THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

HPQ - Q1 2012 Hewlett-Packard Earnings Conference Call

EVENT DATE/TIME: FEBRUARY 22, 2012 / 10:00PM GMT

OVERVIEW:

HPQ reported 1Q12 revenue of $30b and GAAP diluted EPS of $0.73. Expects FY12 GAAP EPS of at least $3.20 and 2Q12 GAAP EPS of $0.68-0.71.

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Ben Reitzes *Barclays Capital - Analyst*

Bill Shope *Goldman Sachs - Analyst*

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

Katy Huberty *Morgan Stanley - Analyst*

Brian Alexander *Raymond James & Associates - Analyst*

Shannon Cross *Cross Research - Analyst*

Keith Bachman *Bank of Montreal - Analyst*

Richard Gardner *Citigroup - Analyst*

Maynard Um *UBS - Analyst*

Kulbinder Garcha *Credit Suisse - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first quarter 2012 Hewlett-Packard earnings conference call. My name is Jeff and I'll 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 towards 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 Co - VP, Investor Relations*

Good afternoon. Welcome to our first quarter 2012 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 that this call is being webcast. A replay of the webcast will be available shortly after the call for approximately one year. 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-K. 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 from the amount ultimately reported in HP's first quarter Form 10-Q. 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, among other things, 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 in the slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations Web page at www.hp.com. Before I turn it over to Meg, I just wanted to briefly touch upon a financial reporting item. Each year, as part of our first quarter annual financial review, we review our reported segments and make any necessary changes to reflect any organizational shifts among our businesses. This year, these realignments resulted in the transfer of revenue and operating profit along the Services, Imaging and Printing Group, Enterprise Servers, Storage and Networking, Software and Corporate Investments segments and the transfer of revenue among the business units within the Services segment.

In addition, we have reclassified certain costs previously reported as cost of sales as selling, general and administrative expenses to better align these costs with the functional areas that benefit from those expenditures. This reclassification of costs did not impact segment reporting, it relates only to the line items within the P&L in which the costs are booked. A detailed reconciliation of the changes, including historical data, is available on our Investor Relations website, as well as furnished on our Form 8-K filed with the SEC. I want to be clear that the changes do not impact HP's previously reported consolidated net revenue, earnings from operations, net earnings, or EPS. I'll now turn the call over to Meg.

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

Thank you, Steve, and thanks to all of you for joining the call. Since I spoke to you last, I've spent a great deal of time with our employees, our customers, partners, and investors. Given some of the challenges of the last year, we've been working hard to set the right tone, calm the waters and reassure our stakeholders that HP is the same reliable Company that they've known and admired for decades.

I've visited HP offices, hosting round table and employee meetings in Palo Alto , Cupertino, London, Vienna, Chicago, Houston, Herndon and Alpharetta, Georgia. I've spent some time with the sales force, communicated regularly with our senior leadership, and worked very closely across the executive team, and I've been out with our customers. At HP Discover in Vienna we brought together more than 7,000 of our top enterprise customers in the biggest event in HP history. And I've participated in more than 80 customer visits, meetings and conversations. I've engaged with the channel, through partner meetings, round tables, interviews and just last week, at the first ever HP Global Partner conference. So what have I found?

Certainly, I've found some skepticism, but I have also found that we have incredible support. People who believe in HP, people who want us to win, people who want to work with us and build for the future, and every day I learn something new about a technology, an innovation, a solution, often just a story about the role HP has played in someone's life or a customer's success. It's inspiring. The more time I spend listening and learning the more committed and passionate I've become.

I've also gotten to know many of you, our investors, and just as I have with our other stakeholders I'm working hard to strengthen our clarity and transparency. I want you to understand where we're taking HP and why. Most of all, I want to set HP on a path to continue to meet and exceed our expectations for the longer term. I believe we've started on that journey during the past few months but we have a long road ahead of us. Back in November, we set the outlook. We said we had a lot of work to do, and we detailed the headwinds that were likely to pressure our business in 2012, including a hard drive shortage, and an uncertain macroeconomic environment.

In Q1, I think our performance by and large tracked pretty close to those expectations. The headwinds we discussed did impact performance, contributing to a decline in revenues, operating margin, cash flows and earnings year-over-year. That said, we met our guidance and delivered non-GAAP diluted earnings per share of $0.92 and revenue of $30 billion. Frankly, it was a tough quarter and every business had its challenges. In PSG, the hard drive shortage and continuing difficulties in China contributed to a revenue decline of 15% year-over-year.

With the supply challenges, we focused on profitability, rather than market share, and did a good job of delivering an operating margin of 5.2%. PSG is important to HP. It gives us great return on invested capital and a lot of synergies. During the quarter, we also saw PSG returning to its roots as an innovation leader. With the introduction of the Spectra Ultrabook, HP won a prestigious Best-of-Show at the Consumer Electronics show in Las Vegas a few weeks ago. We need more of that.

We need to keep driving innovation that generates desire and demand with our customers. The fact is that for all that's right with PSG, we under invested in innovation for the last several years and we've been late to market too often. We have to lead again. In Imaging and Printing, year-over-year revenues decreased 7% with declines in supplies and hardware in consumer and commercial and operating margin declined to 12.2%. All of you know IPG has been the lifeblood of our Company for a long time, with great margin and very resilient revenues. And IPG is still a great HP business, the undisputed leader in the printing and imaging industry and well positioned to capture the shift from analog to digital.

But we also have to recognize that the business is being pressured on multiple fronts, and revenues from our adjacent businesses like commercial digital print are doing quite well but not developing fast enough to replace the revenues we've been losing. We have work to do here and are aggressively exploring ways to build on IPG's leadership given the realities of today's marketplace. In ESSN, revenues declined 10% and operating margin fell to 11.2% year-over-year. Industry Standard Servers revenue was down in a highly competitive environment that was compounded by the hard disk shortage. BusinessCritical Systems revenues also declined as we continued to address the Oracle Itanium situation.

3PAR delivered another terrific quarter but in our broader storage business we're still working through a product transition. And our Networking business remains well positioned in a high margin category. Although the overall market was challenging, we're really excited about some of the innovations we're bringing to our customers. We've launched some great new products like the ProLiant Gen8, the industry's most self sufficient line of servers. We believe that this is just the type of game changing innovation that can help us regain our momentum in the category.

In Services, year-over-year revenues were up 1% while operating margin declined to 10.5%. This continuing margin pressure in Services really goes straight to a couple of our major challenges, like resource utilization and business mix. We're focused on transitioning to more profitable services while enhancing our systems, processes and sales force. Last quarter, we characterized services as a long-term effort. That journey continues.

In Software, with the addition of Autonomy, revenue grew 30% year-over-year with a 17.1% operating margin. The Autonomy acquisition is going well. And we're continuing to grow our set of assets from Information Management to our IT Performance Suite including security, management of hybrid clouds and Application Lifecycle Management. Software is a critical part of our portfolio and of our forward-looking strategy. It amplifies, differentiates, optimizes and secures our core infrastructure, builds on our solution capabilities and expands customer relationships.

For example, with an asset like Autonomy, we see potential synergies across the entire portfolio in IPG, ESSN, Services, and in other software assets like security. Now, from a macroeconomic standpoint, we're seeing an uncertain environment. In the US, there are some signs of economic improvement but we're still experiencing a weak consumer market and commercial customers who are investing cautiously. In Europe, the Middle East, Africa, and APJ, conditions are mixed. We remain guarded about Europe, but some of the larger economies do seem to be stabilizing.

When we last spoke at the end of Q4, I've been CEO of HP for about eight weeks. Now coming out of Q1 it's closer to six months and my perceptions of the business have evolved in that time. Some of that has to do with the external environment, but I also have a clearer picture of the work we need to do in our business. In my mind, I put the issues into three buckets. First, is fixing our execution, ensuring we have the right systems, processes and people. This includes things like optimizing our supply chain, including SKU reduction, to remove unnecessary complexity from the way we design, manufacture, and deliver product, upgrading our sales tools and systems to respond more quickly to customers, and increasing the productivity of our sales force by rationalizing our go-to-market.

The second bucket is about addressing ongoing issues in each of our businesses from IPG, to PSG to ESSN to Services. We didn't make the investments we should have during the past few years to stay ahead of customer expectations and market trends. As a result, we see eroding revenue and profits today. We need to invest now as a market leader from a position of strength, and that's especially true because these businesses are not only under intense competitive pressure but are also under pressure from tectonic shifts that are taking place at the very foundation of the industry. And that's the third bucket, how we deal with these industry shifts.

We are at an inflection point where the delivery, consumption and business model for technology are all being redefined. Long established profit tools are under pressure and other profit tools are forming fast. We need to move quickly to capture emerging opportunities in areas like cloud, security, and information management. We've already assembled some formidable assets. Now we need to align our portfolio to deliver a new generation of capabilities. We see a once in a generation chance to define the future of technology and position HP as a leader for decades to come.

But to seize this moment we have to stabilize financial performance. That's really at the heart of any discussion of business fundamentals, generating enough profit to invest for the future and deliver solid returns for your investor, all underpinned by a disciplined capital allocation strategy. And it's clear from both our revenue and margin profile that our current cost base just isn't affordable. On the current trajectory, we just won't have the capacity that we need to invest. For years, we've been basically running our business in silos and under that model, we've built some of the leading franchises in technology, but it's also made us too complex and too slow. Yes, some of the obvious costs were dealt with in recent years, but there is still much more that we can do to streamline operations.

Even more promising is what we can accomplish by tackling our business processes. We need to standardize, optimize and automate many of our processes which will allow us scale the business without increasing cost at the same rate. We can also take a ton of complexity out of the system, improve our effectiveness and significantly reduce cost. It's not easy work and it's not a quick fix, but it holds the potential to improve the way we operate and execute and it simply has to be done. We have got to save to invest. We have got to save to grow.

In the near term, our focus remains on stabilizing the business, driving execution, and getting back to basics like aligning our cost structure with our revenue profile. Longer term, we'll invest to capture opportunities in cloud, security, and information management that will position HP as a leader for decades. We have a lot of work to do. I've gained visibility into the business over the last few months and I feel very good that we know the challenges, we know what we're going to do about them, and we're headed in the right direction.

After the time I've spent with our stakeholders, I am increasingly confident and optimistic about what we're doing. We have incredible strength and an incredible community of people who care deeply about HP. With their support, we've embarked on rebuilding HP in a thoughtful way that is true to the spirit of innovation, financial discipline and financial success that has defined this Company. I have no doubt that we'll turn HP around. I look forward to continuing our dialogue about HP's progress in the coming quarters, and I appreciate your continued support for our Company. And with that, I'll turn it over to Cathie for some additional color on our Q1 performance.

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

Thank you, Meg. Let me review the details of the quarter and then I'll provide some color on our outlook for Q2. Revenue of $30 billion was down 7% as reported, or 8% in constant currency year-over-year. We estimated that more than half the revenue decline was due to the hard disk drive shortage that impacted both PSG and ESSN. As you know, due to the flooding in Thailand that began last fall, industry supply of hard disk drives was about 30% below the expected demand in calendar Q4. Faced with this shortage, we made the decision to prioritize profitability, product performance, and quality over shipment volume and market share. We expect that the supply of hard disk drives will remain constrained for HP in Q2.

In terms of our revenue performance by geography, revenue as reported was down 9% in Americas, 4% in EMEA, and 10% in Asia Pacific year-over-year. All regions were impacted by the hard disk drive shortage. In addition, EMEA revenue was impacted by the macro challenges and APJ's revenue decline was driven by the weakness in China. On a constant currency basis, Americas, EMEA and APJ revenues were down 8%, 5% and 12%, respectively, year-over-year. Non-GAAP gross margin of 22.4% was down 210 basis points year-over-year and down 90 basis points sequentially. Non-GAAP gross margins continue to be impacted by the strong yen, a lower mix of ink supplies, competitive pricing in our hardware businesses and continued margin pressure in Services.

Non-GAAP operating expenses were $4.2 billion, up 6% year-over-year. If we exclude the impact of the real estate gains that drove our operating expenses down in Q1 last year, operating expenses were essentially flat year-over-year. Non-GAAP operating margin of 8.6% was down 380 basis points year-over-year and the Company delivered $2.6 billion in operating profit. The bridge from operating profit to our earnings per share includes the following. Other income and expense yielded a net expense of $221 million. Our tax rate was 22% and we used $780 million to repurchase 29 million shares, bringing our weighted average share count to 1.998 billion shares which is down 10% year-over-year. As a result, we exceeded our guidance in the quarter delivering non-GAAP diluted earnings per share of $0.92 and GAAP diluted earnings per share of $0.73. The majority of the difference between GAAP and non-GAAP earnings in Q1 was amortization of purchased intangible assets.

Now turning to our business units. The Personal Systems Group delivered revenue of $8.9 billion in the quarter, down 15% year-over-year with a 5.2% operating margin. Total units shipped were down 18% year-over-year. Our Q1 shipment volumes in PSG were impacted by the hard disk drive shortage and our performance reflects the choices we made to drive profitability and tightly manage inventory distribution. By segment, commercial client revenue declined 7% and consumer client revenue declined 25% year-over-year. Workstation revenue was flat year-over-year, desktop revenue was down 18% and notebook revenue declined 15% year-over-year.

Moving on to Services. Services delivered revenue of $8.6 billion, up 1% from the prior year quarter. Operating profit of $905 million was 10.5% of revenue, down 5.7 points from the prior year, primarily due to the cost of additional headcount in sales and service delivery. In the first quarter, IT outsourcing revenue of $3.7 billion was up 2% year-over-year. Application and Business Services revenue was flat year-over-year at $2.4 billion and Technology Services revenue grew 2%.

Turning to Imaging and Printing. Net revenue for IPG of $6.3 billion was down 7% year-over-year with supplies revenue declining 6%, partially due to our focus on reducing channel inventory. Operating profit was $761 million or 12.2% of revenue, which is down 440 basis points year-over-year. These margins remain unfavorably impacted by the strong yen and an unfavorable ink supply mix. Within the segments, we saw double-digit revenue growth in graphics and managed print services and we shipped more than 5 million Web-connected printers this quarter. We now have nearly 27 million Web-connected printers in use around the world.

By category, commercial printer revenue was down 5% year-over-year with commercial hardware units down 10%. Consumer printer revenue and units were both down 15% year-over-year and total printer units shipped were down 13% year-over-year. Turning to the Enterprise Servers, Storage and Networking business. Revenue declined 10% year-over-year to $5 billion due to the impact from the hard disk drive shortage and the continued weakness in BCS. Operating profit was $562 million and the operating margin of 11.2% was 360 basis points lower than the prior year period due to reduced volumes and competitive pricing.

Now let's dive into the ESSN performance by business. Storage revenue was down 6% year-over-year despite double-digit growth in StoreOnce and nearly 100% growth in 3PAR. Year-over-year declines in our tape and EVA product lines offset this growth. Overall, BusinessCritical Systems revenue declined 27% year-over-year. Within BCS, our Mission Critical x86 and Nonstop products grew double digits, but not by enough to counteract the impact of continuing Itanium challenges. With respect to our Itanium portfolio, we are working diligently to enforce the commitments that Oracle has made to our customers and to HP.

And our customers are excited about the capabilities of our new Odyssey platform which allows enterprises to transition work loads off UNIX-based systems to Mission Critical Xeon-based x86 chip. Neither the Storage nor BCS results were dramatically impacted by the hard disk drive shortage. However, we did see a significant impact on industry standard server revenue which declined 11% year-over-year. The hard disk drive shortage caused a mismatch between supply and demand, so we had demand that we could not meet in the quarter. Networking revenue was flat year-over-year at $586 million. We are confident that we have the right product portfolio and the total cost of ownership advantage to compete and win.

Software delivered revenue growth of 30% year-over-year to $946 million supported by the acquisition of Autonomy. In the quarter, we saw 12% license growth, 108% growth in services and 22% support revenue growth. Overall, first quarter operating profit for Software was $163 million, or 17.1% of revenue, unfavorably impacted by acquisition-related integration costs and accounting adjustments, as well as lower mix of license revenue in the quarter. We are pleased with the Autonomy acquisition, the pipeline is strong and the level of lead generation we are seeing across HP for Autonomy software and services is compelling.

HP Financial Services continues to deliver strong consistent results. In the first quarter, financing revenue grew 15% to $950 million. Financing volume was flat year-over-year and net portfolio assets increased 8%. Operating profit of $91 million was up 15% year-over-year to 9.6% of revenue. Now on to capital allocation and the balance sheet. Our focus is on rebuilding our balance sheet this year, but HP's long term strategy is to allocate our capital in a balanced manner between investing in the business and returning capital to shareholders.

During the quarter, we returned $780 million in cash to shareholders via share repurchases leaving roughly $10 billion remaining in the share repurchase authorization. We also paid $244 million to shareholders in the form of dividends. HP generated $1.2 billion in operating cash flow in the quarter and free cash flow of $406 million. Our total gross cash at the end of the quarter was $8.2 billion. In terms of working capital, our first quarter cash conversion cycle was 28 days, up seven days from the prior year. The increase was due to higher DSO and days of inventory by two days and three days, respectively, as well as a decrease of two days in days payable outstanding.

Exiting the quarter, channel inventory was higher than our acceptable ranges due to impacts of the hard disk drive shortage on ESSN and soft sell out in laser and ink supplies. Now, on to our outlook. As we discussed last quarter, HP is managing the business to deliver earnings performance rather than specific revenue growth objectives, and we will continue to provide our earnings per share outlook consistent with this management approach. I'll wrap up with an update on the assumptions relating to revenue and earnings.

We remain cautious about the macro environment globally for both consumer and commercial spending. In Q2, there will be an impact to revenue due to the hard disk drive shortage, although we expect the impact will be smaller in Q2 than Q1 based on the drives for which we have line of sight. We still have work to do in aligning our supplies channel inventory levels with the current demand environment, and we will continue to see a headwind in BusinessCritical Systems due to the Itanium challenges.

Moving on to margins. First, the .... First, the expected year-over-year decline in revenue including the impact from the hard disk drive shortages will impact margins. Second, we expect the pricing environment will continue to be very competitive. Third, we expect to continue to have an impact due to a lower mix of BusinessCritical Systems revenue. Fourth, the Services turnaround continues and we expect margins to continue to decline year-over-year. Fifth, we expect OI&E to be at the low end of our previous guidance and expense of $1 billion to $1.3 billion for the full year, and we will continue to invest in innovation and the systems and processes needed to improve performance across all of our businesses.

With that context, we expect second quarter non-GAAP earnings per share to be between $0.88 and $0.91. We expect second quarter GAAP earnings per share to be between $0.68 and $0.71. We have not changed our full year FY '12 guidance. We continue to expect at least $4 in non-GAAP EPS and at least $3.20 in GAAP EPS. Now I'll turn it over to Meg for a few comments on the upcoming year.

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

So to wrap up before going to Q&A, I'd really like all of you to take away these three messages. One, we're committed to clarity and transparency. We want you to understand the challenges and opportunities we have in front of us. Two, we are getting back to basics, driving execution, focusing on profitability through mix and cost and investing in our business with a disciplined capital allocation strategy. Three, we are building HP to last. We are not managing for short-term objectives. We are taking advantage of this opportunity to position HP for success, not for the next quarter but for decades to come. And with that, I'll open it up for Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Our first question comes from the line of Ben Reitzes with Barclays Capital. Please proceed.

Ben Reitzes - *Barclays Capital - Analyst*

Hey, thanks a lot. My question for Meg is it seems like a real tone change for IPG. Last call you said that you thought it was economic and not secular, but it sounded like you said that there's some secular pressures impacting that. So I was wondering if you could comment and talk about that? And then I've got to ask a follow-up already is, if you could just talk about how you get to the full year guidance because you're in almost $1.80 in the first half and you have to earn $2.20 in the second half to hit your guidance. So if you could just kind of talk about how you get there theoretically, as well. That's my follow-up, so I don't have to talk twice.

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

Okay. Thank you, Ben, I appreciate that. I'll take the IPG question and Cathie will talk a little bit about the perspective we have on guidance for the remainder of the year. There's no question in IPG, we face a number of challenges and the printing market is more mature, and more mature markets tend to be governed more by macroeconomic forces. And I'm convinced that a number of our challenges do relate to the macroeconomic challenges, weak consumer demand, weak small office, home office demand. The sell-through of ink in particular is at pretty low levels and it's not just our ink, it's industry ink.

That said, I think we've got to really look hard and say, okay, we may not see an overall secular decline, but we do see pockets of decline. What we know is that consumers at home are doing less photo printing, for example. That said, over time I think that the analog to digital movement of print is actually going to advantage us. So we're steady as she goes here. We're going to think hard about how we accelerate the growth of some of our new businesses to compensate for the loss of ink, and we are going to work hard. We have headwinds from the yen, no question about it and that is not a good thing, but fundamentally, that we're going to have to live with that.

That doesn't really change quarter to quarter, so I think we've got a very realistic view of the challenges we face. It's a terrific business that has been, as I said in my opening remarks, the lifeblood of HP, but we've got some work to do to address ourselves to some of the secular trends and capitalize on this analog to digital print.

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

And let me address the second question around our guidance. And it's really, I think, a question about our second half and why we would have confidence in the second half. And the first thing you got to look at is the normal seasonal pattern, basically the second half over the first half because that is, obviously, a situation where the second half is typically better than the first half. And then as we've talked about, we expect to work through two big impacts and be largely through them by the time we enter the second half. The first one is the hard disk drive shortage.

We believe that we will be impacted again in Q2 but to a lesser extent than in Q1, and that that will be heavily skewed to ESSN, and that we'll be largely through that when we enter the second half. And similarly on the supply channel inventory, given the current demand that we see, we expect to be through the correction in channel inventory supplies by the time we end Q2. So those, obviously, if you take the fact that those have depressed the first half and we get to a more normal steady state in the second half, that gives you a pretty abnormal increase half two over half one.

And then the other things you really have to take into consideration is we launched new products. We announced the Gen8 server, ProLiant server, that will ramp through the course of the year. And then take Autonomy. Our plans in Autonomy is in the first half it is really around getting Autonomy connected into HP, lead generation, lead qualification. And it's not until you start into the second half that you start to see some of the synergies that we expect from the Autonomy acquisition that both help, obviously, from a revenue perspective and a margin perspective. And then we continue to make progress on our execution, the basic blocking and tackling, just looking at our cost structure and realigning it to the business realities that we see today, and that helps us, as well, in the second half.

Operator

Our next question comes from the line of Bill Shope with Goldman Sachs. Please proceed.

Bill Shope - *Goldman Sachs - Analyst*

Okay, great. Thanks. Cathie, I just wanted to follow-up on that last part of your answer there. When you said you expected to return to sort of a normal steady state for IPG, how do we think about that steady state after this channel inventory correction given some of the secular commentary mentioned before? How should we think about steady state growth particularly in the supply segment going into the second half?

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

So I think there are kind of three big impacts to IPG from a margin perspective, and that's really what I was talking about in terms of getting more back to a more steady state. You have to take into consideration the fact that we do continue to expect and see a weak consumer demand

THOMSON REUTERS

environment, and that is a headwind for our ink supplies revenue, and what we expected. Some of that will continue, obviously, in the second half. We also have the strength of the Japanese yen which is on a year-over-year basis continuing to impact our laser business and put pressure on that business on a set of margins. And then as we work through this channel inventory correction, we do get back to basically growth in supplies more aligned with the demand that we see, as opposed to the adjustment that we're making. And so we do expect that it will continue to be a challenging demand environment with continued competitive pricing, but we don't have the same headwinds that we have in the first half.

Operator

Our next question comes from the line of Toni Sacconaghi with Sanford Bernstein. Please proceed.

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

Yes, thank you. I have one question and one follow-up. Meg, for you. I think if you look at market data and what competitors have reported, there's evidence of pretty significant share loss across all of your businesses, and your gross margins have also declined year-over-year and sequentially, despite a favorable mix shift. So it really doesn't appear to be that your ceding share to improve profitability because of the numbers don't really support to that, support that. So I guess my question is this data appears to point to a widespread lack of competitiveness, and I'd like to get your assessment on whether you believe that and if not what might I be missing? And I know you've talked about stabilizing the business, what exactly does that mean, how do you measure that and how long to get there?

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

Got it. Okay, good. So I think you have to look at share loss by business. There is no question with a shortage of hard disk drives in Q1, we prioritized profitability versus share in both Industry Standard Servers as well as our PSG business. And what you can see is we reported 5.2% operating income, which is actually at the high end of what we report normally. And we made a decision to prioritize profitable customers, profitable products, and customers in profitable regions for us.

And we think, by the way, we will be largely through the hard disk drive shortage for PSG as we enter into the second quarter and we aim to gain share there. If you look at Industry Standard Servers, we didn't have the perfect match between the disk drives we needed and, therefore, we couldn't shape demand as fast as we needed to. In addition, we did prioritize profitability there, as well. So those two businesses I'm not worried about an endemic share loss. I think that was to some degree driven by the decisions we made which, by the way, I think were the right ones. If you look at some of our other businesses we are experiencing share loss, in printers and in ink. And I think that takes me to this notion of we've got really three big challenges at this Company and I don't know that I would say it's widespread lack of competitiveness.

I'd say that it falls in three buckets. It's our own execution and whether that is things like turning orders into products faster than our competitors, I don't think we do that as well. Whether that is our supply chain, that if you back the supply chain all the way up to how we design our products, how we design quality in and how we manufacture those products. I think we're world class at how we buy components. I'm not sure I'd say we were world class in terms of how we think end-to-end about supply chain.

Our systems and processes, we under invested in those over the last few years. SKUs, we have an enormous number of SKUs in many of our businesses, and what you know is when you have a large number of SKUs it leads to complexity in product launch, it leads to complexity in service and support, and it leads to complexity in selling. So there's a number of things that I think we can improve quite dramatically and I think some of our competitors do some of those things better than we do and we got to get better across-the-board.

And then in each of the BUs, there are very specific challenges and each of the BU leaders who are very experienced, very senior guys, are working hard to either reposition their business strategically, lower the cost of doing business so that we can compete more aggressively, bringing new products to market. A couple of our businesses from a product point of view are in the best shape I've seen in some time. So the PSG division, we've got great products coming up for both the commercial as well as the consumer sector.

And in ESSN, we've got great stuff lined up. But each of the business unit leaders has to work hard to focus on the strategic challenges facing their business. And then we have got to make sure that we own three areas of what I would call the tectonic plate shift, and that is cloud, security and information management. So I think we're being very straight up saying we've got some real challenges ahead. The good news is I think we understand the challenges. We've got a plan in place and now we just have to go execute. And by doing that, we will stabilize the business and we will create enough financial capacity to sustainably invest.

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

Let me just, I think Meg did a great job of commenting on the operating profit for PSG, which I think is a really strong result given the kind of volume changes and declines that we saw year-over-year. From an ESSN perspective, we were also heavily impacted by volume as well as soft demand. But the other thing that you've got to take into consideration is that we had -- our disk drive price increases that obviously hurt a bit. And then also the fact of the matter is because we didn't have the hard disk drives that we needed to meet all of the demand we actually were shipping server configurations that were less richly configured. And so it doesn't just impact the top line, it also impacts the bottom line. And then as we've been talking about now for the last couple of quarters, we have been seeing a lower mix of BusinessCritical Systems revenue and we do expect that that will be a headwind going forward.

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

And then, I appreciate that color, so when you both mention this concept of stabilizing the business, what do you mean? Does that mean you are holding or gaining share in your businesses? Does that mean you are growing faster than what you believe your addressable markets are in revenue terms? Does that mean you're growing in absolute terms? How will investors know that you have stabilized the business and what is the timeframe that you think for getting there?

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

Let me take a crack at that, Toni, and then I'll let Cathie also answer. So the first thing we have to do is stop the revenue decline. A formula for success here is not having revenue declines as negative 7% to 8% in constant currency, so the first step to stabilization is stop the decline. The second is then we have to start growing revenues again and the only way that we know how to do that is you've actually got to gain share in virtually every single market. And you've got to gain share because a lot of these markets in technology, the unit cost or the unit price is going down, so you have to sell more units to maintain your revenues and grow your operating margin. So from a time perspective, Cathie will comment on this.

I would hope that as we get through 2012 and enter 2013 you'll start to see the revenue decline flatten out, and then, hopefully, as we get into 2013, by the end you'll start to see us grow revenue. It is very hard to predict. I think it depends on how fast we can get after some of these challenges in the business. It depends, obviously, what the market does. It depends on the macroeconomic environment, but a lot of this is in our own hands, and so we've got to move fast, quickly, and decisively to get after some of the execution challenges that I described.

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

I think the only thing I would also add in terms of evidence of us stabilizing is the fact that we let you know what our outlook is and then we deliver to it, and the more consistently we do that is it's implied underneath that is a much [stabler] business environment.

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

The other thing I'd say, Toni, is if you look at business history and you look at companies who have gone through the kind of turnaround that we're leading HP through right now, these things are not quick. It took us a while to get into the situation in which we find ourselves. It's going to take us a little while to get out. And if you look at history, these turnarounds are not done in less than two years and often they take three or four or five years. So I think you've got to -- and by the way you'll see, obviously, forward progress before five years, of course, but we've got a journey ahead of us. And as I said, it took us a while to get into this, it's going to take us a while to get out. But I can't tell you how good I feel about our strategy, we know what to do, we've got a plan to do it and now we have to execute.

Operator

Our next question comes from the line of Katy Huberty with Morgan Stanley. Please proceed.

Katy Huberty - *Morgan Stanley - Analyst*

Yes, thank you. Speaking of stabilizing revenue growth, how are you assuming that Windows 8, Romley, and Ultrabooks might impact your ability to stabilize the business and see better seasonality in the back half of this year? Are any of these significant enough in fiscal '12 to impact the business?

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

Listen, we feel good about Windows 8. As you know, we have a product line lined up in PSG on Windows 8 on x86. We've gotten great reviews to our first ultra thin product and we believe Windows 8, we're going to be well positioned for holiday on Windows 8 x86, and so I think that will certainly help PSG. Listen, the better Windows 8 is, the better off we are. So we're rooting for a fantastic Windows 8 product that's delivered on time that we can get to market before the holiday season. So I think it's a help. You have to remember that PSG is only a part of our entire portfolio, so it will help PSG. It doesn't have an impact on a number of our other businesses.

Operator

Our next question comes from the line of Brian Alexander with Raymond James. Please proceed.

Brian Alexander - *Raymond James & Associates - Analyst*

Could you help us understand why the HDD disruption seemed to have a disproportionate impact on your business relative to your competitors? I think, Cathie, you called out half the revenue decline due to the HDD constraints. That's $1 billion in revenue. I think it's 7% of your PC and enterprise hardware, so I understand your PC margins at 5.2% were decent, but profits were still down 30% and your x86 performance was worse than your competitors. So, I guess, what is it about the supply chain which is the biggest in the world that has put HP at a disadvantage seemingly and what are you doing to address it?

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

Yes. So the hard disk drive shortage had a significant impact on our revenue in Q1 as Cathie described, and the industry supply of hard disk drives was about 30% below the expected demand. So this had an impact on everyone, and we chose, as I said, with the supply challenges, we focused on profitability rather than share. And ultimately, I think, we were not as advantaged as I might have anticipated given the scale of our supply chain. I will say it was a remarkably fluid situation. The shortage impacted different suppliers, different drives, trying to match the drives that you've got versus the drives you ordered with demand matching in the marketplace, was really tough. But we were not as effective as we needed to be in matching that supply with our demand.

So I think it showed us -- it certainly showed me that we have some challenges in our overall supply chain. And I would say the other thing is we've got to get better at taking an order and turning it into a product in our factories and getting it to customers. We can shrink that total elapsed time and we were not benefited by having a slightly longer timeframe of order to factory floor to customer as we could have been. So you're right, we were not as advantaged as I anticipated and I think there were some [ah-ha's] there for us in terms of things that we need to do to our broadly defined supply chain. And as I said at the beginning, I think we're world class at buying products, but if you look at supply chain all the way from design to delivery, I think there's some opportunities to buy.

Operator

Our next question comes from the line of Shannon Cross with Cross Research. Please proceed.

Shannon Cross - *Cross Research - Analyst*

Thank you. Meg, can you talk a bit about how you're interacting with your direct reports and what changes you've made in terms of how they interact with each other as perhaps you try to break down the silos or have the various leaders fix their specific businesses?

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

Yes. So I think one of the things the team has done very well since I arrived is we now actually are a team. We have a cadence and a rhythm around how we meet, about what we talk about. Everyone is involved, every single business unit leader and major functional head is involved in the strategy going forward, what we're going to execute on. We have very lively discussions about things we need to focus on, and then decisions are made and we work together to get those done.

So I couldn't be more pleased with how the team is working together. And then I've built very strong relationships with each of the BU heads and we, I think, have a good alignment about what needs to be done in each of those business units. So I think it's been, if you were to ask the senior team, I think you would hear that it was a pretty big change from previous management in terms of the amount of time that we work together, the decisions we make collectively and how we are working as one HP. And one particular area that I'm focused on is how do we bring this product portfolio, which is among the very best in the industry, to customers as one HP.

And as I said, we've run this business in a quite siloed way, which had some really good benefits to it. We built huge world class businesses, but particularly the top customers now they want to buy from one HP. We've got to get really good at bringing those products, getting the pricing right in a way we that have not done in the past as well as we might have. So we're on a great path and I think the EC members, if they were on this call, would tell you it's about as good as it's been for a number of years.

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

So I would definitely weigh in and say that. And I think there's been a lot written about us moving out of our offices into cubes and I think that's made a huge difference. I can tell you that I've spoken more frequently with all of the different folks on Meg's staff more frequently in the last two months than I probably did in a whole year, because you just, you're just so much more visible, you know who is in their office and available, and you do a lot more casual kind of over the cube wall quick discussions.

Operator

Our next question comes from the line of Keith Bachman with Bank of Montreal. Please proceed.

Keith Bachman - *Bank of Montreal - Analyst*

Hi, thank you. I have questions, I want to return to printers for a second, and the first one is, Cathie, can you go back to inventory for a second. In the previous call, there was comments that supplies inventory was too heavy, so to speak, and yet sequential growth was actually up in the January quarter by 1%, and the last two years it's been down 7% to 8% sequentially. So supplies actually went up and I want to try to understand, can you give us perspective on what is the status of the extra inventory, why was it up and when does it run out?

And the second related question is the mix of supplies to total revenue in printers was about 65% which is consistent to what it was in the January 2011 quarter and the January 2010 quarter, yet each of those past quarters, operating margins were in the mid-16s, so I'm curious to why profits wasn't better in this quarter given the mix that I just described? Thank you.

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

So in terms of the channel inventory levels, there are a couple of different dimensions that are going on there and they are different whether you're talking about ink supplies versus toner supplies. And so we did make some progress on reducing ink supplies, channel inventory basically from Q4 to Q1, and that's one of the impacts on the margins, why margins are down a bit on a sequential basis. On the toner side, we actually had a price increase, so we had a little bit, not a massive, but a little bit buy-in and so we did not get the reduction in channel inventory in Q1 that we had expected. We do still expect that the channel inventory levels will exit Q2 in acceptable ranges for supplies, and that is fully included in our guidance. And then just to go back, again, to margins, if you look at supplies mix, you're right. It's at 55%, up a little on sequentially and up a little year-on-year, but it's really important what that mix is and it is -- the mix is skewed much heavier to toner which has significantly different gross margins than it is to inkjet, or ink, and that's driving a fairly large impact on margins both year-over-year and sequentially.

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

I'd add one comment to this is that, as I said, this one of the great all-time businesses and has been the lifeblood, as I said, of HP for many years. But there are definitely some market shifts occurring and we've got to create the capacity financially to improve profits in this business, but also create the capacity to invest in innovation more aggressively than we have. IPG was always the go to place for more money at HP, and so we've got to create capacity to sustainably invest in innovation and, frankly, to market again, because if we don't continue to invest in marketing we are going to end up in a situation where our business is being more commoditized than I would like. And then lastly, from a profitability point of view, the yen is a real problem, and you know how this is. Basically, all of our supply of laser jets is denominated in yen, so when the yen moves against us, it has actually a pretty big effect. And I don't know if you want to say anything more about that?

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

Well, I'd just add that if you look at the Yen increase year-over-year, it's like 7% Q1 2012 versus Q1 2011 and during, its been increasing over the last couple of years and we've actually been able to absorb much of that cost increase, until I think it was two or three quarters ago when it just became increasingly difficult that we couldn't take the cost out fast enough to offset the appreciation in the yen. All right. Our next question comes from the line of Richard Gardner with Citigroup. Please proceed.

Richard Gardner - *Citigroup - Analyst*

Okay, great. Thank you. I was just hoping, Meg, and Cathie, to get an update on the progress for Services investments and just get a sense for why the margins continue to trend lower in this business and why, and where is the bottom in Services margin? What do you think is the level where you can invest sufficiently to turn this business around and not see further degradation? Thank you.

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

Okay, well, Cathie, why don't you talk about the margins and then I'll follow back with sort of the more holistic view of where we are with this business.

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

Sure. So the performance that we delivered was in line with the expectations that we set last quarter, and I think that that's an important point. So there shouldn't be any surprises here on that. Revenues in Services did grow 1%, it was flat, on a reported basis it was flat in constant currency while the cost structure increased due to the necessary investments that we've been talking about in service delivery, in basically building out our bench and in investing to build out our strategic enterprise services. And I put -- the services that we put in that category are services around cloud, analytics and security, as well as apps modernization. And those are the higher growth, higher margin services that we need to invest into and convert this business from being less ITO heavy where the margins are not as good, and in some service lines within ITO, the margins are very unattractive and we're deemphasizing some of the revenue in that space.

So we are on this long-term turnaround. We are making progress. And for this specific quarter, combined with the investments that we're making with sales and delivery, we did see margin compression from contract renewals. And I think that the Services people will probably tell me that 100% of the contracts that are renewed come in at a lower price, but I'll say almost all, and the goal, obviously, is to be able to be nimble enough to take cost out quickly enough to offset that price compression that you get on renewals and/or sell a bigger basket of services.

And we're making investments in both processes as well as IT in order to increase our ability to take cost out quickly, especially in the resource management space. So we expect, if you look at the outlook for '12, we do expect that year-on-year, margins will continue to be down.

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

I think Cathie actually said it well. I don't have much to add. I just think at the highest level the way you have to think about our Services business is we're going through a multi-year turnaround with a focus on rebuilding the business and dramatically changing the mix of our business, and this takes time, and we have also got some investments that we have to make here. We've got to have some new IT systems and processes to better manage the business.

We've got to improve the performance and satisfaction in many of our existing accounts, and we've got to enhance the sales specialists and service delivery personnel to support future revenue growth and operating income growth. So we're on a path. Again, I think in some ways Services, we know what the problem is. We've got a plan, and now we've got to deliver on that plan, but I'll be very honest with you this is a multi-year journey. This is not a quick fix. And, frankly, this dates back in my view to the assets that we acquired back in 2008 and then ran right into 2008 and 2009, sort of global slowdown and we took a lot of cost out of this business and we're paying the price for that in many ways in terms of some of the capability that needs to be built back into the organization.

That said, I think it's a very important strategic asset for the Company. Many of -- the role that Services needs to play in terms of the wrapper around our infrastructure products, our software products. This has to be our solution selling arm, and so we're committed to rebuilding this but we've got a multi-year journey ahead of us.

Operator

Our next question comes from the line of Maynard Um with UBS. Please proceed.

Maynard Um - *UBS - Analyst*

Hi, thank you. Just a couple questions. Can you just talk about any particular verticals where there was strength or weakness both from a demand and pricing pressure perspective? And then the second question is it sounds like in some areas HP is making more of a shift to focus on services and solutions inside the channel which has been primarily accustomed to being more transactional. Can you just talk about the feedback from the channel and if there are any sort of significant changes that have to happen for them to find success in this new model? Thank you.

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

Yes, let me talk about the channel. I just got back, as I said in my opening remarks, from our global channel conference in Las Vegas, and, boy, this is one great group of small- to medium-size businesses, who have for many years, made their living betting on HP, and, boy, did they want us to win. And what they need more than anything else is stability it, steady hand on the tiller and some predictability around what we're going to do.

So much of 2011 was not an uplifting experience for them, and so I think we went a long way towards explaining the product road map, explaining where we were headed as a Company and how they fit in, and how much, in particular I, respect the channel because they are looking, does the CEO actually love the channel, or are they indifferent? And I told them I was an enormous booster of the channel. First and foremost they sell product.

They still sell product, but increasingly, they told me they are looking to sell solutions as well and we need to help them get there. And whether that's cloud, whether that's security, ultimately information management, we are going to try to help them sell more services and solutions. But they still first and foremost want to know that we have the very best server product, that we've got great networking, great storage and that they can, with confidence, go to their customers and sell that product. By the way, the PSG uncertainty last year disproportionately affected this channel.

They were terribly worried what did that mean for them, what does it mean for HP, what did it mean for hardware. So I think we've gone a long way towards calming the waters and explaining that, in fact, we're really proud to be an infrastructure and hardware Company. That doesn't mean we are not going to sell solutions, but I think we went a long way towards restoring their confidence, and I can tell you that business is all about the confidence they have in us.

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

Operator, we have time for just one more question here.

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

Oh, he had a question about verticals. I don't think there was really anything notable, Cathie, about whether we did particularly well in airlines versus pharmaceuticals versus travel. I don't think there was anything particular that drove our results in that regard.

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

No, I don't think we had anything specific to call out there.

Operator

All right. Our final question comes from the line of Kulbinder Garcha with Credit Suisse. Please proceed.

Kulbinder Garcha - *Credit Suisse - Analyst*

Thanks. I just have a couple of questions, one, I guess, for Meg. On the whole, I've heard, seen a number of comments that you've made today and also in the past about under investment. On the other hand, you speak about streamlining processes. I'm just trying to think what does all that mean for the levels of OpEx at HP today? Do you actually think you can go through this transition and keep this OpEx level over the next couple of years or do you have to build higher?

And then a question for Cathie, just on the free cash flow, the conversion itself was very poor, as well, this quarter, I think it was about 20% of your net income got converted to free cash flow. Were there any one-time items in there that won't be recurring going forward, because I'm trying to

THOMSON REUTERS

think the speed at which your balance sheet will rebuild so you can actually start doing more distribution to shareholders over the next 12 to 24 months? Many thanks.

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

So we have a strategy here that works, I've seen work many times before, in fact, I've led changes like this. Which is -- and let me sort of say it succinctly -- we have to save so we can invest. What we cannot do is keep our current level of cost and just layer investments on top of that. We've got to streamline our processes, we've got to optimize our supply chain, we've got to reduce SKUs, we've got to rationalize our go-to-market so that we can save money in the OpEx line, so that we can reinvest in the growing product lines, we can invest in our fast growth businesses, and we can invest in innovation.

So what never works in business is, let's keep our cost structure the same and just layer investment on top of that when we're in the situation in which we find ourselves. So my view is save to invest, save to grow, and we're very mindful that as we operate more efficiently and effectively some of that money needs to drop to the bottom line and some of that money needs to really reinforce the strategic initiatives that we have to grow the business. And I think, as Toni asked me earlier in the call, stabilize declining revenues and begin to gain share in the categories in which we compete. And listen, I've done this a number of times in my career. It's what great business leaders do. They figure out how to run things more efficiently so that they can make the investments. It's not as easy as, hey, let's just make some more investments.

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

And then from a cash flow perspective, as you may recall, we pay our annual bonuses in Q1, so we accrue the expense for that bonus in the previous year and then the first quarter of the next year, we basically pay the bonus. So it is typical that Q1 is a low cash flow quarter for us.

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

Great. I think that was the last question, so listen, thank you for joining us today. I remain incredibly optimistic about the long-term future of HP. We've got a lot of work to do but we've got a great team and a great, I think, a really, the best understanding of the situation in which we find ourselves, and how we're going to lead through it. So thanks very much for being on the call.

Operator

Ladies and gentlemen, this concludes our call for today. Thank you for your participation. You may now disconnect. Have a wonderful day.
