

FINAL TRANSCRIPT

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HPQ - Q1 2010 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the [first quarter 2010] (corrected by company after the call) Hewlett-Packard earnings conference call. My name is Kiana and I will be your conference moderator for today. (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. Jim Burns, Vice President of Investor Relations.



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Jim Burns - *Hewlett-Packard - VP IR*

Thank you. Good afternoon, welcome to our first-quarter earnings conference call with Chairman and CEO, Mark Hurd, and CFO, Cathie Lesjak. This call is being webcast and a replay of the webcast will be available shortly after the call for approximately one year.

Some information provided during this call may include forward-looking statements that are based on certain assumptions and are subject to a number of risks and uncertainties, and actual future results may vary materially. Please refer to the risks described in HP's SEC reports, including our most recent Form 10-K.

The financial information discussed in connection with this call, including tax related items, reflect estimates based on information available at this time, and could differ materially from the amounts ultimately reported in HP's first-quarter Form 10-Q.

Earnings, operating margins and similar items at the Company level are sometimes expressed on a non-GAAP basis, and have been adjusted to exclude certain items, including amortization of purchased intangibles, restructuring charges and acquisition related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables in the slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations webpage at HP.com.

With that, I will now turn the call over to Mark.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

Thanks, Jim. Good afternoon. Thank you for joining us. In the first quarter Hewlett-Packard achieved solid growth, gained marketshare in key markets, and delivered good operating leverage. Year-over-year HP grew revenue by 8% or 5% in constant currency, adding more than \$2 billion to the topline.

We expanded the non-GAAP operating margins for the 19th quarter in a row. We generated \$2.4 billion of cash flow from operations, and repurchased \$2.7 billion of stock this quarter.

We also executed on our cost initiatives and reinvested in the business. The net result of these efforts, a non-GAAP EPS of \$1.10.

In 2009, despite the recession, digital content continued to grow at an explosive rate. And in HP we continued to innovate. We delivered new high-performing products with compelling value for customers. In Q1, as the server, PC and printer markets returned to growth, HP was positioned to capitalize and gain share in each of these markets.

ESS grew 11% this quarter, fueled by 27% growth in Industry Standard Servers. Our G6 servers give customers a short payback period, and are being adopted more quickly than any previous generation. Yet still only a fraction of the installed base has been upgraded. Average selling prices continued to move up, and we delivered over 30% operating leverage in this segment.

PSG grew 20% over the prior year. Our innovative lineup of notebooks and TouchSmart PCs continued to push our share gains and ASPs higher, as customers vote with their wallet. The US PC market grew more than 20% in the recent quarter, and we gained roughly 4 points of share in this market, with expected gains in both consumer and commercial.

In IPG, consumer and commercial printer shipments grew 18% and 11%, respectively this quarter. The printing market is improving, and IPG is on the attack, focused on aggressively placing units with high page consumption. In Q1, wireless printers roughly doubled, and ink in the office products roughly tripled. Supplies revenue was up 4% in local currency over the previous year, and 1% as reported. We expect supplies growth this year of low-to-mid single digits, despite currency headwinds.



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We continue to execute our strategy in management services, retail publishing and Digital Press. These businesses are strategic to us, given their growth profile, and very high attach rates of supplies.

We saw continued stability in our services business, which was down a modest 1% from last year. The EDS integration remains ahead of plan. We have a large funnel and had key signings in the quarter. Services operating profits grew 21% over the previous year.

Our software business, which was flat from the previous year, had healthy margin expansion of over 3 points from the prior-year period. Financing grew 13% and delivered double-digit return on equity.

Before I turn the call over to Cathie to review the financials, let me make just a few comments about the three areas where we are devoting a lot of effort. First, our portfolio. I believe HP has the best and the broadest portfolio in the industry. We are number one or number two in virtually every category where we compete. We will continue to invest heavily to ensure that we maintain our technology advantage and align our portfolio to lead the evolution in the marketplace.

The next-generation data center will be delivered by the Company that can best leverage scale, industry standard hardware that is differentiated into software, and financed and delivered via global services. Printer pages will be awarded to the company that can deliver the best quality, usability, speed and affordability. The PC business will be won by the company with scale, innovation, brand and global reach.

As I consider the market trends and survey the competitive marketplace, I like HP's chances to win. Second, our market coverage. We address a \$1.3 trillion IT market. The enterprise market represents roughly half of that. Even though HP's salesforce is roughly 50% larger than when I joined the Company, we want to increase that number.

We also have work to do to address the small and medium business customers, both domestically and abroad, particularly in emerging markets. We are hiring now and will continue to invest in direct sales and channel partners to better reach these customers.

Third, our cost initiatives. We have made substantial progress in [meeting] our cost structure and improving productivity, with revenue per employee up double digits over the previous year. But there is still enormous opportunities in areas such as supply chain, overhead and service and support. We remain focused on rooting out these costs, and will reinvest a portion of these savings to further increase our competitiveness and to build for the future.

While I am proud of what we have achieved, I am convinced that HP's best days lie ahead. With that, I will turn the call over to Cathie.

Cathie Lesjak - Hewlett-Packard - CFO

Thanks, Mark, and good afternoon everyone. HP delivered strong performance in the first quarter. We increased revenue, expanded margins, strengthened our balance sheet, and generated \$1.7 billion in free cash flow. At the same time, we executed on our efficiency initiatives and invested for growth.

Our results demonstrate the strength of our operating model, both the operating leverage from strong hardware growth and the resiliency of our recurring revenue. Compared with a year ago, total revenue in the first quarter was up 8%, or up 5% in constant currency, to \$31.2 billion.

On a regional basis the Americas and Asia Pacific showed strong year-on-year growth with revenue increasing 9% and 26%, respectively. In EMEA revenue increased 1% from the prior year.

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Gross margins for the quarter were 22.8%, down 60 basis points year-over-year. The decline was due to strong growth in PC and printer hardware revenue partially offset by rate improvements in services.

We continue to improve our cost structure, reducing non-GAAP operating expenses as a percent of revenue by 1 point year-over-year to 11.6% of revenue. The structural changes that yield these lower costs drive sustainable improvements and enable us to reinvest back into the business to fund innovation and expand our sales coverage.

Non-GAAP operating profit increased 13% year-on-year to \$3.5 billion, with operating margin expansion of 40 basis points. Non-GAAP net income increased almost \$400 million to \$2.7 billion, or \$1.10 per share.

Looking at the details of our performance by business. During the first quarter revenue in the Imaging and Printing business grew 4% to \$6.2 billion. Supplies revenue grew 1% in dollars and 4% in local currency and we saw the convergence of sell-in and sell-out on a constant currency basis.

Consumer hardware revenue increased 21% and commercial hardware revenue grew 4% compared with the prior year quarter. Segment operating profit totaled \$1.1 billion or 17% of revenue while driving double-digit hardware unit growth.

Total printer unit shipments grew 16%, the largest increase in three years, with consumer and commercial printer units growing 18% and 11%, respectively.

We are reinvigorating the core business. The strong growth in our wireless and OfficeJet products shows that customers value innovation. In addition to placing more units, we are driving growth in long-term, high-value annuity businesses such as managed print services and digital press, which experienced double-digit growth this quarter.

Operationally IPG has made great progress in the last year, and is well-positioned to grow share in 2010. We will continue to invest for growth and profitability through our commitment to innovation, targeted share gains, and a focus on high usage categories and high-value annuity businesses.

At the same time, we are focused on improving efficiency through initiatives to streamline our supply chain and lower product costs. These improvements create capacity to invest in unit placement while maintaining industry-leading profitability.

While laser printer availability will be constrained through the second quarter, we do expect to achieve double-digit unit growth for the full fiscal year in both ink and laser hardware.

Services delivered revenue of \$8.7 billion, down 1% from the prior year. Within services, the IT outsourcing business grew 2%; Application Services declined 8%, BPO declined 3%, and Technology Services declined 2%. We have a solid funnel of deals and continue to deliver strong customer satisfaction.

The EDS integration is going well, and this has significantly enhanced our competitive position.

Segment operating profit in the quarter increased \$240 million year-over-year to \$1.4 billion, or 15.8% of revenue driven by synergies from the EDS acquisition. We remain focused on driving operational improvements in the business via efficiency initiatives, process standardization, and automation.

Enterprise Storage and Server revenue was \$4.4 billion, up 11% compared with the prior year and up 4% sequentially, well ahead of normal seasonality. The ESS results were driven by strong performance in ISS, which increased its revenue by 27% from the prior year. The strength in ISS was partially offset by Storage and BusinessCritical Systems, which experienced year-on-year declines of 3% and 22%, respectively.



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The latest generation ISS platform continues to deliver a compelling value proposition for customers with over three-fourths of server shipment volume now coming from G6.

Blades also delivered strong revenue growth, increasing 24% from the prior year and revenue for our innovative virtual connect product grew more 100% this quarter.

With improved performance in the business we are seeing positive operating leverage in the ESS model. This quarter the business delivered over \$500 million in operating profit and an operating margin of 12.6%, an increase of 230 basis points from the prior year.

HP Software revenue was \$878 million, flat compared with the prior year. On the bottom line, the Software business expanded its margins 310 basis points, delivering 19 points of operating margin in the first quarter.

Turning to Personal Systems. PSG revenue increased 20% from the prior year to \$10.6 billion. The US and emerging countries all delivered strong year-on-year growth, and we saw balanced growth across each of our product categories, with particular strength in consumer demand during the holidays.

Total unit shipments increased 26% year-on-year, with notebook unit growth of 37% and desktop systems growth of 13%. Average selling prices declined at a more normalized rate of 5% compared with the prior year.

Segment operating profit totaled \$530 million, or 5% of revenue, as PSG continues to deliver solid performance and share gains driven by our innovative product portfolio, scale, and global reach.

Rounding out the segment, HP Financial Services continues to deliver strong, consistent results. In the first quarter financing revenue grew 13% to \$719 million and generated operating margin of 9.3%, up 290 basis points from the prior year.

Now on to the balance sheet and cash flow. Our balance sheet remains strong, and we made solid improvements in working capital management year-over-year. We closed the quarter with total gross cash of \$13.7 billion. Our Q1 cash conversion cycle was 16 days, down 13 days from the year ago and our channel inventory is in good shape.

Compared with a year ago, we more than doubled our cash flow, generating \$2.4 billion in cash flow from operations and \$1.7 billion in free cash flow during Q1. We continue to actively repurchase shares, returning \$2.9 billion to shareholders through share repurchases and our quarterly dividend.

And now a few comments on our outlook. For the second fiscal quarter we expect revenue to be approximately \$29.4 billion to \$29.7 billion, and our non-GAAP earnings per share in the range of \$1.03 to \$1.05. Included in these estimates for Q2 is approximately \$0.04 of OI&E expense, a tax rate of approximately 22%, and an expectation for a modest decline in weighted average shares outstanding.

Turning to the full fiscal year. We are raising our revenue and earnings outlook. We now anticipate revenue of approximately \$121.5 billion to \$122.5 billion, representing roughly 6% to 7% growth, up from our prior outlook of 3% to 4% revenue growth. Non-GAAP earnings per share is now expected to be in the range of \$4.37 to \$4.44, representing an increase of 14% to 15% over the prior year.

In summary, we are winning in the marketplace, executing on our cost initiatives, and investing for growth. With that, we will now open the call for your questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Rich Gardner.

Rich Gardner - Citigroup - Analyst

Cathie, I wanted to ask you about component constraints and whether they had a material impact on the topline in the quarter. And then could you also comment on whether the working capital gains that you saw in the quarter are sustainable, or was there some one-time benefit there as a result of supply constraints or other nonrecurring issues in the quarter? Thank you.

Cathie Lesjak - Hewlett-Packard - CFO

In terms of the working capital improvement, the 16 days in the cash conversion cycle is sustainable. We didn't have anything from a sequential perspective that was particularly different from normal seasonality. The year-on-year on improvement of course is off of Q1, which was obviously a high point last year.

In terms of the commodities environment, we definitely saw tightness and pricing pressure in commodities, particularly in memory. To be frank, we expected that. I think we called that out actually in our Q3 -- sorry, Q4 earnings call. We were able to increase some prices to adjust for that, and you did see ASPs -- sequential ASP improvement in PCs, as an example, and also in Industry Standard Servers.

In terms of commodities going forward, we expect it to continue to have upward pressure. But I will remind you that in tight supply environments we actually tend to do pretty well. In fact, we gain more share in these types of environments, simply because we have got a real competency around managing our supplies. We've got great relationships with suppliers and we've got the scale that matters. So we anticipate the uptick for the rest of the year, but we are well able to manage it.

Operator

Ben Reitzes, Barclays Capital.

Ben Reitzes - Barclays Capital - Analyst

Can you guys comment a little more about what is going on with printers, 16% growth? Can you talk about how much the constraints are impacting the laser printer segment, and talk about what is going on as we go throughout the year with printer growth. Is this actually, at least on a -- is this the actual low point for the year in terms of printers in terms of the progression?

Mark Hurd - Hewlett-Packard - Chairman, CEO

It is Mark. Listen, we worked real hard on IPG in 2009. And in a strange way I think 2009 was a blessing for us. It really got us operationally focused. And obviously as you see by the unit growth, probably our best unit growth number in a long time.

To be blunt, I wish we had more stuff. We could have placed more lasers. We could have placed more ink units in the quarter. We did our best to handle the demand that we saw. Demand was linear, and was good across the quarter.

I would tell you that supplies, as you have seen, a sellout basis. Now this is local currency. Make sure I am clear, Ben. Local currency sellout was also the best number we have seen in a long time. So we got to mid single digits there.

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It is a bit complicated, because you have the local currency 4% growth, and then because of our hedging you get to a 1% reported growth. It is important to note, and what we have said today, we're actually raising that 1% in dollars -- in reported dollars higher, even with that currency headwind. So the unit placements are part of that. And, frankly, the fact that we were able to deliver at the high end of our profit range in the context of being able to deliver this [sum] of 16% unit growth is something that very bluntly two years ago we couldn't have done.

I think it shows the kind of strategic work we have done to get the segment in the position we have had. We had tremendous demand in the wireless segment. The wireless segment roughly doubled. And I think importantly with some of the laser issues that you have heard, our OfficeJet business tripled. So our ability to put ink into the office has been a really pleasant thing for us overall.

So when you look at the whole market, the supply sellout on a local currency basis, you look at the demand on the printing units, you look at our ability to perform relative to -- from an operating profit perspective relative to all that, we feel IPG is in strong shape.

Ben Reitzes - *Barclays Capital - Analyst*

When did the --?

Cathie Lesjak - *Hewlett-Packard - CFO*

Just real quickly, let me address kind of the year in terms of unit prices. We do expect that for the full year both ink and laser will grow double digits. Q2 will be a bit tougher. We still have constraints in the laser space. But for the full year we do expect double-digit for both ink and laser.

Ben Reitzes - *Barclays Capital - Analyst*

And the constraints alleviate in the back half?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

They do. They do. But, listen, I've got to tell you, we've got work to do, because the demand is high. And we have just -- as we have improved our availability, demand has improved with the availability. So I'm cautious to answer the question the way you asked it. Let me say it the way I would say it. We will have more availability in the back half of the year.

So we are clearly ramping up in both segments. While I would add -- while you're on IPG, I would add to it, we also had a very good signings quarter in managed print services. It was a very strong quarter, yet again, for us in that segment. We began the retail photo kiosk rollout at one of the very, very large retailers on the planet. So we got a very good start now on retail photo kiosk. Because as you know, getting the graphics, retail photo kiosk in MPS segments, which are high annuity, supply connect kind of businesses, are very strategic to us. They don't yet have as big an impact from revenue perspective as they will in the future, but they are very strategic to us.

Ben Reitzes - *Barclays Capital - Analyst*

All right. Thanks for all the detail.



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Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James - Analyst*

I guess to follow-up on that, a clarification, are you actually expecting an acceleration in supplies growth in local currency, or is the dollar growth improvement you are expecting in supplies a function of a more muted currency headwind going forward?

Cathie Lesjak - *Hewlett-Packard - CFO*

No, we expect an acceleration both in local currency and in dollars. So in dollars we are calling for kind of low to mid single digits this year. And the currency headwind that we have seen year-on-year, this quarter pretty much continues the rest of the year.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

It is a literal improvement. I know it is against your better instincts, but if you wouldn't run away from my guidance, I would appreciate it. But it is a literal improvement in terms of the actual -- and to your point, I think well said -- the sellout on a local currency basis we think improves.

Brian Alexander - *Raymond James - Analyst*

Then the question I have on ESS, the leverage enormous, 33% contribution margin despite all the growth coming from ISS, which I presumed has less leverage than BCS or Storage. What are the key drivers drivers of that leverage? Is it mostly driven by the higher ASPs you're getting on the G6 servers? And given your comments that we are early innings on that upgrade cycle, do you expect that kind of leverage to continue?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

Yes, I think you said it. It is both a growth issue and it is an ASP issue. So by the time we get the growth and our ability to scale, and leverage the cost that we have in the business, as well as the fact that ASPs went up -- we haven't seen the kind of ASPs that we had in Industry Standard Servers in a long time. In fact, I can't remember when I have seen the ASP (multiple speakers).

Cathie Lesjak - *Hewlett-Packard - CFO*

They were up both year-over-year as well as sequentially.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

Which is good news. So I think it actually has a very more strategic question that we are dealing with is that more and more of customers' strategic jobs and strategic apps are going under these kind of architectures. So we find that our ability to now compete for a different type of application is important, and that has an impact on ASPs.

Operator

Kathryn Huberty, Morgan Stanley.



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Kathryn Huberty - Morgan Stanley - Analyst

Good afternoon and congrats on the quarter. As it relates to revenue growth, much of it came from the transactional hardware businesses in the quarter. There were obviously a number of catalysts through December. Can you talk about whether that demand strength continued into the month of January, and whether you saw anything different between the commercial and consumer segments in the month of January?

Mark Hurd - Hewlett-Packard - Chairman, CEO

Just to make sure [I am] specific the way you asked the question, demand was linear across the months of the quarter. So now that doesn't say our supply was always linear, just to be clear on that. Because of some of the questions that got asked earlier on a laser printer or something like that, but demand was linear across the quarter.

Kathryn Huberty - Morgan Stanley - Analyst

It sounds like you did not catch up with supply fully by the end of January.

Mark Hurd - Hewlett-Packard - Chairman, CEO

I guess the way I would say it is we exited the quarter in a position we like from an inventory perspective in the channel. Demand was linear, and we did our best to catch up everywhere that we could. We did a little better in some segments than others. I'd probably leave it at that.

Kathryn Huberty - Morgan Stanley - Analyst

Then just lastly, when would you expect the later cycle businesses, like services, to return to growth?

Cathie Lesjak - Hewlett-Packard - CFO

We are actually -- in terms of the funnel that we are seeing, we are starting to see more activity in the software and the services space. And so we are continuing momentum that we saw in Q4. But it is -- it does come a bit later in the cycle than the hardware uptick. (multiple speakers).

Mark Hurd - Hewlett-Packard - Chairman, CEO

Katy, I would say to you overall, to Cathie's point, if the market is better, we will do better. Our view is right now the market is better. But at the same time we think we are giving prudent guidance, given what we are seeing. And in services we are sort of predicting more of what we saw in Q1 at this point.

Kathryn Huberty - Morgan Stanley - Analyst

Okay, that's clear.

Operator

Toni Sacconaghi, Sanford Bernstein.

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Toni Sacconaghi - *Sanford Bernstein - Analyst*

Mark, you commented on the need to invest heavily going forward. I think if you just looked at R&D dollars, it looks like you're actually going to spend less on R&D in 2010 than HP did in 2000. HP's revenues were less than \$50 billion in 2000 and will be more than \$120 billion today. So how do we think about that? Is that just that you have a lot of wasteful R&D spending before or your portfolio is really different, or how do we reconcile those statements? And more importantly, what is the right level of R&D for this Company going forward, and how do you think about that?

Cathie Lesjak - *Hewlett-Packard - CFO*

So in terms of our R&D investments, one of the things you've got to look at is there are inputs and outputs. And the outputs in R&D really are helping to give -- win in the marketplace. The innovation that we see, whether that is around the G6 blades, the Slate products that we announced, the Web-connected printer, kind of on and on. We've got good new products coming out that are helping us win in the market. And our market share gains, frankly, prove that.

But then that there are also the inputs into R&D. You want to make sure that you are investing in the most efficient way that you can. What we have found is that there are real opportunities to think about R&D as a series of processes and make sure that we are doing those processes in an efficient way.

For example, if you think about labs, if you've got a bunch of little ones all over the world with a bunch of equipment in them, and you've got -- you've basically got depreciation expenses in, that is one kind of flow. If you go to a more virtualized environment, that is going to be much more efficient flow. It didn't change the amount of innovation that the R&D engineers are doing. It just simply changed the process and the dollars associated with that process. So you've got those types of savings that you get in R&D.

And then you also -- R&D gets allocated both real estate and IT expenses. And as those have come down at the total Company level, obviously, R&D benefits from that. The key here is that we've got good roadmaps going forward. We continue to put in the right level of investment into the innovation in [D] spend.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

So Toni, Cathie gave you a lot of data there, and the key to it is our overhead is down, and that shows up in R&D. R&D was one of the bigger consumers of overhead in the Company. That is one point.

Second point, we are in a mode to look for processes that we can standardize. Simple things like testing, QA, how many development tools we've got. All of these have been, because of acquisitions, very random and very unique. And very, if you will, siloed.

So our ability to get standardized on those processes give us an opportunity to take out cost. The way we look at R&D is we don't look - to Cathie's point, we look at R&D in the context of overhead, maintenance and innovation. What we are trying to do is get the innovation dollars up. So when you look at the total R&D spend it is down, and yet be held to the product roadmap is up.

So when you look at the number of introductions of products that have had meaningful change in share positions, that number is actually up for us. That is what we want to measure. We want to get more innovative products into the market sooner.

So I think the way you should think about it -- it is just like somebody asking me if more field selling cost means more sales people, and the answer is no. Because you have to break down all of the cost that sit in the R&D bucket or the field selling cost



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bucket. We have had times in the Company, historically, where field selling cost goes up, but sales headcount doesn't. And you have to peel back these numbers to understand.

So I give you a long answer to just simply say, we feel good about our opportunity in R&D to get innovative, exciting products to the market, like what we have seen this year that have gained share.

As we talked about salespeople, we have a lot of opportunity to get our great portfolio in front of more customers, and that is why it is important to us. You may actually see parts of field selling cost go down. At the same time sales headcount go up. And it is the same phenomena of us making sure we are as effective as we can be, and we have our money in the right place.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

If I could just follow up on a separate topic. You had entered the year talking about market IT spending being zero, or 2%, and said, we feel very confident about our share position. And if the market does better, we will do better. Clearly you are taking up guidance here. Are you ready to declare that the market might be a bit better?

Clearly it sounds like it might be a bit of both in terms of the market and your performance. But can you comment on that and how you're thinking about overall IT spending, and how HP is performing relative to your expectations a quarter ago?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

I think, Toni, that we are probably not going to declare as definitive the point as you'd like. I think that our view in the quarter was that we saw an improving Asia. We saw an improving US again. We saw a mixed story in Europe. I could tell you stories in Europe that were a little better in terms of markets, and markets that actually showed some rebound, and some that looked stagnant to us.

So I think for us to really look at the world as having a robust IT environment, whatever that might be, we would like to see Europe on a little more broad-based trajectory than what we have seen today.

What we do feel committed to, Toni, it is that whatever that market does hand us, we will do better. We feel very confident in our position, confident in our R&D lineup, confident in our acquisitions that we have made. We do have opportunities for more salespeople in the Company, that whatever that market hands us, we think we are going to be pretty well-positioned to take advantage of it.

Probably right now we are going to want to see the whole quarter of Q1 close calendar-wise, get all that data, before we make a call on true IT growth for the year.

Jim Burns - *Hewlett-Packard - VP IR*

Thanks, Toni. Let's move on. Next question please.

Operator

Bill Shope, Credit Suisse.

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Bill Shope - *Credit Suisse - Analyst*

Looking at the PC segment, the PC upside in particular, you noted that you saw particular strength in the consumer market, which I think is in line with what most of us saw within the industry. But can you give us a little more detail on what you're seeing in the commercial segment? There has been lots of talk, obviously, of a refresh cycle this year. Are you seeing any evidence that corporations, and even smaller businesses, are starting to upgrade their PCs? And if you're not actually seeing the orders come in, are you starting to see RFPs or the pipeline building there?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

I think that is a fair way to describe it. I think we saw a pretty strong consumer. We expect that to continue a bit through the first part of the year. We do think there will be a corporate refresh in the back half of the year. We are beginning to see momentum around RFPs, to your point.

Again, the only thing we -- I mentioned earlier in my prepared comments that we still want to delineate between market improvement and share gains. We have had some share gains that have been impressive. Though I think you know I don't always feel as good about those as some might think I would, because we actually have to want to see a market strengthening as well as we want to execute into it.

So I think we will still be a little bit cautious on it. But I do think you're right. We think that there is a corporate refresh coming in the back half of the year.

Operator

David Bailey, Goldman Sachs.

David Bailey - *Goldman Sachs - Analyst*

I was wondering if you could just give us a little bit more detail on the sequential increase that you saw in internal inventory this quarter? And are there some strategic buys in there?

Cathie Lesjak - *Hewlett-Packard - CFO*

So we feel pretty good about our inventory position, frankly. We have improved it both year-on-year, and it is roughly up a tiny bit sequentially, but normal seasonality. We do have strategic buys in there, but we have strategic -- frankly, we have strategic buys every quarter. They are up a bit year -- I'm sorry, quarter-on-quarter, but it is not really something that I would call out significantly. It is basically playing the game the way we have been.

David Bailey - *Goldman Sachs - Analyst*

Then moving onto your storage business, it seems to be lagging some of your other ESS categories. Are there initiatives that you have under way here to jump start that business?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

We have our top guys working on it. So I think for us, we think again there is going to be a pretty strong convergence in the server and storage market. We think there is a move towards more internal storage, away from external storage, which we think strategically really benefits the position we have in the server market.

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We had a very strong quarter in the left-hand product line, very strong. So there are elements within storage that we actually feel quite good about. As I have said, we have got pretty strong push strategically on getting this lined up across the entire ESS productline, as well as within storage itself.

Cathie Lesjak - *Hewlett-Packard - CFO*

The interest in storage basically had more storage demand in the higher tiers of storage, which also plays very well to our hand, where it is more industry standard, lower cost that really, again like I said, plays to our hand.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

We think that trend is going to continue strategically. So we just need to get -- take advantage of the opportunity. But we feel good about the market direction and the position we've got. We just, frankly, have to do a better job from an execution perspective.

Cathie Lesjak - *Hewlett-Packard - CFO*

Some of the areas where we are building out coverage is in the storage space. That is one of the pieces of execution that we are working on.

Operator

Amit Daryanani, RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

I just have a question. Looking at your full-year revenue guidance, we are looking at sales to be down about 5% sequentially. Historically the trend, if I include Compaq and EDS as being flattish. Can you just talk about where you guys are seeing the delta that is making us a little bit more cautious beyond the EMEA region you have discussed?

Cathie Lesjak - *Hewlett-Packard - CFO*

So I think what you have got to do is you've got to add EDS in the mix. Once you add EDS in the mix, the local currency kind of normal seasonality declines about 1 point. Then we do have the currency headwinds. And then -- and that pretty much takes care of what is going on from a revenue guidance perspective, once you layer in the prudence around the EMEA recovery.

Amit Daryanani - *RBC Capital Markets - Analyst*

Got it, thanks.

Jim Burns - *Hewlett-Packard - VP IR*

Next question please.

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Operator

Louis Miscioscia, Collins Stewart.

Louis Miscioscia - *Collins Stewart - Analyst*

I've got two questions. Both of them are on services. I guess, Mark, last quarter you talked about strong momentum in signings, and that signings were substantially above revenue. How long does it take for that to kick in?

Then my second question hopefully doesn't confuse things here, is on British Sky Broadcasting. There was a lawsuit in the UK that was -- recently, I guess, went their way. Maybe if you could just talk a little bit about that, and if there is any other ones just lingering from the old EDS days before you all acquired them?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

Let me take the first one. Listen, I think signings, when you get them they feather in. So some of the signings we had in Q4 began in Q1. Some frankly are just getting started in Q1. Some didn't start until Q2. So you have a lag affect in how these starts occur. And, again, as you grow the services business, particularly the outsourcing deals are like a portfolio. Typically when you start they don't have much of a profitability impact. In fact, some cases they can be negative as you go through the transition costs. So it does take a little bit of time for those to kick in.

To Cathie's point earlier though, the funnel is robust. So we have a pretty strong funnel right now. And obviously we've got to convert it. But if we execute properly this could be a good year for us. We will obviously have to have a couple more quarters to tell.

And we tend to not really look at the thing on a quarter. We tend to look at the trailing 12 months, and then we look at the full-year forecast, because signings really impact over a longer period of time. But right now the funnel is encouraging. We just have to go execute and convert.

Cathie Lesjak - *Hewlett-Packard - CFO*

Lou, in terms of the BSKyB, we put out a press release when, I guess, the judge gave his first conclusions on the liability in that case. We do believe that we are appropriately accrued based on the ruling. But we still need to get to the settlement piece of the case, and there hasn't been any damages yet assessed.

You may have read there was a interim payment made to the tune of about GBP200 million that we made in Q2. And obviously if there is anything materially different than what we accrued, we would call it out to you all.

Jim Burns - *Hewlett-Packard - VP IR*

We will take the next question please, thank you.

Operator

Keith Bachman, Bank of Montreal.

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Keith Bachman - Bank of Montreal - Analyst

I wanted to ask a question about the Enterprise Storage and Server division, essentially the composition of growth. How long is the x86 cycle, Mark? How long do you think that lasts? It appears it is sustainable for 2010. Is that a double-digit kind of growth through the balance of 2010?

And on the other side of that is, when would you anticipate seeing better results in storage. It continues to -- I know, Cathie, you mentioned sales coverage, but EVA was down again, which I would have assumed to have been better. So I just wanted to get a little more color on the composition of the ESS growth, please.

Mark Hurd - Hewlett-Packard - Chairman, CEO

Let me start. I think that we do see a pretty robust server refresh cycle through the year. What quarter hits at what time, what companies do what at what point in time, I can't exactly prognosticate to you. But we expect it to be pretty robust. And that is contained in our guidance. And for what we can see in our funnels looks very attractive to us.

As I also mentioned, the payback on these G6 installations, the TCO returns on that are just extremely attractive. So even in a timeframe of tight budgets, these look like very good deals. So we see a pretty strong uptake on it. As far as we can see, at least during this year, we think it will continue.

Keith Bachman - Bank of Montreal - Analyst

Then just to follow-up on the EVA side, or storage more broadly, I guess.

Mark Hurd - Hewlett-Packard - Chairman, CEO

I think again we feel good -- if you look at our segments, you have got multiple segments. You've got the high-end of storage. You've got the midrange. And then I hate to call up the low end, but it is the lower tiers and more industry standard part of storage. And you have for us is really strong growth in the industry standard part of storage. We have very mediocre performance in the midrange that we think we can improve. And then not a lot of growth in the high-end. We think that reflects market trends as well, that you've got to get -- we've got to get more of our offering into that industry standard part of the market, and have more coverage in relationship to that part of the market.

So we feel -- listen, I mean, the good news for us is it is a big opportunity. The good news is we've got a supply chain leveraging industry standards that are extremely scaled. We believe we now have a better lineup than we have had before. And we believe we have a team that is capable of helping us build the answer. So we look at it as an opportunity, because we think the market is moving our way, and we want to take advantage of it.

Operator

Mark Moskowitz, JPMorgan.

Mark Moskowitz - JPMorgan - Analyst

A question here and a clarification. As far as the clarification, Mark, did you say that all of the server ASP improvements were related to the richer configuration of G6, or is there any impact there from benign pricing as well?

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And then as far as the question -- I was just curious in terms of the full-year revenue outlook boost, is there any sort of impact from the pull through effects that EDS contributing to the outlook yet, or is that more of an upside potential for 2011 and beyond?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

So let me try to give you simple answers. I think G6 is the primary driver. I can't tell you there isn't a bit more of a benign pricing environment out there, but I think you should look at the bulk of it being G6. I think you should look at that as upside as it relates to your second question.

Jim Burns - *Hewlett-Packard - VP IR*

We will take two more questions please.

Operator

Aaron Rakers, Stifel Nicolaus.

Aaron Rakers - *Stifel Nicolaus - Analyst*

A couple of questions real quick. First on the Imaging and Printing segment, 17% operating margin, despite what looks to be a meaningful snap back in the hardware versus supplies mix. I am just kind of curious in terms of what you guys have done internally there around the supply chain and the manufacturing processes to change that cost structure, and whether we should be thinking 17% is the right number versus the low end of your guidance of 15% to 17% going forward?

Then quickly if you can, any update on kind of a pending 3Com acquisition in terms of closure?

Cathie Lesjak - *Hewlett-Packard - CFO*

Let me start with the IPG question. So we have done a lot of work to get our cost structure in a better position in IPG. And to be frank, we are not done yet. So we have made progress. We made a lot of progress last year on the OpEx side. We are starting to get the results from the work that we did on the supply chain side coming through. And that is really -- it is a combination of those that have really enabled us to go out and put out 16% increase in units and still deliver on 17% operating profit.

That should suggest to you that we are probably going to be at the higher end of the margin range for most of the year, since we've still got more savings opportunities and we are going to continue to put double-digit units out there.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

The only caution I would give you on the right -- because I think your question is obviously a good one. We did perform at the high-end of the guidance with a very high unit growth. That said, we are gaining share in supplies, and we want to continue to do that. We believe there is more market coverage, believe it or not, in printing, that we actually can go get. And we want to continue to place units.

So I say to you, I think it is very encouraging that we could put 16% unit growth out there. Have the kind of signings in MPS that we had, etc., etc. Because remember, those MPS signings are a lot like an outsourcing deal. They have transition costs built into them, and we actually absorb those and the unit growth in the quarter and deliver the profit we did.

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That said, we see opportunities in the market now in printing that frankly we haven't seen for a while. We want to take advantage of it. So I think back to the guidance, I know there would be -- I know the math, there would be an interest in running north a little bit on these estimates. My view would be to stay with us here. Let us go take advantage of the opportunity, invest in the market, because we believe it gives us long-term more meaningful growth that brings leverage to the business, and that is what we are going to go do.

Cathie Lesjak - *Hewlett-Packard - CFO*

Actually, as we get our costs down, especially on the supply chain side, that opens up additional units that can be attractive to us that with a higher cost structure just weren't that attractive to us. So that also gives us opportunities to grow more in the unit space.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

This is a really important point that Cathie just brought up. As we bring down our supply chain costs, and bring down our average unit costs, a placement of a unit that didn't look attractive to us over the course of two years' worth of supplies connect that didn't look attractive, now looks attractive.

So it actually -- not only do you bring your supply chain costs that creates more competitive position for you in the market, it actually opens up more market for you. So this for us is just -- as we have mentioned before, very strategic to us. I think the team has done a good job, but I would be remiss if I didn't tell you, we've got a lot of work left to do.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Great. And any update on 3Com?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

Sure.

Cathie Lesjak - *Hewlett-Packard - CFO*

So from a 3Com perspective, we still expect to close in our second fiscal quarter. We have gotten regulatory approval from the US and the EU. We have still got a few more places where we are going through the regulatory process, but do expect it to close in our fiscal Q2.

Jim Burns - *Hewlett-Packard - VP IR*

Let's take our last question please.

Operator

Shannon Cross, Cross Research.



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Shannon Cross - *Cross Research - Analyst*

I made in under the wire. A question for you first on the currency, Cathie, how should we think about your hedging programs? Clearly currency hedging hurt you in IPG for supplies. And how are you balancing overall hedging programs, shall we say? And how should we think about it through 2010 for both the Company as well as on the supply side?

Cathie Lesjak - *Hewlett-Packard - CFO*

Typically what we do on the supply side, as well as on the services side, is we hedge over a longer period of time. That is why you see the headwind that you see in supplies, but you don't see that at the Company level. At the Company level the product -- the other product businesses are typically much shorter term. And this is a pretty consistent hedging strategy that we have had now for a number of years.

Shannon Cross - *Cross Research - Analyst*

Great. Then, Mark, if you could just talk on 3Com. Just as you have sat back and started to look at it, and clearly it hasn't closed yet, but how are you thinking about the networking opportunity? Where do you think your first position will be? Has there been any changes in the last few months since you announced the deal?

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

I think the only thing I know the changes is ProCurve has continued to gain share, both in ports and in revenue. We are obviously very encouraged by that. As we have mentioned in previous calls, it is an area we are investing into. We think we get a lot of it leverage out of our supply chain, a lot of leverage out of our go to market.

Interestingly, 3Com has been gaining share simultaneously separate and apart from HP. As we told you, we just got -- we are obviously very enamored with the technology. The R&D work they have done has been fabulous. So we think the leverage of the two is an extremely powerful combination. We think the market trends tell us that separately. We think together they are going to be a very powerful force in the industry.

So to your point, Shannon, we are just excited about the opportunity. We just think it is a pretty cool thing to be able to come to the market with such a strong lineup of technology and products. And when you integrate it into our services capability, and leverage it across the rest of the ESS, we think customers -- from what we hear from customers, they want us to come help them. And that is what we're going to try and do.

Cathie Lesjak - *Hewlett-Packard - CFO*

Customers are very excited about the 3Com acquisition and the technology that it brings. Just as we went through the process of wondering whether or not -- what the technology really was and then getting more and more excited about it, we are actually finding that with customers as well. So we are very excited about getting this closed and getting the proofs of concept out there for customers.

Mark Hurd - *Hewlett-Packard - Chairman, CEO*

That is a real important point, Shannon, that Cathie made, that we are getting customers asking us for proof of concepts, and we are going to have to get that lined up, and we have to integrate 3Com into the Company, which we will. We are real excited about all the people and capability they bring.

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But give us the time to get the integration right, get the proof of concepts out there, because we are in this for the long haul. We think this can be a real cool segment to add to our already strong position in ESS.

Why don't we -- thanks, Shannon. Why don't we close up. Listen, I think for us, we feel like it was a strong quarter for Hewlett-Packard. We think we advanced our strategic position. We think we executed well within the context of that strategy.

As we have mentioned, we are going to raise our guidance based on what we saw in Q1, and our visibility for the rest of the year. And we feel like for us the most important thing right now is to continue to execute on our agenda, which is what we are about to do.

I probably would close, and I know it is maybe not the place for an analyst call, to just thank everybody at HP. I can tell you this was a real team effort on the part of people across the Company. And I can't tell you how proud I am of them. Thank you.

Operator

At this time I would like to turn the conference over to Mr. Mark Hurd for final remarks.

Cathie Lesjak - Hewlett-Packard - CFO

No, that was it.

Operator

With no final remarks, I would like to thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. And have a great day.

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