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HPQ - Q2 2012 Hewlett-Packard Earnings Conference Call

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OVERVIEW:

HPQ reported 2Q12 revenue of $30.7b, non-GAAP operating profit of $1.9b, and non-GAAP diluted EPS of $0.98. Expects 3Q12 GAAP EPS to be $0.00-0.03, and non-GAAP EPS to be $0.94-0.97. Expects full-year GAAP EPS to be $2.25-2.30. Co. also expects FY12 non-GAAP EPS to be $4.05-4.10.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second-quarter 2012 Hewlett-Packard earnings conference call. My name is Derek, 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. Rob Binns, Vice President of Investor Relations. Please proceed.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Good afternoon. Welcome to our second-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, may I remind you that this call is being webcast. A replay of the webcast will be made available shortly after the call for approximately one year.

Some information provided during this call may include forward-looking statements that involve risks, uncertainties, and assumptions. If the risks or uncertainties ever materialize or the assumptions prove incorrect, the results of HP may differ materially from those expressed or implied by such forward-looking statements and assumptions. All statements, other than statements of historical facts, are statements that could be deemed forward-looking statements, including, but not limited to -- any projections of revenue, margins, expenses, earnings, earnings per share, tax provisions, cash flows, share repurchases, currency exchange rates, the impact of acquisitions, or other financial items; any projections of the amount, timing, or impact of cost savings, restructuring charges, early retirement programs, workforce reductions, or impairment charges; any statements of the plans, strategies and objectives of Management for future operations; and any statements concerning the expected development, performance, market share, or competitive performance relating to products or services and any statement of assumption underlying any of the foregoing. A discussion of some of these risks, uncertainties, and assumptions is set forth in more detail in HP's SEC reports, including its most recent Form 10-Q. HP assumes no obligation and does not intend to update any such forward-looking statements.

The financial information discussed in connection with this call, including any tax-related items, reflects estimates based on information available at this time and could differ materially from amounts ultimately reported in HP's second-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, amongst other things, amortization of purchased intangibles, restructuring charges, and acquisition-related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables and in the slide presentation accompanying today's earnings release, both of which are available on HP's Investor Relations web page at www.HP.com. I'll now turn the call over to Meg.

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

Thank you, Rob, and thanks to all of you for joining us today. The second quarter marked my first six months at HP, and I continued to learn about the Company every day. It's inspiring. You're surrounded by incredible technology, tremendous innovation, and the people are just terrific. For example, since we last spoke, I participated in TechCon, which is HP's annual internal innovation show. Think of it as the world's greatest science fair for adults, and I was just blown away. The excitement, the enthusiasm, the commitment of HP's technical and innovation community is amazing. From nanoscale sensing technologies to the Memristor to software that can actually learn, we have an array of forward-looking technologies that are revolutionary. Without question, our innovation engine is alive and well. Now, we just need to do a better job of aligning that engine with our businesses, and developing a better, faster path to market.

I also recently attended the Drupa conference, which is a show held every four years in Dusseldorf, Germany to showcase the very latest in commercial graphics and printing. And again, I was deeply impressed. It's a chance to see our Color Inkjet Web Press, and Indigo portfolio in context. You can see customers and potential customers gravitating towards our innovation, and you clearly can see the shift from analog to digital commercial print happening right before your eyes. The market is being disrupted and we're leading the charge. I left Drupa with a deeper appreciation for the opportunity HP has to transform that industry.

So now, let's talk about HP's performance. Overall, I feel cautiously optimistic coming out of Q2. Our results appear to be stabilizing. While I wouldn't say we've turned the corner, we are making progress. For starters, we once again did what we said we were going to do. Our guidance for second-quarter non-GAAP diluted EPS was $0.88 to $0.91, and we delivered $0.98, beating the high end of our outlook by $0.07 a share on revenues of $30.7 billion. While earnings and revenues were both down over the prior-year period, the trajectory of the decline began to flatten in Q2, which is encouraging.

Cathie will dig deeper into the numbers and the segment performance in just a few minutes, but let me share a few top-level observations. In PSG, we delivered a solid performance. PSG held margins steady, and an uptick in the commercial business helped offset continued weakness on the consumer side. This contributed to a sequential 6.5% increase in revenue, and revenue that was also up slightly year-over-year. With much less impact from the HDD shortage, we executed well, and achieved a 2 point sequential gain in worldwide PC market share in calendar Q1. In the process, we reclaimed the number 1 share position for commercial globally. And we also took the number one position for commercial in the US from a competitor who has held the top rank for more than a decade.

We're absolutely committed to outstanding product design, engineering, and quality, attributes that defined HP for decades. You can see that commitment in the big refresh of the PC and printing portfolio we announced in Shanghai a couple of weeks ago. The launch gave us a boost in China, where I think we're starting to regain some momentum. Speaking with customers and partners, I've heard a lot of excitement about the products we introduced, like the Spectre XT and our new multi-function color laser jet printer. Consumers love the new products and CIOs trust them in a secure work environment. They strike the perfect balance between beautiful design and the work horse characteristics that businesses and governments require.

In IPG, we improved the channel inventory to within an acceptable range. However, we continue to face a weak demand environment and year-over-year, IPG revenue declined by 10%. Over the last few quarters, IPG has been challenged by external factors, such as weak consumer demand and natural disasters, but we're also getting clarity on some of the key actions necessary to continue building on IPG's leadership. We started marketing the quality and innovation of our hardware and supplies, and we're working on new pricing models, services, and solutions to further differentiate our offerings. As you know, in Q2, we announced a strategic realignment that included having the PC and printing businesses join forces under the leadership of Todd Bradley. So far, this is going very well, and we see tremendous potential for accelerated growth and efficiencies through common branding, improved marketing, better retail positioning, more attractive product bundles, and seamless best-in-class interoperability.

Turning to Services, revenues were essentially flat year-over-year in constant currency and we stabilized margins. While margins may fluctuate quarter-to-quarter, we believe that a 10% to 12% range is the right sustainable profit margin profile for Services through the remainder of fiscal year 2012. We're focused on building out strategic practice areas, in cloud, security, information management, and application transformation. And we're strengthening the industry alignment of our Services business, which will help us better solve customer challenges, create more customer value and deepen customer relationships. We're excited about growing these higher-margin categories, but this is a business that continues to be challenged. It's a journey, and we have a lot of work ahead of us in this turnaround.

In Enterprise, Servers, Storage and Networking, full-year revenue declined 6% over the prior year period. Within that, our Storage and Networking businesses held steady, logging slight annual growth. Storage was a tale of two cities. Our 3PAR solutions continued to gain strong traction in the marketplace, growing more than 100% year-over-year, while revenue in our StoreOnce products almost doubled. At the same time, tape and EVA are declining. This is an anticipated product transition, and we're effectively managing the shift to our next-generation storage arrays.

In Networking, we have a great value proposition and innovation. In one recent development, we worked with AMD on implementing their cloud data center. HP Networking and Server Technologies helped reduce the data center footprint by more than 50%, while increasing network capacity and improving performance. And with new solutions like our recently-launched Virtual Application Networks, we plan to continue being the disrupter.

In industry standard servers, the HDD shortage was still a factor and we had a tough quarter. However, there is strong promise here; we have outstanding solutions in the market that we expect to restore the momentum in the category. For example, the launch order ramp for our Gen 8 ProLiant server is outpacing that of the Gen 7 server. Business critical systems, not surprisingly, still facing challenges from the Oracle Itanium issue, but more important is how we're moving forward. Our Odyssey solution is an innovative mission-critical x86 platform that will offer customers a transition to open standards-based architectures.

As part of the Q2 strategic alignment, the global account sales organization joined enterprise servers, storage and networking under the leadership of Dave Donatelli. This is also going well. The new model sharpens the focus of our sales teams, moves decision-making closer to the deal and provides a simplified customer experience. The outcome is a more responsive HP that will make it easier for us to sell effectively and bring more of our portfolio to more of our accounts. In conversations with customers and partners, it's clear that they understand and appreciate the direction we've taken. In Software, we grew 22% year-over-year, with growth in licenses, support, and services. We had some good wins. For example, in security, we signed a SaaS testing services agreement in Europe that's the biggest deal ever for HP Fortify. However, we're also facing challenges. Autonomy had a very disappointing license revenue quarter, with a significant decline year-over-year, resulting in a shortfall to our expectations.

To help improve Autonomy's performance, Bill Veghte, HP's Chief Strategy Officer and Executive Vice President of HP Software, will step in to lead Autonomy. Mike Lynch, Autonomy's Founder and Executive Vice President for Information Management will leave HP after a transition period. The market and competitive position for Autonomy remains strong, particularly in cloud offerings, and we have been flooded with a number of big deal leads. Bill is an experienced software leader, who will develop the right processes and discipline to scale Autonomy and fulfill its promise, although it will take a few quarters to see tangible improvement.

So big picture, I would say that our performance began to stabilize. We saw some bright spots. There's still an awful lot of work to be done and we're looking at every option to accelerate the pace. As discussed during our Q1 call, we are working very hard to better align HP's cost structure with its revenue profile. We're streamlining and removing complexity at every turn, and in the process, we're creating the capacity to invest in innovation and quality. And over time, we're of course thinking about how we can drop some of our savings to the bottom line.

The strategic realignment we announced last quarter was a good first step and today, we're taking the next step with the announcement of a multi-year restructuring that will touch every part of HP and create a more streamlined business. We expect to take a pretax charge of approximately $1.7 billion, to be included in our fiscal year 2012 GAAP results, as well as an additional pretax charge of $1.8 billion, to be included in our fiscal year 2013 and fiscal 2014 GAAP results. As part of the restructuring, we expect to reduce the work force by 27,000 positions by the end of 2014, which we will achieve through a combination of layoffs and a voluntary early retirement program. This restructuring is expected to generate run rate cost savings of approximately $3 billion to $3.5 billion exiting fiscal year 2014. Work force reductions are never easy. They adversely impact people's lives, but in this case, they are absolutely critical to the long-term health of the Company.

Our goal is simple. A better outcome for the customers at reduced cost for HP. And while optimizing the work force is one area that we absolutely need to get right, we see a lot of opportunity in a number of additional areas as well. I know that you're well aware of the cost reduction efforts that were undertaken in years past. There's been some great work on things like data center consolidation, reducing the number of applications, and in horizontal functions, such as HR, legal, and finance. What we're doing now is very different. We're going after the big cost buckets and fundamental business process reengineering in our core businesses. This includes optimizing the supply chain, reducing the number of SKUs and platforms, continuing to hone our real estate strategy, simplifying our go-to-market, improving business processes and implementing consistent pricing and promotions to drive end-user demand profitably. It's harder work, but we believe it will have a significant payoff over the long-term.

Over time, some of the savings will drop to the bottom line, but the majority will be reinvested using a disciplined data-driven process to prioritize organic opportunities across the business. Return on investment will be evaluated on an ongoing basis and the investments will be calibrated accordingly. We'll be investing to drive leadership in the three strategic pillars of cloud, security and information management. And in each of our businesses, we'll make investments to stay ahead of customer expectations and market trends.

In our PC and Printing businesses, we'll be focused on design, engineering, quality, and generating demand and desire with our customers. In Services, we're improving processes and building out capabilities in cloud, security, and information. We'll also be strengthening our industry practices, as well as our service quality and innovation. In Software, we'll be investing to speed development across security, information and management infrastructure for both on-premise IT and in the cloud, with a key focus on software as a service offerings. This will include the extension of Vertica and Autonomy across our entire portfolio. For example, deploying them in our document workflow solutions and in building out our information management practice in Services. And in ESSN, we'll invest to drive R&D and innovation in our core businesses of servers, storage and networking. Together, they create a converged infrastructure that is the foundation for top customer initiatives, such as cloud, big data analytics and social media. And we'll also invest in our people, in better training and better career development.

There's a lot we have to do, and we are moving quickly, but we are not taking our eye off the ball when it comes to executing against our ongoing priorities. I'll share just a few examples. In the last quarter, we continued to improve our sales tools with the first wave rollout of our new CRM system and enhancements to HP.com. In the PC space, a major Mac reseller has taken on the Z1 workstation, which offers a combination of accelerated performance and design that's not available in any other product on the market today. We also continued to drive our strategy with the announcement of the HP Converged Cloud, the industry's first hybrid delivery approach and portfolio, based on a common architecture spanning traditional IP, private, managed, and public clouds. We announced 10 new products and services to our already extensive cloud portfolio, and customers are embracing the accelerated innovation, enhanced agility, and lower costs that our solutions provide. At HP Discover, we'll be sharing a lot more about our strategy, our portfolio, and how we're helping customers succeed, so stay tuned.

I covered a lot today, so let me leave you with a few final thoughts. During our second quarter, we did what we said we were going to do. HP showed some positive early signs of stabilizing performance. We made progress in a number of areas and delivered on our outlook. We remain confident and expect to achieve non-GAAP earnings per share of at least $4 for fiscal year 2012, even before any savings from the restructuring. While the restructuring should improve EPS over time, the pace at which we're able to realize savings and reinvest them is likely to vary quarter-to-quarter, so we don't expect the progress to be completely linear. Things like normal seasonality may not play out exactly the way you're used to seeing it, so our guidance is going to be important.

But what matters most, I believe, is that HP is now taking aggressive steps to rebuild and strengthen the Company for the long term. I am more confident than ever in our past and in our future. By removing complexity, we're making it easier to do business with HP, easier to sell HP products and easier to work at HP. We're building HP into a more efficient and effective organization that can survive the test of time. And we're creating the capacity to invest, to drive innovation against our strategic pillars of the cloud, security, and information management, to advance each of our businesses, and to ultimately deliver better return for our shareholders.

Turning HP around is going to be a lot of hard work. It's going to take time. But we know what needs to be done and with the actions we've announced today, we're fast advancing the process. With that, I would like to turn it over to Cathie to provide more detail on the quarter. Cathie?

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

Thank you, Meg. I'll start with a quick review of the quarterly performance and then give some more details about the restructuring efforts, including expectations for cost savings, head count reductions, reinvestment, and GAAP charges. I'll close with our guidance for Q3 and the second half of fiscal 2012.

For the Q2 results, revenue was $30.7 billion, down 3% year-over-year, both as reported and in constant currency. PSG revenue was flat year-over-year and gained 2 points of share worldwide, quarter-over-quarter, as the business recovered from the hard disk drive shortage triggered by last year's Thailand flooding. ESSN and IPG revenue declined generally as we expected, due to the impact of the hard disk drive shortage on ESSN and IPG's continued focus on reducing excess channel inventory. In terms of our revenue performance by geography, in the Americas, revenue was $13.8 billion, flat year-over-year, both as reported and in constant currency. Revenue in EMEA was down 7% to $10.9 billion, and revenue in Asia-Pacific was down 1% year-over-year to $6 billion. On a constant currency basis, EMEA and APJ revenues were down 6% and 3%, respectively year-over-year. These results reflect the continued macroeconomic challenges in EMEA, and some sequential improvement in China.

Non-GAAP gross margin of 23.2% was down 150 basis points year-over-year, and up 80 basis points sequentially. Non-GAAP gross margins continue to be impacted by the strong yen, a lower mix in supplies, continued margin pressure in services, and competitive pricing in our hardware businesses. Non-GAAP operating expenses were $4.4 billion, up 4% year-over-year, driven by acquisitions and our annual salary increases. Non-GAAP operating margin of 8.9% was down 240 basis points year-over-year, and the Company delivered $1.9 billion in operating profits.

The bridge from operating profit to earnings per share includes the following -- other income and expense yielded a net expense of $243 million; our tax rate was approximately 22%; and we used $350 million in the quarter to repurchase 13 million shares, bringing our weighted average share count to 1.987 billion shares, which is down 9% year-over-year. As a result, we exceeded our guidance in the quarter, delivering non-GAAP diluted earnings per share of $0.98 and GAAP diluted earnings per share of $0.80. The majority of the difference between GAAP and non-GAAP earnings in Q2 was amortization of purchased intangible assets.

Now, turning to our business segments. As Meg highlighted, the Personal Systems group has strong sequential growth. It delivered revenue of $9.5 billion in the quarter, flat year-over-year, with a 5.5% operating margin. We saw a recovery in desktop and the commercial segment, but consumer notebook demand remains soft. Total units shipped were down 1% year-over-year, but this decline was offset by an increase in the average selling price. By category, commercial revenue increased 3% and consumer revenues declined 4% year-over-year. Workstation revenue was down 1% year-over-year, notebook revenue declined 3% year-over-year on a 6% decline in units, and desktop revenue and units were up 5% year-over-year.

Moving on to Services, Services delivered revenue of $8.8 billion, down 1% from the prior year quarter, and flat in constant currency. Operating profit of $997 million was 11.3% of revenue, down 4.1 points from the prior year, primarily due to the impact of resource management and investments in sales and service delivery. In the second quarter, IT outsourcing revenue of $3.7 billion was down 3% year-over-year, as we are being more selective in the deals we pursue. New deals need to be a good strategic fit and have attractive margins. Application and Business Services revenue was up 1% year-over-year to $2.5 billion, reflecting the progress we're making in the strategic enterprise services, including cloud, application modernization, and information management and analytics. Technology services revenue was flat year-over-year at $2.6 billion and up 3% sequentially.

Turning to Imaging and Printing, net revenue for IPG, of $6.1 billion, was down 10% year-over-year with supplies revenue declining 12% as we reduced our channel inventory. We are now within our acceptable ranges for channel inventory on a consolidated basis, but the demand environment remains a headwind. Operating profit was $808 million, or 13.2% of revenue, which is down 3.4 points year-over-year. These margins were impacted by the channel corrections, the supplies mix, and the strong yen. Drupa, the international print media conference was a successful event for us in March. We announced 10 new digital printing solutions that demonstrated our leadership in graphics. By business unit, commercial printer revenue was down 4% year-over-year, with commercial hardware units down 7%. Consumer printer revenue was down 15% year-over-year, with hardware units down 13%, and total printer unit shipment volume was down 11% year-over-year.

Turning to the Enterprise Server, Storage, and Networking business, revenue of $5.2 billion was down 6% year-over-year, with the majority of the decline due to the hard disk drive shortage. Operating profit was $585 million, and the operating margin of 11.2% was 260 basis points lower than the prior year period. This was due to competitive pricing pressure in industry standard servers and the lower mix of BCS, somewhat offset by the higher mix of storage and networking.

Now, let's dive into the ESSN performance by business. Storage revenue was up 1% year-over-year, with external disk revenue up 8%. StoreOnce revenue was up almost 100% and 3PAR revenue grew by more than 100%, surpassing EVA in size, and making it our largest array business. In fact, combined, EVA and 3PAR grew 19% year-over-year. This growth was somewhat offset by declines in the non-disk businesses, including tape. Overall, Business Critical Systems declined 23% year-over-year and grew 4% sequentially. Within BCS, our mission critical x86 grew double digits, but BCS performance continued to be impacted by Itanium revenue declines. Industry standard server revenue declined 6% year-over-year, with almost all of the decline due to the hard disk drive shortage. Again, hard disk drive availability was uneven during the quarter. As supply availability improved, we had less of a mismatch between supply and demand than in Q1 and were able to deliver 4% growth sequentially. Going forward, ESSN should see minimal impact from the hard disk drive shortage.

Networking revenue was up 2% year-over-year, at $614 million, or up $0.04 when normalized for a divestiture in Q1. We continue to expand our presence in the data center segment and sustained double-digit growth year-over-year in wireless, LAN and security. We are confident that we have the right product portfolio, including our recently announced HP Virtual Application Network. Software delivered revenue growth of 22% year-over-year to $970 million. In the quarter, we saw 7% license growth, 17% support revenue growth, and 72% growth in services. Overall, second-quarter operating profit for software was $172 million, or 17.7% of revenue, unfavorably impacted by acquisition-related integration costs and accounting adjustments, as well as a lower mix of license revenue in the quarter. The market and the competitive position for Autonomy remains strong, particularly in cloud offerings. And the level of lead generation we are seeing across HP for Autonomy software and services is compelling. But as Meg mentioned, license revenue this quarter was disappointing. Sales execution was a challenge, and big deals are taking longer to close.

HP Financial Services continues to deliver strong, consistent results. In the second quarter, financing revenue grew 9% to $968 million. Financing volume was up 5% year-over-year, and net portfolio assets increased 4% year-over-year. Operating profit of $96 million was up 16% year-over-year to 9.9% of revenue.

Now, on to capital allocation and the balance sheet. Our focus is on rebuilding our balance sheet this year. HP's long-term strategy is to allocate capital where it will generate the best return on that investment. During the quarter, we returned $350 million in cash to shareholders via share repurchases, leaving roughly $9.7 billion remaining in the share repurchase authorization. We also paid $251 million to shareholders in the form of dividends. HP generated $2.5 billion in operating cash flow in the quarter and free cash flow of $1.5 billion. Our total gross cash at the end of the quarter was $8.7 billion. In terms of working capital, our cash conversion cycle for the second quarter was 28 days, flat sequentially, and up 3 days from the prior year. The longer cash-to-cash cycle from the prior year was due to an increase in inventory by two days, and a five day decrease in days payable outstanding, somewhat offset by a four day reduction in day sales outstanding. We have work to do on bringing down our cash conversion cycle, and are increasing our focus here.

Now, I'll get into the details of our restructuring. Our restructuring effort will help build the long-term future of HP, and is part of the multi-year effort to make HP a simpler, more effective company. We are addressing the trends in our businesses and the market by reducing our cost structure and realigning our work force to create investment capacity, support growth initiatives and innovation and enable more effective operations around the world. As part of the restructuring, we expect 9,000 employees to exit the Company in fiscal 2012 and cumulatively, approximately 27,000 employees to exit the Company by the end of fiscal year 2014. We are offering an early retirement program in the United States, so the level of non-voluntary workforce reductions may be impacted by the number of employees that participate in that program. Although notifications will begin shortly, we expect minimal savings impact in Q3, with the majority of the fiscal 2012 savings impact in Q4.

We expect the restructuring actions associated with the charge to generate annualized savings in the range of $3 billion to $3.5 billion exiting fiscal year 2014. To achieve the efficiencies, we will be investing in technology and business processes, as well as doing replacement and enablement hiring for new skill sets, in some cases, in lower-cost locations. On top of the cost savings from head count reductions, we expect further non-labor savings from SKU rationalization, supply chain efficiencies, and price and promotion strategy. We expect to reinvest the majority of the savings from head count and non-head count-related actions into our business to foster innovation, particularly in cloud, big data analytics, information management, and security.

And now, on to our earnings outlook. From a macro perspective, we remain cautious about the environment globally for both consumer and commercial spending. Second, we expect the pricing environment to remain competitive. Third, Services margins are expected to remain in the 10% to 12% range for the remainder of fiscal year 2012. Fourth, we expect continued decline in Business Critical Systems revenue and the resulting pressure on ESSN margins. Finally, we expect OI&E to be at the low end of the previous guidance, an expense of $1 billion to $1.3 billion for the full year. With that context, we expect third quarter non-GAAP earnings per share to be between $0.94 and $0.97. If we were to exclude any impact of the restructuring plan we announced today, there would be no change to our previously-provided non-GAAP EPS fiscal 2012 outlook of at least $4. However, because the restructuring efforts are expected to create savings in Q4 faster than we can reinvest in strategic initiatives, we are increasing our fiscal year outlook to reflect the anticipated benefit in Q4. We now expect non-GAAP fiscal year 2012 EPS to be in the range of $4.05 to $4.10.

For GAAP guidance, in fiscal year 2012, we expect to take a pretax charge of approximately $1.7 billion for the restructuring efforts, of which roughly $1 billion will be in Q3. Through fiscal year 2014, we expect to take additional pretax charges totalling approximately $1.8 billion. We expect the cash impact of the restructuring to be approximately $400 million in fiscal 2012. Note that we expect to fund much of the cash payments associated with the early retirement program in the US out of the pension plan. In addition, we are evaluating the carrying value of the Compaq trade name, which we acquired 10 years ago. Due to our plan for a more targeted use of the Compaq brand going forward, we expect to record a GAAP-only non-cash impairment charge of up to approximately $1.2 billion in the third fiscal quarter for the write down of the value of the trade name. Thus, we expect third-quarter GAAP earnings per share to be between $0.00 and $0.03 and full year GAAP earnings per share to be in the range of $2.25 to $2.30. Now I'll turn it over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And our first question comes from the line of Katy Huberty of Morgan Stanley. Please proceed.

Kathryn Huberty - *Morgan Stanley - Analyst*

Cathie, first a question on free cash flow. The second quarter numbers were quite strong after a weak first quarter. But when you take into consideration the cash costs of the restructuring where do you expect free cash flow to end this fiscal year relative to non-GAAP income?

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

So the way to think -- we haven't been guiding cash flow. The way to think about cash flow over the long-term is that cash flow will generally trend in line with our non-GAAP earnings. It is important to understand the cash flow implications for the restructuring charge. In fiscal 2012, we expect the cash flow impact to be about $400 million, and then through 2014, we expect the cash flow impact cumulatively to be about $2.7 billion.

Kathryn Huberty - *Morgan Stanley - Analyst*

Okay, thank you. And then just as a follow-up, do you have a view yet as to whether the share gains in PCs were entirely sell-out, or was some of that sell-in and channel rebuild after the HDD shortages? And just on the back of that, do you have a view around demand next quarter as the channel and consumers wait for Windows 8?

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

Yes, I'll take that. So actually, we saw very good sell-out in the channel and we are running at the low end of our desired channel inventory. So we feel pretty good about end user demand and our ability to pull through that demand with good marketing and great products on the consumer side. And the enterprise side, I think we've actually struck that perfect balance between design and the work horse devices that business and governments need. So we're feeling pretty good about demand.

Kathryn Huberty - *Morgan Stanley - Analyst*

Okay. Congrats on the execution this quarter.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks, Katy. Next question, please?

Operator

Next question is from Bill Shope, Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Could you give us a little bit more detail on how you're thinking about the secular prospects for IPG, particularly in the consumer segment? And when you parse up this quarter's performance, how much of the supplies decline can we assign specifically to channel inventory reduction? And I guess an extension of that, do you still think we can return to sort of mid-teen margins any time soon for overall IPG?

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

I'll take the first part of that question, Bill. Listen, in terms of the broad secular trends in this business, what we see at the highest level is an enormous wind at our back, going from analog to digital. There's going to be about 200 billion pages that are going to move from analog to digital over the next number of years. But you're right, there is some segments, there is some decline. For example, what we know is people who have home printers are printing less photos in their home, but we also feel good about the printing in the enterprise.

So here's what we've got to do, and I'll let Cathie answer the question about supplies. As an industry leader, we need to act like one. We need to step up our marketing. We need to take responsibility for growing the category and demonstrating new use cases for printing. We need to get our pricing correct on both our ink, as well as our printers and we need to make sure we've got the right product at the right time for the right market.

In the enterprise, we missed the cycle on multi-function color laser jets, and we now come to market this fall with eight new multi-function printers in the laser jet category, which is really going to help us. This is the fastest-growing part of the market that we haven't played in as much as we should have.

And then we have to look at different business model, particularly in emerging geographies. And in emerging geographies, what we have found is that you can actually price the printer a little higher, price the ink a little lower, and what you end up doing is selling a lot more ink, because printing is more affordable to these emerging markets.

So we're going to get very aggressive in the printing business. We've got a very clear strategy outlined, and I feel very good about the way forward there. It will take a few quarters to I think see the results of a more aggressive strategy. I think we've got this one, the path forward here is really clear now.

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

To address the question on the supplies decline and how much of that was due to channel inventory, the vast majority of the decline was due to channel inventory corrections this year. I'm sorry, this quarter. And we do expect that obviously to modulate as we go into Q3, because we ended the quarter within our acceptable ranges on IPG supplies. The caveat I give you is that demand continued to be fairly weak and so honestly, we would like to take channel inventories down a little bit in Q3. Nothing compared to what we were, we did in Q2, though.

Bill Shope - *Goldman Sachs - Analyst*

Okay, and then the question on returning to mid-teens margins over time?

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

I think you have to go back and dissect basically where, what drove the margins this quarter. So if you actually look at it, there's three big drivers of the margins year-over-year for IPG this past quarter. The first one is supplies mix, which was, as we've just addressed, was addressed, was caused by both channel inventory corrections, which is the biggest impact, but also, we did see some softer demand from a supplies perspective.

We also saw obviously lower volumes, and that put some pressure on operating margins. And then finally, something that we at this point are not calling for a change, and that's in the strength of the yen. That continues to be a headwind for us in our laser jet business.

Bill Shope - *Goldman Sachs - Analyst*

Okay, thank you.

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

I'll make one last comment on that, Bill, as well. Joining forces between the PC business and the printing business, this is going very well. And I think it's actually going to help the printing business a lot in a couple of areas. One is in emerging markets. PSG had a much broader and deeper footprint in emerging markets than IPG, so we're going to leverage that. PSG had a broader account coverage model, direct account coverage model than IPG did, so we're going to leverage that as well.

And we have some untapped opportunities in supply chain, nodes, logistics, that were not fully exploited because these were different divisions that didn't coordinate as well as they might have. So I think that's another reason where we're going to create some financial capacity, which over time we will invest in things that we think make sense and we'll obviously try to improve the margin over time as well.

Bill Shope - *Goldman Sachs - Analyst*

Okay, great. Thank you.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks very much, Bill. Next question, please?

Operator

Next question is coming from the line of Toni Sacconaghi from Sanford Bernstein. Please proceed.

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

Yes, thank you. I know you stated several times that you expected the majority of your restructuring savings to be reinvested. If we take that quite literally and say 40% will actually drop to the bottom line, it's $1.5 billion, or $0.60 a share after tax. Is that the right framework that we should be thinking about? And I realize it's exiting 2014. But is that the envisioned balance, given you used the adjective majority?

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

We are in the process of -- we have a very well-defined outlook I think for the savings that we will get through the workforce reductions and early retirement programs. Cathie said it was, I think it was in my script as well, $3 billion to $3.5 billion. But you're correct. We are doing a lot of work on supply chain, SKUs and platforms, real estate, go-to-market, pricing and promotion, centralizing advertising and marketing.

But we are not to the point yet where we can make a decision about how much of that we want to reinvest in the business, because we are now wanting to take a very disciplined approach to say what is the return on invested capital of an R&D initiative in the storage business.

So what I would recommend, Toni, is listen to our guidance going forward. There will not be perfect linearity in the savings, and what we put into investment versus what we dropped at the bottom line. So, for example, in fourth quarter, we may get a lot of these savings, but we want to be prudent on investments. But in Q1, we may invest more and bring a little bit less to the bottom line.

So I think the best guidance I can give you is we're going to be very disciplined about reinvestment. We're going to only reinvest in those opportunities that make financial sense, to set up HP for the long term. And this will not be perfectly linear. But I think we'll be able to also give you a little bit more guidance on this at the end of Q3 and end of Q4.

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

Okay. Talking about the non-perfect linearity, perhaps you can talk about forces at work on earnings in Q3 and Q4. I think your guidance, even if you strip out the incremental $0.05 to $0.10 from some of your initial savings that have not been reinvested, if we strip that out from the guidance, it still implies a 30%-plus EPS growth from Q3 to Q4, which is historically unprecedented at HP.

Similarly, you're calling for earnings to be lower next quarter, despite not having the tailwind from further significant supplies reduction, not having the tailwind -- excuse me, the headwind from that, and not having the headwind from HDDs. So Cathie or Meg, maybe you can talk about forces at work on EPS that appear to be pushing down EPS in your view in Q3 and then leading to an unseasonably large expectation for EPS growth in Q4, even excluding the anticipated restructuring.

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

So, Toni, actually I'm a little puzzled by that, because the math that we've done and the seasonality that we've looked at is that Q4 seems very much in line with normal seasonality off of Q3. And Q3, again, pre-restructuring, and Q3 looks roughly in line with what we normally see from Q2. So we're really feeling like this is consistent with normal seasonality.

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

So you don't expect any sequential benefits, or I gather what are the offsetting headwinds to tailwinds that you should be getting from relief from no supplies channel draw down and from better availability on the HDD side?

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

Tony, it's Meg again. Let me copter all the way up here. Because as I said, overall, we feel cautiously optimistic coming out of Q2, but I wouldn't say yes confidently that we have completely turned the corner. We have made real progress, but we're in the early stages of what we hope to achieve over the next several years. And that the headwinds we're facing I think into Q3 and Q4 is first of all, Europe.

I was just in Europe a couple weeks ago and I will tell you every business leader over there is very concerned with the election of Hollande and what that will mean and what will happen to Greece. We are, as I said, at the early stages of a turnaround in a number of our different businesses, and in my experience, having done a number of these turnarounds, they are not linear either. So there may be a setback that we can't anticipate at the moment.

And then we're going through a lot of change here. We're just joining forces of IPG and PFG. Global accounts now report to Dave Donatelli. We have centralized all of our marketing and communications. We've centralized sales ops for the first time under John Hinshaw, and we are undergoing a pretty big restructuring charge and a workforce reduction. So there's a lot of moving parts at HP. I feel confident about our ability to execute against that, but I don't want to get out over my skis in terms of what we tell you we can deliver.

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

And Toni, I think you also have to play through a little bit on the currency. Now, we are exposed to a huge basket of currencies obviously and we do a series of hedging, different hedges across different businesses. But at the end of the day, the currency that we're looking at right now is a head wind on a year-over-year basis in Q3 and for full-year fiscal 2012. On a sequential basis, it's minimal. But on a year-on-year basis, it is still a bit of headwind from a top-line perspective.

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

Thank you.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks, Tony. Next question, please?

Operator

Your next question is from Shannon Cross from Cross Research. Please proceed.

Shannon Cross - *Cross Research - Analyst*

Meg and Cathie, could you provide more color on how you're thinking about the restructuring? Is every business unit going to get a percentage to cut? Does it include any potential divestitures of non-core businesses? And then finally, I'm just curious if you think the back office systems that you have in place right now will allow you to manage through the process? Because that's one comment I've heard from people over time, is that they would like to see a little bit more on the back office system from an operations perspective.

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

Yes, let me take a crack at that. If you pull all the way back, our restructuring is really about three things. We've got to better align HP's cost structure with our revenue portfolio. We've got to position the Company to take advantage of some of the biggest shifts that I've seen in technology in my 30-year career in business. And then we've got to streamline our operating model.

And so the way we did this, is we went business unit by business unit. And by that, I don't mean just at the ESSN level. I mean in networking and the different projects, products of networking, to the different PC categories, to the different services businesses that we're in, to the different software products. And basically said what do we want to focus on, how many individuals do we need to deliver that service, what pieces of those businesses do we want to emphasize versus deemphasize.

And came up with a bottoms-up approach to the cost savings that we thought we could achieve from the reduction in work force, as well as the VER. And then began to size things like supply chain and go-to-market that we've talked about. Then, you're right. We have to make some investments in this business, and internal tools and back office processes are something that we need to invest in. It is not perfect by any means.

And one of the steps we took was to combine our sales operations from both our enterprise business and consumer business under John Hinshaw and we're finding lots of opportunities to streamline, to put tools in, so we'll actually make it easier to work at HP. So we've got a lot of work to do in that regard. It is only one bucket of investment that we need to make. But when we do that, boy, I think you're going to see this company hum a lot more efficiently and effectively, and be a lot easier place to work for the incredibly dedicated people that we have working here.

Shannon Cross - *Cross Research - Analyst*

Great. And the second question I have is just on Autonomy. Can you talk a little more about the weakness in revenue and if it changes your outlook on the business at all, and how it integrates with HP or is this something that different oversight will fix?

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

When Autonomy turned in disappointing results we actually did a fairly deep dive to understand what had happened here. And in my view, this is not the product. Autonomy is a terrific product. It's not the market. There is an enormous demand for Autonomy. It's not the competition. I was wondering, is there a competitor that we didn't see, and the answer to that is no. This is classic entrepreneurial Company scaling challenges.

And I have seen this movie before. When you try to go from $40 million to $400 million to $1 billion to $2 billion, boy, it takes, it's a whole different ball game. And we need to put in some sales processes. We need to put in better interface into HP in terms of how Autonomy interfaces with our services business, as well as our server, storage and networking business, and we need a new organizational structure to support a $1 billion-plus company.

So we have the people to do this. We have the expertise to do this. Something I'm extremely familiar with, having grown eBay from $4 million in revenues to $8 billion. I really have seen this movie before. So I feel confident about the long haul. But it may take us a couple of quarters to work through some of the growing pains of the organization.

But I think this was a very smart acquisition, I feel great about the product, and we have absolutely hit one of the themes that is changing most in the technology business. The opportunity around big data and analytics is fantastic, and it can flow right across all of our businesses.

Shannon Cross - *Cross Research - Analyst*

Great. Thank you very much.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks, Shannon. Next question, please.

Operator

Your next question is from the line of Brian Marshall of ISI Group. Please proceed.

Brian Marshall - *ISI Group - Analyst*

If we assume roughly $1 billion dollars of the $3 billion to $3.5 billion of savings goes to the bottom line when this is completed in fiscal 2014, and the majority of that's going to be going into the new focus areas, obviously cloud, big data, security.

Is the majority of that $1 billion, would that go towards organic investment, therefore probably talking about pretty sizable increase to the R&D, currently about $3.5 billion of spend annually on R&D? So if that's correct, I would assume that we're not looking at any sizable M&A in these three areas as well going forward?

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

Yes, Brian. I thank that's a fair characterization. We're looking towards organic innovation or organic investment. We don't see any big M&A transactions on the horizon. There may be some tuck-ins as I've said before to augment our software business or maybe some of our other businesses. But I think that's exactly right.

The heritage of Hewlett-Packard is a fantastic engineering culture, products engineering, service engineering, and the best payback I can see here is to put money into R&D for our engineers to create great services and products and software. So we are going to increase the R&D budget pretty substantially.

We're also going to be looking at design and quality, because that's another area I think was a hallmark of HP. We need to have the very best quality in the industry across all of our products. And I think we have good quality, but I think we can do better there.

We are going to make investments in our people, as I said, in terms of career development, training. We've got a lot of work to do there as well, and I think Shannon has called this out, we've got some investment in internal systems that are going to allow us to be a lot faster and nimbler in the marketplace. Cathie, do you want to add anything to that?

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

The only thing I want to add is that there were a bunch of numbers thrown out there and I want to be really clear about what those numbers mean. We expect to, as we talked about, to save on an annualized run rate basis between $3 billion and $3.5 billion exiting 2014. And it's from that pool of savings that we will look at reinvestment. And at this point, we're not quantifying for you how much drops to the bottom line. Some will definitely drop to the bottom line.

But the vast majority will be reinvested back into this business, either in key growth areas where we can grow faster in higher-margin categories, or back into process reengineering, IT, automation that will allow us to continue to generate savings over the long haul because we're a much more efficient organization.

Brian Marshall - *ISI Group - Analyst*

Sure. And the quick follow-up is with the extra monies that are not reinvested in the organization, any change to capital allocation post the completion of the reduction in workforce? Thanks.

THOMSON REUTERS

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

So there's no change in our capital allocation, focused both in the short term and the long term. So in the short term, we've talked a lot about the fact that 2013 -- I'm sorry, 2012, and into 2013, that our focus is on rebuilding our balance sheet. And we made progress in Q2 in doing just that because our net debt position improved $1.2 billion. So, making progress there.

Over the long term, the way we think about capital allocation is basically looking at the different opportunities to deploy capital, and what types of returns we can get, factoring in both long term and short term, because you need some of both. But it's going to be a risk-adjusted returns basis. And frankly, share repurchase has to be on that list of potential investments as well.

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

Because we've got to rack and stack all of these investments on an ROIC basis, and so if we're returning cash to shareholders is one of the highest return on invested capital decisions that we make, that we can make, then that's what we'll do.

Brian Marshall - *ISI Group - Analyst*

Thanks.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks, Brian. Next question, please?

Operator

Next question is from Keith Bachman from Bank of Montreal. Please proceed.

Keith Bachman - *BMO Capital Markets - Analyst*

I had two questions, if I could. The first is on services. You've identified that you want to take out a number of people out of the collective HP. Yet at the same time, indicated that there's area of services, particularly on the consulting side, that you need to nurture and grow. How do you think about the net headcount as you look at services over that period that you have suggested, say, two, three years? How do you look at the actual change in headcount of trying to provide the consultants and yet at the same time take cost out? And I have a follow-up, please.

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

We talked a lot about the fact that services is a turnaround. And that it's going to take three to five years. And what we're doing is having a transition. We are transitioning our services business from being heavily weighted to slower-growth, lower-margin portions, or services within ITO.

And we want to transition this to faster-growing, higher-margin sections related to strategic enterprise services. What we consider strategic enterprise services, cloud, security, information management and analytics, and application modernization. And that's going to take us time to make that transition. But that is a big focus here.

And at the same time that we're doing that, that obviously has headcount implications. So what we've done is we basically modeled out that transition over a number of years and the types of skills that we need in order to execute on this transition. And I think it's also important to understand that's a mix. You can get better margins and services as a result of that mix shift.

But it's not just about mix. We're also applying business process engineering, lean methodologies to our delivery, so that we also get a rate benefit on our installed base and obviously on future contracts that we win.

Keith Bachman - *BMO Capital Markets - Analyst*

That's what I was alluding to, Cathie. If I can just press on that before I ask my follow-up. Net-net, you need to add people. Net-net over the next two years in services, do you see headcount being up, down or flat? In services?

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

Down. I mean, we will -- I believe we will have a smaller, more profitable services business over the next two to five years, which will have fewer people in it today than -- fewer people in it tomorrow than it does today, because we will have changed the mix to businesses. We can make a real -- we have a real differentiation in our offering.

Keith Bachman - *BMO Capital Markets - Analyst*

Fair enough. Okay. Then let me try my follow-on the enterprise side. As you've had two quarters of non-GAAP margins of about 11.2%, and as the G8 X86 side ramps a little better here with HDDs, would you expect the operating margins to improve over the next few quarters in that division? And that's it for me. Thank you.

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

If you go back and you look at what drove the decline year-over-year this quarter, that's insightful. So we did have lower top-line growth that was driven partially due to hard disk drive shortages, which we believe we are largely through exiting Q2. So minimal impact in the second half from the hard disk drive. But we also saw softer economic demand. I would say Europe in particular.

And that's going -- we're not calling in our guidance, at least, at this point for a significant improvement in that. We also have seen higher hard disk drive costs, which we expect will also continue through fiscal 2012. And then finally, you've got the ongoing headwind from a lower mix from Business Critical Systems that will continue to put pressure on us. We've got some -- I would say some different solutions for customers in that space, but we expect that to continue to put pressure on margins.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay, thank you.

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

I'll just add one more thing, that this is an area where I believe the return on invested capital in R&D is going to prove to be very high. This is sort of the core of who HP is, is our server, storage, and networking business. So we may see some organic improvement of operating margins, which we may choose to reinvest in R&D over the next several years. This is an area where I think we can be ahead of the curve, in servers, storage and networking, and you can start to see that in our results, I think.

Even in industry standard servers, which people say to me all the time, isn't that a commodity business? Not if we can help it, it shouldn't be. Look at our next-generation Gen 8 ProLiant servers. Look at Moonshot, look at Odyssey. These are things that redefine that category, and that's the thing that we want to invest in.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. Thank you.

Rob Binns - *Hewlett-Packard Development Company, L.P. - VP IR*

Thanks very much, Keith. I think we've got time for one more question here before pass to Meg for some closing comments. Operator, one more question, please?

Operator

Our last question comes from Ben Reitzes from Barclays Capital. Please go ahead.

Benjamin Reitzes - *Barclays Capital - Analyst*

Thanks for squeezing me in. I had some technical difficulties. Meg, you said something about China in your opening remarks. I want to make clear that you said that things were turning around there, and that was a big head wind for you. And I had a quick follow-up on end demand for PCG, why you're so confident. I'll ask you those two at once.

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

I don't want to get out over my skis on China, because we've had a really tough couple of years in China. But it is looking better. There's a six- or seven-tier distribution system in China, which we're feeling better about. We have a new head of APJ, Dion Weislerm who lives in Beijing, who has a tremendous amount of experience. We have spent more time there. I think we are seeing the fruits of our labor in our China development center and our China design center. So I think we are seeing positive early signs of stabilization and turnaround.

We announced our new product line in Shanghai for a reason, because we wanted to show the commitment to the Chinese government, for the Chinese people, for our long-term commitment to the China market. So I feel good about it, but it's early days, and as you know better than most, it's been a tough road for HP and China over the last couple of years.

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

And those are specific comments to PSG. A couple of other bright spots in China in industry standard server, we had a record quarter in China. Things are looking good there from a networking perspective. We are continuing to really do well with our H3C products in China. There are bright spots, and then the sequential improvement, on the PSG side is a positive direction as well. But to Meg's point, we'll take it one quarter at a time.

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

And we've got a fledgling but growing services business in China, got that with some of our biggest services customers there and actually, I think we have a good opportunity there. On your second question, which was end user demand for PCs, everything we see in the marketplace says that there is a demand, there is a refresh coming potentially around Windows 8, and it appears to be stronger end user demand I would say in Asia and the United States.

We still worry about Europe. Europe is one tough place to do business right now, and my personal prediction is that this is going to get a little bit softer before it gets stronger, given all of the uncertainties around the sovereign debt crisis, around what's going to happen to the Greek debt, about what's going to happen in France and what Germany's going to do to bail everybody out over there.

Benjamin Reitzes - *Barclays Capital - Analyst*

Thanks a lot. I appreciate it.

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

Yes, good. Okay. Well, let me just wrap up and end where we began. Overall, we feel cautiously optimistic coming out of Q2. While I wouldn't say we've turned the corner, we have made real progress. And I think the entire senior leadership team at HP is increasingly confident in the way forward and in our future. So we're excited about continuing to execute over the next several quarters and years. So thank you very much for tuning in.

Operator

Ladies and gentlemen, this concludes our call for today. We thank you for participating. You may now disconnect.