

29-May-2024

HP, Inc. (HPQ)

Q2 2024 Earnings Call

CORPORATE PARTICIPANTS

Orit Keinan Nahon

Senior Vice President-Finance & Head-Investor Relations, HP, Inc.

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

OTHER PARTICIPANTS

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Michael Ng

Analyst, Goldman Sachs & Co. LLC

Wamsi Mohan

Analyst, BofA Securities, Inc.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Samik Chatterjee

Analyst, JPMorgan Securities LLC

A. M. Sacconaghi

Analyst, Sanford C. Bernstein & Co. LLC

Michael Anthony Cadiz

Analyst, Citigroup Global Markets, Inc.

Steven Kinney Chin

Analyst, TD Cowen

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Second Quarter 2024 HP, Incorporated Earnings Conference Call. My name is Eric, and I'll be your conference moderator for today's call. At this time, all participants will be in listen-only mode. We will be facilitating a question-and-answer session towards the end of the conference. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

I would now turn the call over to Orit Keinan Nahon, Head of Investor Relations. Please go ahead.

Orit Keinan Nahon

Senior Vice President-Finance & Head-Investor Relations, HP, Inc.

Good afternoon, everyone, and welcome to HP's second quarter 2024 earnings conference call. With me today are Enrique Lores, HP's President and Chief Executive Officer; and Tim Brown, HP's Interim Chief Financial Officer.

Before handing the call over to Enrique, let me remind you that this call is a webcast and a replay will be available on our website shortly after the call for approximately one year. We posted the earnings release and accompanying slide presentation on our Investor Relations webpage at investor.hp.com.

As always, elements of this presentation are forward-looking and are based on our best view of the world and our businesses as we see them today. For more detailed information, please see disclaimers in the earnings materials relating to forward-looking statements that involve risks, uncertainties and assumptions.

For a discussion of some of these risks, uncertainties and assumptions, please refer to HP's SEC reports, including our most recent Form 10-K. HP assumes no obligation and does not intend to update any such forward-looking statements. We also note that the financial information discussed on this call reflects estimates based on information available now and could differ materially from the amounts ultimately reported in HP's SEC filings.

During this webcast, unless otherwise specifically noted, all comparisons are year-over-year comparisons with the corresponding year-ago period. In addition, unless otherwise noted, references to HP channel inventory refer to Tier 1 channel inventory.

For financial information that has been expressed on a non-GAAP basis, we've included reconciliations to the comparable GAAP information. Please refer to the tables and slide presentation accompanying today's earnings release for those reconciliations.

With that, I'd now like to turn the call over to Enrique.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you, Orit, and thank you all for joining today's call.

When we started the fiscal year, we committed to very specific goals, drive profitable growth in our core, accelerate in key growth areas and deliver operational efficiencies.

I am pleased to say we accomplished this and delivered a solid quarter and first half. The focus of our teams and actions we have taken, continue to drive results and build momentum. We delivered non-GAAP operating profit and non-GAAP EPS growth on a sequential and year-over-year basis. We made good progress against our Future Ready plan, and we continue to invest in innovative technologies with a strong emphasis on AI and hybrid.

Today, I will cover our second quarter results, including the recovery we are starting to see in commercial PCs, progress against our strategic priorities, key innovations we are bringing to market, and our expectations for the remainder of fiscal year 2024. Then, I will turn the call over to Tim for a deeper dive into our financials and outlook.

I will start with our results. We continue to navigate well a dynamic and competitive environment. While our net revenue was down 1 percent, the rate of decline slowed for the fourth straight quarter. Personal Systems also returned to growth for the first time in eight quarters. This is a good indicator of overall market stabilization and solid execution.

Non-GAAP operating profit grew 2% and non-GAAP EPS was up 4% year-over-year, which was slightly above the midpoint of our last quarter's guidance.

In terms of new innovations, Q2 was one of our most significant quarters. At our Amplify Partner Conference in March, we showcased over 100 AI-enabled solutions redefining productivity and collaboration. This event is our largest annual channel conference, attracting over 1,500 of our top partners from 95 countries. It inspired our partners and will help us to drive long-term sustained growth.

Let me share some of the key innovations we announced.

For the more than half-a-million data scientists who are using our workstation solutions to create AI models that improve company workflows, we had a lot to share. We announced the HP AI creation center, the world's most comprehensive workstation solutions for AI development. And we unveiled a strategic collaboration with NVIDIA

to integrate their pre-trained models and software into our AI studio set of tools. They will allow customers to access share and edit their data science workflows more easily from anywhere.

At the same time, we launched the industry's largest portfolio of AI PCs, the first to deliver the benefits of running AI locally on the device, for improved performance, efficiency, and privacy.

In Print, we shared how AI will unlock opportunities to make printing smarter, more efficient, and more personalized. And we unveiled our new Color LaserJet series, optimized for small and medium businesses.

We also stepped up in our key growth areas. In Hybrid Systems, we expanded our portfolio of room solutions with a Poly Studio 360-degree camera, enabling more immersive meeting experiences. In Workforce Solutions, we introduced an enhanced Workforce Experience Platform providing CIOs with an AI-enabled digital experience to unlock the full potential of their teams.

In addition, we are enabling our partners and sales teams to capitalize on the AI opportunity. We have introduced the industry's first ever role-based AI MasterClass training and certification program.

Doubling down on our momentum, last week at the Microsoft Copilot+ PC event, we introduced the world's most powerful ultra-mobile, next-gen AI PCs.

Designed from the ground up, they enable on-the-go leaders and freelancers to harness the most powerful AI technologies available. We also showcased our new AI Helix logo, that helps you easily identify and select this new category of devices. Initial reaction has been overwhelmingly positive, with our next-gen devices being recognized as "some of the most premium" announced and having "beyond cutting-edge hardware".

We are already helping customers unlock tangible value from their AI PCs. For example, collaborating with Deloitte Consulting, together we have created an on-device assistant to drive efficiency around common IT support challenges. The solution has the potential to return close to 100,000 hours of productivity to their practitioners. This is a powerful example of the positive impact of AI PCs.

One of HP's most important assets is the strength of our brand, and we continue to invest in it to build even greater value.

This quarter, we announced a historic title partnership with Scuderia Ferrari. This is an opportunity to elevate our brand and reach new audiences and geographies, particularly younger and premium customers. It also improves the effectiveness and efficiency of our marketing spend. And we are excited to work with Scuderia Ferrari, leveraging the latest HP innovations to help them drive their competitive advantage.

HP is a trusted brand. We are a company that stands for more than just the products we make. For the fifth year in a row, HP has earned a Triple "A" rating from CDP. Next month, we will release our annual Sustainable Impact Report outlining the progress we are making towards our climate action, human rights and digital equity goals.

Let me now share in more detail what we saw in each of our businesses in Q2. In Personal Systems, we executed our strategy, driving both revenue growth and increasing profitability year-over-year. The PS revenue was \$8.4 billion. That's up 3% year-over-year, driven mainly by market growth and signs of commercial recovery.

Our PS operating profit was 6%, in line with our expectations and solidly within our long-term target range. Our teams continue to show their focus by driving profitable PC share in calendar Q1 in high-value categories like commercial premium and mobile workstation.

Importantly, we continue to invest and grow in high-value and key growth areas. In Gaming we grew revenue year-over-year again this quarter. PS Services was up, with strong growth in managed services. And in Hybrid Systems we saw signs of recovery. Here we drove sequential growth and strong performance in video collaboration. We remain confident that this evolving market will be a long-term growth opportunity.

In the second half, we expect to see the introduction of AI PCs accelerate demand, over-and-above the anticipated PC refresh cycle and Windows 11 roll out. We believe the AI opportunity in front of us, will help drive higher ASPs and premium mix.

We have a comprehensive portfolio of AI-enabled devices, from consumer, commercial, gaming, accessories, room solutions, to advanced workstations solutions. We are innovating beyond hardware, with software and security solutions like HP AI companion and HP Wolf Security that uses deep learning, behavior analysis and AI-based protection against malware and deepfakes. With a rich history and proven track record of integrating meaningful AI technologies, such as noise removal and gesture controls, together with our strong innovation pipeline - we are well positioned to capture the opportunity and lead the industry.

Turning to Print, results were in line with what we expected. Revenue was \$4.4 billion, down 8% year-over-year and flat quarter-over-quarter. We continue to see soft demand, particularly in China and some parts of Europe. The pricing environment remains competitive in consumer, with intensifying pressure in commercial. We continued to make progress on pricing and share gains in Supplies, with revenue results as expected.

We delivered Print operating profit of 19%, in line with our guidance. Once again, we demonstrated disciplined cost management, improved mix, and the benefits of the strong innovations we have brought to market.

Our focus in Print remains on regaining profitable share, and we are making progress. We grew share quarter-over-quarter in home and in office. Importantly, we gained share year-over-year and sequentially in big tanks and business ink. We also grew in key growth areas like Consumer Services. We saw growth in revenue and in subscriber numbers across Instant Ink and our new All-In plans.

In Industrial Graphics, we continue to accelerate the adoption of digital technologies. In Q2, we grew year-over-year and for the third straight quarter. We also expanded our portfolio adding new end-to-end automation processes leveraging AI and robotics. These are on full display right now at Drupa 2024 – the largest trade fair for the printing and graphics industry worldwide.

3D continue to be impacted by elongated purchasing cycles in Q2, reflecting constraints on capital spending. The decline in hardware was partially offset by growth in services and supplies.

Overall, in Q2, we made good progress against our Future Ready strategy. We continue to execute according to plan, and we are on track to deliver on our three-year annual gross run rate structural cost savings target of \$1.6 billion by the end of fiscal year 2025.

We remain committed to our capital allocation strategy and expect to return approximately 100% of our free cash flow to shareholders in fiscal year 2024 and over time, as long as our gross leverage ratio remains below 2 times and unless higher ROI opportunities arise.

Looking forward to Q3 and the second half of fiscal year 2024, we expect the demand environment will remain dynamic and that our markets will continue to be very competitive. That said, we're encouraged by the progress we have made delivering a solid first half. And we expect a stronger second half.

The anticipated commercial PC refresh as well as early gains from the AI PC, together with our plans to gain share in Print, gives us confidence we are well-positioned to drive growth in our core businesses. At the same time, we see significant opportunities to accelerate in our key growth areas.

As you have seen repeatedly, we are delivering to expectations and will continue to maintain our focus as we enter the second half. We remain confident in our strategy and we'll continue to execute on our plan.

Let me now turn it over to Tim.

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

Thank you, and good afternoon, everyone.

We delivered solid financial results in Q2, driven by disciplined financial management and focused execution, while navigating a dynamic and competitive environment.

We are pleased with our continued progress we made in Q2 toward delivering on our financial commitments. Total revenue decline slowed further. Our gross profit dollars and margin, our non-GAAP operating profit dollars and margin and our non-GAAP EPS, all improved both year-over-year and quarter-over-quarter. In addition, we generated solid free cash flow. We achieved these results while simultaneously reinvesting in our key growth areas and in AI, and managing through a mixed market environment, characterized by slightly stronger PS commercial performance, balanced against continuing Print market demand challenges.

Now, let's take a closer look at the details of the quarter:

Net revenue was \$12.8 billion in the quarter, down 1% both nominally and in constant currency; in constant currency, Americas increased 2%, EMEA declined 3%, and APJ declined 5%. APJ was impacted as soft demand in China continued.

Gross margin was 23.6% in the quarter, up 1 point year-over-year, primarily due to lower commodity and logistics costs and cost savings, partially offset by unfavorable mix and competitive pricing.

Non-GAAP operating expenses were \$1.9 billion or 14.8% of revenue. The year-over-year increase in operating expenses was driven primarily by continued investments in higher variable compensation, partially offset by cost reductions. Non-GAAP operating profit was \$1.1 billion, up 2%. Non-GAAP net OI&E was \$158 million, down primarily due to lower interest expense driven by a decrease in debt outstanding.

Non-GAAP diluted net earnings per share increased 3 cents or 4% to 82 cents, with a diluted share count of approximately 1 billion shares.

Non-GAAP diluted net earnings per share excludes a net expense totaling \$205 million primarily related to:

- Amortization of intangibles,
- Restructuring and other charges,
- Acquisition and divestiture-related charges, nonoperating retirement-related credits, and other tax adjustments.

As a result, Q2 GAAP diluted net earnings per share was \$0.61.

Now let's turn to segment performance.

In Q2, Personal Systems revenue was \$8.4 billion, up 3%, or 2% in constant currency, driven by higher volumes led by Commercial, partially offset by a decline in ASPs and continued weakness in China. Total units were up 7% with Consumer down 1% and Commercial up 12%. Personal Systems revenue returned to growth, exceeding our expectations. We are encouraged by the positive momentum exiting Q2 as we head into the seasonally stronger second half of the year.

Drilling into the details, Consumer revenue was down 3%, and Commercial revenue was up 6%, representing greater than 70% of Personal Systems revenue. ASPs were flat quarter-over-quarter driven by a favorable mix shift toward commercial and increased consumer pricing, offset largely by an increased mix of lower end devices. While our market share declined in calendar Q1 as competition intensified, we drove share improvements in high value categories including mobile workstations, and commercial premium. We remain focused on driving profitable revenue and share growth in both our consumer and commercial markets. Last week we announced the launch of our next gen AI PC which is part of a series of launches planned for this year that will expand our portfolio of AI PCs, as we enable our customers to deploy advanced AI technology at the edge.

Personal Systems delivered \$508 million of operating profit, with operating margins of 6.0%. Our margin increased 0.7 points year-over-year, driven by lower commodity and logistics costs and cost savings, including Future Ready savings, offset partially by competitive pricing and investments.

In Print, our results reflected our focus on improving execution and diligently managing cost as we continue to navigate a very competitive Print market.

In Q2, total Print revenue was \$4.4 billion dollars, down 8% on a reported basis and down 7% in constant currency. The decline was driven by declines in both hardware and Supplies. Hardware revenue was down 18% year-over-year, driven by lower volumes attributable primarily to continued weak demand, especially in China and EMEA, as well as share loss in both home and office due to aggressive pricing partially driven by further depreciation of the Yen. Total hardware units decreased 17% year-over-year. Industrial Graphics grew revenue for the third consecutive quarter driven by supplies and services, offsetting softer hardware demand as we believe customers delayed purchasing decisions in anticipation of Drupa which started yesterday.

By customer segment, Commercial revenue decreased 12% with units down 17%. Consumer revenue decreased 16% with units down 17%. In Big Tank we increased our volumes and market share sequentially, partially offsetting continued market softness and competitive pricing in the traditional home ink market. In Consumer Services, we drove revenue and subscriber growth in both our Instant Ink and All-in plans.

Supplies revenue was \$2.9 billion, down 5% on a reported basis, and down 4% in constant currency. This was in line with our outlook.

Print operating profit was \$829 million, down 8% year-over-year, and operating margin was 19%. Operating margin was flat year-over-year, driven by disciplined cost management, including Future Ready savings and favorable mix, offset by competitive hardware pricing.

Turning to our Future Ready transformation plan. We are on track to achieve our fiscal year-end 2024 goal of delivering a cumulative 70% of our year-end 2025 goal of gross annual run rate structural cost savings of \$1.6 billion. We expect to achieve this by driving efficiencies in our core businesses.

We are pleased with our progress in reducing our cost across Print and PS. We continue to see the benefits of initiatives we launched in prior quarters. For example, we continue to optimize our location strategy with plans for additional site actions this year. In our digital transformation initiatives, we're accelerating our generative AI

capabilities, including rolling out AI tools such as GitHub Copilot to approximately 60% of our developers, as well as implementing HP-specific large language models to improve efficiencies across our sales and service organizations. In Marketing, we continue to optimize and in-house our digital media capabilities and maximize programmatic investments. Specifically, we are delivering savings through AI-enhanced capabilities, scaling content production and working towards translation cost efficiencies, helping us improve our NPI marketing efficiency, with lower agency costs and next-gen market insights and measurement. In PS, we are simplifying our portfolio as we announced last week our brand simplification strategy across our consumer and commercial portfolios.

Now let me move to cash flow and capital allocation.

Q2 cash flow from operations was approximately \$581 million and free cash flow was \$481 million, driven by net earnings.

The cash conversion cycle was minus 31 days in the quarter. This decreased 2 days sequentially due to days inventory increasing 9 days, days payable increasing 16 days, and days receivables increasing 5 days. The increase in DOI was driven primarily by an increase in strategic buys and sea shipments, both of which drive economic value. The strategic buys continue to allow us to take advantage of attractive economic offerings from suppliers to reduce the near-term financial impact of rising commodity costs. The increase in DPO was driven by an increase in accounts payable due to purchase timing and higher strategic buy inventory.

In Q2, we returned approximately \$369 million dollars to shareholders, including \$100 million dollars in share repurchases and \$269 million dollars in cash dividends. We finished the quarter within our target leverage range, and expect to return approximately 100% of our free cash flow to shareholders in FY24 and over time, as long as our gross leverage ratio remains below 2 times and unless higher ROI opportunities arise.

Looking forward to the second half of FY 2024, keep the following in mind related to our FY 2024 and Q3 financial outlook.

- As Enrique said, we expect performance in the second half of fiscal 2024 will be seasonally stronger than the first half.
- We continue to model multiple scenarios based on several assumptions. For FY 2024, we are narrowing our non-GAAP EPS outlook range to \$0.30, but we continue to see a range of potential outcomes for H2 2024, which is reflected in our updated outlook.
- We remain focused on improving our cost structure and our performance, while continuing to invest in our growth businesses.
- Regarding OI&E expense, we now expect it will be approximately \$0.6 billion in FY 2024.
- We continue to expect free cash flow to be in the range of \$3.1 billion to \$3.6 billion for FY 2024, improving sequentially in both fiscal Q3 and Q4. As a reminder, our free cash flow outlook includes approximately \$300 million of restructuring cash outflows.

Turning to Personal Systems,

- Specifically, for Q3, we expect Personal Systems revenue will increase sequentially by a high-single digit, though slightly less than typical seasonality.
- We expect Personal Systems margins to be towards the high-end of our long-term target range of 5% to 7% in Q3, augmented by disciplined cost management actions.
- For FY 2024, we expect Personal Systems margins to be solidly within our long-term target range, driven by improved PC revenue in the back half of the year, continued mix improvements and cost efficiencies.

In Print, we expect Print to stabilize in the second half of the year, consistent with the market outlook. For Q3, we

expect Print revenue to decrease sequentially by low-single digit, in line with typical seasonality. We continue to expect supplies revenue in FY 2024 to decline by a low- to mid-single digit in constant currency. For Q3, we expect Print margins to be in the upper half of our 16% and 19% range and now expect FY 2024 margins to be at the high-end of the range, driven by rigorous cost management.

Taking these considerations into account, we are providing the following outlook for Q3 and fiscal year 2024:

- We expect third quarter non-GAAP diluted net earnings per share to be in the range of \$0.78 to \$0.92, and
- Third quarter GAAP diluted net earnings per share to be in the range of \$0.63 to \$0.77.
- We expect FY 2024 non-GAAP diluted net earnings per share to be in the range of \$3 dollars and 30 cents to \$3 dollars and 60 cents, and
- FY24 GAAP diluted net earnings per share to be in the range of \$2 dollars and 60 cents to \$2 dollars and 90 cents.

I'll stop here so we can open the lines for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. And we will now begin the question-and-answer session. [Operator Instructions] And our first questioner today will be Erik Woodring with Morgan Stanley. Please go ahead.

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you, guys, very much for taking my questions. Enrique, maybe if I, I think, turn to you first. At the start of the year, you had talked about the Print business kind of performing in line with the market at roughly flat this year. Year-to-date, it's declining, let's call it, mid-single digits. You're telling your supplies will continue to decline low- to mid-single digits, but you expect the market to stabilize in the second half of the year.

And so, maybe my first question is, why do you believe other than easier year-over-year compares, the Print market will stabilize in the second half of the year? Are there any of the underlying factors that have impacted the Print business? Are any of those changing as you look to the second half, like yen competition and broader market trends?

And then as we think about hardware seasonality in the second half of the year, should we still be thinking about an improving trend sequentially there? How does that translate to year-over-year growth? Kind of if you could unpack all of that just for print, that would be super helpful. And then I have a follow-up. Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Sure. Thank you, Erik. It's a long question. So I'll try to cover all your points. So first of all, in terms of what do we see from a competitive perspective, as you mentioned, we continue to see fairly strong competition in the Consumer side, similar to what we were seeing in Q1. Where we have seen an intensified competition is in the office space, driven by the similar reasons what has happened in Consumer. So this clearly has evolved.

When we think about the second half, we expect the market to stabilize and you mentioned one of the key reasons, which is an easier compare to what we had in the second half of 2023 are underlying drivers that give us some confidence in this number. First of all, is what we are seeing from a usage perspective that usage has been fairly stable, especially in the office space per printer, which is always a good indicator of what is going to be the overall performance from a printer perspective?

And then, in terms of our own projections for HP, as we shared last quarter, we have been working to reduce our cost structure to be able to be more competitive. So we expect to have some share gains in the second half, again, because of the cost actions that we have been driving during the previous two quarters. So in our performance, you should see that reflected. And again, this doesn't mean that we have changed our strategy. Our strategy continues to be profitable growth. It's just that we will be able to sell more units in a profitable way and capture share in this way.

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's helpful. Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you.

A

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

And then, maybe if I stay on the Printing side, again, really strong Print operating margin performance. It was down about 90 basis points sequentially. And I think Print supplies as a percentage of Print mix was up sequentially, just given the weak Print hardware trend. So I deduce that would mean supplies margins were lower sequentially. Can you maybe just unpack it? One, if that's the correct way of thinking about it? And then, two, kind of what drove that trend and how is it impacting your view on Print operating margins for the second half of the year? Thanks so much.

Q

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

Yeah. Erik, this is Tim. I'll maybe take that. From a quarter-on-quarter perspective, you're right. It was down about 0.90%. It wasn't so much driven by supplies gross margin rate. We made some additional investments, most notably in variable compensation, and that was a bigger driver.

A

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Margins for the second half.

A

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

I'm sorry, margins for the second half. Yeah, from a Print perspective, as I said in the prepared remarks, we expect to be in the upper half of the long-term 16% to 19% range in Q3; and for the full year, at the upper end of that range. I think a couple of the key drivers that you should think about is, one, the 2H sequential improvement we do expect to see in hardware, both from a market and a share perspective. We'll continue to focus on driving operating profit dollars as well through new business models and cost management.

A

And then, just to reiterate, as we said before, our forecast for supplies is to decline low to mid-single digits in constant currency for the full year. And again, from a range perspective, just keep in mind, we provide these for modeling purposes, but we really are trying to drive OP dollars.

Erik W. Woodring

Analyst, Morgan Stanley & Co. LLC

Great. Thank you so much, guys.

Q

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thanks, Erik.

A

Operator: Your next question comes from Michael Ng with Goldman Sachs. Please go ahead.

Michael Ng

Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good afternoon. Thank you for the question. Within Personal Systems, we saw inflections in both consumer and commercial units. You talked a little bit about a recovery that you're seeing in commercial PCs. I was wondering if you could just expand a little bit more on that. Are there any specific verticals where you're seeing Xthat spend improve? Do you think this is an indication of a broader IT spending recovery? And then, are there any comments you can make on the slowdown in consumer unit growth? Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Sure. So let me start, and maybe Tim wants to make a few comments afterwards. So I think you highlighted the key points. We saw, for the first time in eight quarters, growth in the PC business. And really, commercial is the highlight of the quarter. That performed even better than we were expecting. It was fairly consistent between North America and Europe and between enterprise and SMB. So probably the key thing is that was not one segment, was across the segments, while we continue to see weakness in Asia, especially in China.

Probably some of the underlying factors that we have seen the drivers of this: is the need to refresh the installed base as it has been aging, and especially as we look at the second half, when we look at the funnel of opportunities that we see, that is significantly bigger than what we had last year, and also the fact that we are starting to see some deals driven by Windows 11 refresh. This is what we are reflecting in the projections that we have for the second half, where we expect this momentum to continue.

Also, for the second half, we expect the federal business, and this is our US-focused comment, will also improve because during the first half, the business was impacted by the budget discussions. And as some of them has been released, we expect the federal business to also be stronger in the second half.

Michael Ng

Analyst, Goldman Sachs & Co. LLC

Q

Excellent. Thank you for all that color, Enrique. And then, just as a quick follow-up, it was helpful to hear about the inventory increase due to strategic buys. I was just wondering if you could refresh us on your philosophy and strategy around those component purchases. Said differently, how far in advance are you buying some of these components? When would we see more market rate component flow through the P&L? Thank you.

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

A

Yeah, sure. This is Tim. I'll take that one. We haven't changed our philosophy or our strategy with respect to strategic buys. We'll continue to kind of evaluate them based on the opportunities that present themselves. And if it makes financial sense for us, we'll take those. And certainly, that is something that we try and do and offset from an operational standpoint by making our operational inventory more efficient and utilize that more efficient. So I think that just underscores our commitment to efficient inventory management. And I think as we look forward, we'll continue to do that.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

And there is not a predetermined view in terms of how many months or – we're really looking at the impact it will have in the P&L and our ability to consume those products in a reasonable amount of time.

Michael Ng

Analyst, Goldman Sachs & Co. LLC

Great. Thank you, Enrique. Thank you, Tim.

Q

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you.

A

Operator: Your next question comes from Amit Daryanani with Evercore ISI. Please go ahead.

Q

Hey, guys. Thanks for taking the question. This is Chenon for Amit. I just had a question on the commentary about AI PCs that you talked about on the call. We're obviously hearing a lot about AI PCs across the supply chain heading into the second half of the year. How are you thinking about the adoption curve of these AI PCs? And really because there hasn't been a killer app introduced yet. How should we think about the mix of AI PCs versus non-AI PCs and your units shipped in the back half of the year? And how should we think about the ASP tailwinds from these AI PCs in fiscal 2024 and 2025?

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Sure. We think that the penetration of AI PCs is going to be growing over time. This year, we have products coming both from the first generation that we announced in January and February, and for the next generation that we just announced a couple of weeks ago. If we look at the total of both, we expect that they will represent around 10% of the shipments for the second half. That's how we are quantifying that. But really, the impact will be more relevant in 2025 and in 2026.

In fact, we expect that AI PCs, and at that point will be our new generation, will be between 40% and 60% of our sales three years after launch. That's kind of how we're looking at that. And as we have discussed before, we continue to believe that they will drive an improvement in average selling price of between 5% and 10%.

Q

Great. Thanks for the color.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you.

A

Operator: Your next question comes from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan

Analyst, BofA Securities, Inc.

Q

Yes. Thank you so much. Enrique, I was wondering if you could expand a little more on the comment on signs of commercial recovery in PS. I think you said, partially driven by adoption of Windows 11. How much would you characterize – have you seen any real traction yet on Windows 10 end-of-life support-driven strength? Or perhaps, if you could characterize it even from a COVID refresh perspective or anything else? Any color there would be helpful. And I have a follow-up.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Sure. As you know, Wamsi, this was one of the assumptions that we had at the beginning of the year that Windows 11 refresh would be impacting the results on the second half. And we are starting to see that not so much on the numbers for Q2. But, yes, in the funnel that we are starting to see and the opportunities that many of our large enterprise customers are starting to bring us. It's clearly starting to happen. During Q2, Microsoft published dates and costs to support the previous operating systems. And this always creates an acceleration of the process, and this is what we have started to see.

In parallel to that, as you mentioned, clearly, the installed base has been aging during the last two, three years, and we think this is also impacting the strength that we are starting to see on the commercial side.

Wamsi Mohan

Analyst, BofA Securities, Inc.

Q

Okay. Thanks, Enrique. As a follow-up, I was wondering if you could touch a little bit on the seasonality. I think you said you're expecting in PS, revenue up high-single digits, slightly below typical seasonality and then continuing to grow into Q4. Just wondering maybe if you could put that in perspective of maybe second half versus first half, how that might compare to a typical year seasonality half versus half.

And just on the margin side, clearly, very impressive margins here, and you're on track on your Future Ready program. Would you say that – like, is there any sense you can give us on how those savings are flowing across PS and Print, just so we would understand sort of cost savings and things that you're doing on your Future Ready side versus pricing and mix? Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Tim, do you want to take the seasonality one?

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

A

Yeah. As you said, Wamsi, from Q2 to Q3 perspective, we do expect to grow sequentially high-single digits, slightly below normal seasonality. I think if your question is really about the full half, I think you could think about the seasonality to be slightly stronger than historical for the full half, if you think about Q4 in PCs.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

And the split between Q3 and Q4, traditionally, Q4 is a stronger quarter. So this is how we've built the guide for the second half and the guide for each quarter. And then, in terms of savings, Tim?

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

A

From a Future Ready savings perspective, we do see the Future Ready across both businesses. I don't know that it's more pronounced in one versus the other. We're definitely focused from a core perspective where we're driving some of those efficiencies.

I think the important thing to note about the Future Ready savings is it does help us deliver our margin rates even in a challenging demand environment. And it is allowing us to reinvest in some of the key growth areas and key areas such as AI and our people. And I'll leave it at that.

Wamsi Mohan

Analyst, BofA Securities, Inc.

Q

Okay. Thank you so much.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Thank you.

Operator: The next question comes from Ananda Baruah with Loop Capital Market. Please go ahead.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Hey. Yeah. Thanks a lot. Hey, guys. Good afternoon. Appreciate you guys taking the question. I guess, let's – well, yeah, just sticking with PCs, what's a good way to think, Enrique and Tim, about I guess kind of margin as you go through the refresh cycle, given that it sounds like I think gen AI PCs are going to – and AI PCs are going to be sort of a disproportionate amount in the mix? And then, just a quick follow-up also. Thanks.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Well, from a margin perspective, Ananda, we are not changing the guidelines that we have provided in the past. We expect the PC business to stay in the 5% to 7% range and Tim mentioned where we expect this to be for the second half. At this point this is the projection that we have. We have multiple variables, ups and downs, but this is our view at this point.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Cool. And just a quick follow-up is, have you guys – I'm just interested in if you have any thoughts yet, Enrique, on battery, battery power, battery capacity, battery life over the next sort of 36 months. As gen AI PCs start to make their way into the world, the battery drain becomes with the use of gen AI capability. Any thoughts there on battery? And that's it for me. Thanks, guys.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Sure. Let me make two comments. First of all, in the next-generation AI PCs that we introduced a couple of weeks ago, actually battery life is one of the key differentiators. In fact, battery life is over 30 hours, and this is

driven by the fact that both we are using ARM technology in the PCs, which is more efficient from a cost perspective, but also because one of the enablers of AI PCs is that we are building in our PCs large language models that optimize the utilization of the PC based on how each user is going to be using that.

What this means is the PC will learn what applications we are using, what applications we are not using, and how to optimize consumption based on that. That is really a personal device based on your own utilization, which over time is also going to have a significant impact on battery savings, not only on ARM products, but also on x86 products; this is one of the big differentiators of AI PCs.

Ananda Baruah

Analyst, Loop Capital Markets LLC

That's a lot of great context. Super helpful. Thanks, guys. Thanks, Enrique.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Sure.

Operator: The next question comes from Samik Chatterjee with JPMorgan. Please go ahead.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Yes. Hi. Thanks for the questions. I guess, if I can just start, Enrique, you had in your prepared remarks, just in terms of the outlook or what you're seeing in the China market looks overall from the momentum perspective that overall demand is not strong in that market. We've seen some of the more, I guess, macro data come out a bit more positive in recent weeks.

Anything more you can share in terms of how you're thinking about the geography, sort of that particular region progressing through the rest of the year? Are things getting a bit better or do you see further downside from where things are in terms of demand? Any more recent sort of commentary that you can see in terms of your order trends there? And I have a quick follow-up. Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Sure. So, we didn't see an improvement of demand in the second quarter, not for Print, nor for Personal Systems. And we haven't built any improvement in our projections for the second half. We think that the economic situation will continue to be challenged, and this is what we are building in our plan. And this applies to China. In other geographies, we are seeing great momentum, great progress, for example, in India, and this has been a very positive market for us in the last quarter.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Got it. Great. And on the Poly business specifically, I mean, it seems like overall demand trends are starting to improve. But when you think about sort of overall enterprises and their willingness to go back and spend on video collaboration again, what you're seeing in relation to sort of reengaging in terms of making that a priority in relation to their office space and investments in their office space? Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Yeah. Thank you. On the overall hybrid systems business, which is how we call it, we continue to see from one side the demand has been limited. And as you said, enterprises have been limiting their investment. At the same time, quarter-on-quarter, we started to see some momentum, and we expect it to continue in the second half. And this was especially true in video conferencing systems.

From a long-term perspective, we continue to believe that this is going to be a growth opportunity for us. We think the flexibility that the hybrid work world means – brings is important for companies and is important for employees. And therefore, this opportunity is going to continue to be very real in the years to come.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Got it. Great. Thank you. Thanks for taking my questions.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Thank you.

Operator: The next question comes from Toni Sacconaghi with Bernstein Research. Please go ahead.

A. M. Sacconaghi

Analyst, Sanford C. Bernstein & Co. LLC

Q

Yes. Thank you. I just had a couple of quick clarifications, and then a question. Just to clarify, you sound very constructive on the recovery in PCs and some further tailwind from AI PCs. So I'm a little surprised you're actually guiding below normal seasonal for Q3. Can you explain why that is? And also, just on the buybacks, the buybacks are only \$100 million this quarter, quite a bit lower than the first quarter. Again, could you just clarify? And I have a follow-up, please.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Sure. Let me take the question on PCs. We saw strength on the commercial side in Q2, and we are projecting that in the second half. At the same time, we are more cautious on the demand side on consumer, and we are also projecting that to continue in the second half. And this is what has some impact from a seasonality perspective because, as you know, from a seasonality perspective, consumer has a stronger seasonality in the second half, and this is why we're being a bit more conservative in our assumptions for the second half.

In terms of share buybacks, probably the most important comment to make is we have not changed our approach. Our goal continues to be to return 100% of free cash flow to investors, unless we identify better ROI opportunities and while our leverage stays below 2 times. And investors should expect that we will continue to return 100% of free cash flow over time.

A. M. Sacconaghi

Analyst, Sanford C. Bernstein & Co. LLC

Q

Okay. Thank you. And just if I could zoom out and just try and level set, like I think revenue this year and last year for HP overall, it's going to be \$53 billion to \$54 billion. Pre-COVID, the two years, it was about \$58 billion. The

PC market is going to be about the same level of units this year. I suppose the printing market is down a little bit. But why do you think revenues are still almost 10% below pre-COVID levels? And do you think like there actually should be some snap-back to pre-COVID levels, or do you think there's been some share loss over the last few years? How do I reconcile those data points? Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Yeah. I think we will have a more detailed conversation about 2025 in the coming quarters, and what are the projections there. I think you touched on some of the key points. The pre-market both on Print and office is smaller than it used to be. So this has an impact on size. Also, on PCs, even if during the last quarter we have been recovering share, we are still not at the level where we were before the pandemic. And our goal is to continue to grow share. So there are multiple factors. And in Q4, when we'll talk about 2025, we will give kind of the projections and what we expect to see versus 2019 and previous years.

A. M. Sacconaghi

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Thank you. And looking forward to see you tomorrow, Toni.

A. M. Sacconaghi

Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you.

Operator: Your next question comes from Asiya Merchant with Citigroup. Please go ahead.

Michael Anthony Cadiz

Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good afternoon. This is Michael Cadiz for Asiya at Citi. Just one question. I know you've given some good points on commercial versus consumer in the second half. But through the lens of AI PCs, as they gain traction starting in the back half, can you review those comments on commercial versus consumer and how we should look at them through that AI PC view?

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

A

Yes. I think the key thing, though, is from – especially on the next-generation AI PCs, we expect a fairly small impact in the results of the second half. But the products were just launched, and we will continue to expand the portfolio. But the impact in the second half is going to be fairly small. Of the products we just launched, we expect a stronger traction in consumer because commercial requires some evaluation done by customers. That takes some time. But over time, we expect the penetration in commercial to grow and to be more relevant in 2025 and in 2026.

Michael Anthony Cadiz

Analyst, Citigroup Global Markets, Inc.

Q

Excellent. Thank you.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you.

A

Operator: The next question comes from the line of Krish Sankar with TD Cowen. Please go ahead.

Steven Kinney Chin

Analyst, TD Cowen

Yes, hi. This is Steven calling on behalf of Krish. Thanks for taking my questions. The first one, if I could, I guess, Enrique, could you talk about what percentage of your revenues today are coming from subscription-based revenues, whether it's the Print-related or also the newer All-In programs? And kind of do you have like a longer-term view on what that mix could be for next year? And are you also willing to quantify what the operating margins might be for the subscription-based revenues versus what you normally sell through the retail and distribution channels?

Q

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Sure. We don't disclose the specific numbers of our subscription business, but let me make a few qualitative comments. First of all, in Q2, we continue to see growth, both of net subscribers and also of revenue in the consumer services space that integrates all the subscription models.

During the last quarter, we have been expanding our portfolio to first paper and then in Q2 to also include the printer in what we call the All-In model, and we keep making good progress in the three subscription programs that we have at this point. Our goal is, of course, to continue to grow this business because both enables us to offer a better value proposition to our customers, but also because it allows us to capture more value per customer as the value proposition seems stronger, and you can approx that to profit that we'll get from customers. So we really think this as a way of building a more accretive business.

A

Steven Kinney Chin

Analyst, TD Cowen

Great. Thank you for that. And as my follow-up question, maybe for Tim. I had a question on the balance sheet and specifically inventories as well. I was wondering if there was a major structural change that is going on in terms of inventory dollar levels. If I look at current revenue run rate and also the current inventory levels, I would have – and comparing to pre-pandemic levels in fiscal 2017 where revenue levels were similar to today, your inventory levels are much higher in terms of dollars.

Q

I'm just kind of wondering, is this all just due to buy ahead or strategic buys? Or is there also some element of changing your current business mix, whether it's higher commercial PC mix and also the shift to more subscription model-based revenues? Is that having a bigger impact on how much inventory you have to maintain? Thank you.

Timothy J. Brown

Interim Chief Financial Officer, HP, Inc.

Yeah. First, on the subscription comment. No, that doesn't impact the inventory levels that we're taking. From a structural standpoint, we haven't changed our structural inventory meaningfully. Most of what you see is related to

A

strategic buys and sea shipments as we choose to put those on the ocean, and that will change over time – at times. So there's nothing more than those two things. And what I would say is, and the only thing I would add is what I said before is partially offsetting some of those decisions we make, we are continuing to actually improve our operational inventory to help fund those other items.

Steven Kinney Chin

Analyst, TD Cowen



Great. Thank you so much.

Enrique Lores

President, Chief Executive Officer & Director, HP, Inc.

Thank you, Tim. Thank you, everybody, for joining the call. As you saw, Q2 was a solid quarter that closes a solid first half of the year. And the more relevant thing is the recovery that we saw in PC, especially in Commercial business, which makes us being positive about the second half where we expect a stronger second half than what we have seen in the first half. And the combination of the progress on the execution side and the growth that we continue to experience in, what we call, the growth businesses gives us confidence in our ability to continue to create value long term. So thank you again, everybody, for joining and looking forward to seeing many of you in the coming weeks. Thank you.

Operator: Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.