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HPQ - Q2 2010 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the second quarter 2010 Hewlett Packard earnings conference call. My name is Michael and I will be your conference moderator for today's call. At this time all participants are in a listen only mode. We will be facilitating a question and answer session towards the end of the conference. (Operator Instructions) As a reminder this conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's call, Mr. Jim Burns, Vice President of Investor Relations. Please proceed.

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Jim Burns - *Hewlett-Packard - VP IR*

Good afternoon. Welcome to our second quarter earnings conference call with Chairman and CEO, Mark Hurd, and CFO, Cathie Lesjak. This call is being webcast. A replay of the webcast will be available shortly after the call for approximately one year.

Some information provided during this call may include forward-looking statements that are based on certain assumptions and are subject to a number of risks and uncertainties, and actual future results may vary materially. Please refer to the risks described in HP's SEC reports, including our most recent Form 10-Q. The financial information discussed in connection with this call, including tax related items, reflects estimates based on information available at this time and could differ materially from the amounts ultimately reported in HP's second 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 purchase 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 accompanies today's earnings release, both of which are available on the HP Investor Relations web page at hp.com.

Before I turn the call over to Mark, I want to remind you that we closed the 3Com acquisition on April 12. As a result, the 3Com business contributed approximately \$50 million in revenue in Q2. We are in the process of integrating 3Com into the HP networking business. We will continue to report the financial results of our networking business as part of the Corporate Investment segments for the remainder of this fiscal year, and we will begin reporting those results as part of the ESS segment beginning in FY 2011. I'll now turn the call over to Mark.

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

Good afternoon and thank you for joining us. Hewlett Packard had an exceptional quarter. Year-over-year we added \$3.5 billion of growth and over \$500 million of net earnings. Revenue of \$30.8 billion was up 13% over the prior year, non-GAAP EPS of \$1.09 was up 27% and operating margins of 11.2% were up 80 basis points over the prior year.

Our growth this quarter was broad based. Americas and Asia Pacific each posted solid double digit growth. Europe also grew double digits, performing better than historical seasonality. After many customers deferred hardware purchases in 2009, we are seeing strong growth in a number of our businesses. Industry standard service grew 54%. ProCurve grew 31%. PCs 21%, Storage 16%, Consumer printer hardware 16% and Commercial printer hardware grew 13%. We achieved this growth while investing in sales coverage and R&D, executing our transformation initiatives and absorbing 3Com.

Our enterprise business had solid growth this quarter fueled by ESS, which grew 31% over the prior year. We have built and acquired many assets over the recent years to serve our enterprise customers. We now have the industries premier arsenal of hardware, software and global services to deliver converged infrastructure, and to manage and transform customers IT environments. A good example of converged infrastructure is our Blade platform, which is the industry leader with over 50% share. An HP Blade Chassis can accommodate industry standard blades, mission critical blades, storage blades, even PC blades. All are designed to maximize computer density and minimize wiring and power consumption. We then can virtualize the networking ports with virtual connect and for all of the ports that are needed, we attach HP networking gear, which has been significantly broadened and enhanced with the acquisition of 3Com. Add to that the software to automate the data center and global services, and it's clear we're uniquely positioned to win. Our Services business has made great progress integrating EDS and we see the results both in our pipeline of opportunities and the improved margins. That being said, we still have more work to do to fully capture the enormous opportunity.

The Imaging and Printing Group delivered a solid 8% growth, with double digit revenue growth in consumer and commercial hardware, and 6% growth in supplies. IPG continues to make significant progress in placing units with high page consumption such as ink in the office, wireless, and graphics, each of which grew more than 30%. We installed roughly 2400 retail photo

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kiosks this quarter and expect roughly 7,000 placements by year-end. Managed print services had strong signings and Indigo press pages grew 26%. We continue to make significant investments in this business while delivering 17.2% operating margin.

The Personal Systems Group had another solid quarter balancing revenue and profitability. We grew revenues 21% and expanded operating margins. In Q2, we announced our intent to acquire PALM in order to enhance our intellectual property in the fast growing and profitable connected mobility space. After closing the acquisition, we expect to leverage webOS and the app store beyond smart phones in the form factors such as slates and web-connected printers.

Before I turn the call over to Cathie to review the financials, let me reiterate the three reasons why I'm so confident in HP's future. First our broad, market-leading portfolio. HP is the only Company with significant IP, global scale and market leadership in servers, storage, networking, software and services to deliver the next generation data center. HP is winning in the market, investing in innovation and moving deeper into high growth segments like networking and mobility.

Second, our ability to leverage scale and global reach. The global demographics are rapidly changing with a fast growing middle class population, migrating to large cities in emerging markets. In fact, over the next 20 years the pace of urbanization is estimated to be at the rate of about 60 million people a year. This class of people will expect to be seamlessly and securely connected to the global community with mobile devices and the underlying infrastructure. As the largest IT company in the world, delivering products and services in over 170 countries, we are well positioned to capitalize on this opportunity.

Third, our track record of successfully transforming ourselves. Over the past five years, numerous transformational initiatives have helped HP better serve our customers and profitably grow our business. The results speak for themselves. However, we still have a lot of work ahead of us and that's good news. Ongoing transformations in areas like supply chain, sales coverage and service delivery offer outstanding opportunities for growth and for margin expansion. We're proud of what we've achieved, we're investing aggressively in the future to create a meaningful competitive advantage for years to come. With that I'll turn it over to Cathie.

Cathie Lesjak - Hewlett-Packard - CFO

Thanks Mark and good afternoon, everyone. HP delivered exceptional performance in the second quarter. We increased revenue by \$3.5 billion, expanded margins, strengthened our balance sheet and generated \$3.1 billion in operating cash flow. At the same time, we executed on our transformation initiatives and invested for growth. Our results demonstrate the strength of our operating model and the consistency of execution.

Compared with a year ago, total revenue in the second quarter was \$30.8 billion, up 13% including four points of favorable currency impact. On a geographical basis, we delivered double digit growth in every region, with the Americas and EMEA each growing 11% and Asia Pacific increasing 19%. On a constant currency basis the Americas, EMEA and Asia Pacific were up 9%, 7% and 10% respectively. The second quarter gross margin was 23.5%, flat with the prior year. Sequentially the gross margin increased 70 basis points in line with normal seasonality.

Turning to expenses, we are investing in a number of strategic initiatives to expand our sales and go to market capabilities, while continuing to drive productivity. Operating expenses increased 5% to \$3.8 billion, demonstrating both our operating leverage and the acceleration of our investments to drive long term growth including building out our enterprise sales force and further strengthening our product portfolio. Non-GAAP operating profit increased 22% year-on-year to \$3.5 billion, with operating margin expansion of 80 basis points. Non-GAAP net income increased over \$500 million to \$2.6 billion or \$1.09 per share.

Looking at the details of our performance by business, during the second quarter, revenue in the Imaging and Printing business grew 8% to \$6.4 billion. Consumer hardware revenue increased 16% and commercial hardware revenue grew 13% compared with the prior year quarter and supplies posted solid 6% growth. Segment operating profit totaled \$1.1 billion or 17.2% of

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revenue. Total printer unit shipments grew 9%, with consumer printer units up 15%. Commercial printer units declined 8%, reflecting constrained product availability. During the quarter, laser printer average selling prices increased as we focused on placing high value units. We expect LaserJet system availability to improve significantly in Q3 with more than 30% year-over-year unit growth next quarter. For the full year, we still expect double digit unit growth for both Inkjet and LaserJet printers.

We continue to gain significant traction in our growth initiatives with managed print services, retail publishing and commercial graphics each delivering double digit growth. Managed print services had multi-million dollar wins in every geography across diverse industries including financial services, telecommunications, and transportation. HP's managed print services offering is being recognized by customers and industry analysts for its industry leading management tools and infrastructure, and its ability to deliver focused solutions for customers. Retail publishing has had several large wins, installing approximately 2400 systems this quarter. In our commercial graphics business, growth accelerated across the portfolio with digital impressions up 26% from the prior year.

Services delivered revenue of \$8.7 billion, up 2% from the prior year. Within services, the IT outsourcing business grew 6% with strength in the government and financial services sectors. In addition, we continue to see a significant increase in the level of product pull through into our accounts. Revenue in both Technology Services and Business Process Outsourcing was flat compared with the prior year, and Application Services declined 2%. That said, both Application Services and BPO saw solid findings in the quarter. Services segment operating profit in the quarter increased \$208 million year-over-year to \$1.4 billion or 15.9% of revenue, driven by synergies from the EDS acquisition.

Over the last 18 months, we have made significant progress with the EDS integration. We have extended our customer relationships, improved utilization and expanded our operating margins. That said, we have more opportunity to transform the business. We will continue to invest in delivering innovative service offerings for our customers, while at the same time driving efficiency, process standardization and automation to further enhance our competitiveness.

Enterprise Storage and Server revenue was \$4.5 billion, up 31% compared with the prior year with balanced growth across every region. The ESS results were driven by exceptional performance in ISS, which increased its revenue by 54% from the prior year. This was partially offset by the Business Critical Systems revenue decline of 17%. ESS Blades delivered strong revenue growth, increasing 45% from the prior year, and the Virtual Connect revenue more than doubled. We continue to be the market leader in servers with 37% market share in x86 servers, gaining share again year-over-year. Our G6 platform delivered strong performance and we recently launched our G7 platform as customers continue to demand the differentiated performance based on industry standards that HP is uniquely positioned to provide.

Storage revenue increased 16% from the prior year, driven by solid growth in high-end and entry storage arrays and significant growth in our scale out iSCSI products based on technology acquired from LeftHand networks. With improved performance in the business we are seeing positive operating leverage in the ESS model.

This quarter the business delivered \$571 million in operating profit and an operating margin of 12.6%, an increase of 540 basis points from the prior year. With the close of 3Com this quarter, we are accelerating our investments in networking. HP Networking, which is reported in the Corporate Investment segment, recorded organic growth of 31% or 58% growth, including a partial quarter of 3Com results.

HP Software revenue was \$871 million, down 1% compared with the prior year. License growth improved this quarter with particular strength in the BTO applications portfolio. On the bottom line, the Software business expanded its margins 80 basis points, delivering 18.6 points of operating margin in the second quarter.

Turning to Personal Systems, PSG revenue increased 21% from the prior year to \$10 billion, with Notebook and Desktop revenue up 17% and 27% respectively and workstation revenue up 47%. Regionally we saw balanced growth across every geography. Total unit shipments increased 20% year-on-year, with notebook unit growth of 19% and desktop systems growth of 23%. We introduced several new consumer and business products this quarter including a new consumer All-in-one desktop, the 12-core



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Z200 workstation and our lightest EliteBook commercial notebook to date. Segment operating profit totaled \$465 million or 4.7% of revenue as PSG continues to deliver solid performance driven by our innovative product portfolio, scale, and global reach. Rounding out the segment, HP Financial Services continues to deliver very strong consistent results. In the second quarter, financing revenue grew 18% to \$755 million and generated operating margin of 9.1%, up 190 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 \$14.3 billion. Our Q2 cash conversion cycle was 17 days, down seven days from a year ago and our channel inventory is in good shape. We generated solid cash flow in the quarter with operating cash flow of \$3.1 billion and free cash flow of \$2.3 billion. We continue to actively repurchase shares, returning \$1.8 billion to shareholders through share repurchases. Finally, we paid our quarterly dividends totaling \$196 million.

And now, a few comments on our outlook for the third quarter and the full year.

The currency markets have been volatile and we are assuming that exchange rates stay roughly where they were last week with the Euro in the mid 120s. Taking into consideration our hedging strategies and exposure to a wide basket of currencies, we now expect third quarter revenue of \$29.7 billion to \$30 billion and a full year revenue growth of 8% to 9%. Included in this outlook are unfavorable sequential currency impacts of approximately two percentage points from Q2 to Q3 and approximately one point from Q3 to Q4.

Regarding earnings, our outlook includes both the absorption of the \$0.03 incremental legal settlement recorded in the first quarter, but not previously included in our full year outlook and the dilution associated with the 3Com acquisition. While we've not included the revenue impact of PALM in our outlook, we expect to be able to absorb the dilution associated with the acquisition in our full year non-GAAP earnings.

The other variables to consider in our earnings outlook are;

an expected OI&E expense of about \$0.04 per quarter,

a tax rate of approximately 22%, and,

weighted average shares outstanding to decline slightly in the second half of fiscal 2010.

With that in mind, we expect third quarter non-GAAP EPS in the range of \$1.05 to \$1.07. For the full year, we are raising our outlook and now expect non-GAAP EPS in the range of \$4.45 to \$4.50 representing growth of 16% to 17% for the year. With that, we will now open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Katy Huberty of Morgan Stanley. You may proceed.

Katy Huberty - Morgan Stanley - Analyst

Thanks, good afternoon and nice quarter. As it relates to the revenue guidance, if I net out the second quarter fee, the incremental currency headwind and the benefit from 3Com, you're actually raising core revenue growth by about 2 points versus the guidance in February. So I wonder if you can just go into more detail around where that upside is coming from either by geography or business segment? Thank you.

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Cathie Lesjak - *Hewlett-Packard - CFO*

Katy, I think the best way to think about it is that we basically took our strong performance in Q2 and layered on basically normal seasonality, and then added in the 3Com revenue as you announced -- as you mentioned, and that's really how you get to our guidance.

Katy Huberty - *Morgan Stanley - Analyst*

And just as a follow-up to that, what expectations have you made around the demand impact in Europe from some of the macro catalysts over the last few weeks?

Cathie Lesjak - *Hewlett-Packard - CFO*

Again, if you think about it, by taking the Q2 performance and layering in the normal seasonality, implicitly we're assuming normal seasonality for EMEA. And again, that's off of a change in position for us because going into Q2, our expectation was that EMEA wasn't quite at the point where we could call for normal seasonality and so we're feeling better about Europe. And definitely taking into consideration the currency impact in our thought process around that.

Katy Huberty - *Morgan Stanley - Analyst*

Okay, fair to say in the last couple of weeks you haven't seen anything in Europe that scares you around the back half of your fiscal year?

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

Let me say it this way, Katy. I think that we try to talk about the quarter primarily, as opposed to what's going on now in our Q3, but obviously we're sitting here today giving the guidance and so when we look at the demand picture, I think we saw the demand picture improve in Europe during the quarter. I think it's important to note Katy we saw the demand picture improve in Europe across countries, it wasn't four or five countries, it was across countries and it was across segment, product segment. So it's very broad based for us and so we went in also in a very end of the quarter in a very attractive channel position in Europe as well.

So I think overall, we felt good about it and listen, I can tell you when I haven't felt good about Europe, which is over the past several quarters in terms of its behavior relative to what we've seen in the Americas and Asia so I think we feel good about that. So I think this guidance is again what we've seen with normal seasonality and us factoring in the lower currency, and that's what we are giving it.

Katy Huberty - *Morgan Stanley - Analyst*

Great. Thank you very much.

Cathie Lesjak - *Hewlett-Packard - CFO*

And let me add because I'm sure this is a question around peoples mind is really around the euro. Obviously, our business prefers a stronger euro than a weaker euro but in total, the euro exposure is only about a fourth of our revenue and then you layer on top of that the fact that we've got local currency costs that represent natural hedges and then we basically hedge and

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we hedge out longer and to a greater degree in the lines of businesses where we have less flexibility to raise prices for currency. So the actual impact of kind of volatile currencies on our P&L, especially the euro, is much more muted than you might believe.

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

I think the net-net of it is a -- I wouldn't want to be confusing that a higher euro is good for us with our business in Europe, but a bad euro is probably as negative as some of the things that at least I've seen written, so because of the description that Cathie gave. So I think that's the best way to think about it.

Katy Huberty - *Morgan Stanley - Analyst*

Thanks for the clarification.

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

Thanks, Katy.

Operator

Your next question comes from the line of Bill Shope of Credit Suisse. You may proceed.

Bill Shope - *Credit Suisse - Analyst*

Okay, thanks. Mark, can you walk us through your strategic rationale on the PALM deal, and then going forward should we still assume that most of your future acquisition focus will be at least more enterprise focused than consumer?

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

Well, our enterprise -- our history has been more acquisitive certainly in the enterprise but again, Bill, like we've said before, all of our acquisitions, regardless of where they are, go through a pretty extensive filter in terms of making sure they are strategically sensible, financially sensible and that we can actually operate and get some incremental leverage in operating performance out of it. So it's got to hit all three filters.

I think in this case, of PALM and our planned acquisition of PALM, it really has more to do with the intellectual property and the fact that when you look across the HP ecosystem of interconnected devices, it is a large family of devices and we think of printers, you've now got a whole series of web connected printers and as they connect to the web you need an OS. We prefer to have that OS in our case to be our IP where we can control the customer experience, as we always have in the printing business and that's a big deal to us. You can certainly make the same case for smaller form factor products in the mobile world like Slate and some other products and again, I don't want to tell you that we're not going to have -- Microsoft is probably one of the best relationships we've got in our Company and they are still extremely important to us.

There are a couple of form factors, though, that are very attractive for us and there are small form factors where we think the IP can be very additive to us. So it isn't precisely, Bill, a SmartPhone play as I've seen some people write. Clearly that's a \$45 billion total available market that is growing and so that is an attractive market, but it is for us strategically broader in the context of the number of HP interconnected devices where we can leverage the IP and that's what we plan to do.

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Bill Shope - *Credit Suisse - Analyst*

Okay, great. Thank you.

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

Thanks, Bill.

Operator

Your next question comes from the line of Richard Gardner of Citigroup. You may proceed.

Richard Gardner - *Citigroup - Analyst*

Great, thank you. Mark and Cathie, I was hoping you could give us an update on the 3Com integration, just in terms of your plans and your progress with sales specialist hiring, getting the sales force trained on the new product portfolio, and getting the product in front of customers in the US and Europe and any sort of color on early customer reception to the portfolio, and how many customers are willing to take a look at it now that it's under the HP umbrella? Thank you.

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

Rich, thanks. Let me give you a quick trip through HP networking and try to give you context and fit 3Com into it. Again, we've had a continuation of strong performance in what we call ProCurve, now HP Networking, Edge products, wireless products, obviously 31% growth in the quarter that's organic, obviously very strong for us. Simultaneously, Rich, it's important to note that we've been building software capabilities in ESN. We talk about this product called virtual connect. It is nothing more complicated than -- most of the networking market is sold by number of ports. Those ports aren't always fully utilized. Virtual connect actually virtualizes those ports, so as a rudimentary example of a customer usually buying 10 ports, we can virtualize and perhaps reduce that by 30% to 40% so they now need six ports. Our strategy is then to come in with the best performing products and the best TCO in the industry to then actually work with the customer on those ports.

Historically we've been on the edge in wireless, now with 3Com we can do the exact same thing in the data center and so for us, we've had a very good start with 3Com. We have been aggressive in hiring and hiring has started and hiring is ramping. In the quarter, 3Com we closed two fortune logo accounts with 3Com products in the data center. We also had a number of very significant wins where you would think of as the traditional ProCurve line and had a very strong virtual connect quarter as well. So the reason I bring that up to you, Rich, is to give you context that our networking strategy isn't a 3Com strategy. It's not a ProCurve strategy. It's not a virtual connect strategy. It's in all of those capabilities brought together across the HP portfolio and its why when we talk about this converged infrastructure that the ability to leverage IP from the server family, the storage family and the networking family became so integral to our overall story.

So we think a very good start, we're very excited about it, we've installed products the 3Com technology is now in our data centers and it's now performing our networking tasks. We plan to do more and more of that and so we feel very excited about it and the specialist to your original question, the specialist hiring is ramping.

Cathie Lesjak - *Hewlett-Packard - CFO*

I think the other point that I would just add is that we also got a very key asset in TippingPoint which is around network security, also a product that is very well respected in the market and basically being used at HP in this point in time.



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Richard Gardner - Citigroup - Analyst

Great.

Jim Burns - Hewlett-Packard - VP IR

Next question, please?

Operator

Your next question comes from the line of Ben Reitzes of Barclays Capital. You may proceed.

Ben Reitzes - Barclays Capital - Analyst

Thanks a lot. Mark, could you talk about what's going on in printing? I was kind of stunned by the guidance for laser printers next quarter, up 30%. It would seem like there was a significant deferral or push out and last quarter you said that the constraints would be over by this quarter and now it's by next quarter, I'm just wondering if this is a firm target or a moving target and then just how we reconcile the printing units for the year that way.

Mark Hurd - Hewlett-Packard - Chairman, CEO

Sure, thanks, Ben. Listen, we think we'll have a strong quarter this being Q3 in terms of unit placements for lasers. I'm not thrilled with the Q2 unit numbers, but I am pretty pleased with the types of units we put in the market. The ASPs were up significantly in lasers, so the units we could get, we got the right units, if you will, from a printer placement perspective. So I think you should expect a very strong back half in laser and a very strong Q3 and we have good line of sight and good visibility to that going into the quarter. Demand has continued to be strong.

I think, Ben, when you talked about the broader printing business, a very strong quarter for us obviously in ink placements again, we felt very good about our ink line up of products, the growth in wireless printing and in web connected printers continues to be very strong. So I think IPG very strong in ink. As we mentioned in our script and in our opening messages, the position in retail photo kiosk, Ben, is a big deal. We installed as many retail photo kiosks in the quarter as we had for the entire life of the product, so for us this was a doubling of that base. We plan to exit at over 7,000 as we exit the year.

Managed print services had another very significant quarter and again, the importance of those two businesses for us are those are long term businesses, managed print services five year contracts, retail photo kiosks staying installed nine and 10 years, 100% connect of supplies to those products and they are beginning to be a meaningful part of our portfolio. So I think across IPG, when you look at the supplies growth we reported, which is the dollar number as opposed to the local number and the local number would have been yet higher. Ben, overall we felt very good about the IPG quarter, and we've worked hard to get the business in a position to be able to do what we've just reported. The one thing we really want to get done is what you opened with. We want to get the laser printer number into a position where we're driving unit growth and the demand is there.

Ben Reitzes - Barclays Capital - Analyst

It sounds like you're guiding for acceleration in the segment, so that's the bottom line, right?

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Mark Hurd - Hewlett-Packard - Chairman, CEO

Yes, listen. We feel good about the position of the segment. Now, as you know, the acceleration of the segment and sometimes comes with a price and as we place more units when we see the demand opportunity, but that's one of the reasons we've worked so hard on the supply chain, to put ourselves in a position to actually get that acceleration, or if you will, seize that acceleration when the opportunity presents itself. And Ben, I think that's the position we put ourselves in.

Ben Reitzes - Barclays Capital - Analyst

Thanks a lot.

Cathie Lesjak - Hewlett-Packard - CFO

Ben, the other thing I'd add is that we did say at the end of Q2 and we still believe this is the case, that we will get double digit growth in laser units and ink units for the full year and if you actually look at the results that we teed up in terms of laser unit placements in Q2, they were not materially different than what we had expected going into Q2.

Ben Reitzes - Barclays Capital - Analyst

Okay, thank you.

Mark Hurd - Hewlett-Packard - Chairman, CEO

Yes, thanks, Ben.

Operator

Your next question comes from the line of Tony Sacconaghi of Sanford Bernstein. You may proceed.

Tony Sacconaghi - Sanford C Bernstein & Company - Analyst

Yes, thank you. Mark, your services growth rate has been about 10 points lower than the Company average in each of the last two quarters, and been negative in total at constant currency. I think your long run outlook is for services to grow roughly in line with the Company average at around mid single digits. You're now a year and a half into EDS. Do you still have high conviction in that and I understand there's the cyclical part of services, but much of your services business, namely your support and your outsourcing businesses, are backlog driven and so they don't change very quickly. Can you give us your perspective on how we should think about the longer term services growth rate, and to the degree that we are going to see something that's closer to the Company average, when do we begin to see that and why? And I have a follow-up please.

Mark Hurd - Hewlett-Packard - Chairman, CEO

Okay, follow-up, do you want to give me the follow-up too and I can just do the whole--?

Tony Sacconaghi - Sanford C Bernstein & Company - Analyst

No, it's for Cathie actually.



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Mark Hurd - Hewlett-Packard - Chairman, CEO

Oh, okay, all right I'm not sure that's within the rules, Tony, but let me take a crack at your services one. So I think the answer to your question is yes. We feel really good about the services business all in. Now, remembering you've got a blend of technology services and what you would think of as more outsourcing services around apps and ITO in the same bucket there, and the maintenance piece of the business does react more to the hardware sales and is a lagging effect on hardware sales as a result -- in terms of growth so that's sort of one point.

Second, we've been spending a lot of time getting the business right. We have seen very strong improvement in our pipeline and you know we exited the year with very strong signings. We expect to have a very strong signings year this year, Tony, so when you look at our pipeline and you look at where we're at, we feel very good about the position of the business. Now, let me go farther just to give you a little bit more color.

We have spent a lot of time over the past year and a half really operationalizing the business, getting underneath issues in the business, opportunities in the business, and I think the team for the most part has done a very good job. We certainly improved our profitability, improved our cost structure, better aligned our cost with our revenue. That said, as what happens in most things, as we've gotten deeper into details, the opportunity we think to be very open with you is even better and we're in the process of working through this right now. These are things like how we automate and drive forward in our data centers, how we align and drive our tool strategy going forward, and I won't go into too much detail because of the time on the call, but I will at a future period of time.

There are material opportunities for us in the business to improve it and we will invest into that to get that right and we think that plays long run to our opportunity to grow the business, and our opportunity to scale the business. So don't take anything away from this other than we think we've got a major opportunity in the business and we feel very good about the position of it, Tony, and I think you are right in your analytic. I wouldn't necessarily put it to this hardware result in terms of driving the services business to those kind of growth rates, but we certainly expect it to grow at and above market.

Cathie Lesjak - Hewlett-Packard - CFO

And actually Tony for this quarter we believe we grew roughly in line with market. You saw the acceleration in ITO, we were up 6%, that's really reflecting the strong signings growth that we had basically coming out of 2009. On the apps services side, it's been softer, although as I mentioned in my prepared remarks, the signings in application services this quarter were up significantly and so we should see an acceleration from a revenue perspective in that space as well in the second half.

Tony Sacconaghi - Sanford C Bernstein & Company - Analyst

Okay, thank you. Quick follow-up. Cathie, can you share with us your assumptions on what dilution to non-GAAP earnings will be from 3Com and for PALM? What are you including in your forecast? And then for currency, what's your year-over-year currency assumption at a EUR1.25 for Q3? Your impact from currency this quarter was significantly different than I had modeled, so I'd like to try and understand how you're thinking about it at a EUR1.25 all in for the Company year-over-year in Q3.

Cathie Lesjak - Hewlett-Packard - CFO

So on the 3Com, we are -- in our guidance we've got about \$0.01 of dilution in Q3. For PALM it's mostly in Q4 and it's the few cents we talked about. It's completely included in our guidance, so you don't have to worry about anything running away on us from a dilution perspective on PALM. In terms of our currency assumption, we have modeled our business on a go forward basis at basically a mid EUR1.20s and that gives us a sequential headwind from Q2 to Q3 of roughly 2 points, and a sequential headwind from Q3 to Q4 of roughly 1 point.

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Jim Burns - *Hewlett-Packard - VP IR*

Let's take the next question please?

Operator

Your next question comes from the line of David Bailey of Goldman Sachs. You may proceed.

David Bailey - *Goldman Sachs - Analyst*

Great. Thank you very much. What are you seeing right now that makes you more or less confident that we'll see a corporate PC upgrade cycle starting this year and how should we think about the ramp in demand through the end of this year and into next year?

Cathie Lesjak - *Hewlett-Packard - CFO*

Let me give a couple of data points and then Mark can add to it. Basically, we saw commercial clients grow 19% this quarter and that was led by 47% workstation growth. The workstation growth was heavily financial services industry, which they tend to be more early adopters and then broadly around commercial, more in the SMB space, and we've always thought that the refresh would start with consumers, then go to SMB and then go to corporate.

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

David, listen, I think we've seen this already going on a bit and we expect to see some more of it. We obviously had very strong workstation growth in the quarter. We had very strong desktop business, desktop growth in the quarter. When we look at what's coming out from data perspective, we gained 8 points of share in the US enterprise in the last quarter. That's second or third quarter that we've seen very large gains in terms of enterprise share, so -- and that puts us in a pretty good position we think, that if this corporate refresh accelerates, this will be very good news for us.

Now what we've modeled frankly, David, is more of the same. We have not modeled some big corporate refresh coming that's sort of sequentially better than what we've seen. What we have seen, though, is some improvements in our funnel, some improvements in our performance in the areas that I've described, some quicker times to decisions, that's a very important thing and the fact the decision seems to be getting made a little bit faster than they were a year ago. But if there is a spike, obviously, given the share position and the things that we're describing, this certainly would be good news.

David Bailey - *Goldman Sachs - Analyst*

Great. Thank you.

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

Thanks, David.

Operator

Your next question comes from the line of Keith Bachman of Bank of Montreal. You may proceed.

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Keith Bachman - *Bank of Montreal - Analyst*

Hi, thank you. I wanted to ask two questions on margins if I could, Mark. The first is related to the last comment. It seems like ASP erosions on PCs with perhaps netbooks slowing a little bit has slowed and how does that make you think about your PC margins as you look out over the next couple quarters with mix and ASPs impacting, and the second question is similar on services. If in fact the services business picks up a little bit as you alluded to from Tony's questions, how should we be thinking about the services margins as we look out to the balance of the year? Thank you.

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

Thanks, Keith. I appreciate it. A couple points and I think again, you don't want to react to any one single metric in these businesses, Keith, but I agree with your conclusion that ASPs have improved. Some of that is frankly the commodity environment and the commodity environment, as you can imagine in 2009, many of the commodity providers, particularly memory providers, really clamp down on CapEx and so when you look at their capacity today, their capacity is low as demand is increasing and that of course increases the price in some of the commodity areas. Typically as you know, Keith we do very well in environments like this from a procurement perspective and alignment of supply.

That said there is a passing through of those commodity prices, which you've seen across-the-board for most companies in the industry and that is having some effect on ASPs. In addition to your point, some of this sort of better performance you're seeing in some areas like business desktops and workstations, that mix is also affecting the aggregate ASP as well. So that is also a benefit that you're seeing going on in the quarter and what's transpiring.

In terms of margins, we'll continue to balance growth and profitability and make sure we hit the right optimal point within it. Remember for us, Keith, we think about the PC business more broadly than we do the PC business just in isolation. The PC business really is the procurement arm for almost the entire Company from a product perspective. We leveraged the common parts across almost all of our infrastructure. So for us we think about it not just in the context of PSG operating performance, but the leverage and the position it gives to the entire Company. So I think it's generally good news in terms of the growth that you're seeing in the market the ASP improvements you're seeing. There is a tighter commodity environment and we'll continue to balance it as we go forward in terms of optimizing growth and profitability.

Jim Burns - *Hewlett-Packard - VP IR*

We'll take the next question please?

Operator

Your next question comes from the line of Shannon Cross of Cross Research. You may proceed.

Shannon Cross - *Cross Research - Analyst*

Thank you very much and good afternoon. Could you talk a little bit about what you're seeing or your thoughts on what we're seeing in the software industry with regards to the acquisitions, you had a [fifty] for Sybase, it sounds like Symantec is taking out their sign security business, just how are you thinking about software and your position and where you might want to go?

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Mark Hurd - Hewlett-Packard - Chairman, CEO

Listen, I think we continue, Shannon, to be very excited about the opportunities that sit in the management space, management again of servers, the management of PCs, the management of storage, the management of networks, the security around it. We think these are big -- remember when we talk about security, Shannon, we don't just talk about a product. We talk about a whole gamut of capabilities. Cathie mentioned earlier tipping point on the data intrusion side, but it's security on the product level, on the services level, on the architecture level. So we continue to focus in these areas.

Some of the acquisitions that you've described and I won't go into them are frankly not that intriguing to us and are not that relevant to our strategy, which really is around this whole automation management place that we think directly affects our converged infrastructure business on one side, and also helps automate our services on the other. So our software business has three strategic objectives for HP. We try to sell them as individual products and data center transformation, we try to integrate them with our converged infrastructure. At the same time we try to use them as the baseline for our tools capability to automate our services and we try to do all three at the same time. And we'll continue to look for organic ways and other ways to continue to improve our capabilities in those areas and that's what we're thinking about.

Shannon Cross - Cross Research - Analyst

Great and a really quick follow-up Mark. Could you talk a little bit about your thoughts on the tablet given what we're seeing with the iPad and clearly your PALM acquisition?

Mark Hurd - Hewlett-Packard - Chairman, CEO

Well, I think we think there is a market there and we expect to be a participant in that market, so we feel very good. We've again never felt like the market was one product or one device would become ubiquitous, and we believe that the world is going to a series more and more mobility, not less, and more and more differentiation between what users want to have in terms of capability, all the way from a purely voice product, up through a SmartPhone capability, through a tablet, through a notebook and we expect to play across that gamut of capabilities the customers want and that's where we expect to go.

Shannon Cross - Cross Research - Analyst

Great. Thank you.

Operator

Your next question comes from the line of Scott Craig of Banc of America-Merrill Lynch. You may proceed.

Scott Craig - Banc of America Merrill Lynch - Analyst

Thanks, good afternoon. Cathie, can you maybe look at the IPG margins over the next couple of quarters as you see the hardware increasing perhaps as a percentage of sales, particularly given the laser growth that you're looking at? How does that impact the margins of that business and your thought process around the range of what possible margins could be in there throughout the rest of the year? Thanks.

Cathie Lesjak - Hewlett-Packard - CFO

Well, I'm not really going to update the guidance for the full year beyond the 15% to 17% that we think are kind of the margins for IPG this year. We believe we can definitely manage anything that's coming down the pike right now in that range. On the

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hardware unit placements can uptick significantly and we still absorb it and that's because we've just done a great job of frankly making operating IPG in a tighter way and getting supply chain costs and OpEx costs out of the cost structure, so that we're able to absorb these unit placements and still maintain industry leading profitability.

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

I think to Cathie's point, this is a big point, Scott, in a very strange way 2009 was really a blessing for us and I'll emphasize in a strange way, because it really got us sharper and IPG is a really good example of that. We thought we were going in pretty sharp and we certainly sharpened up.

Our ability now to deal with some of these issues has just given us more flexibility, to do the kind of unit performance that we've talked about here for the full year, forget this quarter or that quarter, but when you look at the full year unit performance and the opportunities we have in terms of placements. Again understand, Scott, we've done this while investing and placing these retail photo kiosks. So I want to make sure this is no trivial issue that we've been able to absorb the start up of the managed print services businesses, we've been able to install these retail photo kiosks, which are very similar to the printer model just bigger units, forecast the growth to take the unit growth in Inkjet, the forecast that we have in laser and do all of that within the targeted margins that we've described, and this has given us a level of flexibility that, frankly, if you went back three or four years, we simply couldn't have done this and so this is a big deal for us.

Cathie Lesjak - *Hewlett-Packard - CFO*

Scott, it's not just about the P&L. It's also about working capital management. We have -- we're able to operate with much lower channel inventory levels today because we've improved our efficiency on that side, and then also the owned inventory levels are down significantly year on year, again this quarter. And we expect continued improvement in that space and so it's really the entire ecosystem of the IPG business, both the income statement and the balance sheet and our partners.

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

Great. Thank you.

Scott Craig - *Banc of America Merrill Lynch - Analyst*

Thanks, I'll keep it to my one question.

Jim Burns - *Hewlett-Packard - VP IR*

Let's take two more questions please?

Operator

Your next question comes from the line of Aaron Rakers of Stifel Nicolaus. You may proceed.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Yes, thanks. I guess another operating margin question for me. On the enterprise side of the business, obviously we saw an even stronger mix towards your Industry Standard Servers and we're still generally sitting in front of what looks to be a high end product cycle in that product category going forward, yet you guys did a 12.6% operating margin versus your target of

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11% to 12%. So I'm trying to understand do we think about 11% to 12% or do we think about a sustainable trend above that and if not above that why might not that be?

Cathie Lesjak - *Hewlett-Packard - CFO*

Well, so if you look at the quarter we had roughly 30% operating leverage in ESS this quarter and that's about what we had last quarter too. I think it was about 33% last quarter, but obviously exactly how much that continues will depend on the mix and the business because the gross margin profile of Industry Standard Servers is very different than business critical systems, which by the way, is very different than virtual connect which is also in the enterprise server and storage growth.

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

Well, I think you're right what you say though. The fact is that we are introducing a new business critical system. It is in Q3 though, mostly the mid range part, the new superdome is actually showing up at the end of Q3, really more of Q4 and I think to Cathie's point, you're going to continue to see a mix, a combination of, we think, very strong growth in the industry standard server Blade market combined with virtual connect, combined again.

There's also a transformation going on in storage as I mentioned earlier. We've got very strong growth going on in iSCSI part of the market, which we think is a very attractive part of the market where we've seen significant growth occurring. So I do think you're right. We feel very good about the new product release that probably has more of an impact to us in the back half of the year than it does in Q3, but again I think to Cathie's point, when you get 30% leverage like what we're seeing, ESN has done a lot of what we described in IPG working hard. They aren't quite to the same position that IPG is now, but they are on the same path to do more work in its operations and its supply chain that we can get more flexibility and more leverage as we bring an assortment of products, we think, to market that are pretty darn exciting.

Aaron Rakers - *Stifel Nicolaus - Analyst*

Fair enough. Thanks.

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

Thank you.

Operator

Your next question comes from the line of Brian Alexander of Raymond James. You may proceed.

Brian Alexander - *Raymond James & Associates - Analyst*

Thanks, just to go back to the laser business, sorry for beating a dead horse, but can you just be a little more specific on what caused the core laser units to be down 8% after growing 11% last quarter while the market growth was actually accelerating? What specifically needs to improve? Seems like the product constraints have been prevalent for multiple quarters. So is any of this intentional seeding of market share due to low price points by competitors, and if you could comment on supplies, did the growth in local currency accelerate in line with your expectations and do you think that will continue for the balance of the year as placements for lasers pick up? Thanks.

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Cathie Lesjak - *Hewlett-Packard - CFO*

Well, on the laser side it's really capacity. Just the inability to get as many laser units as we wanted and the demand that we had for them so two things have happened. One is demand has picked up and improved more than what we had expected. That's good news and it's also bad news because we haven't been able to get the capacity.

We have a very strong backlog coming out of Q2, and like I said earlier, what happened in Q2 in terms of the laser unit decline is not really a surprise to us. It's materially what we had expected going into Q2. This was always going to be a back half, very strong back half unit placement for lasers in order to get to the double digits for the year that we believe is very doable.

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

Yes, Brian, this is where we expected to be roughly speaking. There was no sort of surprise to us. I think what -- I would characterize it differently. We would like to have had more. That's probably the better way to think about it and let me make sure I'm clear with you. No, we did not do any hold back because of price points, quite the opposite. We were pushing as hard as we could towards the end of the quarter and we're pushing as hard as we can right now. The demand is strong, so to Cathie's point that's the good news.

The bad news is we haven't been able to fulfill as much customers want. The brand loyalty to HP is just, unless you're here feeling it you wouldn't get it. It is just amazing how our partners and our customers stick with us on this and we're going to get better at this and I'm telling you, I think you three will turn on it.

To your point about supplies, supplies have been strong. It's good news and I think it's also not just the unit placements, as we've talked before, Brian. Getting the right units placed is actually more important than the unit -- number of units that get placed and to some degree I think you saw that show up in Q2 as well. When you look at the ASPs in the laser business, let me flip it around, what we were able to focus on was getting the right units out and that did pay dividends within the context of a number that clearly we just wish was better.

Okay, well let me wrap it up here. I think the conclusion of it for us is we feel very good about the broad based growth in the quarter, 13% growth for us is, we think, a good result, not only the fact that we grew 13, but the fact that it was contributed to across regions and across our businesses we think was extremely positive.

We are a stronger Company today and I want to emphasize that based on our portfolio, our scale, and our consistent execution. Now, at the same time we have more work to do to transform ourselves to reach our potential. So as good as we feel in some respects about what we've done, we are still not to our full potential and we feel good about our position, which gives us the confidence, as we described here, to raise our outlook from where we previously had it. So thank you all for joining us. We do appreciate it.

Operator

Ladies and gentlemen, this concludes our call for today. Thank you very much. You may now disconnect. Have a great day.

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