

Asiya Merchant
Great. Thank you for taking my questions. If you can, Storage was up sequentially, which was a positive and it seems like HPE Alletra is getting traction. As you think about the fourth quarter...the fiscal fourth quarter, if you can provide some guidelines on how you're thinking about your Storage portfolio, both on the top-line as well as when you think margins get back to the target margins, which are much higher than where they are right now? Thank you.

Antonio Neri
So, let me start and I will pass it to Jeremy. The team and I drove an intentional strategy to pivot that portfolio, which was a conglomerate of different offerings that we built over 15 years or so to one consistent architecture that allows customers to consume data services, both primary and secondary in a cloud-native way and a subscription-based model. So, HPE Alletra is our

primary storage that now covers pretty much all the price segments of the price bands, if you will, of the traditional storage from general purpose to business critical to mission-critical. And we address block and file. And in the future, we're also going to address the object piece.

So as a customer, you can now subscribe to HPE GreenLake, deploy one consistent back-end infrastructure, whether it's in a colo, or the edge, or in your own data center and consume hybrid cloud data services. And you can put block type of solutions or file and then eventually object, which is a significant CAPEX reduction for customers because they don't have to buy three different ways to deploy it. And an OPEX reduction because obviously, it's very efficient to manage in a cloud type of experience. And so, this business went from zero to in excess of $1 billion very, very quickly. And it's amazing that it's one of the fastest-growing products in our portfolio, growing triple-digits. But what I'm really pleased about is that it comes with a significant subscription, which is growing double-digits. So maybe, Jeremy, you want to take the second part of the question, how we see this evolve in particular from a margin perspective.

Jeremy Cox
Sure. And that's where I'll pick up, Antonio, on Alletra. I think we've previously talked to you guys about how this product is really a combination now of a higher software component and that software component does have an element of taking what was prior product revenue and now deferring that onto the balance sheet, about 14% is deferred onto the balance sheet. And so, as we see that work off over time as that product is deployed out, we'll start seeing an inflection point, and that should positively impact revenue as we look forward particularly into FY '24. And that also has an impact on the margin line, too, as that deferral is deferring software-based revenue that has a higher margin concentration to it. So, we would expect to see our operating margins start to recover back to historical levels as well as we look forward to '24.

Antonio Neri
And as Jeremy said, there is a specific component that is ratable here. So, we are going through that transition. But for two consecutive quarters, we saw demand improving, Q1 to Q2 and Q2 to Q3, and that's very positive. And we expect that to show up as we go forward as we transition those orders into revenues.

Jeff Kvaal
Thank you. Gary?

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

Samik Chatterjee
Hi, thanks for taking my question. You mentioned a couple of times in your prepared remarks about the cyclicality in the Compute business, which is a headwind. Maybe if you can outline your thoughts on where we are in the cycle? Is there more downside to revenue and margins as we move into fiscal fourth quarter or, you did reference a demand improvement. So, I'm just curious, does it imply fiscal 3Q is the near-term trough here in the business. And more broadly, if I can ask like questions that investors are asking us today is, how much of the demand improvement that you're seeing going into fiscal '24 helps you offset the tailwind that you have this year from backlog and still enable you to grow in fiscal '24, if you can share any early thoughts on that? Thank you.

Antonio Neri

Sure. So first of all, I think it's important to recognize that the traditional general purpose Compute business goes through these cycles. Last year, we obviously had a significant demand uptick because of the supply chain challenges. Customers are absorbing that, in some cases still need to deploy some of those products and the like. But we saw signs of stabilization and we saw demand improvement at the unit level, which is super, super important because demand in the unit level also drives attach. And as I referenced in my remarks, that unit demand together with the storage demand and obviously, the acceleration we saw in HPE GreenLake drove double-digit growth in operational services, which obviously is important as we think about ratable revenue and profit as we look into the future.

Now, we have this unique expectation of the company, because in the past we wanted to give you visibility of what is general purpose compute and what is HPC and supercomputers. But when you combine the two is what I refer to the server category because in the end, there is a server component associated with that. And there is different IP you bundle depending on if it's a general purpose or a supercomputer. And the combination of general-purpose compute, as you refer and HPC and supercomputers demand clearly improved very nicely quarter-over-quarter.

I think as I think about 2024 as a server category, I think you're going to see the continued improvement in demand on HPC & AI. I think the AI inference related to Compute will be announced to the rate for Compute. And then we have to see you know, the evolution of price in the commodity space, which you will expect some time in '24. That curve will end up again, because as demand stabilizes and improves, cost of commodity will start going up. And remember, we also have a transition in the making from what I call Gen 10 and Gen 10.5 to Gen 11. And Gen 11 also comes with a higher, we call it, product intensity. So as more options and the options come with larger memory and larger type of storage and obviously more GPU embedded in the traditional compute will drive, over time, AUPs up. I don't know if Jeremy, do you have anything to add.

Jeremy Cox
Maybe I'll pick up on the margin side of it, Antonio. Obviously, in these cycle times, I think we've proven that in down cycles where commodities are declining, causing declines in AUP. We've been able to hold pricing to drive margin. And then as it inflects back and turns back up, we've been able to be market leaders on pricing to make sure that we're catching it appropriately on that. So, our expectation is as that changes throughout this process, on top of the point that Antonio made about Gen 11 really driving an AUP premium for us, which can also be an impact. We still expect that 11% to 13% operating profit structural range to be reflective of what our longer-term expectations are.

Antonio Neri
But let me reinforce one important point because if you go back two years or three years, whatever was the cyclicality at the time, we will have a different dynamic in our total company revenue and profit. I want to reemphasize that because of our mix shift to edge, hybrid cloud and now AI as we go forward, which always expect margins to improve. The strong performance we had in that mix shift more than offsets the cyclicality we saw in Compute, which is very evident in our Q3 results because our margins improved again, 120 basis points. If you go back two years ago, our margins at the company level were in the 33's, in 2022, we're in the 34's, and in 2023, we are in the high 35's. And so, that tells you that structurally, our business composition is shifting, and we intend to continue to drive that mix shift. And that's why software and services with Intelligent Edge and hybrid cloud and now AI with our software-led strategy,

we'll continue to sustain that. And we will be able to manage the cyclical Compute much, much better.

Jeff Kvaal
Thank you, Samik. Gary, could we make this our last question, please?

Operator
And our final question will come from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Yes, thank you. Antonio, you're exiting this year with a high single-digit decline in revenues and Edge clearly is doing extremely well and some benefit from backlog. How confident are you that HPE can grow revenues in fiscal '24, given the current exit trajectory of the business, you also noted some stabilization. So curious to get just some high-level thoughts, not explicit guidance, maybe, but just some directional commentary on how you could see that playing out.

Antonio Neri
I think your comment is related to Q4, right? So obviously, we are going to lap a very high quarter, because last year in Q4, we were able to convert more of that order-book related to the fact that supply started improving in Q4 and you saw that in Q1. So, to me, it's just a lapping of the numbers. But that said, we're going to talk about this at the Securities Analyst Meeting, we expect revenue to continue to improve in fiscal year '24. We're going to tell you exactly what that will look like. But I will say that while revenue will improve year-over-year, and remember, in Q1, we're also going to have a big lap because Q1 revenue was $7.8 billion, the fact of the matter on a yearly basis, this year, we are growing 4% to 6%. And Jeremy talked about the headwind we saw in the FX, which is now 300 basis points. So, we are growing faster than what we guided you at the beginning of the year, which was 2% to 4%. We are now growing 4% to 6%. And we expect our revenue to continue to improve because of the momentum we have in the businesses, but we'll guide you to a specific percentage at the Securities Analyst Meeting.

But the other important part is that the mix of our revenue is changing, and the gross margin mix is changing, and the way we generate free cash flow is changing. And so, more to come when we talk at the Securities Analyst Meeting, okay?

I know that, unfortunately, you have to cover a lot of companies today, and I understand HP is about to start their call. I hope you can see from this quarter's results how our strategy is working. We are delivering on our commitments. We always do what we say. And we are successfully shifting our portfolio. And so, despite some aspects of the market being a little bit more challenged than others, we continue to grow revenue, we continue to expand margins, and we'll continue to improve our net earnings per share on a non-GAAP basis.

So, I'm looking forward to seeing you at the Securities Analyst Meeting in October. We're going to have it in New York, so it's a little bit more accessible. So, I hope to see you soon. And if you have any questions, we'll follow up with you offline. Thank you for your time today.

CONCLUSION

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