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HPQ - Q4 2011 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the fourth-quarter 2011 Hewlett Packard earnings conference call. My name is Amesia, and I will be your operator for today. At this time, all participants are in a listen-only mode. We will conduct 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 call over to Mr. Steve Fieler, Vice President of Investor Relations. Please proceed.



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Steve Fieler - *Hewlett Packard Co - VP, IR*

Good afternoon. Welcome to our fourth quarter and full year fiscal 2011 earnings conference call with Meg Whitman, HP's Chief Executive Officer, and Cathie Lesjak, HP's Chief Financial Officer.

Before handing the call over to Meg, let me remind you this call is being webcast. A replay of the webcast will be available shortly after the call for approximately one 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.

Financial information discussed in connection with this call, including tax related items, reflect estimates based on information available at this time, and could differ materially from the amounts ultimately reported in HP's fiscal 2011 Form 10-K. Revenue, 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 adjustments relating to the wind down of HP's webOS device business, impairment of goodwill, impairment in amortization of purchase intangibles, restructuring charges, and acquisition related charges. Comparable GAAP financial information and reconciliation of non-GAAP amounts to GAAP are included in the tables and in the slide presentation accompanying today's earnings release, both of which are available on HP investor relations web page at www.HP.com.

I'll now turn the call over to Meg.

Meg Whitman - *Hewlett Packard Co - President, CEO*

Thank you, Steve, and thank you for joining today's call. In the couple of months since becoming HP's CEO, I've spent time with our people, our leadership team, our customers, and our investors. I've seen and heard a lot of great things. We have unmatched strength to build on, number one or number two positions in nearly all of our businesses, customers who want us to win, key intellectual property, global scale and reach that are unmatched, and employees who are smart, committed, and resilient, but I also know we didn't live up to our expectations in 2011. We need to get back to doing what we do really well, being the reliable, trusted partner with whom our customers want to work, and delivering the reliable, consistent results that all of you can count on.

When I took this role, the team established three short-term priorities -- deliver on the Q4 outlook, accelerate the decision on PSG, and get Autonomy off to a good start within HP. So let me give you a quick update. First, we delivered Q4, and Cathie will give you more color on that in a few minutes. Second, we completed our analysis on PSG, and the response from all corners has been overwhelmingly positive. There's no question in our minds HP and PSG are better together. Third, we closed the Autonomy acquisition on October 3. In the last month, we've had hundreds of leads passed between the two companies, and we've created a new information management business group that combines Autonomy, Vertica, and other HP software assets under Mike Lynch, and reports directly to me.

So we're off to a solid start, but I also know that it's going to be important to provide as much clarity as possible about our future because over the course of last year, and certainly on our last earnings call in August, we confused customers, employees, shareholders and partners on one fundamental issue around HP's strategy. As I travel, the one question I keep getting is -- what is HP? Well, here is the first part of that answer. HP is the largest provider of information technology infrastructure, software, services and solutions to individuals and organizations of all sizes. We have incredible scale and breadth, and that's a powerful advantage that we know how to make the most of. We're a leader in PCs, printers, servers, storage, networking, services, and information, automation, and management software. HP has a great platform from which to build. And to be clear, we're in the software business to deliver value for our customers, not to transform HP into a software company.



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We bring the breadth and depth of our portfolio to meet customers' toughest problems, and we will continue to invest in our solutions through both internal innovation and M&A. We increased our R&D spend in FY '11 by nearly 10%. We launched some outstanding new products, and drove innovation into the marketplace. In fact, just three weeks ago we became the first large server vendor to announce new, extreme low energy server technology, code named Moonshot. This is a revolutionary architecture that uses 89% less energy, 94% less space, and 63% less cost. That is meaningful and exciting innovation, and in 2012 we plan to do more of the same, and to increase our R&D investment once again.

We've also seen good traction with our recent acquisitions. 3PAR, 3Com, Fortify and ArcSight all are experiencing strong double digit or better growth, and are taking advantage of HP's global distribution. Our software business has now posted several strong quarters in a row, demonstrating our success at integrating these new companies. Our IT performance suite and security platform are unique and winning in the industry, and I'm also excited about the future of Autonomy as part of HP.

HP has all of the components of an outstanding company, but we're not taking full advantage and leveraging these parts to drive the results where the whole is greater than the sum of the parts. We need to be simpler, clearer, and more consistent -- no more surprises. We need to articulate a clear direction, from business strategy to financial strategy to capital allocation strategy. While I won't be communicating all the answers today, the executive team is hard at work on this. One thing we do know is that we're getting back to the basics of executing business fundamentals, which, frankly, we struggled with in FY '11. So what made FY '11 such a challenging year, and what are we doing differently in 2012?

Let's start with the full 2011 results. We grew revenue 1%, non-GAAP EPS 7%, and free cash flow 8%, and we generated \$12.6 billion of cash flow from operations. While this was not HP's best annual performance, generating nearly \$13 billion of cash flow is a good, healthy result. We faced some challenges that increased throughout the year, and will continue into FY '12, some were in HP's control and others were not. Some will take time to resolve, others are more short term in nature.

First, we increased our investment levels through fiscal-year 2011 because there are areas where HP had previously under-invested. This is a big reason why our services margins have been coming down and remain pressured. And we also increased OpEx to drive more innovation, and a bigger, better sales force. These are the right things to do for HP's future, and looking forward, we'll continue to invest organically. This includes investments in our people, intellectual property, and services capabilities. We'll also increase our investments in IT systems and in processes to enhance our scale advantages. We'll be selective about the areas where we invest, and we'll monitor our performance and make adjustments as needed.

Second, HP is a company known for its execution, but we did not execute consistently in FY '11. I'm a big believer in prioritization -- pick the things you need to accomplish, knock them down, and pick up the next ones. We're doing this in each of our businesses, and I'm confident that we'll restore the execution consistency that we all expect.

Third, we faced unplanned challenges outside our immediate control, many of which still remain. The macroeconomic picture became increasingly uncertain through FY '11, and we're remaining cautious about 2012. Our consumer business was down throughout 2011, and the commercial business slowed down as the year went on. Using Q4 as a baseline, consumer was down 9% and commercial was down 2% year over year. We also confronted one-time issues like the natural disaster in Japan, and now we're facing the flooding in Thailand. We'll do our best to mitigate these external impacts, but prudent expectations are appropriate.

Finally, HP went through a large number of distractions last year that affected performance. We had a CEO change, strategic shifts, and many news cycles. We also deployed significant capital in 2011 through share repurchases, acquisitions, and an increase in dividends. Through this, we created confusion with many of our shareholders about what kind of company HP is.

As we move ahead, I'm very focused on being clear with all of you about who we are and on continuing to drive strong financial discipline. Our strategic decisions will have solid financial underpinnings, just like our PSG decision did. Each of our businesses will use their respective levers to drive profitable growth, but we'll manage HP as one company, and ultimately we'll measure

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ourselves by the Company's earnings per share. As a result, we're modifying our guidance approach to focus only on EPS at a company level.

To summarize, HP is getting back to business fundamentals in 2012. We'll make smart investments, fix our execution challenges, plan prudently, and drive strong financial discipline. Our near-term focus is on driving execution and investing for the future, but, frankly, many of the FY '11 headwinds are still with us. We're expecting declines in both revenue and profits in FY '12, but we'll be doing the hard work that will position us for consistent, profitable growth in 2013 and beyond.

HP will continue to be a strong generator of cash, and I know many of you want more clarity on our capital allocation plans. I can tell you that we'll be pursuing a disciplined and balanced approach. You should assume in 2012 that HP will be rebuilding its balance sheet, and will not be doing any large M&A. Additionally, you should expect that share repurchases and dividends will continue to be a core part of our long-term capital allocation strategy.

Over the long term, we expect HP to be a GDP-type growth company that can grow revenue in line or better than our markets, grow earnings faster than revenue, and produce consistent cash flow. I'm optimistic and confident about HP's potential over the next several years. Don't get me wrong, we have work to do, and it will take time, but we have some of the best core franchises and technology, a solid earnings and cash flow base, customers who want to do more business with us, a world-class leadership team, and people who are motivated to win.

With that, I'll turn the call over to Cathie.

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

Thanks, Meg, and let me start by saying I agree with you. HP is well positioned, and committed to delivering value for our customers and investors. HP has a broad portfolio of industry-leading technology and capabilities, and we must use these assets to achieve our financial goals and create shareholder value. For fiscal 2012, we will focus on the business fundamentals of operational excellence and financial discipline to make this happen. Let's review the Q4 results to set some context for our outlook.

Non-GAAP revenue of \$32.3 billion was down 3% as reported, or 6% in constant currency year on year. Note that our non-GAAP revenue excludes net GAAP revenue associated with the wind down of our webOS hardware business in Q4. By geography, non-GAAP revenue in the Asia-Pacific region grew 3%, but declined 4% in constant currency year over year. Non-GAAP revenue in the Americas decreased 3% in dollars and 4% in constant currency versus the prior year period, and non-GAAP revenue in EMEA was down 6% as reported, and 10% in constant currency.

Company-level non-GAAP gross margin of 23.2% was down 170 basis points year over year, and down 10 basis points sequentially. Gross margins were impacted by the strong yen, and a lower mix of printing supplies, as well as continued margin pressure in services. Non-GAAP operating expenses were \$4.3 billion, up 1% year over year primarily driven by the increase in field selling costs. Non-GAAP operating margin of 9.7% was down 230 basis points year over year with \$3.1 billion in earnings from operations.

The bridge from operating profit to our earnings per share includes the following. Other income and expense yielded a net expense of \$125 million. Our tax rate remained at 22%. Additionally, we repurchased 17 million shares in the quarter for \$500 million. Share count as a result declined 13% year over year to 2 billion shares. Non-GAAP diluted earnings per share decreased 12% to \$1.17, and GAAP diluted earnings per share were \$0.12.

There were several adjustments to earnings in Q4 that were excluded from our non-GAAP results. First, we took a total charge to operating income of \$788 million. This was associated with the wind down of our webOS device business. This charge included a net revenue reduction of \$142 million related to the sales incentive programs, \$548 million in cost of sales due to supplier related obligations and inventory reserves, and \$98 million in operating expenses and restructuring charges.

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Second, as a result of our decision to wind down webOS devices, we have taken an impairment expense of \$885 million against the carrying value of goodwill and purchased intangible assets related to the acquisition of Palm. Finally, the expense related to the British pound options we bought to limit our exchange rate risk in connection with the Autonomy acquisition was \$276 million, a bit less than what we had guided in August.

Now, turning to our performance by business. The Personal System Group delivered revenue of \$10.1 billion in the quarter, down 2% from the prior year. The segment delivered 2% operating profit growth year over year with a 5.7% operating margin. Work stations continued to produce double digit revenue growth, contributing to the 5% growth in commercial client revenue year over year. Consumer client revenue was down 9% versus the year-ago quarter, with notebooks seeing a bigger decline than desktops. Total units shipped were up 2% year over year, but with average selling price declines, we saw no growth in desktop revenue year over year and a 4% decline in notebook revenue. Both form factors continue to be affected by weakness in consumer demand.

Turning to imaging and printing. We delivered net revenue of \$6.3 billion, down 10% year over year due to channel inventory reductions, broad based weakness in EMEA, and softening consumer demand, particularly for supplies. In Q4, operating profit for IPG totaled \$808 million, or 12.8% of revenue, down 460 basis points year over year. Margins were unfavorably affected by the strong yen, and lower than normal supplies mix of 64%, as we continue to work down the high supplies channel inventory we discussed last quarter.

Commercial printer revenue was up 4% year over year, with commercial hardware units up 5%. Consumer printer revenue was down 8% year over year, with an 8% decline in units. In total, printer unit shipments were down 5% year over year. Indigo Digital Press page volume was up 20% year over year, and we shipped more than 9 million web-connected printers this quarter, beating our target of 20 million web-connected printers by the end of fiscal 2011.

Supplies revenue declined 14% year over year to \$4 billion in the quarter. Remember, we entered Q4 with higher channel inventory than we would have liked, and we worked to reduce this throughout the quarter. As we said last quarter, supplies revenue closely follows economic cycles. Sell-out continued to be impacted by softness in consumer demand as a result of continued pressure on unemployment globally, and was below our expectations in the quarter. We ended the quarter with higher channel inventory than we would have liked in some regions.

HP services delivered revenue of \$9.3 billion, up 2% from the prior year quarter, but down 1% in constant currency. Operating profit of \$1.2 billion, or 12.8% of revenue, was down 360 basis points from the prior year. Our services turnaround will take time as we work to shift the business mix toward higher growth, higher margin services. IT outsourcing revenue of \$3.9 billion was up 1% year over year. Application services revenue increased 2% year over year to \$1.8 billion. Business process outsourcing revenue was down 2% year over year, and Technology Services revenue grew 3% with double-digit growth in TS consulting services.

Enterprise server, storage, and networking revenue declined 4% year over year to \$5.7 billion. Across ESSN, we are seeing the effect of a slower economic environment. Operating profit of \$733 million was down 17% year over year, and the operating margin of 13% was 210 basis points below the prior year. Operating margins were impacted by a lower mix of BCS revenue, competitive pricing pressure, and incremental investments in sales and R&D.

As we mentioned last quarter, we are seeing the macro slowdown impact Industry Standard Servers. Revenue in ISS declined 4% year over year. Revenue in business critical systems declined 23% year over year primarily due to a decline in our Itanium-based servers. Our ability to close deals has been impacted by Oracle's Itanium decision, and we are working diligently to enforce the commitments that Oracle has made to our customers and to HP.

Our HP storage portfolio showed revenue growth of 4% year over year with 11% growth in our external disk products, and once again, triple-digit growth in 3PAR. Year-over-year declines in our tape and EVA product lines partially offset this growth. HP networking grew 5% year over year, and enterprise switching and routing grew 7% from the prior year period. We feel good



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about our business model and customer value proposition, and we added 50 new logos in the quarter. We expect to continue to gain market share in switching and routing.

Turning to HP Software. We delivered another strong quarter, with revenue of \$976 million, up 28% compared with the prior year, including 33% license growth, 36% services revenue growth, and 20% support revenue growth. Our security offering continues to do well, and the IT performance suite offers enterprises a comprehensive solution for managing their infrastructure and applications. Overall, fourth quarter operating profit for HP software was \$270 million, or 28% of revenue.

We closed the acquisition of Autonomy in October, and therefore, we had roughly one month of results in the software numbers. The integration is going well thus far, and we are focused on enabling our global sales force to ramp on the Autonomy product line-up, so they can begin selling Autonomy software in fiscal '12.

HP Financial Services continues to deliver strong, consistent results. In the fourth quarter, financing revenue grew 18% to \$952 million. Financing volume increased 12%, and net portfolio assets increased 12%. Operating profit of \$98 million is up 34% year over year to 10.3% of revenue.

Now on to the balance sheet and cash flow. We ended fiscal 2011 with total gross cash of \$8.1 billion. Our fourth quarter cash conversion cycle was 26 days, up five days from the prior year, primarily due to a four-day increase in inventory days. Days sales outstanding increased one day from the prior year, and days payable were flat year over year. Channel inventories are a bit higher than we would like in some regions, but within acceptable ranges at the company level. HP generated operating cash flow of \$2.4 billion in the quarter, and free cash flow of \$1.2 billion. During the quarter, we returned \$500 million in cash to shareholders through share repurchases, and \$239 million in dividends. At the end of the quarter, we had roughly \$10.8 billion remaining in our share repurchase authorization.

Today, we are providing our outlook for both the first fiscal quarter and the full-year 2012. We will continue to be transparent about the tailwinds and headwinds that our respective businesses are facing. We will no longer be providing quantitative revenue or segment-level outlooks. We will be managing the business towards earnings performance rather than particular revenue growth objectives, and we will continue to provide earnings per share outlook consistent with how we are managing HP's performance as one company.

Here is some color on our assumptions relating to revenue and earnings for the coming year. Based on what we saw in Q4, the macro environment remains uncertain globally, and particularly in Europe. Consumer spending remains soft, and we have begun to see a slowdown in commercial spending. We expect these dynamics will lead to below normal sequential revenue performance in Q1, and year-over-year revenue declines through 2012.

From a business perspective, we expect the decline in our business critical systems business will remain a headwind throughout the year. Additionally, during the first half of the year, we expect to experience headwinds associated with the flooding in Thailand affecting hard disk drive supply, primarily within PSG, but also across ESSN. We also expect a slow correction in our IPG channel inventory levels.

Moving on to margin. In fiscal 2012, we will continue to be focused on profitable revenue, but we expect our margins will be impacted by several factors. First, the overall decline in revenue will impact margins at the company level. Second, we are seeing a competitive pricing environment across our transactional businesses. Third, we expect an impact due to the lower mix of business critical systems.

At the same time, we are investing in our services turnaround, which is driving an increase in costs due to delivery and sales personnel in that business. And we will continue to invest in innovation, and the systems and processes needed to improve performance across all of our businesses over time. We will have increased other interest and expense due to the change in our capital structure with more debt. We expect OI&E to be an expense of roughly \$1 billion to \$1.3 billion for the full year. And finally, we expect our tax rate to remain at 22% for the full year.

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With that as context, we expect first quarter non-GAAP earnings per share to be between \$0.83 and \$0.86. We expect first quarter GAAP earnings per share to be between \$0.61 and \$0.64. For the full year fiscal 2012, we expect non-GAAP EPS to be at least \$4, and we expect full year GAAP EPS to be at least \$3.20.

In conclusion, HP is making strategic investments in our people and our processes this year to enhance the core strength of HP, and to build upon our leadership position across hardware, software, services, and solutions. Meg and I will watch these expenditures closely against expected returns, making adjustments as required. In the end, we expect to be a stronger, more consistent performer, creating value for our customers, our employees, and our shareholders.

With that, I'd like to turn it over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bill Shope, with Goldman Sachs.

Bill Shope - Goldman Sachs - Analyst

When looking at the fiscal '12 EPS guidance, can you help us understand the pressure relative to prior expectations and I guess prior investor expectations? Can you help us separate out how much is driven by incremental investments for the long term versus more near term pricing or demand related pressure, and I recognize that would probably be a qualitative answer. Finally, if you could give us some color or examples on what type of investments you're looking to make, again for the long term.

Meg Whitman - Hewlett Packard Co - President, CEO

Sure. Let me take that and then Cathie can chime in. We have taken a prudent approach, Bill, to 2012 and Q1 guidance, by modeling the year-over-year declines throughout the year and I think it really falls into three buckets for me. First, is that one-third is macroeconomic forces. We're seeing headwinds in all three regions, particularly in Europe. We are, also, aggressively working through the Thailand situation which will I think affect us in Q1 and Q2.

The third bucket of things that we're looking at specific HP issues and this is where we are making some investments. We've got business challenges that actually need to be sorted out. So, first of all, we are driving more organic innovation with R&D -- the R&D investment in virtually every business we are taking up this year after an increase last year but it is absolutely required. If we're going to get out of the M&A business -- of big M&A, we've got to actually invest in R&D.

We also have a services turnaround on our hands and while that isn't R&D investment per se, that is investment in sales and it is investment in people who can actually deliver the product that we want to deliver in services. Then, the last area is sales force. We did invest in sales force last year. We've trimmed some of that expense but we're making another investment this year in coverage in big accounts, where I think there is a lot more revenue for HP. So, those would be the three major areas of investment that we're going to make in 2012. Cathie, do you want to add anything to that?

Cathie Lesjak - Hewlett Packard Co - EVP & CFO

Yes. Let me add a couple more points. The other thing, Bill, you should take into consideration in your modeling, is the fact that we will continue to see a decline in our business critical systems business. It's going to continue to be a headwind for our

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Enterprise Server Storage and networking margins. The strength of the yen. So, at the end of Q4 -- the yen was up again quarter-on-quarter but the year-on-year strengthen the yen and that's going to continue to be a head wind for our IPG business.

Then, the other spot I would call out is there are two impacts that are predominantly first half. So, we would put the channel inventory corrections for the IPG supplies, we believe by the end of Q2 we will have gotten the level in the channel roughly in line with what we think the demand is. So, that's a first half event and the other first half, we think the impact from the Thailand flooding on the hard disk drive availability, starts to be alleviated by the end of the first half as well. So, we've got those two impacts that help us in the second half as we work through them.

Then, maybe the only other thing to remind folks, as I did say in my prepared remarks, is we will have an OI&E expense we believe between \$1 billion and \$1.3 billion this year. That is an increase over this year -- I'm sorry over 2011, as a result of the capital structure changes that we made, as we exited Q4 and the fact that, interest rate differentials have gone against us. So, the cost of our hedging programs has gone up fairly significantly.

Operator

Katy Huberty with Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

Just to clarify, is the lack of revenue guidance a function of the new strategy to be more selective in the revenue you choose and maximize profitability? Or is it more of a function around visibility and the disruptions you talked about in Thailand. Then, as a follow-up, Cathie, you mentioned a number of areas like BCS and the IPG inventory correction that will weigh on your revenue performance. Can you talk about if there are any segments where you think you can take share in fiscal 2012 whether it be the product portfolio you're entering the year with or other functions like leveraging pricing and bundling.

Meg Whitman - *Hewlett Packard Co - President, CEO*

So, let me start out by taking that question. Katy, the reason we're not guiding to revenue is we want to manage this Company focus on earnings per share and cash flow. So, that we, particularly in some of our businesses like services we drive towards more profitable business. So, that our business unit heads are focused on business mix. Where can they find the most profitable parts of the mix that they can sell as opposed to just drive for revenue.

Now, I don't want to overstate it. Obviously, this Company has always been focused on profitability, but I think the better measure of our success as a management team is going to be on EPS growth and revenue growth -- I'm sorry, EPS growth and cash flow. So, that's the reason that we're doing that. I want to make sure that everyone knows. Obviously, we're going to report revenue by segment. We're going to have the same transparency and reporting that we always have but it's going to give us some degrees of freedom I think to improve the management of this Company by just guiding to EPS.

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

Katy, if I can answer your question around where we think we can take share. We'll be focused on profitable growth. That has not limited us in the past to go ahead and gain share. So, right now our guidance is really reflective of an uncertain macro environment at large. We do believe that we'll be able to continue to maintain or gain share in a number of our key segments.

Operator

Richard Gardner with Citigroup.

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Richard Gardner - Citigroup - Analyst

I just wanted to focus on the weaker than expected results in supplies and the fact that you mentioned that they were below your internal expectations. I'd just love to get your thoughts on how we can be confident that, that's simply a cyclical issue as opposed to a bigger secular issue. What evidence can you offer us that this will reverse when the economy gets better.

Meg Whitman - Hewlett Packard Co - President, CEO

Let me answer the cyclical versus the secular question. Richard, because this is, obviously, the question that we get asked a lot. I completely believe that this is not a secular trend decline in printing; that there is more information, more things to be printed, more people who have the capacity of print than ever before. In my view, and I've only been here eight weeks, this was all about correcting a higher than normal supplies in the channel that what got put into the channel in Q1 and Q2. I think the slowdown in Q3 and Q4 was a surprise to us, particularly on the commercial side but also on the consumer side. What we know, from years in this business, is that supplies are almost a perfect predictor of economic health, of almost any region. So, I think what you're seeing is, consumers and small businesses in particular are worried about the economic environment. They are not buying as much printing supplies, but I do not think that this is a secular trend. Obviously, we are making an investment in things like graphics, E-print and a whole host of things that are designed to actually increase the amount of printing -- but at least at this juncture I don't see it as a secular decline.

Cathie Lesjak - Hewlett Packard Co - EVP & CFO

For those of you who are statistically minded, we have looked at what the correlation or the R-squared is against retail sales, against unemployment, against GDP, region by region globally and the R-squared is incredibly high, on each of those above 70%. So, that would suggest again some strong data that when, and if, the macroeconomic environment starts to turn around that supplies will come back as well.

Richard Gardner - Citigroup - Analyst

Cathie, if I could follow-up on that answer. Thank you for that. Is the decline that we're seeing right now consistent with the line that you would expect based on that R-squared?

Cathie Lesjak - Hewlett Packard Co - EVP & CFO

Yes, it is. I mean -- I'm sorry, I should clarify that. We've got the channel -- supplies channel correction, but if you actually look at the sell-through. Yes, it is consistent with that.

Operator

Ben Reitzes with HP.

Ben Reitzes - Barclays Capital - Analyst

Hi, I'm with Barclays. So, far, as far as I know.

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

I think they said you were with HP? (laughter)

Ben Reitzes - *Barclays Capital - Analyst*

I wanted to ask you about ISS and some of the puts and takes there. There's an argument there, that there's a secular move towards in-house developed servers and you put out some arm-based initiatives during the quarter. I just wanted to see how you can get after that opportunity in ISS, going after the guys who make their own servers and whether that is impacting you adversely right now. Something you can turn around -- and anymore detail about what's going on with ISS and how you turn that around?

Meg Whitman - *Hewlett Packard Co - President, CEO*

Sure. So, as you know, we're number one in that market, in the X86 market, in all three regions. The other thing you have to remember about this quarters results is we had a tough compare. Because in Q4 of 2010, we grew 32% year-over-year. So, it's a tough compare. I'd say from talking to the guys in the business, we're back to a normal, more normal refresh cycle and -- but there's going to be near term pressure I think due to weaker demand and to the disk drive constraints. You know, we hear all the time that people are building their own servers. There are a few number of companies that are building their own servers. I will tell you right about now they are not building their own servers because they can't get the disk drives. So, they're calling us but I don't think it is a huge longer term trend. Yes, the Googles and the Facebooks are doing some of that -- but I will tell you they're all calling us right now because they don't have the ability to get the drives. So, I think we should watch out for that but that's not one of the worries I have about this business.

Ben Reitzes - *Barclays Capital - Analyst*

You want to elaborate on the drive trend a little bit and what you're expecting, now that you mentioned it. Then, I'll seed the floor as they say.

Meg Whitman - *Hewlett Packard Co - President, CEO*

Sure. Then, I'll turn it back to Cathie, because I think she had something they wanted to add. The flooding in Thailand, first of all I have to say it's been a personal tragedy. We have employees, our partners have employees, it's a really terrible situation and I will say that it remains pretty dynamic. I've been on the phone with the heads of all four of our disk drive partners. I'm not even sure they have a complete picture about when they're going to be back up and running but I'll tell you some of the things we did.

First of all, we reacted really fast to this. We set up a war room, we began pulling in inventory and made strategic buys of hard drives back in early October. So, I think we will get more than our fair share of drives here because of the long-term relationships that we have with our suppliers because we were on this really fast. I think this is going to affect the industry pretty dramatically because it's PCs, it's servers, it's storage, and I think there's going to be some shortages in Q1 and Q2. I think we're as well positioned as we can be, but I think this is going to be pretty tough for the industry.

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

Ben, the only thing I'd add there is that we have tried to capture this uncertainty in our EPS guidance. So, that it's already encapsulated there. Also, just I was going to make a comment on the ISS. I think what's going to be key for us in ISS is really going to be investment and innovation, because what's going to keep folks from building their own servers is going to be the



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innovation that Hewlett Packard can bring to the party and we've done that consistently over a very long time frame and we are continuing to increase R&D. We saw it in fiscal 2011 and it's in our guidance as well for 2012, that we're increasing R&D.

Meg Whitman - *Hewlett Packard Co - President, CEO*

I think we're pretty excited about this new server that we've code named Moonshot. This has a chance to change the game in the industry which is what Hewlett Packard should be doing.

Operator

Toni Sacconaghi with Sanford Bernstein.

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

My observation is that you are placing more emphasis on the tough macroeconomic environment than other companies have through this earnings period. Many have seen that -- many have said that they remain somewhat cautious but they really haven't felt its impact whereas you seem to be saying it very definitively. I want to explore that a little bit in why you are confident that some of the business erosion is macroeconomic driven rather than competitive driven. My observations are that most companies are coming in slightly below normal seasonality for this quarter. You came in dramatically below normal seasonality.

ISS grew at minus 4%. IBM was at plus 1, Dell was at plus 12. Looks like you lost share. PCs, market grew at 3 to 4, you grew at 2 in units. IPG you grew 10 points lower than Lexmark. Just some simple benchmarking would suggest you're losing share. So, the question is why do you believe this is predominantly macro? Do you believe that you're as competitive as you ought to be, or is there some brand damage that was created earlier this year because of results and/or your PC decision that may be impacting near-term results in a more dramatic way?

Meg Whitman - *Hewlett Packard Co - President, CEO*

Let me give you my perspective on that, Toni. So, I would say if you look at 2011 there were three buckets of problems for HP. I would say the weaker performance, than we would have liked in 2007, is allocatable about a third, a third, and a third. A third is macroeconomic trend and we saw pretty significant -- the consumer was weak all year for us, and the commercial segment weakened in Q3 and Q4. So, no denying that, I think we absolutely saw that.

I would say one-third of our challenges in 2011 were HP specific. Absolutely whether it was the channel in IPG, whether it was China in PSG. We were hurt disproportionately in China from the NVIDIA recall, the Intel recall and, then, no question our mid August announcement hurt us in China more than any other market. Frankly, I think there was some brand damage to that, at least it created uncertainty. I had customers tell us they thought we were getting out of the hardware business entirely. So, no question we did ourselves in there.

I would say on services, the lack of the right tools and the mix of that business, we didn't perform as well as the industry in that business in 2011. On the other hand we had a great year in Software and a great year in Financial Services, but the other third was what I would call the distraction factor. We just need to get back to putting our heads down and get out of the news cycle and reduce the drama here. There was a lot of drama in 2011. So, I'd say looking backwards I'd say it's a third, a third, and a third.

Going forward, listen, we've still got macroeconomic headwinds. Maybe we're calling it out more than others but we see it and I don't think anyone knows what's going to happen in Europe -- even our EPS guidance does not take into account a complete meltdown in Europe. Then, we've got some business issues we have to work through that I think Cathie and I have covered.



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Hopefully, the distraction we'll be out of it, but I don't want to paint the picture that everything is perfect within HP. We've got work to do in each and every one of our businesses.

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

Toni, if you actually look at share on the preliminary basis for calendar Q3, we believe we held or gained share in printing, LaserJet and ink. We believe we gained share in networking. We believe we gained share in storage. We believe we gained share in PCs, a lot of share in commercial PCs. We do believe that, it's a close call in terms of share from an industry standards server perspective. But you've probably noticed there's a lot of volatility in share these days in Industry Standard Servers because you've got these big service provider deals. If you happen to win that quarter deals you're going to show a lot of share gain and other people aren't -- and you'll have tough compares. So, I think you have to take that into consideration as well. So, overall, I would actually say that, we were performing at or better than market. So, if we're calling out something more than others are, I'll leave it up to you to draw your conclusion.

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

Okay. Then, my second question is just on capital allocation. You made several statements, you talked about balanced and disciplined approach for 2012. You've said in the past that you want to maintain your existing credit rating. But I can't help wondering -- look, if you're going to generate \$8 billion to \$10 billion in cash, you could certainly return more cash than your dividends, in the form of buy backs in 2012, and still exit the year with an improved capital structure relative to the beginning of the year. So, you bought back 500 million in shares in the quarter. Why can't you and why won't you be more prescriptive about having incremental share repurchases in 2012 given your low stock price and given the rough economics that I just outlined?

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

Toni, we're always evaluating the best use of our cash both for the short term and the long term. So, at a minimum we will offset the dilution that comes with employee benefit plans in 2012. Then, we'll look opportunistically for potentially a bit more than that. From a credit rating perspective, I think there's more flexibility on the credit rating, but in the mid term we really want to focus on building back our balance sheet. We have significantly more debt. It is an uncertain economic macroeconomic environment for 2012 and we just don't want to get out ahead of ourselves on this one.

Operator

Keith Bachman with Bank of Montreal.

Keith Bachman - *BMO Capital Markets - Analyst*

I wanted to ask about services and, in particular, I would like to get some more color and see if you can bound how you're thinking about both the revenue growth and the margin implications as you're going through this investment cycle during the course of FY '12. Can you give us, for instance, a little more color on how you're thinking about the revenue growth potential there, either in absolute or against the market categories. Then, also you mentioned margins will decline. Is there any, again, bounds that you can provide to us to help us think about the margins and services. Finally, if you could just let us know will the services you think be at a run rate at the end of either FY '12 or CY '12 that suggest that HP's at where it should be in the services portfolio?



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

So, margins were in line with what we told you last quarter.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes, sorry I meant going forward, Cathie.

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

We think we're making good progress in services but I think it's really important to level set everyone that this is a journey that's going to take some time. I think it's more appropriate to think about the services as more of a turnaround. So, turnaround that's measured, success is measured in years as opposed to quarters.

I think that's the best way to think about it. So, talk about some of the headwinds that we've got at the services margins. We know that we've got to improve our mix of higher margin, higher growth business services such as applications. That's going to take time, and at the same time that we're doing that, we've got to carefully review everything in our portfolio to make sure that we're focused on the right services. So, that could mean de-emphasizing some of the lower margin services as well. We are absolutely investing in the right tools to effectively and efficiently run this business. This is a very big business and to date, guys, we put manual processes in place, in order to manage this business. This is not the way to do it. So, in 2011 we made some investments, in 2012 we are accelerating those investments and tools for this business.

We are, as we've talked before, we're investing in sales and we're adding significantly to the delivery resources because at the end of the day, happier customers will buy more product at better margins. We also -- you also have to factor in the fact that you've got these ITO deals. These large ITO deals that are over many years, they come on at lower margins and they run off at higher margins. Just because of the life cycle of an ITO deal and we've got a bit of that going on as well.

In the Technology Services space, you've got the headwind from Business Critical servers revenue. Over time it's going to hit us. It doesn't hit all at once. It's got a very long tail on it. I think it's important for you guys to understand this, so you can think about how you model services. But the fundamental that you got to take away from this is that, we're making the right investments to create a good service business, despite the fact there will be continued pressures on the margins in 2012.

Operator

Scott Craig with Banc of America.

Scott Craig - *BofA Merrill Lynch - Analyst*

You mentioned, Cathie, a long tail on the services business with regards to issues like in BCS. Can you maybe provide a little more color around what the definition of a long tail is. Then, secondly, within the ESSN business. When do you start to see the year-over-year declines in the BCS business abating or even on a sequential basis. How do we think about that one over the next couple of quarters?

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

So, in terms of the tail on Technology Services with respect to the BCS, it's probably five-ish plus years, that it takes. I mean if you actually think about some of the DEC servers. A, we're still shipping them and B, we're still servicing them, and we would expect that very long tail on BCS as well.

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Meg Whitman - *Hewlett Packard Co - President, CEO*

Yes, I would agree with that. I think the BCS business is a declining business and it's a slow decline but I don't think you're going to see an accelerating growth rate in that business. So, we just have to manage that as best we can and, again, invest in R&D. So, we get to a new platform as fast as we possibly can, that allows us to service the clients that need this kind of power. So, I'd just agree with Cathie on that. It's a slow decline but it's declining.

Operator

Brian Alexander with Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

Just to follow up on M&A. You said you aren't interested any major acquisitions near term. Is that because you think HP doesn't have major strategic holes to fill or would you rather just strengthen the balance sheet following the Autonomy acquisition and focus on execution? I'm just trying to understand, if the lack of M&A appetite is more timing related than strategic decisions around the portfolio.

Meg Whitman - *Hewlett Packard Co - President, CEO*

I'd say it's a bit of both, but first and foremost is timing. We've got to get back to business fundamentals. We've got to execute. We've got to make improvements in all of our businesses in 2012 and we need to rebuild our balance sheet. So, we may make some small acquisitions that help us, particularly in our Software business and other spots. We're not going to do any big acquisition in 2012. Then, of course, we'll evaluate where we are when we get through this rebuilding year. What I would characterize as a reset and rebuilding year.

I think one of the things I've been struck by is we have a fantastic portfolio of assets. We just need to make them work harder together, and we need to run this Company as one HP. So, that we can bring the full portfolio to bear to solve customer problems. As you probably know, it has been more run, historically, by business units and not as much synergy between different portfolio of products that I think we can hugely benefit from. So, we can update you when we get to 2013 but no large acquisitions in 2012.

Brian Alexander - *Raymond James & Associates - Analyst*

Just to follow-up, Meg. Could you define what you mean by large or in terms of revenue or purchase price?

Meg Whitman - *Hewlett Packard Co - President, CEO*

(laughter) I don't know, that's a little hard to say. Certainly, nothing near the size of Autonomy, let me put it that way. I would say these are going to be more acquisitions in the sub \$500 million range would be my guess. We might get to a billion but I doubt it.

Operator

[Brian Marshall with ISI Group].

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Brian Marshall - *ISI Group - Analyst*

You talked a little bit about profitable growth. Can you talk perhaps about which segments you actually think you can generate the most improvement later this year, from a profitability perspective, based off of the October level as a starting point from operating margins?

Meg Whitman - *Hewlett Packard Co - President, CEO*

Well, I'll start out. I would say first of all, I think IPG will end the year stronger than it started because I think the channel sell-through of supplies will abate by the end of Q2. So, we ought to be back to more normal levels of supplies and, as you know, all the money is in supplies. So, I would think that, that will be an improvement as we hit the end of the year.

Listen, I'm looking forward to an improved profitability and great year for ESSN. We going to, hopefully, gain share in networking, gain share in storage. I think we've got a great ISS business. I think that's a business I'm looking for improvements in. Software ought to be a big improvement with Autonomy, as well as our IT performance suite. (technical difficulty) I don't know that you'll see a big improvement in profitability in PSG, but I think you'll see the stabilization of that business which admittedly, probably of all of our business, it had the toughest year last year. Due to chip recalls, as well as the announcement that we made on August 18. So those probably would be what I'd say.

Brian Marshall - *ISI Group - Analyst*

On the services side, bouncing around 10% to 12%, I would assume for this year. Something like that?

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

I think that's a reasonable range to be in.

Operator

Mark Moskowitz with JPMorgan.

Mark Moskowitz - *JPMorgan Chase & Co. - Analyst*

Meg, I want to see if you can give us a little more context around the acquisition strategy, at least for the next 12 months. I appreciate how you've done a nice job in terms of trying to restore stability but I'm just concerned about the long term competitiveness of HP, particularly in Services and Software. If there are some good assets that are out there above \$500 million and they can get taken out in the next 12 months, the macro really slows down and sellers appetites may be improved to maybe divest their businesses or get out. Are you kind of taking yourselves out of the game here? I know a lot of folks will say, Larry Ellison and Oracle are due for a big acquisition.

Meg Whitman - *Hewlett Packard Co - President, CEO*

Yes. Well, listen, Software would be the one area that I think there may be some assets that are ready to move in 2012. We would want to be there. But, again, we have to deal with the situation in which we're in and we made a big acquisition last year -- which, by the way, we haven't talked about Autonomy. I'm excited about that acquisition. We can talk more about it. So, there may be two or three acquisitions that we want to take a look at in the Software space and now I know I'm going to be held to if it's less than \$500 million we won't do it. Let me refrain that. If there is a great acquisition that's in the billion range, maybe

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we will take a look at it, but we've got to be sure it fills a hole, that we don't pay too much for it and that we are financially disciplined about it. So, that's the caveat I'd give to you.

Listen, I have a history, to some degree using acquisitions to grow companies, I'm in favor of acquisitions but I will tell you we cannot continue to rely on acquisitions alone at Hewlett Packard. It's just the wrong thing to do. We have tremendous R&D capability here and that's how you really do the -- what I would call required evolutionary innovation. For the completely disruptive revolutionary innovation, certainly we can look outside. But we've got a lot of runway with our own internal R&D capability if we run it right and invest in it right.

Mark Moskowitz - JPMorgan Chase & Co. - Analyst

Okay. I appreciate that clarity and you led to my second question. I wanted to get a better handle around the R&D investments, as well as the sales and marketing coverage investments. How should we think about kind of the ROI in terms of when these folks will be productive? I know over the past five years a lot of muscle had been cut out of R&D. When should we think about the return where we can see this monetized? Is it 2013 or is it 2014, before it shows up in the P&L?

Meg Whitman - Hewlett Packard Co - President, CEO

Listen, R&D in the technology business is a longer term gain. It's not an ROI in year one or year two. I think the investments we make in 2012, you'll start to see in 2014 and 2015. I wish I could tell you differently, but it's not true and you're right. We cut out a lot of muscle in R&D at this Company and we have to invest back in it. So, it's a long-term play and what I will tell you is this management team, we are now building HP, we're building it to last. We are not building it for next month or next quarter. We are building this Company to be great over the next decade. You'll see improvements every single year. You'll be able to measure us on how we're doing, but we're making some long-term bets here because we just can't continue to run this Company for the short-term.

Operator

Shannon Cross with Cross Research.

Shannon Cross - Cross Research - Analyst

One, Meg, you mentioned Autonomy. So, if you could provide some thoughts and metrics you have on the Autonomy acquisition and what you're seeing, and if you could talk about linearity during the quarter. I'm most interested given some of your more [negative commentary as if things weakened during] October and potentially into November. (technical difficulty)

Meg Whitman - Hewlett Packard Co - President, CEO

Well let me just spend a moment on Autonomy. I am really excited about this acquisition. As you all know, I think it really positions HP as a leader in the Next-generation information management and analytics capabilities, as the explosion of data is making these capabilities absolutely critical. Autonomy is a unique asset. It has a remarkable ability to manage unstructured information in a way that no one else in the market does. I think that adds a lot of value not only in their space but actually across HP.

So, what we've set up is Autonomy is actually running fairly autonomously (laughter) but we have done a great job I think of integrating the go-to market. So, there are sales leads that are going from Autonomy to HP -- interestingly, which we didn't expect so much of in terms of a hardware pull-through -- but also from our HP sales team back to Autonomy. We've got a clearing



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house that vets all those leads. So, that what we turn over to Autonomy are really high quality leads that will allow Autonomy to grow much faster than they would have grown on their own. That's the name of the game for 2012.

There's going to be lots of other things we do together but accelerating the growth of Autonomy using the distribution capability of HP is priority number one, two and three for 2012. We're really excited about it. I, also, have to tell you we're really excited about the team -- great set of folks who are passionate about what they do and I think are excited to be at HP.

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

Shannon, real quickly on the linearity question, I would say it was roughly normal linearity over the course of the quarter.

Meg Whitman - *Hewlett Packard Co - President, CEO*

Let me just wrap up and make a few closing remarks because we've covered a lot of ground here. I have to say I'm incredibly optimistic about HP's future, but we need to get back to the fundamentals in 2012 and that's what this management team aims to do. I'm sure there will be puts and takes here but I feel really good about the progress that we've laid out in front of us and about the long-term future of HP. So, I look forward to meeting many of you over the next couple of weeks and months and thank you for tuning in today. Really appreciate it. Thanks a lot.

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