FINAL TRANSCRIPT

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HPQ - Q3 2011 Hewlett-Packard Earnings Conference Call

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CORPORATE PARTICIPANTS

Steve Fieler
Hewlett-Packard - VP, Investor Relations

Leo Apotheker
Hewlett Packard Co - CEO, President

Cathie Lesjak
Hewlett-Packard - EVP & CFO

CONFERENCE CALL PARTICIPANTS

Katy Huberty
Morgan Stanley - Analyst

Ben Reitzes
Barclays Capital - Analyst

Richard Gardner
Citigroup - Analyst

Toni Sacconaghi
Sanford C. Bernstein & Company, Inc. - Analyst

Shannon Cross
Cross Research - Analyst

Bill Shope
Goldman Sachs - Analyst

Keith Bachman
BMO Capital Markets - Analyst

Brian Alexander
Raymond James & Associates - Analyst

Aaron Rakers
Stifel Nicolaus - Analyst

Kulbinder Garcha
Credit Suisse - Analyst

Maynard Um
UBS - Analyst

Peter Misek
Jefferies & Co. - Analyst

Brian Marshall
Gleacher & Company - Analyst

Abhey Lamba
ISI Group - Analyst

Amit Daryanani
RBC Capital Markets - Analyst

PRESENTATION

Operator

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Good day, ladies and gentlemen, and welcome to the Third Quarter 2011 Hewlett-Packard Earnings Conference Call. My name is Regina and I will be your conference moderator for today's call. At this time, all participants are in a listen-only mode. We will be facilitating a question and answer session toward the end of the conference. (Operator Instructions) 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. Steve Fieler, Vice President of Investor Relations. Please proceed.

Steve Fieler - *Hewlett-Packard - VP, Investor Relations*

Good afternoon. Welcome to our third quarter earnings conference call with Leo Apotheker, HP's Chief Executive Officer and Cathie Lesjack, HP's Chief Financial Officer. By now, you've seen our press releases reporting our Q3 earnings and Company transformation, including our decision to evaluate strategic alternatives for PSG and our announced intent to acquire Autonomy.

We will discuss each of these topics in more detail on today's call. Before handing the call over to Leo, let me remind you that this call is being webcast. A replay of the webcast will be available shortly after the call for approximately 1 year. In addition, some information provided during this call may include forward-looking statements that are based on certain assumptions and are subject to a number of risks and uncertainties and actual future results may vary materially.

Please refer to the risks described in HP's SEC reports, including our most recent Form 10-Q. The financial information discussed in connection with this call, including tax-related items, reflects estimates based on information available at this time and could differ materially in the amounts ultimately reported in HP's Q3 Form 10-Q.

Earnings, operating margins, and similar items at the Company level are sometimes expressed on a non-GAAP basis and have been adjusted to exclude certain items including amortization of purchased intangibles, restructuring charges, and acquisition-related charges.

Comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables and in the slide presentation accompanying today's earnings release. We have also provided supporting materials for today's announced acquisition of Autonomy, all of which are available on the HP Investor Relations web page at www.hp.com. I'll now turn the call over to Leo.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Thank you, Steve, and good afternoon. By now, you have seen all of today's announcements. It is indeed a lot of news that can put it all in some perspective for you. Today is all about driving shareholder value and addressing the challenges we face in our business.

But most of all, today is about transforming HP for the future. I've now been here as CEO for 9 months. I've looked at all of the businesses. I examined each in depth and carefully consider the path forward. These are tough decisions. There are 4 elements to that path. Let me summarize them and then I'll talk about each in turn.

First, there are circular trends impacting our PSG business as consumers are changing the use of the PC. The tablet effect is real and sales of the TouchPad are not meeting our expectations. We see the opportunity for PSG to compete and win in the PC marketplace and our Board has authorized to us explore strategic alternatives for PSG.

We intend to evaluate a range of options that may include, among others, a separation of PSG from HP to a spinoff or other transaction. To contemplate the direction is an important component of our strategy to sharpen HP's focus of clients, solutions and software accessible to any type of device, while we continue to expand and leverage our strong technologies including printing hardware, software and services.

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Second, our Enterprise Service business needs to be reshaped as we have discussed the last 2 quarters. That effort is well underway and today we will announce a new leader for that unit. Third, there are tactical issues that we are facing. The challenge to our BusinessCritical Systems business due to the Oracle Itanium issue is real and we are addressing that. And we are confronting the challenge of the Japanese earthquake in our printing business and still face a yen headwind.

Fourth, we must create more strategic relationships with our customers that will come from the delivering value-added IP. Our focus on building a successful software business has momentum and we are going to accelerate that today with the acquisition of Autonomy. Let me address each of these topics in turn.

First, the velocity of change in the personal device marketplace continues to increase and the competitive landscape is growing increasingly more complex, especially around the personal computing arena. There's a clear circular movement in the consumer PC space.

The impact of the economy has impacted consumer sales and the tablet effect is real and our TouchPad has not been gaining enough traction in the marketplace. For our PC business to remain the world's largest personal computing business, it needs the flexibility and agility to make decisions best for its [user] direction.

That is why the Board of Directors has authorized our Management team to explore strategic alternatives for PSG. We intend to evaluate a range of options that may include, among others, a separation of PSG from HP to a spinoff or other transaction. We anticipate that we will take 12 to 18 months to complete this process. Meanwhile, we will be very focused on continuing to drive profitable growth and execution in PSG.

For HP's customers, trading partners, and employees, we will continue to demonstrate PSG's market leadership, ingenuity and innovation. Additionally, we have been tracking closely the progress of webOS and analyzing its operational performance and market opportunities. We were successful at launching software that was poised for its differentiated user experience.

We know that many developers feel the operating system is elegantly designed and is a respected platform. Therefore, we are exploring options for how best to optimize the value of webOS software going forward. However, our webOS devices have not gained enough traction in the marketplace with consumers and we see too long a ramp-up in the market share.

Due to market dynamics, significant competition, and a rapidly changing environment and this week's news only reiterates the speed and nature of this change, continuing to execute our current device approach in this market space is no longer in the best interest of HP and HP shareholders.

Therefore, we have made a difficult but necessary decision to shut down the webOS hardware operations within Q4 2011. Transformation can involve difficult decisions, but we take these steps to better position for the future.

Second, let's take a look at Services. As we have discussed the past 2 quarters, we're focused on transforming our Services business. While I feel good about the progress and increased lever of rigor we're building, I reiterate that this will be a multi-quarter journey.

There are also areas requiring increased discipline and improved processes. On the investment side, we continue to invest in emerging Services to accelerate growth including cloud, industry solutions and analytics. We're also focused on addressing sales, delivery, and business development challenges.

We are working to better manage our skill supply in order to more effectively meet customer demand. We're rigorously conducting systematic account reviews to ensure that we're optimizing value for our customers and results for HP.

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I am very pleased to announce that, effective immediately, John Visentin will become the new EVP of Enterprise Services and he will report directly to me. John has a solid track record of success in this arena. Previously, he served as general manager of IBM's Integrated Technology Services unit for North America.

John has brought his extensive experience to HP where he has been fully invested in our business for the past several months in the Americas region and is already demonstrating his leadership. I welcome him to our executive council.

Following her recent appointment to the HP Board of Directors, Ann Livermore will fully transition out of the day-to-day operations. I look forward to her continued contributions to HP as a member of our Board and I thank her for her interim leadership of our Services business and for her support.

Third, we must address some of the technical challenges facing our business. In BusinessCritical Systems, we firmly believe that HP Itanium-based server platform is by far the best in the industry and we have fully committed to its future. In fact, it is the strength of this platform that is likely behind Oracle's approach to drive customers away from HP technology.

We are doing everything we can, including pursuing legal actions, to protect our customers and our business against Oracle's anti-customer behavior. In IPG, we have seen revenue and margin challenges from Japan due to laser shortages caused by the earthquake in Japan and the margin impact from the rising yen.

Cathie will detail more of this in a moment, but I think HP has done a good job in managing the crisis. The speed and the size of the yen movement created the margin headwind for us in Q3 and at these yen levels, we expect there will be a continued headwind going forward. Fourth, I'd like to discuss our move to drive more value-added IP into our portfolio.

We laid out a strategic vision in March and I'm ever more convinced it's the right 1. We will continue to expand and leverage our strong technologies including hardware, printing, software, and services. We will invest in our HP strategy focused on clouds and solutions, and the software underpinning it all, including big data analytics and security.

We will move more firmly into higher margin growth opportunities that position HP for more strategic customer relationships. When we acquired Vertica earlier this year, we talked about how it's enhanced our capabilities for information optimization by adding a sophisticated realtime predictive analytical capability for large and complex sets of data.

Emerging trends we saw at that time have now accelerated and reached a point where there is an opportunity for us shape the industry's information and data market. We believe we can build the next generation information platform to reinvent our information as processed, analyzed, optimized, automated and protected, both for unstructured and structured data.

And just to be clear, structured data is about database or transactional data. Unstructured data is all about how all of us interact naturally through e-mails, video, text, voice, and social media. That is why I'm excited today to announce our plans to acquire Autonomy, the leading enterprise information management software company specialized in unstructured data.

Before I outline the strategic rationale behind this deal, let me give you some financial highlights. Today we announced the terms of a recommended transaction under which HP will acquire all of the outstanding shares of Autonomy for GBP25.50 per share, in cash.

We expect the acquisition to be accretive to non-GAAP earnings per share for HP shareholders in the first full year following completion. It is not a profit forecast for Rule 28.6 of the City Code of the United Kingdom and we expect to complete the acquisition of Autonomy by the end of calendar 2011.

This is a milestone moment because there is a very real and concrete need for our customers to address the explosion of unstructured and structured information. Autonomy's intelligent data operating layer is in effect the standard on more than 400 OEMs and is supported by substantial IP.

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Additionally, the Autonomy platform pulls structured and unstructured data from a broad range of sources. And they offer their products via both traditional software license and cloud mode.

Autonomy today is one of the largest cloud players of over 30 betabytes of customer information under management by their cloud-based archiving and backup solutions. They have over 25,000 customers globally. Autonomy sees the information transformation and subsequent market opportunity exactly as we do.

Moreover, Autonomys business is well-aligned to HP's effort to change and focus our business mix. In 2010, Autonomy had gross margins in the high 80s and operating margins above 40%. They have demonstrated a strong consistent track record of double-digit revenue growth.

Mike Lynch, Autonomy's Cofounder and CEO, heads a team of brilliant scientists and employees. Additionally, operationally, the 2 companies and cultures will blend together well. Reporting directly to me, Mike will continue to lead Autonomy, which will continue to operate separately so we can keep them focused on their own market momentum, while at the same time they can play a key role in enabling the opportunities we see in the strategy we've outlined for HP.

As an executive who has spent most of my career primarily in software, this is a world I know well. Some acquisitions require heavy lifting, but bringing Autonomy into the HP world will be seamless and highly complementary. We believe this transaction will unlock synergies, which in Autonomy and the HP Enterprise offerings including ESSN, software services and IPG and across multiple industry verticals. We are building a strong HP Software business.

We have done so through successful acquisitions like ArcSight and Fortify. We have had excellent growth and performance this year from our software unit, so the acquisition of Autonomy will build on that momentum and accelerate our HP Software strategy. We all have witnessed an increased level of market volatility and especially today.

So you might ask if a move like Autonomy is right in this market. But the market fluctuations has not changed the underlying opportunity, the value proposition of HP and Autonomy and the need to transform HP's business to create a stronger company. And most importantly, we very strongly believe the transaction will create significant value for our shareholders.

All of the decisive moves I've made provide HP with the most shareholder return, markets where we can demonstrate a sustainable competitive advantage, maximize customer value, deliver on our solutions vision, differentiate with IP and win.

We are focusing on what needs to be fixed, what needs to be shut down and what needs to be considered for separation. And equally, if not more importantly, we are focused on what value-added IP needs to be added to HP in order to stay a leader in the IT world and represent a true value proposition for our customers and investors.

Lastly, I'd like to make a comment on guidance. I'm lowering the Q4 guidance to be realistic about where we are and the challenges we are facing. These challenges and the transformation we are undertaking will take several quarters to fully resolve. I don't take this action lightly.

I know our investors don't like being in this position and neither do I. I feel their pain, but as CEO, I believe in transparency about what we are facing and be clear on the decisive things we are doing now about it. To conclude, I'm taking ownership for these decisions and investments with a focus on driving actions that deliver value for shareholders as we shape the new HP. Now, let's take a look at the numbers with Cathie.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

Thanks, Leo. Today we're delivering a tough outlook, definitely the most difficult 1 for me as CFO. Leo has walked you through the details of the steps we are taking and how they will lay the foundation for transforming and rebuilding Hewlett-Packard.

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Let me review our Q3 results to set some context for our outlook. Revenue of $31.2 billion was up 1.5% year-over-year, but down 2 points in constant currency. By geography, revenue in the Asia-Pacific region grew 9% year-over-year or 1% in constant currency. Revenue in the Americas was flat year-on-year, but down 2% in constant currency. Revenue in EMEA was also flat year-over-year, but down 5% in constant currency.

Company-level gross margin of 23.3% was down 70 basis points year-over-year and down 130 basis points sequentially. Our printing services and webOS businesses posted lower gross margin rates which were partially offset by a favorable commodity pricing environment in PSG and ESSN.

Non-GAAP operating expenses were $4.2 billion, up 7% year-over-year, with increases in R&D and field selling costs. Non-GAAP operating margin of 9.8% was down 140 basis points, with operating profit down 11% year-over-year.

We generated $3 billion in earnings from operations compared to $3.4 billion a year ago and down 14% sequentially. Other income and expense yielded a net expense of $121 million. Our tax rate remained at 22%. Third quarter non-GAAP net income of $2.3 billion was down 11% year-over-year, while non-GAAP diluted earnings per share increased 2% to $1.10.

Share count declined 12% year-over-year to 2.08 billion as we repurchased 128 million shares in the quarter for a total of $4.6 billion. HP generated $3.2 billion in cash flow from operations in the quarter and $10.2 billion year-to-date.

Now turning to the business unit performance, the Personal Systems group, which reminds the number 1 PC business across notebooks and desktops with 18.1% share, delivered revenue of $9.6 billion, down 3% from the prior year. Operating profit for the segment was up 21% year-over-year to $567 million or 5.9% of revenue.

This is up 120 basis points year-over-year, largely due to lower component costs and favorable customer mix. Commercial client revenue grew 9% led by another strong quarter in workstations which generated 19% revenue growth. Total consumer client revenue was down 17% versus the year-ago quarter.

Both Desktop and Notebook were down 4% year-over-year as both segments continue to be equally affected by the weakness in the consumer demand. Corporate Investments, which includes webOS, recorded revenue of $266 million, and an operating loss of $332 million in the quarter.

About a year ago, we made a bet on webOS and the opportunity to launch our own ecosystem around devices, applications, and new markets. At that time, we set clear metrics and milestones to monitor the success of webOS. We launched the flagship product, the TouchPad, on July 1 and frankly, the software was met by strong reviews, but the sell-through of the product was not what we expected.

Our intention was to solidify webOS as the clear number 2 platform for tablets, but with such a young ecosystem and poorly received hardware, we were unable to achieve our target. Additionally, it quickly became clear that pricing parity would not generate demand and we subsequently lowered TouchPad pricing by $100 which has added incremental near-term costs to our model.

Even with the price reduction in Q3, we needed to better align our unit forecast with the sell-through reality in the quarter and we took a $0.05 charge to EPS in addition to the loss we were already expecting in the business. We would expect an even larger loss for webOS in Q4 if we continue to operate the business in its current form.

Essentially the TouchPad and our webOS phones have not met our financial targets and other milestones that were set. To make this investment a financial success would require significant investments over the next 1 to 2 years, creating risk without clear returns.

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Therefore, we have decided to shut down operations around webOS devices and will be exploring strategic alternatives to optimize the value of the software platform and development capability.

Turning to Imaging and Printing, we delivered net revenue of $6.1 billion, down 1% year-over-year. The Q3 Japan impact, resulting primarily from the LaserJet hardware and toner constraints, was about what we expected in terms of revenue and operating profit on our commercial business.

Commercial revenue was down 7% year-over-year with commercial hardware units up 1%. Consumer revenue was up 1% year-over-year and 7% unit growth. In total, printer units were up 6% year-over-year. IPG continues to lead the market in innovation.

Indigo Digital Press page volume was up 23% year-over-year and we shipped more than 3 million web-connected printers again this quarter. Supplies revenue was flat year-over-year at $4.1 billion. We ended the quarter with higher than normal channel inventory in supplies, especially ink, as sell-through slowed at the end of the quarter.

Our Supplies business tends to follow the economy and given the current market uncertainty, we're remaining cautious. We'll need to begin working through this inventory and the resulting mixed shift toward hardware is expected to have a revenue and margin impact over the next few quarters.

In Q3, operating profit for IPG totaled $892 million, or 14.7% of revenue, down 220 basis points year-over-year. Roughly half of the operating profit decline year-over-year was due to laser toner supply shortages caused by the tsunami in Japan and half was due to the rising yen. The speed and the size of the yen movement created a margin headwind for us in Q3 and at these yen levels, we expect there will be a continued headwind going forward.

HP Services delivered revenue of $9.1 billion, up 4% from the prior year quarter, but was down 2% in constant currency. We delivered operating profit of $1.2 billion, or 13.5% of revenue, down 220 basis points from the prior year.

As we have discussed over the last few quarters, we're focused on driving a greater mix of higher value-added services. This means investing in delivery and business development resources, as well as developing industry-specific services practices and IP.

We're also improving our tools and processes while adding more management rigor at the account level. We've been conducting systematic account reviews to ensure that we're optimizing value for our customers and results for HP.

These investments and incremental process improvements are expected to generate mid- to long-term growth, but they continue to put pressure on HP Services margins. Our Services transformation is a 4 to 6 quarter journey and we expect our services margins to be roughly 12.5% during this time. IT Outsourcing revenue of $3.9 billion was up 5% year-over-year.

Signings were largely driven by renewals in an environment of contractual price reductions and competition. While these renewals helped to protect revenue backlog, we need to work on new logos and add-on deals to generate sustainable revenue growth.

ITO is focused on improving its revenue growth and margins through new service offerings including enterprise cloud services. We are also methodically working to improve profitability at some legacy accounts that have lower gross margins.

Application Services revenue was up 2% year-over-year and we continue to invest in the business and pursue application modernization services, security, private and hybrid cloud services, and analytics. Business Process Outsourcing revenue was down 9% year-over-year including a 4-point headwind from the divesture of ExcellerateHRO and revenue runoff that was only partially offset by the volume increase in healthcare.

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Technology Services revenue grew 5% with strong order growth in TS Consulting Services. We continue to gain strong traction with our Cloud Workshop. Enterprise Server, Storage and Networking grew revenue 7% to $5.4 billion. Operating profit of $699 million was down 1% and operating margin of 13% was down 110 basis points from the prior year.

Operating margins were impacted by a lower mix of BCS revenue and incremental investments in sales and R&D. Across ESSN, we are seeing a slower economic environment and expect below normal sequential growth going forward.

Our industry standard servers remain number 1 in share across all 3 regions with revenue growth of 9% and we expect to show share gains for calendar Q2. While we remain well-positioned in the fastest growing areas of the market, we expect ISS year-over-year growth to slow in the fourth quarter, driven by a very difficult prior year comparison and the slowing demand environment I mentioned earlier.

HP remains number 1 in the blade server market with roughly half the market and grew ESS blade revenue 15% year-over-year. Revenue in BusinessCritical Systems declined 9% year-over-year. This decline is sharper than expected, as our ability to close deals has been impacted by Oracle's Itanium decision and orders are being delayed or canceled. We are working diligently to enforce the commitments that Oracle has made to our customers and to HP.

Our HP Storage portfolio is in transition. Overall HP Storage revenue increased 8% over the prior year driven by 17% growth in external disc products. Our products, based on StoreOnce data deduplication technology, had another strong quarter and 3PAR sales continue to accelerate, achieving triple-digit revenue growth year-over-year on a normalized basis. Partially offsetting growth in these key areas were year-over-year declines in our tape and EDA product lines.

HP networking grew 15% year-over-year, the seventh quarter in a row of double-digit growth. Switching and Routing, including Virtual Connect, grew 18% while our major competitors are seeing declines in their networking businesses. We're expanding our presence in core datacenter enterprises with more than 30 new logos in Q3.

We feel good about our business model, customer value proposition, and ability to continue gaining share. Turning to HP Software, we delivered another strong quarter with revenue of $780 million, up 20% compared with the prior year including 29% license growth, 30% services revenue growth and 12% support revenue growth.

Our newest Security Solutions, ArcSight and Fortify, continue to generate double-digit growth on an operational basis, as did the BTO business. Third quarter operating profit was $151 million, or 19.4% of revenue.

HP Financial Services continues to deliver strong, consistent results. In the third quarter, financing revenue grew 22% to $932 million. Financing volume increased 16% and net portfolio assets increased 17%. Operating profit of $88 million is up 22% year-over-year to 9.4% of revenue.

Now on to the balance sheet and cash flow -- our balance sheet continues to remain strong. We closed the quarter with total gross cash of $13 billion. Our third quarter cash conversion cycle was 26 days, up 9 days from the prior year, due primarily to a back-end loaded quarter.

Days sales outstanding increased 6 days from the prior year. Inventory days were flat and days payable decreased 3 days. Channel inventories are within acceptable ranges for PSG and ESSN, but higher than we would like for IPG, as I described earlier.

HP generated operating cash flow of $3.2 billion in the quarter and free cash flow of $2.2 billion. During the quarter, we returned $4.9 billion in cash to shareholders through share repurchases and dividends.

At the end of the quarter, we had roughly $11.3 billion remaining in our share repurchase authorization. Looking forward, HP continues to be challenged by macro uncertainties that may impact each of our businesses, both consumer and commercial.

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We are also working to transform our Services business, which will take time. Given the variability and changes in our operating model as we execute this significant transformation, we are removing our long term financial target of a $7 EPS in 2014. For the fourth quarter, our non-GAAP expectations are first, we expect revenue to be in the range of $32.1 billion to $32.5 billion, which is below our normal seasonality given the macro environment, higher channel inventory in printing supplies, and our ongoing Services transformation.

Second, we expect the operating margins on the Services business to be roughly 12.5%. Third, we expect OI&E expense of approximately $150 million and the tax rate is expected to be approximately 22%.

We expect only moderate reduction in weighted average shares outstanding in Q4 as a result of Q3 repurchases that occurred late in the quarter. Thus, we expect fourth quarter non-GAAP earnings per share to be between $1.12 and $1.16.

For GAAP guidance, we expect to take a GAAP-only cash charge of approximately $1 billion for restructuring and shutdown costs related to webOS devices. In addition, as of July 31, the carrying value of goodwill and other intangible assets was approximately $1.2 billion per PON.

As we work through strategic alternatives for webOS software, we will evaluate these assets for any potential impairments and if appropriate, recognize a related non-cash charge. We expect to have a $300 million to $400 million GAAP-only expense due to the costs of the British pound options we're buying to hedge the purchase price of the Autonomy transaction.

Thus, we expect fourth quarter GAAP earnings per share to be between $0.44 and $0.55. For the full year FY '11, we expect revenue to be $127.2 billion to $127.6 billion. We expect non-GAAP EPS to be between $4.82 and $4.86 per share.

We expect full year GAAP EPS to be between $3.59 and $3.70 and cash flow from operations to be roughly $12 billion and free cash flow of $8 billion, including the cash charge associated with the shutdown of webOS devices. We are repositioning our portfolio, discontinuing or exploring options for lower margin businesses and investing in higher margin areas, including Services and Software.

This effort will require patience, but the clear objective is to drive long term shareholder value. With that, I'd like to turn the call back over to Leo.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Thank you, Cathie. Obviously, this has been a lot of information to digest at 1 time and there is a simple way to summarize it all and I said it before. This is about a transformation to position HP for a new future and about driving long-term shareholder value. HP is at a critical point in its existence and these changes are fundamental to the success we all want as investors, employees, and customers.

These changes I've outlined today will transform HP and accelerate the strategy we have laid out and the transformation starts today. Decisive steps are never easy and change doesn't happen overnight. As CEO, I am steadfast in my commitment to take action to do the right things to drive value for our shareholders and assure a sustainable future for this great Company. And now, Operator, we are ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

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Katy Huberty, Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

I guess to start, can you talk about which customer segments and geographies weakened in the July quarter and which segments you are expecting to weaken further in October based on the guidance? You're just thinking about US and Europe versus other regions and then obviously, commercial versus large enterprise and consumer. Thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Kind of a summary of all of this is that we saw our business in Asia-Pacific grow slightly in constant currency and if you look at the other 2 regions in constant currency, they did somewhat decline. I'm talking in constant currency and not in current dollars. You can also say on a rough basis, in particular when you look at PCs, that consumer declines, while commercial, increased and Cathie just walked us through these numbers. When you look at our ESSN business, you will see that we have actually good performance across the entire board of our values offerings.

What is important to note is that the public sector, which counts for about 10% of our business, has been impacted by budgetary restraints that are being imposed on both sides of the Atlantic Ocean, if not more. And we, of course, have exposure to that sector and we have been hit somewhat by this and we expect to continue to be hit by this. So public sector continues to have budgetary struggles.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

Katy, I would also add that if you look at the linearity in the quarter, we did have a back-end loaded quarter, but at the same time it was softer than what we had expected in July.

Operator

Ben Reitzes, Barclays.

Ben Reitzes - *Barclays Capital - Analyst*

I want to talk about Services. I heard you say 12.5% now is your guidance for the upcoming quarters or foreseeable future. I wanted to confirm that and why are we going down to that level and did you cut enough when you bought EDS I think the margins were even lower? So is 12.5% conservative enough and how long will we be there and why is my question? Thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Let me try to answer the question and I'm sure Cathie will chime in to give her perspective as well. From my perspective we're making progress in Services, but we have to recognize and we said this before, it's a multi-quarter journey. One of the things we are focused on in a very, very tight manner is growing the top line and we still have to show and demonstrate that we can do this on a consistent basis. We didn't do this in Q3 in constant currency, but we're working hard on this. I'm delighted to be able to announce that we now have a leader for this business, John Visentin, and we're going to work very closely with him and his team on driving this service transformation. What we're trying to achieve is a much better mix of higher value-added services in our portfolio of services that we offer our customers.

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And from the execution standpoint, we are investing in sales, delivery, and business development capabilities that we can enter that can increase our coverage. We're increasing our bench in application services. At the same time, we're improving our tools and processes and we're adding a significant level of account-level rigor. And we are engaged in conducting a systematic account with you so that we can ensure that we're optimizing value for both customers and HP [and turn] results.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

And then let me just chime in on that on the margin and I will confirm that I said 12.5%. We are affected by the weakness in the public sector, which Leo mentioned, and also by the lower mix of BusinessCritical Systems which has a knock-on effect with Technology Services. We don't expect the public sector budgets to really improve over the near-term and so as we execute on our Services transformation, we do believe that the near-term margin profile is closer to 12.5%. This also gives us more flexibility to make the right level of investments for our customers and invest for future revenue growth.

Operator

Richard Gardner, Citigroup.

Richard Gardner - *Citigroup - Analyst*

Leo, I was hoping that you could give us your views on the synergies between the Printer business and the Enterprise business following the strategic evaluation that you've been doing during the past 9 months. How do you feel about keeping Printers and Enterprise together? Thank you.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

First of all, I'd like to make sure that everyone understands that IPG is an important and a profitable business for HP and it actually fits solidly in our overall strategy. As you know, IPG has a double-digit margin business. It's supported by industry-leading IP and innovation and they have been leading the disruption of the traditional analog printing markets as more and more pages shift to digital and that has actually a very strong commercial enterprise impact. A lot of it has been driven on the commercial side and not on the consumer side.

IPG has the opportunity to reinforce its strength in the commercial printing market and, in fact, in the commercial digitalization market. And we are driving, with a lot of focus, our document and content Management and managed print solutions. In fact, I might be jumping the gun here, but just wanted to make sure that you understand this, with the acquisition we announced today, we will actually be able to accelerate that strategy and provide IPG with additional differentiated IP in verticals such as financial services and public sector.

Operator

Tony Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - *Sanford C. Bernstein & Company, Inc. - Analyst*

I wanted to talk about the Autonomy acquisition and capital allocation. Leo, you're paying a fantastic price, close to 11 times trailing revenue, particularly when you add in some of the incremental hedging costs at a time when your stock is at an all-time low on every single valuation metric, currently trading at about 6 times earnings. I hear you when you say this is a potentially transformational move, but it's less than 1% of your revenues. It's going to cost you more than 15% of your market cap. I was

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hoping you can comment on the price paid and the rationale, your thinking on capital allocation and specifically your outlook for share repurchases in Q4 and looking forward?

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Okay. Well, that's a pretty broad question. Let me start by actually making sure that everybody on the call understands what Autonomy represents for us.

Autonomy represents an opportunity for HP for us to accelerate our vision to decisively and profitably lead a large and growing space which is the Enterprise Information Management space. It also brings HP higher value business solutions that will help customers manage the explosion of information. If we execute this deal, it will position HP as a leader in the large and growing space. It will complement our existing technology of portfolio and enterprise strategy.

It will provide differentiated IP for Services and extensive vertical capability in key industries. It will provide IPG a base for content management platform. It will, over time, significantly enhance HP's financial profile and the Board believes that the transaction is accretive to HP's non-GAAP earnings in its first full year after completion.

Autonomy as a business has a very profitable financial model with a very compelling value proposition and I have been able to bring solutions into 400 OEMs, which shows that they are basically a de facto industry standard. Autonomy has grown its revenues at a compound annual growth rate of approximately 55% and adjusted operating profit at the rate of approximately 83% over the last 5 years. We're buying a very strong business and we believe that we can extract a lot more out of this business by combining it with HP. And that was the justification for the price.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

Leo, let me handle the capital allocation question that was in there as well. So, Tony, on a trailing 12-month basis we've repurchased $13.6 billion worth of shares. And now we've announced our attempt to acquire Autonomy and so we would expect that we would spend, in fiscal 2012, the time and resources rebuilding our balance sheet and therefore will moderate our buybacks that will keep a minimum of maintaining zero dilution.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

My question is with regard to the PSG business. I'm curious as to why not just spin it off right now? Why leave the overhang of some other potential strategic move?

And also within that, given that you're getting rid of webOS, how do we think about the thoughts that you were going to try to push webOS further into your PC division? So are you now more aligned on the Microsoft side? Are you still going to try to continue to use webOS? Just any color you can give us on how you anticipate PSG developing over the next year to year and a half.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Let me try to answer this and we'll try to answer this as a team. What the Board and the Management team both have been working very diligently over the last period to really look at all of our options. What the Board has decided to do, together with

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the Management team, is to look at all of the strategic options around PSG and we'll be examining all of them. The announcement of today will allow us to look at this much more closely, including all of the synergies, the dissynergies and other aspects of this operation and over time, a decision will or will not crystallize on what the most appropriate way is to deal with PSG going forward. That's all I can say about this right now and we will refrain from commenting on what the strategic options are until the Board will make such a decision.

Regarding webOS and the future of webOS and I will not talk about the device business, I will talk about the software side of it. We are looking at all of our strategic options concerning the software. I'd like to repeat what Cathie has said earlier on. The software has been received very well. It is very elegantly designed.

Developers like it, users like it and we will be looking at all of the options from our own devices, to third-party devices, to other hardware manufacturers, to other manufacturers to other people who need this kind of software. And we will be looking at all possible business models from licensing to any other possibility in order to evaluate how we can best extract value out of webOS.

Operator

Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

With the potential for increasing macro pressures in coming quarters beyond the public sector, I think beyond the consumer there's certainly concerns amongst investors that we could see a pressure spreading. How should we think about your strategic actions, particularly your investment needs versus the natural potential for further needs for cost reductions in certain areas of your business? How are you going to balance that going forward, particularly in light of the fact that clearly there is a view that there was under-investment in prior years?

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Well, let's focus about the future, not necessarily about prior years. What we are going to do is we're going to be very selective which is why we're trying to focus the Company so that we can make our capital allocations in those places where we believe we can generate the highest return for our shareholders, in those markets that have a real sustainable promise for us to generate long term sustainable profit, which is what this Company is now executing as part of our transformation plan. We'll be driving this very carefully and we'll be doing this on a very consistent basis. And we are going to have a sharp operational cadence so that we can extract maximum value out of all of our assets and out of our operational expenses, as well.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

I think it's also important to realize that it's not an either/or. It's an and, and we're still focused on operational efficiency including our supply chain transformation and the other types of areas of opportunity that we've talked about in the past.

Operator

Keith Bachman, Bank of Montreal.

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Keith Bachman - *BMO Capital Markets - Analyst*

I'd like to follow from a previous question, Leo. The metrics that you threw out for Autonomy, particularly on top line growth, included a lot of acquisitions for Autonomy. What's the organic growth rate that Autonomy has achieved lately? Because the metrics that you threw out included the total top line growth and given the price you're paying, would like to understand a little bit more about the organic growth rate that you see in the recent past or if you could talk about what you think the forward growth rate would look like with that asset? Thank you.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

I cannot comment on that specific thing. What you should consider when you analyze the numbers of Autonomy is that over the last few years, they have been executing a very successful shift to SAS, software as a service, delivering their software through the cloud, which is a totally different revenue generation model and have done a splendid job doing so. Actually, one of the few traditional license-based companies that have executed such a successful transition.

Roughly, I'm giving you a rough number, about one-third of their revenues are now SAS-based and therefore, that has a totally different growth profile than what you would see on a normal license-based business. So you need to factor that in and at this call we're not going to talk about any forward-looking growth rates.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

On the PC business, in the past you've talked about the strong return on capital and cash flow nature of that business and the synergies with the rest of your hardware portfolio, specifically around supply chain and procurement leverage and distribution. Can you talk about what's changed there and what level of dissynergies you're contemplating with this potential transaction? Thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

So one of the reasons why we made the public announcement today is to actually give us the opportunity to go in detail and study all of the questions that you have just mentioned. I want to make sure that people understand that we are going to look at all of our options, all of our strategic options. And I also want to make sure that people understand in this call that when we say this, all outcomes are possible, including a potential non-transaction. We're looking at all of our options. That's what the Board has authorized us to do.

We'll be looking at all the various dissynergies, proprietary and litigation issues. Once we'll be done with that work, we'll report back to the Board and a decision will or will not be made.

Operator

Aaron Rakers, Stifel Nicolaus.

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Aaron Rakers - *Stifel Nicolaus - Analyst*

I want to ask a question on the operating profitability levels for 2 segments in particular, the Enterprise side of the business which looks now to be at 13% and running below what you've previously stated as your overall target of 13.5% to 14.5%. How do we necessarily think about that trend over the coming quarters and balancing that relative to investments? And the same question as it pertains to the Imaging and Printing business now running this last quarter at 14.7%, albeit obviously having some supply chain issues?

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

As I talked about in my prepared remarks, the macro picture has somewhat deteriorated since the last quarter. In the case of Enterprise Service Storage and Networking, we saw some softness in Europe and Americas and this lower than expected growth put pressure on our operating margins in Q3. In addition, we've talked about the lower mix of BusinessCritical Systems in the Enterprise Service Storage Networking numbers and this negatively impacted our margins year-over-year and quarter-over-quarter.

Longer term, we really haven't changed our approach at all. We still will continue to focus on expanding the higher margin components of the ESSN portfolio and you see evidence of that in our portfolio this quarter when you see networking up 15% year-over-year. And we have 17% year-over-year growth in our External Storage Business.

Operator

Kulbinder Garcha, Credit Suisse.

Kulbinder Garcha - *Credit Suisse - Analyst*

My question is -- Cathie, given some of the secular pressures that you're seeing and the multi-quarter journey you've got to have on Services. I'm kind of surprised that given what's happened so far this year as well at the group-wide level, why there isn't a major restructuring driver and efficiency drive? Could you just speak about what you're doing in that regard, especially if maybe the macro environment gets worse or just if you overestimate your Services margin again, what you might have to do in terms of just from an efficiency perspective? Is there scope to actually cut further costs to HP at the group level, do you think? Many thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

It's a great question. I think you need to look at it from a number of aspects. First of all, you have to ask yourself the question, how are we performing compared to our peers and are we gaining, are we losing market share? Do we have a fundamental issue there? In fact, we are actually competing rather well on market shares across the vast majority of our businesses are either stable and in some cases, we actually managed to eke out some additional gains.

The second thing you have to consider in this question is are there any specific issues affecting our business in particular? Now, we are all facing some macro trends, the entire industry, and we'll all work through this. But HP is facing, in addition to the macro trends, essentially the following things -- we are being challenged on the BusinessCritical Systems and we're dealing with that. We talked about it in our prepared remarks and we had a specific issue that is in our printing business which was impacted by the Japanese situation.

Overall, though, we have one issue that we really want to tackle in this Company and it's our productivity and salesforce. That is something that we really want to work hard on. We're going to work diligently to create a better platform for HP's Unified Solutions to go to market, so that we can extract way more value out of our salesforce. Our global accounts will be driving

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operational and process excellence as well and we are now going to have a regular cadence and discipline around strategically managing major account in this Company. That's what we're intending to do and I'll leave it at that at this moment in time.

Operator

Maynard Um, UBS.

Maynard Um - *UBS - Analyst*

Can you just give us a sense of how much of the $332 million corporate investment losses were related to webOS and what the normalized run rate should be there? Because what I'm trying to understand is, if you don't either shut down this business or sell it, it'll be very difficult to get the segment to break even. For example, if you pursue a licensing model and get to $300 million assuming $5 per device, you'd have to sell more than 60 million licenses. So, I'm just wondering how long the leash is to lower the losses here or to get to break-even? Thanks.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

With the decision and announcement that we made today to shut down basically the webOS device business, we expect that the ongoing OpEx in the remaining pieces of the business around the software and the software engineers and marketing and [BusDev] folks in the developer community is probably $0.01 to $0.02 a quarter. The run rate expense is coming down dramatically. If you look at the corporate other investments and the loss of $332 million there, you can attribute that pretty much to [POM].

Operator

Peter Misek, Jefferies.

Peter Misek - *Jefferies & Co. - Analyst*

Just a question around free cash flow, if we look at the puts and takes going into the remainder of the year, can you give us an understanding or a thought process of the cash balance just getting a sense for what we should be exiting? Also, do we have any bullet payments or anything that we need to worry about on that regard?

In terms of the strategic acquisition, Leo, you mentioned that Autonomy is going to be run as a separate business, but that you saw a lot of synergies across other businesses. Can you walk us through how we should think about that? Is it going to be an integration by product team, by salesforce or some other fashion? That would be great. Thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Why don't I try to answer that question first. Yes, we will run Autonomy as a separate entity. It will be managed by Mike Lynch, the current CEO and Cofounder of the company.

But, of course, we will be looking at identifying as many synergies as we can as quickly as possible. The first obvious one is to give Autonomy access to our channels across the world which will help them in a significant manner. And at the same time, we will also be working across between our software teams and their software teams to actually create additional capabilities there. We already mentioned IPG. We haven't yet talked in detail about whether this we can do with ESSN, but you can easily imagine what the synergy possibilities are between our ESSN division and Autonomy in particular when you look at things such as storage.

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Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

Let me address the cash question. We ended the quarter with $13 billion in gross cash. Our net cash position was negative roughly $12 billion. Our top line -- with our lower top line expectations and obviously the profits that will drop as a result of that and the cash charges related to the discontinuation of the webOS device business, that's putting downward pressure on our cash flow expectations. Now we expect that our cash flow from operations for the year will be approximately $12 billion and our free cash flow should come in roughly around $8 billion.

Operator

Brian Marshall, Gleacher & Company.

Brian Marshall - *Gleacher & Company - Analyst*

I was wondering if I could delve into the storage aspect a little bit more. Clearly, you're seeing good success in networking up 15%, but storage is up 8%. I know we've got some lower performing products in there. Can you talk a little bit about the puts and takes with respect to driving that business to higher growth levels in the future and the time frames associated with that? Thanks.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

As we already talked about last quarter, our Storage business is going through a planned mix shift into higher margin, HP-IP-based products. 3PAR is a great example of the products we are focused on growing. It had another strong quarter with Q3 revenues growing triple digits year-over-year.

Our external storage portfolio had a strong quarter going about 17% year-over-year, somewhat offset by the weaker performance in tape and EDA. We are in the early days of the P6000 launch and expect the product to be particularly attractive to 2 populations of customers, the EVA install base and the customers in developing countries looking for key features offered by EVA, ease of everything, high quality and HP support that is available everywhere in the world.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

And let me just make sure it's clear because the 3PAR revenue is up triple digits on a normalized basis, so that doesn't have any denominator effect related to the acquisition. It is, in fact, up triple digits.

Operator

Abhey Lamba, ISI Group.

Abhey Lamba - *ISI Group - Analyst*

Leo and Cathie, given that the PSG spinoff could take over a year, do you expect disruption in the PSG revenues during that time? How do you plan to minimize that and have you factored that in the fourth quarter guidance?

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Leo Apotheker - *Hewlett Packard Co - CEO, President*

We have looked very hard at our fourth quarter guidance. We have tried to take everything into account. I just want to make sure people understand that as we move forward and for the foreseeable future, PSG is part of HP and will be managed in a very normal manner and very normal way. We have great employees, we have good management, we have very focused people and the team, the employees, the executives, everybody at HP will continue to interact and work with PSG as if we are a normal day-to-day business. And that's the expectation we have. That's the expectation that PSG Management has and I'm sure we can manage through whatever potential distraction there is by having tight focus on our day-to-day operations, continue to deliver great products for our customers.

Operator

Amit Daryanani, RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

I think before you talked quite a bit about macro softness impact would have on the revenue line. Can you tell us potentially plans to focus on OpEx reduction to defend margins or EPS and a degrading revenue line? Is there some absent margin number that you really do not want corporate HP numbers to get below?

Leo Apotheker - *Hewlett Packard Co - CEO, President*

We are very much focused on extracting as much as possible value from our assets, in particular on the revenue line. We want to maintain our share of growth across all of our businesses. That's what we're focused on. But we're also focused on doing this in the most effective and efficient way possible.

Cathie mentioned earlier and already the initiatives that we are driving on supply chain. We have a few others on the way and that's how we expect to be as effective and as efficient as we just can.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

And I think it's important to realize that the transformation toward an enterprise-focused solutions business is going to take some time and it will require investments and we therefore, do not expect any significant margin expansion in the mid-term. We also have a huge cost base and there's always opportunities to be more productive as we grow our revenue.

Steve Fieler - *Hewlett-Packard - VP, Investor Relations*

Thanks, everyone, for attending the call today. We'll finish it from here.

Leo Apotheker - *Hewlett Packard Co - CEO, President*

Thank you very much.

Cathie Lesjak - *Hewlett-Packard - EVP & CFO*

Thank you.

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Operator

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

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