FINAL TRANSCRIPT

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HPQ - Q2 2009 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second quarter 2009 Hewlett-Packard earnings conference call. My name is Stacey and I'll be your conference moderator for today. 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.

Jim Burns - *Hewlett-Packard - VP of IR*

Thank you. 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 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 Form 10-Q for the fiscal quarter ended January 31, 2009.

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 Form 10-Q for the fiscal quarter ended April 30, 2009.

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 and in the slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations webpage at www.HP.com.

I'll now turn the call over to Mark.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Good afternoon, and thank you for joining us. In the second quarter, Hewlett-Packard executed well in a tough market environment. We delivered revenue of $27.4 billion and non-GAAP EPS of $0.86. We effectively managed our inventory and generated a record $5 billion of cash flow from operations.

The Technology Solutions Group, which now represents more than half of HP's profits, had a solid quarter, highlighted by strength in services. The Services business more than doubled profits to $1.2 billion and is now our largest segment. In Technology Services, we're benefiting from advances in HP product quality and a more productive work force, resulting in improved customer satisfaction.

That said, we have more work to do to optimize our delivery model, and that opportunity is good news for customers and shareholders.

The integration of EDS is going well, and customers are responding favorably. We had a number of large signings this quarter and the pipeline has grown double-digit since the deal closed. And during the integration, customer satisfaction has gone up. At the same time, we are building a competitive cost structure and have now removed roughly half of the 25,000 headcount outlined in our September 2008 restructuring plan. Despite this progress, we have the vast majority of the EDS-related savings ahead of us.

And across HP, we're making good progress on our cost structure, with transformations across virtually every function and business group. For example, we have significant opportunities as we bring EDS into our ongoing real estate transformation. By increasing utilization and leveraging a more mobile work force, we've identified additional annual savings of approximately $500 million, beginning in 2012.

These savings are incremental to a plan that we announced last September. This is one of many examples where we are dramatically changing the expense profile of the Company and making steady progress toward our goal of having the industry's best cost structure. We set this object not only because of the benefit to our margins, but also because our improved efficiency provides the platform from which we can invest and innovate for market success.

For example, this quarter, PSG extended its share leadership by 2 points and captured the number one position in the US and Asia-Pacific. IPG, which generates approximately one-third of our profits, made good progress optimizing its owned and channel inventory, and aligning them to the reduced demand environment.

Despite the cyclical pressures impacting its growth, IPG continues to generate solid profits and cash flow, demonstrating the strength of the business model. We are performing well in high usage segments such as MFPs, wireless, and digital press. And we're well-positioned to lead the market transition to digital printing.

HP is leveraging a broad patent portfolio to drive innovation that will shift trillions of printed pages from analog to digital devices. And once the economy fully recovers, we expect IPG revenue to grow in the low to mid-single digits.

We also continue to drive meaningful innovation across our product lines. This quarter, we launched Matrix, converged blade servers and storage, virtual networking technology and software, delivering the industry's first Cloud infrastructure in a box. The solution, which saves customers significant money and dramatically reduces complexity, serves as an example of the power of HP's integrated portfolio.

Before I turn the call over to Cathie to review the financials, let me reiterate the three reasons why I'm confident that HP will emerge from the current market environment as a stronger force in the industry.

First, our broad market-leading portfolio. HP has scaled services, software and hardware built upon open industry standards that differentiate us in the marketplace. We understand customer needs and can deliver integrated solutions today.

Second, our increasingly efficient cost structure. Our efficiency programs are significant and ongoing, and our scale provides a sustainable competitive advantage.

Third, our track record of successful execution. As this quarter demonstrates, we are executing in the marketplace, executing on the EDS integration, and executing on our cost initiatives.

Our goal is to maintain our strategy through this economic cycle by continuing to drive innovation, build sales and customer support, and invest for growth. We have the opportunity to create a meaningful competitive advantage for years to come.

With that, I'll turn the call over to Cathie.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Thanks, Mark, and good afternoon, everyone. HP posted another solid quarter in Q2 fiscal 2009, and continues to demonstrate its ability to execute in both good and challenging markets. Our portfolio diversification, focus on innovation, and operational excellence have enabled us to effectively deliver results to both customers and shareholders.

During today's call, I will recap our financial results for the second fiscal quarter and highlight some of the actions we have taken to position HP competitively, when the economy recovers.

Total revenue for the second quarter, including the EDS acquisition, was down 3% year-over-year as reported, and up 3% in constant currency.

Looking at revenue by geography -- including the addition of EDS, America's revenue increased 9% year-on-year; EMEA was down 11%; and Asia Pacific decreased 10%. Excluding the effects of currency, revenue was up 12% in the Americas; down 2% in EMEA; and down 5% in Asia-Pacific. Overall, the Q2 performance in each region was similar to Q1.

Gross margins for the Company were 23.5%, down 150 basis points from 25% one year ago. This decrease was driven by the addition of EDS, which has lower gross margins, as well as rate declines in our hardware businesses.

Non-GAAP operating expenses for the quarter were $3.6 billion, down $643 million or 15% from a year ago, despite absorbing EDS. In addition to benefiting from the stronger dollar, this decline highlights both the work we've been doing over the last few years to make our cost structure leaner and more flexible, and the actions we have taken to improve our competitiveness in the current environment.

While some of the actions we have taken on discretionary spending are, by their nature, temporary, we are making good progress in structurally improving our cost model and have line of sight to a significant amount of savings ahead of us.

Non-GAAP operating margin increased to 10.4%, up from 10% in the prior year, driven by strong expense management and solid contribution from services. On the bottom line, this was offset by OI&E expense of $180 million, primarily due to interest on our EDS-related debt obligations as well as hedging losses. All in all, we delivered solid non-GAAP earnings-per-share of $0.86.

Now moving on to the details of our performance by business. Services, including the addition of EDS, delivered revenue of $8.5 billion. On a year-over-year basis, operating profit in the quarter more than doubled to $1.2 billion or 13.8% of revenue, reflecting the addition of EDS and our sustained efforts in optimizing service delivery.

Drilling down into the Services business, Q2 revenue was $3.8 billion in IT outsourcing; $2.4 billion in technology services; $1.5 billion in application services; and $709 million in BTO.

The EDS integration continues to go well. Customers see value in the EDS acquisition. We have a growing pipeline and had solid deal signings, including a $1 billion deal with Aviva.

Enterprise storage and server revenue was $3.5 billion, down 28% year-over-year. Operating margin was 7.2%, pressured by lower volumes, tough market conditions, and the impact of the Cornell litigation charge.

Revenue and business-critical systems and Industry Standard Servers each declined 29% year-on-year, even as we gained share in x86 servers and maintained our market leadership. Total storage revenue declined 22%. These results were driven primarily by unfavorable currency exchange rates and market conditions.

HP software revenue declined 15% from the prior year to $880 million. BTO and other software revenues were each down 15% from the prior year. Support performance was solid across the portfolio, reflecting strong maintenance renewals and a sustained business value of our solutions. For the quarter, software operating profit increased 51% from the prior year to $157 million or 17.8% of revenue.

Personal systems delivered revenue of $8.2 billion, down 19% year-on-year and operating profit of $374 million or 4.6% of revenue. Total unit shipments were roughly flat year-on-year, with notebook unit growth of 14% offset by desktop systems decline of 13%. Average selling prices declined more steeply this quarter due to product mix, currency and a competitive environment.

PSG continues to execute well in this challenging demand environment, gaining 2 full points of market share, fueled by improvements in US consumer and China.

Imaging and printing revenue for Q2 was $5.9 billion, down 23% year-on-year, due to a tough economic environment. IPG delivered another quarter of operating profit in excess of $1 billion. Segment operating margin increased 220 basis points to 18.2%, as favorable supplies mix and cost reductions were partially offset by hardware rate declines.

Compared to the second quarter of last year, total printer units declined 27%, and consumer and commercial hardware units declined 23% and 36%, respectively. Supplies revenue declined 14% due to lower end-user demand and reductions in channel inventory.

Last quarter, we outlined several actions that IPG was taking to align its supply chain with lower demand. IPG made progress against these objectives with both owned and channel inventory down significantly since the end of Q1.

We continue to be the undisputed leader in printing, with over twice the market share of our nearest competitor. We are investing in new innovation across the printing business that we expect will drive page growth and extend our leadership. Some of the more innovative investments include our retail publishing systems, touch smart technologies, the Indigo 6000, and new mobile and Cloud printing technologies. In addition, we've demonstrated good momentum in wireless printing and managed print services in Q2.

Rounding out this segment, HP Financial Services had revenue of $641 million, down 6% year-over-year, due to unfavorable currency exchange rate impacts, and generated operating margin of 7.2%.

Now onto the balance sheet and cash management. We closed the quarter with a strong balance sheet, increasing the total gross cash to $13 billion while reducing our total debt by $1.7 billion. Excluding the debt associated with our financing business, we returned to a positive net cash position this quarter.

Day Sales Outstanding increased to 48 days in Q2, up from 43 days one year ago and up from 46 days in Q1 '09. Days payable was 49 days, down six days year-on-year, and up one day sequentially. Owned inventory was down seven days year-on-year to 25 days, and down six days sequentially, reflecting good progress in aligning inventory to the demand environment.

With regards to channel inventory, each of our segments is within its target range. Compared with a year ago, ESS channel inventory was flat; PSG was up a week; and IPG was up 0.5 week. We made significant progress in improving IPG's channel inventory position in Q2, reducing it by one week sequentially.

Gross CapEx was $842 million, up 20% from the prior-year period. On a net basis, CapEx was $744 million, up 24% year-over-year. Increased capital expenditures were primarily related to growth in our leasing and outsourced services businesses, including EDS.

Cash flow from operations grew $4 billion sequentially to $5 billion in Q2, with free cash flow increasing to $4.2 billion. Share repurchases in the second quarter totaled $801 million, or approximately 24 million shares. At the end of the quarter, we had roughly $7.1 billion remaining in the current share repurchase authorization.

Finally, we paid our normal quarterly dividend totaling $192 million.

Before turning to outlook for Q3, I wanted to provide an update on our restructuring activities. In September, we outlined the details of the EDS integration with plans to achieve $2.5 billion in annual growth run rate savings, once the integration is complete.

As the integration has progressed, we have been able to further refine the real estate requirements of the combined company, and as a result, expect to achieve incremental annual savings of approximately $500 million, beginning in 2012. This brings the total expected annual growth savings associated with the EDS acquisition to $3 billion.

The incremental charges associated with the real estate transformation are expected to total approximately $1 billion, including a $210 million charge to goodwill in Q2. The remainder of the charges will be recorded over the next 2.5 years, as we cease to use the facility.

In addition, we'll be taking some targeted actions to structurally change and improve the effectiveness of our product businesses. These actions will result in the elimination of approximately 2% of the HP workforce, as we further streamline and simplify our organization and our supply chains. These actions will be implemented over the next 12 months, after consultation with employee representatives, where required.

As a result of these real estate and headcount actions, we expect to record a charge of approximately $0.12 to $0.14 in the Q3 '09 GAAP P&L.

Now looking ahead to our outlook for Q3 and fiscal 2009. We expect Q3 fiscal 2009 revenues to be approximately flat to down 2% sequentially, in line with typical seasonality. For the full year, we expect revenue to be down 4% to 5%, including an unfavorable impact from currency exchange rates of approximately 6 to 7 percentage points.

Regarding earnings, there a few variables to keep in mind. We expect OI&E expense of about $0.05 per quarter; a tax rate of approximately 21%; and weighted average shares outstanding to be roughly flat in the second half of fiscal 2009.

With that in mind, we expect third quarter non-GAAP EPS in the range of $0.88 to $0.90. For the full year, our outlook for non-GAAP EPS remains unchanged in the range of $3.76 to $3.88, representing growth of 4% to 7% for the year.

We will now open the call for your questions.

Operator? We're ready.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Toni Sacconaghi, Sanford.

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

I was wondering if you could comment on just the overall market environment. Last quarter, you said you expected revenues to decline minus 2% to minus 5%. You're now saying you expect revenues to decline minus 4% to minus 5%, even though currency is actually going to be more favorable now than you anticipated before.

So your outlook for the year has deteriorated, yet you're guiding for normal seasonality. How do we reconcile those points? Do you think the market is actually worse than you had anticipated a quarter ago? Do you feel that HP is less competitive in any way? How do we reconcile your guidance from last time versus now?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Okay, Toni -- Mark. First of all, I would not go -- certainly we don't think HP is less competitive. We think HP is more competitive. So, that would be how I feel about that point.

I think we see the market as roughly the same. We're within the same revenue ranges we talked about before. We probably haven't -- currency to us is still volatile. So I wouldn't say that we've factored every currency spot rate into the number; this is more of a local comparison, local currency sort of a move-to-move.

So while we see at a macro level a couple of areas that we see some encouraging signs, I think that would be the right way for me to describe it. China was a little stronger than we've seen it, and so we would look at that as good news. We saw some slight improvements in US consumer, so we would look at that as some good news.

In terms of the rest of the market, I could tell you a lot of stories with a lot of different signs, but I'm not ready to call it better, beyond the two that I described to you. So I think you should view this as sort of steady as she goes.

When you looked at the quarter, if we went back 90 days ago -- the quarter for us being Q2 that we just reported -- behaved roughly as we expected. It was -- there were a few things here or there, but generally it behaved at a macro level as we expected.

I would say we were a little better on the bottom line than we expected, but the revenue top line was about what we expected. And our view is that with the exception of a couple of places that I talked about, it's roughly going to be the same the rest of the year.

I think that's the way you should view our guidance. If currency tends to be a help, that's great. We're not really factoring in a major improvement in currency in anything that we've seen yet so far, either.

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

Mark, just one quick follow-up, if I may. You commented a little bit on the quarter being kind of in line with your expectations. I presume that means normal linearity --

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Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Yes.

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

If I could just pick up on one point. I think IDC had said that your unit growth in PCs for March -- from January to March was plus 3. The unit growth that you reported in PCs was actually flat. So if you took that data as sacrosanct, which I know it's not, it would actually suggest that, at least in the PC market, April was a little bit worse than January.

Any comments on that data point specifically or linearity across businesses in the quarter?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Toni, as always, I applaud you for your analytics. As you know, it's just not that good, I mean, in terms of the analytics. The IDC data has got one dimension to it that requires a little bit more detail. And I would not run there with your analysis.

I would say your first point is the way to think about it. Linearity-wise, the quarter behaved roughly as we expected. So there's just absolutely no news I could give you in the context of linearity.

April did not look weaker on a relative basis than March or February. In fact, each month behaved roughly as we expected. So I hate to make it sound like there's no news, but on the top line, the quarter was, frankly, amazingly from where we were 90 days ago, it behaved roughly as we expected.

And I think perhaps, Toni, in the context of that, that's good news. If you want to look for something that was at least predictable compared to the kind of environment we were actually going through in Q1, which was clearly more volatile.

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

Thank you.

Jim Burns - *Hewlett-Packard - VP of IR*

Let's take the next question, please.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James & Associates - Analyst*

Okay. On the supplies business, just given the year-over-year declines of 7% and 14% that you've seen over the last two quarters, so a little bit over 10% in the first half of the year, Mark -- what specific metrics do you track internally, whether they be macro or micro in nature, that might support your argument that the declines you're seeing in the supplies business are entirely cyclical versus secular?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

So, there's a lot of metrics we track. Obviously, we track revenue performance. We track owned or profit, if you will. We track owned inventory and channel inventory, if you will -- the aggregated supply chain across the business.

We track market share by segment. We track market share by country. So it's a pretty thorough score card we track in the printing business. We obviously, then, look at it relative to our pools of the business, which is graphics, which is obviously a place that we have a lot of intellectual property -- inkjet, where we have a lot of intellectual property, and then laser. So we actually look across those three pools as well, with the same metric set.

So, with supplies, I think you should expect probably in Q3 a bit more of what you saw in Q2 for us. There's some places that we did a very good job in IPG, managing the collective owned inventory and channel inventory. We feel very good about that. But there's some places that we like to align the mix of hardware with supplies within the context of the channel inventory.

I also think in Q3 you should expect to see us going after a bit more share than what you saw in Q2. This is really interesting for us -- one point that would be a little noticeable I thought in the quarter was we had some hardware situations where we had some outages. And we could have shipped some more hardware units in the quarter than we did. So we'll try to take advantage of those opportunities from a market share perspective in Q3.

Brian, let me just for a second, though, try to take you up a level and try to give you some context for how we look at the whole business, because I think it's related to your point. I mean, our view is the base business is slightly up over the long-term -- flat to slightly up would be the way I would think of the entire printing segment.

Digital printing content is growing. So the cyclical stuff that we're seeing right now, as we've talked about before, is based on GDP and unemployment. But secular changes that occur in printing, which I've heard from several people that says, is there some big secular change in printing? Secular changes occur over years and decades and over very long periods.

I mean, home photo-printing, for example, is less than 10% of our supplies revenue. It's shifting to the Web and it's shifting to retail locations as well as the home, which is one of the reasons why you see HP investing in Snapfish. It's one of the reasons why you see HP investing in retail photo kiosk. That as everything that goes -- when things go to Snapfish, a photo book, for example, is printed on an Indigo printer using HP intellectual property and HP ink.

When you go to a retailer and see an HP photo kiosk, you're printing that on HP ink and HP intellectual property. And the reason why we build that strategy around pages is because we want to be where the consumer goes to print. And so we're agnostic as to where the consumer goes, to be able to get that photo printed. And we see that base business being again some good things and some things that perhaps are headwinds, in terms of what the overall business looks like.

So, think of it this way -- continued growth and printable content; a lot of movement from analog printing to digital. So there is a big market pool for analog printing to move to digital -- things like brochures, signage, labels, coupons, manuals -- stuff like this is all stuff that's shifting from analog to digital, giving us an opportunity for us to get more business.

At the same time, digital printing is increasing and improving its ability to deliver quality, speed; it's lowering its costs. And that will shift to more applications to digital. So things like newspapers, directories, magazines, all these things have an opportunity to move to digital. And then that gives us an opportunity for us to leverage our intellectual property as we move.

So, when we look at the whole thing, we say the base business is flattage -- flat to up slightly. And then we like our opportunities to gain share in the context of that hand that gets dealt to us.

Brian Alexander - *Raymond James & Associates - Analyst*

Thanks for the detail.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Let me just add that we think that with the position that we've got our technology roadmap and our strong competitive position, that we will gain share in that market over the long-term, when economies come back. And that that would allow us to grow this business in the low to mid-single digits, which Mark talked about earlier.

I think the other thing I really want to make clear to folks is, IPG today is roughly one-third of HP's profit. That's a very different position that IPG is in today versus historically. We've now got a much better balanced set of segments from a profitability perspective. I mean, you see services this quarter generating over $1 billion -- $1.2 billion in operating profit. And IPG, at just over $1 billion.

From a margins expectation perspective in the near-term, we expect IPG margins to stay up in the high teens, because we get such a high supplies mix. But over the longer term, with us going out and gaining share, again, getting the unit placements when the market turns around, we expect it to basically go back to the more normal mid-teen range.

And so that's really how you should think about this printing business. We are very well-positioned for when economies turn and we have this makeshift from analog to digital.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

I mean, I think, Brian, probably more data than you're asking for, but I think it's important to set the context. And we look at the market as being a low single-digit growth market. And then we like our opportunity to gain share within it.

And that's probably the point when we're dealing with some of the issues we had in Q1, where we get frustrated because we just think the opportunity is a marvelous one for us to take advantage of, given our IP position, our share position, our brand position, and the movement from analog to digital.

Brian Alexander - *Raymond James & Associates - Analyst*

Thanks.

Operator

Ben Reitzes, Barclays Capital.

Ben Reitzes - *Barclays Capital - Analyst*

I want to take the tack, I guess, of revenue guidance minutiae with a half-full view. You guys had way below seasonality the last two quarters, including this one and -- in terms of sequential trends. And now you're guiding normal sequential seasonality.

You said you saw an uptick in China and consumer in the US. But to get to normal seasonality, with the deterioration you saw over the last two quarters, doesn't that mean that the rate of declines are going to get much better in ESS and printing? And what are you seeing there to actually make things better on a year-over-year trend basis? I mean, to get to normal seasonality sequentially after two such downside [done] normal seasonality.

And by the way, you are the only large tech company that I cover that's coming close to the consensus revenue for the current quarter. So, I give you credit for that. But anyway, any views on that?

And then, Cathie, could you just mention how much the charge hurt earnings in the quarter? What would EPS have been without that Cornell litigation charge? And even without the hedging losses? Thanks.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Let me take the last one first. The Cornell charge was roughly $0.02. It was about $0.01 in operating profit and $0.01 in OI&E. So that would be comparable to us delivering $0.88 versus the $0.86.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

And then the $0.01 -- I think Cathie mentioned it earlier -- the $0.01 in operating hit in ESS.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Right.

Ben Reitzes - *Barclays Capital - Analyst*

Great.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

So that's where it hit. Listen, I think there's merit to your points, Ben. I mean, I think that, as I mentioned to Toni's question, it's a more predictable environment than we had and I think that's your point. And so we are seeing some normal seasonality show up.

I would add to it, we have an EDS now inclusion in the Company and their seasonality isn't precisely what HP's seasonality was. So you've got a little bit of an effect there used to a calendar quarter.

So they both have a stronger Q4 and don't have some of the Europe issues that we have from a product perspective, as Europe goes on vacation at least for some part of our Q3. So there is some of that in there.

But I mean, Ben, I mean, I think your points are right. I mean, again, we had a quarter where we looked at the numbers at the beginning in the quarter behaved roughly as we expected from a revenue perspective. And there are many normal seasonality points that you see coming into the outlook that we're describing to you.

The only caution I give you is we are not forecasting any significant change in behavior, because we just want to see more data before we feel good that there's any material improvement in the market.

What I do like about what's going on is our ability to align our cost with the demand we are handed has proven to be very, very strong. And I think operationally, it's been a very good performance by our management team -- certainly not me and not Cathie, but the people that are really running the business are doing a good job of lining that cost with the demand.

And then onside the demand that's handed to us, in at least many important segments, we're gaining share. So I think we like -- to Toni's earlier question, which I'll say again, we like our chances, when the rebound does occur, to be a major participant in the market when that occurs, because of what we're doing right now. And I say again that the winners, when the rebound occurs, are determined in the downturn. And we like our position, Ben.

Ben Reitzes - *Barclays Capital - Analyst*

Thanks a lot.

Operator

Mark Moskowitz, JPMorgan.

Mark Moskowitz - *JPMorgan - Analyst*

I want to touch base on the EDS revenue profile, if you could, Cathie or Mark. I'm just trying to get a sense in terms of the runway you still have ahead of you in terms of the quality of the revenue. You mentioned the signings and the $1 billion-plus deal, but just trying to get a sense of the legacy deal. Are there certain underperforming contracts that you're starting to prune that could really drive even greater incremental leverage, either later this year or next year, from a margin perspective?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Yes, and I'm going to do my best to be concise, which is not my strength when talking about this subject -- maybe it's not my strength on a number of subjects, but with this one -- there's a lot of work we're doing at EDS to operationalize the business. So I would say, again, the strength of EDS is absolutely superior service delivery to its customers. We believe it is the best service delivery organization on the planet -- that's our belief. And that our data supports that with the measurements that we did.

Now we have work to do to align the cost with the revenue, so we've got work to do to make sure we have a clear line of sight about why that cost is there and why it supports what revenue and what service delivery. And that is work that is ongoing.

Additionally, this is an organization that created most of its demand by picking up the telephone and hearing from a contract negotiator that a company was about to outsource. So if you think about it on its two extremes, Mark, we are trying hard to align the demand to get the leverage of the greater HP sales organization that's out in the field.

And you're beginning to see that occur in the funnel. That's exactly when I talk about the uptick in the funnel that's occurring, is because we are seeing more deals than EDS saw before, because of our position in the marketplace through our sales force.

Secondly, the integration that you're seeing, and the work that Cathie and I talked about in terms of the number of people that have left the business, there is work far beyond that. And we gave you the real estate example earlier, which is continuing to align the overhead structure; the cost that sits inside EDS that does not specifically support service delivery; and then the alignment of the specific delivery -- service delivery itself.

And we are working all of those simultaneously. And I'll just say one more time, which I think I said earlier -- the best days of our performance in our Services business are ahead of us, with the work we've got to get done.

And I can tell you as happy as I was when we announced the EDS deal, as optimistic as I think Cathie and I were in August of last year, I would say that we are even more positive on it today than we were at that point. And firmly think -- we have a lot more work to do. So I'm not here trying to tell you it's done by any means. It's just the signs of progress are there.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I'd also add that when you think about the cost savings opportunities and the margin improvement that we've seen year-on-year in services, that really came from both the traditional HP services business as well as the EDS side of the house. In fact, they both equally contributed to that performance.

And that's really because we're in kind of the mid-inning, I would say, on the transformation with respect to the HP traditional services. And we're in very early innings, to Mark's point, on the EDS opportunities, from a savings perspective.

And that's with 190 basis point improvement year-on-year in operating margin.

The other thing I just wanted to add to Mark's comment on the customer side, is that while we are ahead on the integration -- and it has obviously ramifications for individuals at EDS -- customer satisfaction is up. Customers like the acquisition and they are continuing to be delighted by the EDS side of the house. So it's really an all-around good story.

Jim Burns - *Hewlett-Packard - VP of IR*

Great. Let's take the next question, please.

Operator

Richard Gardner, Citi.

Richard Gardner - *Citigroup - Analyst*

Okay, great. Thank you so much. I think on the last call, Mark and Cathie, you talked about the inventory correction potentially taking up to two quarters or a quarter and one-half to get done.

Can you talk about whether you ended the quarter with more or less inventory than you wanted? In other words, was the inventory correction in the quarter bigger or smaller than you expected? And do you believe that levels are where you need them to be at this point?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Let me first talk about owned inventory, because it may not have been clear on the last call. We expected that we could correct and get our owned inventory in good shape in the quarter. And we did that.

We made great improvements on the channel side. We are now within our target range. And so we feel good about that. It's now really about optimizing the mix underneath.

And so there are going to be some countries that are not exactly the way we want them to be. There will be some locations where we have more hardware than supplies or vice versa. So there's still some optimization that needs to take place, but we made the progress that we had hoped to make.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Rich, I think you got about as good an answer as you could get from me. That's exactly where we are. And I think it's probably good news.

We just have to optimize, as Cathy's point, by -- as I mentioned earlier, by country, by sort of SKU number. And within the quarter, probably the only thing that I'd say was a bit of a surprise to us in IPG was that there was more demand on the hardware side than we could fulfill. And part of that was because we were adjusting our inventory.

And that's when I say in Q3, you'll see us get a little bit more aggressive on the market share side. That's what you should expect. But I'd say, what happens to us in IPG, we have quarters like we had in Q1 and we have to go back and do what we did. But I think overall, good score card on that aspect of it in Q2, for sure.

Richard Gardner - *Citigroup - Analyst*

Okay, and then if I could ask two quick follow-ups. The inventory situation -- is that part of the reason that your confident in normal seasonality for the third quarter? Because I know that Europe is typically tough during the June/July timeframe. And we've actually heard a number of your distribution partners talk about Europe continuing to deteriorate at the margin.

So, I guess, as a follow-up to the inventory question, I'm wondering what gives you comfort guiding to normal seasonality for the third quarter?

And then also, Cathie and Mark, I was hoping you could give us a sense of whether distributors in emerging markets, which I guess were really dramatically reducing their supplies inventories to free up working capital, whether they started to come back and order again? Thank you.

Jim Burns - *Hewlett-Packard - VP of IR*

Rich, why don't you pick one of those questions to ask here? We're not allowing multiple questions.

Richard Gardner - *Citigroup - Analyst*

Okay, Jim. Let's go with the guidance question.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

At some level the normal seasonality really depends on the mix of your business. And we had a bigger services mix this year than we've had traditionally. And that gives some more normal seasonality relative to HP historically.

And then there are different stories kind of underneath that normal seasonality. But obviously, EDS gives us a fair amount of cover, because it's a more linear business, which Mark commented on when we talked about this -- I think we answered this question earlier.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Yes, Rich, I think that's your point on IPG, too. I mean, clearly it's one of the reasons why we wanted to get the work done in Q2 -- to give us the room to be able to take advantage of some of the market dynamics that unfold.

And you've got a little bit of disparity now between some of the things going on in Asia, some of the things going on in the US, and some of the things, to your point, going on in Europe. And so we want the opportunity -- to, I think the point Cathie made -- to say let's get this thing instrumented right now at a lower level of detail, so we take advantage of what we think is a pretty big opportunity.

You've got to remember, in our ecosystem, it's not just the consumer inkjet and laser jet stuff; it's also the graphics piece. Because we're very riveted on the places that we have extremely strong IP portfolios. So for us, it's not just getting the channel inventory right in the consumer side; it's making sure we've got our digital presses and everything lined up too.

And part of what we do -- to your point -- is to free up capital and room so that we can take advantage of market opportunities -- which is, in Q1, we had ourself in a position where we just didn't have as much flexibility as Cathie and I would have liked. And that's why we need to do the work in Q2, to be in a position to take advantage of it in Q3.

Richard Gardner - *Citigroup - Analyst*

Okay, thank you.

Jim Burns - *Hewlett-Packard - VP of IR*

Let's take the next question, please.

Operator

Scott Craig, Banc of America.

Scott Craig - *BAS-ML - Analyst*

Thanks, good afternoon. Hey, Cathie, with regards to the cash flow and related to the guidance you're giving on the top line and on the bottom line, can you maybe take us through where you think the cash flow plays out over the course of the year? And maybe some of the working capital ranges around that, do you think are going to be appropriate? Thanks.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Scott, we had a great quarter from a cash flow -- from our [op] perspective. I think we told you on the call last quarter that it was going to snap back and it certainly snapped.

We also, last quarter -- and I'll reiterate this quarter -- believe that we'll have a strong FY '09 cash flow from operations [year] as well. Part of that is going to come from the fact that our cash conversion cycle does have some opportunity to improve a bit. That improvement will come predominately in the inventory as we streamline our supply chain a bit more this year.

And frankly, it will continue into next year. The opportunities that we have in some of our supply chains, specifically in IPG, are going to continue into next year. So that will give us some improvement there.

You should expect to see a bit better on the days of inventory. From a DSO perspective, kind of roughly where we are is what you should expect in the same, pretty much on the payable side. We've done a really good job and it's not as evident because you don't know -- we don't produce numbers that normalize for EDS.

But the [DPO] is actually up two days year-on-year when you normalize for EDS. And so we're really making good progress in managing our payables as well.

And we're doing all of this as well as doing those transactions that help us leverage our balance sheet, that drive economic value for the Company. And I think that that is probably an underlying story that we don't tell enough; but to be able to do as well as we've been doing on the cash conversion cycle and take advantage of these opportunities, is really a testament to how well we're managing the Company.

Operator

David Bailey, Goldman Sachs.

David Bailey - *Goldman Sachs - Analyst*

Just switching to PCs. You continue to gain share but your op margins are also coming down. How do you think about the trade-off between market share and profitability in PCs at this point?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

We think about it but we're not really pricing that aggressively in the market. So I wouldn't say we've gone out, David, to your point -- I know we've gained share but it isn't our objective, necessarily.

We try to run a good solid business. What is going on inside PSG has more to do with currency being in effect on the business. And frankly, the mix of what's being sold skewing -- and this is not a -- this is like a more highly configured notebook being a little less highly configured; a highly configured desktop being a little less highly configured.

And so we've got sort of a SKU shifting occurring, whereas what we see is customers just buying what they have to buy to get the job done. And that's more of an effect than, say, an aggressive pricing environment in the traditional way that might be asked.

So I think for us -- we look at a [50] last quarter, a [46] this quarter is pretty good performance considering a 19% revenue decline. So again, just to give you some context the way I look at PSG -- here's a group 19% down, to your point, gaining share while they do it; delivering to the Company a cash conversion cycle, which is reminiscent of their growth days in terms of operating performance; continuing to deliver a strong return on invested capital; and delivering, I'd say, at least reasonable op margins, given the fact that you've got this skewing going on -- no, that was s-k-e-w-i-n-g -- on what's going on with the mix within the revenue portfolio.

So, I tend to look at PSG as pretty strong at the current time. You know they took the share lead in the two regions that we didn't have the lead in the quarter. And again, that's not the objective -- it's the result, I think, of doing business fundamentals pretty well.

Scott Craig - *BAS-ML - Analyst*

And as you look forward, do you expect that skew to continue to come down and margins to continue to come down? Or do you think it's probably stabilized?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Well, I mean, like we said, with everything in the quarter, you saw a very -- yes, some similarity in Q2 than what you saw in Q1. So we didn't see the volatility in the Q2 -- if you looked at it sequentially from what we saw in Q1. So we're predicting again more of the same as we look out over the course of the year as opposed to it changing to the negative.

Operator

Kathy Huberty, Morgan Stanley.

Kathy Huberty - *Morgan Stanley - Analyst*

Mark, HP customers haven't spent this little on servers and storage in an April quarter since before the Compaq acquisition. So I'd love your perspective on how long you think corporates can delay spending? And if there are any anecdotes you picked up that -- at least it won't get worse from here and maybe even it starts to get better?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

That's a great question. We talk about it all the time. I mean, it is exactly the right question.

We have customers that tell me, we're just delaying as long as we can until we have to buy. And we've got a pretty good model that looks at what those time frames are that people can put things off to. And you've got customers -- and remember, particularly in the enterprise, most customers start planning their fiscal year September and October; make some tweaks to it November and December before the year starts.

My view is the fact that you'll see any catalyst, material catalyst, that will change the '09 trajectory in enterprise spending is probably not realistic. Most of these companies fix on their budget. In order for that budget, that CapEx budget to go up, most of the companies doing the buying have to have some change in their plan.

I think the more important question is, what are those planning sessions looking like in August and September of 2009 about 2010? I think there is a chance that people see any sort of meaningful catalyst, that some people say, listen, if Q4 is getting a little better, maybe we'll pull something from 2010 into the fourth quarter of 2009.

But I think that's more likely what's going to happen here. I think CIO's have been giving marching orders that says -- take that infrastructure; keep the infrastructure running. If you have to replace things to keep things running, replace it. New projects -- be very particular about new projects you start. And if you can avoid starting that project, avoid starting it.

And so I think that's what's going on. And to your point, there are some enterprises that are struggling with not having to do replacements. And that's where you see some of the business coming from.

So there will be a pop. I think it's more of the time frames I'm describing to you, though.

Operator

Bill Shope, Credit Suisse.

Bill Shope - *Credit Suisse - Analyst*

Okay, great. Thanks, guys. Mark, we've had some major shifts in the Enterprise segment, obviously, as of late -- Cisco getting into servers, Oracle planning on tying up with Sun, etc. Can you give us a sense on how you see HP's strategy fitting into this landscape over time? And perhaps ways the strategy may have to evolve?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Oracle, Bill, is a strong partner of HP. We obviously do a lot of stuff together. We built a joint product that we go to market with called Exadata. We have just done more and more together over the past several years. So we think we have a very strong partnership and we expect that to continue.

When you look at the greater enterprise, again, maybe we ought to be clear about our strategy. I mean, we continue to see the enterprise with being a very much an industry standard, common components-based environment.

When you look at the server market, the server market, the storage market, the networking market, all look sort of similar when you look at them from a revenue and a market sizing perspective, but have very different margin profiles.

The gross margins of the industry in storage are exponentially higher than those of servers. The gross margin in the networking market is exponentially higher than that of storage. And we see that entire market being built off a series of standard components that you would think of today being PC components.

So think of this scaled tens of billions of dollars supply chain of common industry components -- not just silicon, but hard disk drives, memory, power supplies, et cetera, et cetera, feeding whether that's a PC, an industry standard server, a blade, a storage array, or a networking device.

And the fact that you have to have tremendous scale and yet the unique of common components and yet the unique capability to take into one of these individualized products and yet simultaneously, as we did with Matrix, integrate them into a common platform.

So for us, it's very important to continue to build out that ecosystem and gain the leverage of that scale. And so anybody who wants to get into that fight, which is -- you've got to be able to fight against that whole PC scale, that server scale, the storage scale and the network scale, and you've got to be able to take it to common components.

Just to give you one anecdote. If you went back two years ago, our storage componentry was less than 35% that was common components. And we believe over time, we can do more than double that, using the same components that sit -- and I think more than double that -- off common components that you would think of today being part of a PC.

So in the context of companies that are able to go grab that scale and leverage off that ecosystem, we're excited and ready to get after it.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

And it's not just about scale and standard componentry. It's also been about wrapping it with software and other IP as well as services, in order to deliver the entire package. Modernizing the data center is not just about piece-parts. It's about being able to put them all together with unique IP to run, automate, and service the data center.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Yes, I mean that's exactly -- so for us, I mean, we're trying to then put on top of these common capabilities, management software, data center automation, server management, storage management, et cetera, and then be able to deliver the services, soup to nuts, to be able to run it; which is why we've done what we've done -- continue to build scale in our industry standards business across all of those categories, support it with a software strategy and support it with a services strategy.

So, Bill, when you net it all out, we feel pretty good about our position. We'll have to execute and show that it all comes together in a way that's meaningful improvement for the Company and our shareholders.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

And this is also moving up the margins stack for HP. So it's going to have good benefits to gross margins too, as we execute.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Yes. We just like the opportunity to move up the margins. We think there's more for us to go get in -- not just at the -- the revenue piles look -- or market sizes look roughly the same; the margin pools look very different. And so for us, we think that's upside.

Bill Shope - *Credit Suisse - Analyst*

Very helpful. Thank you.

Jim Burns - *Hewlett-Packard - VP of IR*

Let's take two more questions, please.

Operator

Maynard Um, UBS.

Maynard Um - *UBS - Analyst*

Mark, I think you may have touched on this, but I just wanted to make sure I was clear. As it relates to the US and China, can you distinguish between inventory restocking and end demand? There's obviously been a lot of news flow talking about (inaudible) and destocking during the holidays, so this quarter may have benefited from a rebalancing.

Your comments, I think, clearly pointed to the April quarter from a US and China demand, but can you just clarify if your comment includes what you're seeing in the market today? And relative to other markets outside of US and China, I know you don't want to call a term, but do you think you might call it or couch it as a stabilization that's occurring? Thanks.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

So I think, Maynard, what I'm going to do is stick with what I said -- that we saw improvement in China and it was material. We saw improvement in US consumer that I wouldn't say was as material, but we could see the improvement. And that is meant to be a demand point, not a stocking point or anything along those lines.

The rest of the market -- again, I could tell you a lot of stories about different markets in the Nordics versus Spain versus this -- I just think we're going to need another quarter of data to be able to really make a meaningful statement about any of upturn or anything like that.

I think our guidance alone shows you more predictability and what we've given you. Our guidance is meant to be sort of a steady-as-she-goes guidance, relative to what we gave you before. There will always be some puts and takes, but at the Company level, we think pretty solid, so -- relative to what we gave before. So that's where I'll leave it, Maynard.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Thanks for taking my question. Just -- Mark, as you're thinking about -- you're working through the EDS integration; you paid down debt this quarter; you've got about $1.8 billion of cash net of HP FS. Can you talk a little bit about your appetite for acquisitions? What you're thinking about the market? And just any thoughts you have on that. Thanks.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Shannon, it's interesting you said it, because we're trying to get our Analyst Day lined up so that we give you meaningful go-forward guidance on our models and where we're taking the Company. And it was suggested in a note that I got that we move the Analyst Day because we're looking at some large transformational acquisition. (multiple speakers)

Shannon Cross - *Cross Research - Analyst*

Would you like to tell us what it is now?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Well, I'm sure you wouldn't tell anybody. But let me be clear -- all jokes aside -- let me be clear. That is not why the Analyst Day meeting was moved. We moved the Analyst Day because we want to give you more information, not less. We want to give you more insight as to where we're going, not more -- and the timing didn't give us the opportunity to give us much forward-looking guidance as we'd like.

But there's no connection, no thing that aligns some large transformational acquisition to some reason we're moving the Analyst Day. And any help you could give me in this small conversation we're having to make sure that message gets out, I'd sure appreciate.

Shannon Cross - *Cross Research - Analyst*

I think you just did. But any thoughts going forward on acquisitions just in general?

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

I mean, we try to be very disciplined, Shannon, as I think we've always been. I mean, I hope -- using your point about EDS, it shows we think we're pretty thoughtful when we try to acquire something. We try to think -- make sure something fits strategically, it fits operationally. And then it makes sense financially.

We'll continue that. But right now, we're very focused on running the Company, taking advantage operationally of what we think are some pretty significant opportunities for when this thing does turn, to take advantage of it.

And as I hope you can see by what's gone on in the quarter, we've been very focused on our cost initiatives; very focused on integrating EDS and getting that right; we've been working on our cash flow. And we just think it makes darn good sense to improve our cash position as time goes on.

So I would not read anything more into it than us just trying to run the Company in the best way that we can and optimize our position. So that's the way I think I'll answer it, Shannon.

Shannon Cross - *Cross Research - Analyst*

Okay. Thanks.

Mark Hurd - *Hewlett-Packard - Chairman of the Board, CEO and President*

Okay. Maybe we'll close up here. Just to say, listen, let me just summarize quickly on the quarter.

I think the Company executed well in a -- I'll, at least, say a challenging environment. We're working hard to align our assets and our cost structure to the demand environment that we're handed, and generate solid earnings and cash flow.

We had good strength in services. It's our largest profit driver today with significant opportunity, as we talked about, for us to increase that contribution going forward.

So while market conditions are still tough, we feel very well-positioned, given our broad portfolio, our global reach, our scale; we've talked about our shared performance in many segments. We have confidence in our EPS guidance with the revenue ranges that we provided, given all the cost savings and the opportunities from the EDS integration and our diverse and recurring business mix.

So that's where we'll leave it today and we look forward to talking to you again soon. Thank you.

Operator

We thank you for your participation in today's conference. This does conclude your presentation. You may now disconnect and have a great day.
