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HPQ - Q3 2012 Hewlett-Packard Earnings Conference Call

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OVERVIEW:

HPQ reported 3Q12 revenue of $29.7b and GAAP loss per share of $4.49. Expects FY12 GAAP loss per share to be $2.23-2.25.

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PRESENTATION

Operator

Welcome to the third-quarter 2012 Hewlett-Packard earnings conference call. My name is Monica and I will be your Operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded. I would now like to turn the call over to Mr. Rob Binns, Vice President of Investor Relations. Rob, you may begin.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Good afternoon. Welcome to our third-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 fact 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 statements of assumptions 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, reflect estimates based on information available at this time and could differ materially from the amounts ultimately reported in HP's third-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 investor relations web page at www.hp.com. Now I'll turn the call over to Meg.

Meg Whitman - *Hewlett-Packard Co - CEO*

Thank you, Rob, and thanks to all of you for joining us today. Since our last earnings call, we've made progress on HP's turnaround. We are focusing the Company on our strategic priorities and driving organizational change. These actions will make HP more efficient, easier to do business with and easier to work for. We have great opportunities in front of us but we also have a number of challenges.

Some of them are macroeconomic; others are industry trends, and frankly, some are about HP's execution. Make no mistake about it, we're still in the early stages of the turnaround. There will be challenges ahead that could create some variability in performance. But I'm confident in our ability to work through them and get to where we want to be.

With that as a backdrop, let's take a look at the third quarter. Overall we had a decent quarter and again, we did what we said we were going to do. While revenue declined 5%, or 2% in constant currency, the trajectory of the decline flattened in Q3. This is encouraging in light of the deteriorating macroeconomic environment. At the same time, we exceeded the non-GAAP diluted EPS outlook of $0.94 to $0.97 that we gave in May. We delivered $1, beating the high end of our outlook by $0.03 a share on revenues of $29.7 billion.

When you look at our performance during the quarter, there were things that we did well and there were things that we could have done better. Looking at the positives for the quarter, Storage, Networking, IPG and Hyperscale servers delivered solid results. Our 3PAR business grew more than 60% in the third quarter and we announced new enhancements to our HP StoreOnce product that delivers record breaking backup performance. This technology was developed in HP labs and includes more than 50 patent pending innovations.

In HP Networking, we delivered strong results with revenue growth up 10% over the prior year, normalized for a divestiture. Our virtual application network technology is enabling administrators to automate changes in their networks and deploy an application in minutes instead of the weeks it currently takes. In Industry Standard Servers we made progress in aligning our supply chain and engineering capabilities in Hyperscale. This is building our competitive advantage to win and win profitably in this fast-growing market.

On a less positive note, the Mainstream Server market continues to show weakness. However, we believe the progress we're making in Hyperscale will inform our capabilities to further improve in the Mainstream Server business over the long term. In IPG we saw solid margin improvement in the third quarter. Ink Advantage, our innovative business model targeting affordable printing in emerging markets made significant progress. We greatly expanded the number of countries we now cover with this program.

Our focus on the high end of the hardware market continues to show positive results with strong share gains. We also launched HP ePrint Enterprise 2.0. This amazing technology enables enterprises to easily connect every employee's mobile device to an existing fleet of network printers via HP's Cloud printing solutions.

In the area of Cloud and Information, we introduced a number of innovations including an enhanced version of our flagship product HP Cloud System. Cloud System enables enterprises and service providers to create private, managed and public cloud environments. We now have almost 750 unique Cloud System customers.

We also announced HP Converged Cloud Services for airlines. A hybrid delivery approach to the Cloud specifically designed to help airlines create new revenue streams, deliver better service to their customers, lower their costs and increase productivity. And we released our first public Cloud Services, backed by an industry leading service level agreement. Built on proven HP technologies, HP Cloud Services also leveraging open stack, providing a foundation for one of the most open and scalable set of Cloud Services in the market.

And we continue to leverage the IP of our acquisitions across the portfolio. We announced a number of integrated solutions that combine the power of Autonomy, Vertica, Enterprise Services and our Converged Infrastructure to address the problems and opportunities of big data.

Now, let me talk about our customers. And in Q3 we had some great customer wins. For example, Russian Railways, the world's second largest railway engaged HP Software to improve the efficiency of their IT operations using HP's broad portfolio of IT Management Software. The US Air Force selected HP to provide PCs and workstations around the world.

NASCAR announced the development of the NASCAR fan and media engagement center, a resource that will leverage HP's information management, analytics and social media offerings to enable NASCAR to engage with consumers through leading media channels. And Consolidated Graphics, one of the world's largest and most extensive commercial print service providers, purchased 10 HP Indigo 10,000 digital presses. These customer engagements give you a sense of the breadth and scale of the difference HP makes in the world every day.

Now, let me outline some areas where we're not where we need to be. While Enterprise Services performance in the third quarter was within our expectations, there's still a lot of work that needs to be done. Earlier this month we announced a change in leadership at ES with Mike Nefkens stepping in to lead on an acting basis. Mike is an experienced leader who has led IT transformations for a number of our largest accounts.

In addition, JJ Charhon has taken on a newly defined role as Chief Operating Officer for ES, focusing on increasing customer satisfaction and improving service delivery efficiency. ES is in a multi-year turnaround and as I have said before, progress will not be linear. We expect to see some variability in performance as we transition and build a more profitable business. We will turn ES around but it's going to take some time as we focus on margins with both our new business and contract renewals.

Moving to PPS. The PC market remains weak and channel inventory is high across the industry, ahead of new product releases. Our PC revenue was down 10% year over year, driven by this weakness and an aggressive pricing from our competitors. The reality is, we're locked in serious competitive battles but we're determined to win. We will fight to sustain our leadership position, particularly in the commercial space, while remaining focused on profitable growth. To this end we are executing targeted marketing and promotional programs to support the business in Q4.

Autonomy still requires a great deal of attention and we've been aggressively working on that business. Among the many changes we've instituted is a global dashboard to track Autonomy's pipeline. A single global sales methodology, a single HP Services engagement process, and a global process to measure client satisfaction and service delivery progress. These actions are designed to help deliver predictable results and improve after-sale customer satisfaction.

We crossed an important customer milestone with Autonomy Live Vault, our Cloud-based data protection service for content archiving, passing the 10,000-customer mark during the quarter, demonstrating great momentum for this HP Cloud service. Overall we have a very long way to go, but we are taking steps to fix the problems and help Autonomy succeed.

In Q3 we achieved significant progress in reorganizing and restructuring the Company. We made several executive moves to help strengthen HP's leadership bench and support our turnaround. Bill Veghte was named Chief Operating Officer with responsibility to further accelerate the execution of the Company's strategy. Bill is working closely with his peers to support key projects with the ultimate goal of making the collective HP more than just the sum of its parts.

And we welcomed George Kadifa as our new head of HP Software. George joined us from Silver Lake Partners and is well-known for his expertise in building and managing technology businesses and software development.

The integration of PSG and IPG is well under way. We are reducing overlap and driving cost reductions between the two businesses while at the same time taking advantage of their combined scale. We've streamlined the Enterprise Group's sales management. As I mentioned earlier, we are taking aggressive steps to right the ship at Enterprise Services.

Moving on to other parts of our restructuring. We achieved our targets in Q3 with approximately 4,000 employees leaving the Company. Given the timing of the action, we saw minimal savings due to these efforts inside the quarter. However, greater than expected acceptance of the early retirement program has accelerated the workforce reduction program and we now expect approximately 11,500 employees to leave the Company in fiscal year '12, versus our prior estimate of 9,000.

That sums up where we ended Q3. Now let me spend a couple of moments talking about Q4 and our future outlook. There are a number of headwinds we faced that fall into three areas, macroeconomic and industry trends, as well as challenges in HP's execution. I've talked before about the techtonic plate shifts in the industry that are occurring, Cloud, mobility, virtualization and more. All are impacting the way customers, both Enterprise and consumer, are leveraging technology.

This means HP needs to shift its portfolio. This will require some tradeoffs and some time. We expect the underlying macro and industry headwinds, which have recently intensified, will remain in Q4 and well into FY '13. This will pressure both our top-line performance and our ability to reposition our portfolio and make the right investments.

HP has some great assets to build on, but the near-term outlook will be challenging as we set this Company up for the long term. While there is little we can do about the macroeconomic and industry trends, execution is another matter. HP has to do a better job of executing against its goals. To that end, we've made a number of organizational changes that may be a distraction in the short term but are absolutely the right thing to do in the long term. Therefore, we expect fiscal year '12 non-GAAP EPS to be between $4.05 to $4.07, consistent with the low end of our previous outlook for the fiscal year.

So in summary, we're focused on driving innovation across our business. I'm very excited about the new products and services we will launch this fall including a new line of PCs and tablets with a focus on design, a line of multifunction printers and new additions to our security portfolio both in Software and Enterprise Services.

We're also rebuilding our balance sheet. We generated $2.8 billion in operating cash flow and $2.1 billion in free cash flow in the quarter and reduced our net debt position by over $1.5 billion in the quarter. In short, we still have a lot of work ahead of us, but with the support of customers, employees and investors I'm confident in our ability to reinvigorate HP. With that, I'd like to turn it over to Cathie to provide more detail on the quarter.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Thank you, Meg. I'll review the third-quarter performance and then close with our fourth-quarter outlook. In the third quarter, revenues was $29.7 billion, down 5% year over year as reported and down 2% in constant currency. Our geographic performance reflects the continued macroeconomic challenges across the globe.

In the Americas, revenue was $13.4 billion, down 5% year over year as reported and down 3% in constant currency. Revenue in EMEA was down 4% to $10.6 billion, and revenue in Asia-Pacific was down 7% year over year to $5.7 billion. On a constant currency basis, EMEA was up 1% as growth in Russia and Central and Eastern Europe was somewhat offset by declines in Western Europe. APJ was down 6% in constant currency, largely driven by continued weakness in China.

Non-GAAP gross margin of 23.4% was flat year over year as improvements in IPG and Software margins were offset by declines in PSG and Services. The 20-basis-point sequential improvement in gross margin was driven by the improvement in IPG. Non-GAAP operating expenses were $4.2 billion, down $22 million year over year and down 4% sequentially due to lower marketing and field selling costs.

As we discussed previously, there was little impact of the restructuring cost savings in Q3 as most of the employee departures were late in the quarter. Non-GAAP operating margin was 9.2%, down 60 basis points year over year, and the Company delivered $2.7 billion in operating profits.

The bridge from non-GAAP operating profits to non-GAAP earnings per share includes the following. Other income and expense yielded a net expense of $224 million. Our tax rate was approximately 22%. And we used $365 million in the quarter to repurchase 16.5 million shares bringing our weighted average share count to 1.975 billion shares, which is down 5% year over year. As a result, we exceeded our non-GAAP guidance in the quarter, delivering non-GAAP diluted earnings per share of $1, and a GAAP loss per share of $4.49.

Third quarter fiscal 2012 GAAP loss per share includes after tax costs of approximately $5.49 per share, related primarily to the impairment of goodwill, amortization and impairment of purchase intangible assets, restructuring charges and acquisition-related charges. We have a detailed bridge in the earnings deck, posted on the HP Investor Relations website.

Now turning to our business segments. Personal Systems Group delivered revenue of $8.6 billion in the quarter, down 10% year over year, with a 4.7% operating margin. Total units shipped were down 10% year over year as we saw weakness in overall consumer demand as well as geographic softness across Asia-Pacific and the Americas. By category, commercial revenue was down 9% and consumer revenue declined 12% year over year.

Turning to Imaging and Printing. Net revenue for IPG was $6 billion, down 3% year over year with supplies revenue declining 3%. As Meg mentioned, we have made hardware share gains in the high end and are pleased to see the traction with moving ink products into the commercial segment. At the same time, the demand environment, particularly for consumer, remains a headwind, affecting our success in balancing sell-in and sell-through activity with the channel. We need to reduce channel inventory through close inspection and end user demand stimulation.

Operating profit was up 1.6 points year over year to 15.8% of revenue, and $949 million in profits. Supplies were 67% of the mix and we saw margin rate improvements across hardware and toner which contributed to the margin improvements. By business unit, total printer unit shipment volume was down 17% year over year, largely driven by the decline in consumer as we focus on the higher-end units. Consumer printer revenue was down 13% year over year with hardware units down 23%. Commercial printer revenue and hardware units were up 4% year over year.

Moving on to Services. As we announced on August 8, we are recording a GAAP only non-cash pretax charge of approximately $8 billion for the impairment of goodwill within the Services segment. The impairment stems from the recent trading values of HP stock coupled with market conditions and business trends within the Services segment. We do not expect this goodwill impairment charge to result in any future cash expenditures or otherwise affect the ongoing business or financial performance of the Services segment.

In the third quarter, Services delivered revenue of $8.8 billion, down 3% from the prior year and up 1% in constant currency. Operating profit of $959 million was 11% of revenue, down 2.7 points from the prior year, but still within our expected range of 10% to 12%. The year-over-year decline was due to the unfavorable impact of resource management and account performance and runoff, somewhat offset by an improvement in the cost of Services delivery.

We saw strong sequential growth in the total contract signings for our strategic Enterprise Services, which includes Cloud, application modernization, security and information management and analytics. The revenue pipeline is promising, although it is not yet significant enough to outweigh the revenue declines created by the runoff of lower-margin, less-strategic business.

IT outsourcing revenue of $3.7 billion was down 6% year over year as we continue to scrutinize new deals and renewals for margin and strategic fit. Application and Business Services revenue was flat year over year at $2.5 billion and up 5% in constant currency. Technology Services revenue was down 1% year over year to $2.6 billion and flat sequentially.

Turning to Enterprise Servers, Storage and Networking. Revenue of $5.1 billion was down 4% year over year, impacted by declines in BCS and softness in the EMEA market. Operating profit was $562 million, and the operating margin of 10.9% was 2 points lower than the prior-year period. The margin decrease was driven by competitive pricing and a higher mix of less profitable customers in regions within Industry Standard Servers and a lower mix of BCS, somewhat offset by growth in Networking.

Let's dive into the ESSN performance by business. In Storage, the continued strong performance of 3PAR with more than 60% growth and StoreOnce with double-digit growth did not offset the decline in EVA and tape revenue. External disc revenue was flat year over year and total Storage revenue was down 5% year over year. Overall, BusinessCritical Systems revenue declined 16% year over year. Within BCS, non-stop server revenue grew double digits, but BCS's performance continued to be impacted by Itanium revenue declines, even with the first ruling in the Oracle Itanium case going in our favor.

Industry Standard Server revenue declined 3% year over year, with broad-based geographic weakness across the industry and competitive pricing. The order ramp for the Gen 8 ProLiant Server is still outpacing that of Gen 7. Networking revenue was up 6% year over year at $647 million, or up 10% when normalized for a divestiture in Q1. We have made significant improvements in sales execution, successfully signing 46 new logos in the quarter, which has been up every quarter this year.

Software revenue of $973 million was up 18% from the prior-year quarter. Macro challenges in EMEA and the Americas, as well as sales execution issues negatively impacted Software license revenue, which grew 2%. This was offset by growth in our Support and Services revenue of 16% and 65% respectively.

As Meg discussed, we have a lot of work to do over the next several quarters to improve Autonomy performance and we will be focused on improving pipeline conversions and execution across the entire Software business. SaaS revenue, a strategic aspect of the portfolio is growing well. Overall, third-quarter operating profit for Software was $175 million, or 18% of revenue. HP Financial Services revenue was flat year over year at $935 million. Financing volume was down 2% and net portfolio assets increased 2% year over year. Operating profit of $97 million was up 10% year over year to 10.4% of revenue.

Now on to capital allocation and the balance sheet. As we have said, we remain committed to rebuilding our balance sheet. Operating cash flow was up quarter on quarter to $2.8 billion and free cash flow was $2.1 billion. Total gross cash at the end of the quarter was $9.9 billion. During the quarter, we returned $365 million in cash to shareholders via share repurchases, leaving roughly $9.3 billion remaining in the authorized share repurchase program. We also increased the dividend by 10% and paid $260 million to shareholders in the form of dividends.

We have been working to improve our cash conversion cycle and brought it down by one day sequentially this quarter. But at 27 days, it is still up one day from the prior year. We have more work to do in Q4 and fiscal '13 on accelerating our cash conversion cycle and are focused here to get back to historical levels.

Now turning to our outlook, which is impacted by HP execution issues, market dynamics and macro assumptions. For HP as a Company, we are in the early stages of our turnaround and of our restructuring efforts. In fact, some of the changes we are making to improve our business long term, such as realigning and restructuring our sales force, are impacting our revenue performance in the short term.

In Services, our diligence around account profitability is putting pressure on our signings of both new logos and renewals, which accelerates the need to manage costs aggressively. The organizational and operational improvements we are making to our cost structure will have a positive impact in the fourth quarter. But those benefits will be needed to counteract some of the headwinds we are facing.

In terms of the market conditions, consumer demand remains soft in PCs and Printing, resulting in elevated levels of channel inventory for us in PSG Consumer and IPG. We will look to manage sell-in consistent with the underlying soft demand. Additionally, the pricing environment in our hardware business remains competitive.

From a macro perspective, the environment is even more challenging than we previously thought even two months ago. We are cautious about the growth prospects globally for both consumer and commercial spending. And we expect that currency will be a headwind to revenue of approximately 3 points year over year in Q4.

With that context, we expect fiscal year 2012 non-GAAP EPS to be between $4.05 and $4.07, at the low end of our previous outlook for the fiscal year. From a GAAP perspective, we expect a full-year GAAP loss per share to be in the range of $2.23 to $2.25. We typically conduct an annual review of the carrying value of goodwill during the fourth quarter of each fiscal year. The factors considered in such a review include market conditions, the trading value of HP's stock and the long-term outlook for the business.

Any one of these factors or any combination thereof may require us to record in Q4 an additional impairment charge against the carrying value of the goodwill in the HP portfolio. Our largest balance for goodwill is in the Software segment. Additionally, as is typical in these cases, there could be a true-up to the goodwill and related tax impact of the impairment charge we recorded in Q3 as we finalized the impairments. We expect to provide an outlook for fiscal 2013 at our Security Analyst Meeting on October 3. Now I'll turn it back over to Meg.

Meg Whitman - *Hewlett-Packard Co - CEO*

Thank you, Cathie, and Operator, why don't we go right to question and answer.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions) Ben Reitzes of Barclays.

Ben Reitzes - *Barclays Capital - Analyst*

Thank you very much. Wanted to ask about Printing and you mentioned the channel inventory was really high, obviously it would seem that you over earned in the segment in the quarter. The Street consensus was looking for about 13.7% in terms of operating margin and so maybe it over earned by $0.05 if the consensus would have been right without the extra inventory and sales of those supplies. I was wondering if that analysis makes any sense and what the earnings hit will be in the future when you do finally pull back that inventory and how should we look at it?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So Ben, let me talk first a little bit more broadly about our margins in IPG. So while we continue to face headwinds of lower volumes and the impact from the Japanese yen on our cost structure, the year-over-year increase in margins was really driven by three things. The first is that in Q3 '11 we were dealing with the tragic impact of the tsunami. And as a result of trying to get parts and product out the door, we incurred significant additional costs that we talked about at the time. Obviously that didn't happen in Q3 '12. We also had improved hardware margins generally due to the higher mix of higher value units and also a lower mix of Inkjet hardware. So those are what contributed to the year over year.

From a sequential perspective, what you saw was again a higher mix of higher value units as well as higher margins in toner, on toner. When you think about kind of going forward and thinking about margins, you have to take into consideration the challenging demand environment that we expect will continue as well as competitive pricing. The yen will remain quite strong on a year-over-year basis and then in Q3 kind of to your point, we did end with higher channel inventories than the underlying demand would suggest and that was especially true for ink supplies. What we need to do in that space is continue to focus on channel inventory. The sell-out in the last couple of weeks of July fell off a bit more than what we had expected and we ended up with more than we intended. In terms of the actual math and the sense that you came up with, my math would suggest a lower delta as a result of the channel inventory.

Ben Reitzes - *Barclays Capital - Analyst*

Okay. Great. Thanks a lot.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Next question, please.

Operator

Bill Shope of Goldman Sachs.

Bill Shope - *Goldman Sachs - Analyst*

Okay, thanks. Given the comments you made about being aggressive in PCs, the channel inventory issues you have there now and some of the promotional programs you talked about in the coming quarter, how should we think about the near-term trajectory for operating margins and ASPs in PSG? Obviously we saw some pressure this quarter on the operating margin line, but my sense is that your commentary is telling us that things could get a lot worse in that respect.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Again, maybe perspective on what drove the margins this quarter will help inform kind of how you think about it going forward. The operating margins for PSG this quarter was 4.7%. So while it was down year on year, it is still very much in the range that we've been targeting for some time. The bridge on a year-over-year basis includes items like the volume, currency and to some extent obviously commodity prices were also unfavorable. Now this was partially offset by favorable warranty and logistics costs. When we look out at commodity prices into Q4, we would say that LCDs and DRAM prices are going to be up slightly quarter on quarter, so there will be additional prices from a quarter on quarter perspective. We do expect the demand environment to remain challenging and the pricing to remain competitive.

Meg Whitman - *Hewlett-Packard Co - CEO*

Let me just give you a little perspective on our strategy for our PC business because I think that can help shape your thinking about where margins will go. So first is, we are focused on profitable growth and continuing to deliver a very strong return on invested capital in this business. But we are under attack by very strong competitive pressures and we're going to respond and what we're -- how we're responding is really three parts. One is product lineup. I think we have among the best product lineup we've had in the PC business for a long time. A host of thin and light Ultrabooks, a Windows 8 tablet for the Enterprise. Two sort of tablet, if you will, tablet combined with laptops for the consumer space and we've also done a lot of work on our cost structure.

One of the benefits of putting IPG and PSG together is we have a much more seamless go-to-market. We see very good opportunities for freight, logistics, supply chain and we have got to make sure that our cost structure allows us to compete effectively because we're going to defend our number one position in this business.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Great, thanks for the question. Next question, please.

Operator

Toni Sacconaghi of Sanford Bernstein.

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

Yes, thank you. I wanted to follow up on the comments that you made about channel inventories in both PC and Printing. So perhaps you can tell us where absolute levels of channel inventory are for hardware and supplies on the Printing side and how that changed sequentially. And similarly on the IPG side, where are inventory -- excuse me, on the PC side, where is inventory? And given the launch of Windows 8 at the very end of your fiscal Q4, how should we be thinking about inventory changes in both PCs and IPG, quite frankly, over the next one to two quarters?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Thanks, Toni, let me start. In terms of channel inventory for IPG, on an absolute dollar basis they're down. What we have -- the impact that we have is really a denominator effect and that's why I talked a little bit about the fact that sell-through softened in the second half of July because that is what ended up driving weeks of supply higher than our acceptable ranges. But the dollars were down on an absolute basis. And really where we saw weak demand was predominantly in Europe and Asia and that impacted the sell-through in Q3 and obviously hampered our efforts to reduce the channel inventory. The channel inventory is more problematic in the supplies area and not in the hardware area for IPG. For PSG, the channel inventory challenges, overall the channel inventory is within our acceptable ranges, but where we saw a pop up was in the consumer space and so we've got some work to do on that end.

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

Cathie, if I could just follow up. If your IPG absolute inventory is down, seasonally IPG is always up in Q4 so that would suggest on a look forward basis, unless you were expecting a dramatic decline in IPG revenues, you actually should be in better shape. So perhaps you can help us understand how supplies inventory, particularly on the consumer side, changed sequentially in terms of number of weeks. Because from the information you've given us, it actually sounds like your weeks of forward-looking inventory should be better unless you're expecting something cataclysmic on the demand side. And similarly on the PSG side maybe you can help us understand where in number of weeks consumer inventory went.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So Toni, we are not expecting anything cataclysmic on the demand side in Q4. And we will continue to work on bringing down our channel inventory levels for supplies in the fourth quarter as well as we're focused on bringing down the consumer channel inventory in PSG.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Okay. Thanks a lot, Toni. Next question, please.

Operator

Katy Huberty of Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

Thank you. Similar to your comments on the weak last few weeks of July in IPG business, can you comment on linearity in the other businesses? And do you at all prescribe to the Cisco commentary that there were some signs of stabilization or improvement in the month of July in the Enterprise business? Thanks.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Except for the comments that I've made with respect to the sell-out in the second half of July, we don't have a significant linearity difference. What we would probably say is that the entire quarter was fairly weak.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Okay. Thank you, Katy. Next question, please.

Operator

Keith Bachman of Bank of Montreal.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes I was hoping you could talk a little bit about what you think the revenue trends would be in the division. You've talked about IPG and the PC division, but if you could just talk a little bit more about HP in total relative to normal seasonality in October, and specifically with the Enterprise systems and Software division as well in that overall context, please?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So I think when you think about -- I'll talk broadly about the Q4 guidance if you don't mind -- several key considerations that drive the Q4 guidance are really related to revenue and in fact at some level for me it begins and ends with revenue.

Keith Bachman - *BMO Capital Markets - Analyst*

Yes, sorry, Cathie, I was referring to revenue.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Yes, I know. The macro was softer than what we had expected in Q3. And we don't expect that to get better in Q4, so that's going to drive year-over-year revenue declines in Q4. We also expect to see well below normal seasonality when you go from Q3 to Q4 in revenue and that's driven by macro, it's driven by a very competitive pricing environment. But it's also due to HP's specific issues which range from the Oracle Itanium situation, our challenge in getting our Software license growth where it needs to be as well as choices that we're making when you think about focusing on services that have better margin and are more strategic for us. And then also one of the things that Meg mentioned, which I think is important, is that the realignment of our sales force, while in the short term is creating some revenue challenges, has a great long-term payback. So that's kind of part of what's going on with revenue.

Then we've just talked about the fact that channel inventory is also a bit of a headwind from Q3 to Q4 as well because it's out of sync with the underlying demand. So the way I think about it and the reason why I think revenue's the beginning and the end because we are maniacally focused on cost reduction. And we are going to get the benefits from the restructuring charge that we've announced, and we're well on our way. The top line headwinds are limiting our ability to expand operating margins.

Keith Bachman - *BMO Capital Markets - Analyst*

Cathie, is there any quantification you could provide to the sequential revenue trends on the consolidated basis, will in fact it be up sequentially from the July numbers or any kind of quantification?

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So the normal seasonality is that it would grow from Q3 to Q4 and we expect it will grow, it's just going to grow well behind normal seasonal trends.

Keith Bachman - *BMO Capital Markets - Analyst*

Okay. Thanks very much.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Thanks a lot, Keith. Next question, please.

Operator

Aaron Rakers of Stifel Nicolaus.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Yes, thanks for taking the question. Questions on the Services or server side of the business particularly in the X86 server side. You talked about broad-based weakness there. You also kind of hinted at faster Gen 8 cycle. Maybe you could give us some insight into what you're seeing competitively and also from a demand perspective? And any color on where we stand with regard to the Gen 8 product cycle, I believe your closest competitors talked about 50% of their business now being on the latest platforms.

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, let me take that, it's Meg. So our Industry Standard Servers business, I tell you where we have made the most progress is actually in Hyperscale and we are improving that business and we have some real business model innovation that's absolutely required to compete in that business. We're working on our cost structure. We've got modular shared architecture. And I think we're getting a lot better at this business and I think we can win in this business and win profitably. Right now, that is dilutive. The Hyperscale business is dilutive to our overall ISF margins and we need to move that up a bit over time. It will also be a slightly lower margin but we can do better.

I will say we are seeing still some weakness in main stream ISS. And we've got an action plan in place around our sales efforts, around our R&D efforts to make sure that we don't continue to lose ground in that business. It's a very important business for HP and deeply focused on sort of changing the trajectory of that business.

Aaron Rakers - *Stifel Nicolaus - Analyst*

And can I follow up, how much is Hyperscale of that business today? Is it fairly small, or any color there would be helpful.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

It's -- I don't know what your definition of small is but I would say it's relatively small but growing rapidly.

Meg Whitman - *Hewlett-Packard Co - CEO*

And it's where all the growth in the market is. The mainstream server business is probably declining in low-single digits. The blade business is still growing reasonably well, but the real growth in the business is in Hyperscale and we're making a concerted effort there with I think quite good results thus far.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Thank you.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Thanks, Aaron. Next question, please.

Operator

Brian Alexander of Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

Thanks. Cathie, should we think about the $8 billion goodwill writedown in Services as a reflection of past deterioration in profitability or is that perhaps a precursor of future profit erosion? I wasn't clear based on your comments. And if you could update us on the 10% to 12% margin target in Services and if that's still applicable going forward? Thanks.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Okay let's start with the 10% to 12% margin, that is what we are reconfirming for fiscal '12. And then in terms of the impairment of the Services segment, you really have to look at the fact that there's a number of different factors that drive that. Things like the trading value of HP stock plays a role as well as the market conditions and the business trends within the Services segment. Our view is that the goodwill impairment charge doesn't result in any, I'm sorry, can't talk, future cash expenditures or otherwise affect the ongoing business or financial performance of the Services segment.

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, let me add a point of view on Enterprise Services. I think I've said from the very beginning of my tenure at HP that this was a business that was in need of a turnaround. And after watching and working closely with the group over the first nine months, I decided that we were not making progress fast enough in terms of the turnaround and so decided to make a leadership change. But here's the things that we need to do to fundamentally get this business on a better track. First is we've got to change the accountability model. Somewhere along the line, the account basis of accountability with the account leader got diffused across the organization. And in the end the person who leads these accounts needs to be in charge, have control of revenue and control of the costs.

We then need to shift the business mix from some of the low end services that frankly EDS was founded on to where we want to be which is profitable ITO, the strategic Enterprise Services in Cloud, in Security, in Information Optimization and over time that will shift the margins in the place that we want to be and will frankly add a lot more value to our customers, which will in turn allow us to sell in more hardware and other products into those very important top 200 accounts that account for a big chunk of that revenue. So we're on a journey here. I feel more confident today about the path forward in that business than I have any time in the last 12 months, but make no mistake about it, we got a little ways to go here.

Brian Alexander - *Raymond James & Associates - Analyst*

Just a quick follow up on the accelerated headcount for Q4, Cathie. I came up with about a $0.03 benefit to EPS, I just wanted to confirm that. Thanks.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

So we haven't quantified that benefit. I think the best way to think about it is obviously it's included in our guidance and that some of the benefit that we're getting from the restructuring activities is in fact going to counteract the top line headwinds we're seeing.

Brian Alexander - *Raymond James & Associates - Analyst*

All right, thank you very much.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Great, thanks. Next question, please.

Operator

Mark Moskowitz from JPMorgan.

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

Yes, thank you. Meg, I want to get a sense here as we all talk about or think about growth and some of the challenges, both macro and structural and Company-specific, as we think about rolling forward to 2013 with the pace of reinvestment in terms of taking HP where you want to be, will that require EPS to actually maybe decline year over year in 2013 because of these reinvestments?

Meg Whitman - *Hewlett-Packard Co - CEO*

So we will give our fiscal year '13 guidance at our Security Analyst Meeting in the first part of October, and so we'll be quite precise at that point. Let me just sort of elevate all the way back up here and just try to give you some perspective on the situation that I see at HP now having been here nearly a year. So first is we are facing some macroeconomic trends, Western Europe, the United States, China and the consumer broadly. From an industry perspective, we've got changes where tablets is a growing part of the consumer device business. We've got some challenges around consumer printing and we've got pricing pressure across the board, which means we need to adjust our cost structure to be able to compete. Sometimes folks say to me, well, I'm sure the competitor's losing money. Well actually they aren't, and we need to make sure that we have a cost structure that allows us to be successful in all parts of the world in all of our businesses.

And then we've got some execution challenges. And HP had some very serious challenges and headwinds when I first got here and we've made progress on many things, but there are still some very serious execution issues in this business. And whether that is improving sales and delivery in ES, whether that is getting the pipeline conversion to where it needs to be in Software, whether that is our ability to compete successfully in

Hyperscale, whether that is fixing the weak supplies demand in IPG. I will say a minute about IPG. I think we set up a very crisp strategy after I'd been here about three or four months. By the way, I think that's part of the reason you're seeing some improvement in that business. But as the category leader, we are the acknowledged category leader here and we've got some weakened competitors and we need to go after them. And we also need, as the category leader, we need to grow the relevance of Printing which you've seen us begin to do in some of the advertising that we've done and explain the difference between our ink and reman ink and our toner and reman toner.

And then lastly sales in my view is not where it should be. I think we've done the right things in reorganizing sales management, I'm excited about that. But we've got to improve our aggressiveness. We've got to improve our go-to-market. And we've just got to get a lot more aggressive and with a much more shall I say focused accountability model that we enforce on a day-to-day basis. So when we look at 2013, we're going to tumble all of the pluses and the minuses. We're going to put in the investments that we think are required and yet we have to have a cost structure that allows us to win in the marketplace. So we'll have a crisp view of that by 2013. Let me say there's puts and takes.

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

Thank you.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Great, thanks for the question. Next question, please.

Operator

Maynard Um from Wells Fargo.

Maynard Um - *UBS - Analyst*

Hi, thanks. Meg, you talk about the tectonic plate shifts that are happening in the industry, but at the same time you're obviously navigating some challenging HP specific issues. Can you just talk about whether you think you can really focus on the longer term while you still have a lot of work to do over the near term? And then relative to your competitors, do you feel like they're any further along than HP at this point? Thanks.

Meg Whitman - *Hewlett-Packard Co - CEO*

So that's what we have to do is we have to focus on the short term and we have to focus on the long term, because if we don't focus on the long term we will constantly be behind. But if we don't fix our short-term operations, we won't have the money to invest in the long term, so we have to do both and it's a balancing act. I will say one of the things we are doing is we are looking through all the different things that we do at HP and the portfolio is vast. I don't know if you had a chance to come to HP Discover and see everything that HP did. But we are looking through all our different portfolios and saying do we need to be doing this R&D? Do we need to be focused on this many products in this many segments of the market across 166 countries? Because my deeply held belief is focus, focus, focus, is going to be an important thing for us.

So we are committed to the major businesses that we are in 100%. But behind the curtain there's lots of smaller initiatives that I think we can take those resources and get more bang for the buck by really investing behind some of our best growth opportunities. So that's part of the way we're going to solve our near-term problems and at the same time free up the capacity to invest in the long term, along with of course or restructuring program. So it's complicated, there's no question about it. But I feel like we're much farther along on that journey than we were say 9 or 10 months ago.

Maynard Um - *UBS - Analyst*

If I could just follow up, does that imply then that some of the-- that we could see some smaller divestitures from HP and not necessarily large ones that people have talked about in the past but some of the sort of non-core assets?

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, they wouldn't be big divestitures by any stretch of the imagination but we have lots of little initiatives buried throughout this Company. Some of them we may just shut down if they're organic R&D. Some of them there may be a saleable asset there. But these are not big dollar items, they're just going to let us focus and let us put the resources where we're going to get the best returns.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

And I think the way to think about it is that we're stepping that up because we have had small divestitures kind of off and on over the last number of years. This is just much more focused attention, to Meg's point, we need to focus more, not less.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Great, thank you. Next question, please.

Operator

Kulbinder Garcha of Credit Suisse.

Kulbinder Gacsha - *Credit Suisse - Analyst*

Thank you for the question. I have a question for I guess Cathie on free cash flow. It looks, Cathie, like this year HP will probably do maybe $5 billion of free cash flow which is meaningfully down year on year, so can you just remind us what the exceptional let's say one time cash items may have been this year? Because I'm just thinking if this is the rate of cash flow that HP can generate, if you were to repair your balance sheet and really start meaningfully giving cash back to shareholders, accelerate it, it may two more years from where we are now. Many thanks.

Cathie Lesjak - *Hewlett-Packard Co - CFO*

Sure. So first off, I think that a high point for this quarter is the cash flow that we generated. We generated $2.8 billion of cash flow, free cash flow, $2.1 billion. We were able to improve our net debt position at the Company level by more than $1.5 billion this quarter at the same time that we reduced the shares outstanding by roughly 17 million shares, and we increased our dividend 10%, so we paid dividends of $260 million. So I do think that we're making progress there. If you look at what the meaningful headwinds were to cash flow for this year compared to last year, earnings has to be number one.

We have also had cash conversion cycles. I'll also tell you I think it was a positive point in this quarter around our cash conversion cycle. Last quarter I told you that we needed to pay attention to it and really focus on it. We weren't happy with the results and quarter on quarter we improved a day. We've got more work to do. It'll take us into -- through Q4 and into '13 to get back to historical levels. But we're deeply focused on the cash conversion cycle as well.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Great. Thanks for the question, Kulbinder. Then we have time for one final question, please.

Operator

Shannon Cross of Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thank you very much. Can you talk a bit about what you're seeing in China? We heard pretty negative commentary out of Dell yesterday. Clearly you had some pressure in the region as well, but not just for PCs but also within printers, and then any other services and products that you provide into that market, and also from a vertical standpoint because it sounds like public may be slowing there. I don't know, just any color you can give would be very helpful.

Meg Whitman - *Hewlett-Packard Co - CEO*

Yes, sure. Well let me elevate to the BRIC countries because actually Russia and India were good performers for us. Brazil was sort of medium to mixed and China was not as strong as we would have liked. And there's challenges across the board there. We are rebuilding from as you will recall a whole series of incidents that hurt HP disproportionately to our competitors there. So we are building, rebuilding first our leadership in China. We have almost an entirely new team across the board in China and I'm very confident in their abilities. I like them very much, they know what's going on, they're experienced hands.

Second, we are building -- rebuilding the channel in China for both PCs as well as Printers. This is actually one of the benefits of putting these two business together, because as we build the channel in China there's a lot more to offer a channel partner. And then we are also rebuilding the channel with ESSN, our Server, Storage and Networking. A bright spot of course is our Networking business in China where we have a very significant market share that did very well during the quarter.

But we see economic slowdown in China. The reported growth rates many people say gee, I'm not sure that the reported growth rates are actually what we're seeing on the ground and I would agree with that. And at the same time, I think we can improve our execution in China. And you've got a regime change that will happen there as well and I think there's a bit of what I've seen in the business community there is let's wait and see and see what happens there and what is the public sector spending going to look like. What is the Chinese stimulus program going to look like, which will drive public sector sales.

Rob Binns - *Hewlett-Packard Co - VP- IR*

Okay, great. Thanks for that question, Shannon. And with that, ladies and gentlemen, I think we can conclude the call for today. Thank you very much.

Meg Whitman - *Hewlett-Packard Co - CEO*

Thank you very much.

Operator

Thank you for participating in the third-quarter 2012 Hewlett-Packard earnings conference call. This concludes today's conference. You may now disconnect.