



CORPORATE PARTICIPANTS

Steve Fieler

Hewlett-Packard Company - VP of IR

Leo Apotheker

Hewlett-Packard Company - President, CEO

Cathie Lesjak

Hewlett-Packard Company - EVP, CFO

Ann Livermore

Hewlett-Packard Company - EVP of Enterprise Business

CONFERENCE CALL PARTICIPANTS

Katy Huberty

Morgan Stanley - Analyst

Ben Reitzes

Barclays Capital - Analyst

Richard Gardner

Citi Investment Research - Analyst

Toni Sacconaghi

Sanford Bernstein - Analyst

Scott Craig

BofA Merrill Lynch - Analyst

Keith Bachman

Bank of Montreal - Analyst

Bill Shope

Goldman Sachs - Analyst

Shannon Cross

Cross Research - Analyst

Brian Alexander

Raymond James - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second-quarter 2011 Hewlett-Packard earnings conference call. My name is Alika, and I will be your conference moderator for today's call. At this time, all participants are in listen-only mode. We will be facilitating a question-and-answer session towards the end of this 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, Steve Fieler, Vice President of Investor Relations. Please proceed.



Steve Fieler - Hewlett-Packard Company - VP of IR

Good morning. Welcome to our second-quarter earnings conference call with Leo Apotheker, HP's CEO; Cathie Lesjak, HP's Chief Financial Officer; and Ann Livermore, HP's EVP of Enterprise Business.

Before we get started, I wanted to explain the decision to accelerate the timing of our Q2 earnings announcement. Yesterday afternoon, we became aware of a published media report quoting from an internal HP communication. While that communication did not contain information about HP's second-quarter financial performance, we believe that having access to HP's second-quarter financial results and fiscal 2011 financial outlook would assist investors in evaluating the information in the media report. We therefore determined that the most prudent course of action under these circumstances was to accelerate our second-quarter earnings announcement.

Before handing the call over to Leo, let me remind you that this call is being webcast. A replay of the webcast will be available shortly after the call for approximately 1 year.

In addition, 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 Q2 Form 10-Q. Earnings, operating margins and similar items at the Company level are sometimes expressed on a non-GAAP basis, and have been adjusted to exclude certain items, including amortization of purchased intangibles, restructuring charges and acquisition-related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables 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 will now turn the call over to Leo.

Leo Apotheker - Hewlett-Packard Company - President, CEO

Thanks, Steve, and thanks to all of you for joining us today on such short notice. As Steve mentioned, we felt announcing early was the right thing to do given the circumstances.

As we discussed at our Summit in March, the forces of cloud and connectivity are changing the world of technology and creating exciting new opportunities. There are new market realities in this evolving world and some companies will pay lip service to change, but fail because they will be stuck trying to protect their legacy business models.

The winners will be companies who not only talk about the future, but also actually evolve their strategies and adjust their business accordingly.

At HP, we intend to lead by making the right customer-focused decisions to take advantage of the changing technology landscape and by executing aggressively on our long-term strategy. As always, these decisions need to be balanced, with a focus on operational efficiency and prudent financial discipline.

In the second quarter, we demonstrated our ability to execute aggressively, make the right decisions for our future and drive operational efficiency. We achieved solid results, growing revenue 3% and gaining market share in key segments.

From a profitability perspective, we expanded both gross and operating margins as we continue to drive a better portfolio mix. We grew non-GAAP EPS 14% versus last year, and we generated a healthy \$4 billion cash flow from operations in the quarter.



We continue to make investments in the business with new innovations and incremental R&D spend. We announced many new offerings, including the successful launch of Cloud Systems, Flex Network and Networking and (inaudible) smartphones.

Our customers had a very positive response to our strategy laid out in March. They are seeing us make good progress bringing together assets across the Company. Cloud Systems is a great example, where we are leveraging converged infrastructure, software, security and services to help customers build, manage and consume cloud services across private clouds, public clouds and traditional IT environments. We have already attracted thousands of customers in our pipeline.

In Q2, we continued to demonstrate strength in our commercial business across the Company. Our commercial business, which represents close to three-quarters of the HP revenue, was up 8% year-over-year.

ESSN had another solid quarter. We continue to be the worldwide leader in servers and our networking business is innovating and steadily taking share. And I am pleased with the improvements being made in our software businesses, which grew total revenue 17% and license revenue 29% versus last year.

IPG executed very well across the board during the quarter, with particular strength in commercial. IPG is working diligently with its Japanese laser engine and toner supplier to address anticipated customer and financial impacts resulting from the earthquakes and related events in Japan.

More broadly, we are focused on working to minimize the expected supply chain impact in our fiscal second half. We are thankful for the heroic efforts of those who are working to restore the situation, but HP will not be immune to the impact.

In February, we highlighted two specific areas where we needed more attention, Consumer PC and Services. Since then, we have done a great deal of work in each area, so let me give you an update on where we currently stand.

The PC market continues to be bifurcated. On one hand, the commercial PC market remains strong. HP again grew commercial PC revenue double digits, gaining share sequentially and year-over-year. Our product and go-to-market are very well positioned to capture the ongoing corporate demand.

On the other hand, the consumer PC market has continued to be challenging industry-wise. In Q2, consumer PC revenue declined over 20% year-over-year. Even though our consumer PC expectations had been cautious, the steepness of our Q2 decline is greater than what we had anticipated. We are remaining cautious in the near term.

However, we are excited about a tablet opportunity. You will be hearing and seeing more from our TouchPad in the weeks and months to come. It will be an exciting product release for HP.

A quick update regarding PSG in China. (inaudible) and his team have been very focused on driving our recovery plans. We made good progress in Q2, where we again grew double digits sequentially. We still have significant headroom to get back the share we lost, and we expect our momentum to carry into the second half.

Now, let me shift to Services. As I highlighted in March, Services is an important part of HP's long-term strategy, giving us a platform to be more solution-oriented and a better strategic partner with our customers. A significant Services footprint also provides an architectural link with customers. So as customers look to optimize their traditional IT environments, transition to private clouds, first to public clouds or to [conform] to a hybrid model, HP will help implement and manage these capabilities.

That said, as I have been digging into our Services business in joining HP and diving even deeper over the past couple of months, I have concluded that we had a solid strategy for Services, but we didn't invest in the [path] to support the strategy. Instead, HP focused on maximizing its shorter-term margins. We have overexecuted operationally and underinvested strategically. As a result, our short-term margin expectations have been too high.



This has impacted our ability to create sustainable growth for the long term. In particular, we have not yet shifted our Services mix to higher value, higher-margin and higher-growth categories. You have seen it in our historical results. Our margins have expanded quickly and significantly, but our revenue has not grown as fast as it can or should, and our mix of ITO Application Services, BPO and NTS, has been unchanged over the past several years.

The same is true when I look at recent signings, which have been heavily weighted towards longer-term ITO deals. As we add ITO deals, our margins are pressured as we (inaudible) faster than revenue during the startup phase. We want these ITO deals, but our customers are asking us to expand our application and BPO capabilities more quickly.

So we have a choice point. HP can continue executing for some time along these same lines, or we can improve the value of our Services business by better aligning our Services strategy with the Company's strategy. I've decided that we are not going to just talk about our future; we are going to aggressively execute on our strategy and make some immediate changes.

First, due to the importance of increasing the value of our Enterprise Services business, we have decided to launch a search for an EVP for this business reporting directly to me. Ann Livermore, in addition to her role as EVP for our Enterprise Business, will be the interim leader of ES.

We also have decided to combine the Technology Services organization with the ESSN organization under Dave Donatelli's leadership. The TS business has made great improvement over the last several years. The next phase is to create greater go-to-market leverage with our products and embed more technology into our products to further automate services.

Second, we will accelerate portfolio investments in higher value-add services. We will deepen industry content and form a Business Solutions Group to create more strategic value for our customers. We will enhance our Services offerings in emerging areas, such as cloud services and consulting, application modernization, business analytics and mobility.

Third, we will continue to enhance our delivery and sales capabilities. We will be increasing our bench strength in our Application Services business. We will continue to invest in our sales, business development and delivery capabilities to increase customer satisfaction.

Finally, we will continue to have a tight focus on operational excellence. We will move forward with modernizing our data centers and rationalizing processes, leveraging HP software. This is my top focus going forward.

As I said in my opening remarks, companies need to evolve their strategies, adjust their business models and execute aggressively to enduring these technology shifts. This is exactly what we are doing.

HP has the right long-term strategy, and I expect that the decisions announced today with our Services business will better align that business to our Company strategy, better enable us to meet the needs of our customers and generate a more sustainable return for our shareholders over the long term. I now hand the call over to Cathie.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Thanks, Leo. In the second quarter, HP continued to build on our strategy of delivering cloud and connectivity from consumers through to enterprises. With disciplined execution, we successfully expanded both gross margins and operating margins. We grew non-GAAP earnings per share by 14% and generated \$4 billion in cash flow from operations.

Revenue for the second quarter totaled \$31.6 billion, up 3% from the prior year. Commercial hardware was strong across the Company, but we still saw weakness in consumer PCs. We have solid performance in industry-standard servers, ESS blades and software; double-digit operational growth and networking, as it remains a large market opportunity; and continued momentum in commercial printing.



By geography, revenue in Asia Pacific region grew 10% year-over-year or 4% in constant currency. Revenue in the Americas grew 2%, or 1% in constant currency. And revenue in EMEA was down 1% year-over-year, or flat in constant currency.

Gross margin in the second quarter was 24.6%, up 100 basis points from the prior year due to a continued favorable commodity environment, as well as favorable mix from Networking, PSG and Software. We are investing some of our gross margin improvements back into the business.

Total operating expenses were \$4.2 billion, up 10% year-over-year, with increases in R&D and field selling costs, both of which are expected to enable revenue growth in coming quarters. As we have said before, we actively monitor and evaluate all investments against key milestones as we work to achieve our objectives and deliver results for shareholders.

Non-GAAP other income expense yielded a net expense of \$76 million due to a more favorable currency impact. We delivered non-GAAP operating income growth of 3% year on year to \$3.6 billion or 11.3% of revenue.

Second-quarter non-GAAP net income improved year-over-year to \$2.7 billion and non-GAAP diluted earnings per share increased 14% to \$1.24.

In the second quarter, we continued to execute on our cloud vision, including all aspects of the converged infrastructure, from storage, servers and networking to software and services. The Enterprise Server, Storage and Networking business grew revenue 15% to \$5.6 billion.

Operating profit grew 1.5 times revenue growth, or 23%, to \$766 million for the quarter. Operating margin of 13.8% was up 90 basis points from the prior year, driven by a favorable product mix and supply-chain savings.

Our industry-standard Servers business remained number one in share across all three regions, with revenue growth of 11%. Revenue in Business Critical Systems was up 1.5% year-over-year, with strength in non-stop enterprise servers. In addition, customers are responding to the low total cost of ownership and the reliability in our Superdome 2 systems.

In Storage, there is tremendous interest in the 3PAR utility storage solutions, as customers move to the highly virtualized and dynamically tiered storage arrays built for public and private cloud computing. 3PAR had another quarter of high double-digit operational revenue growth year-over-year, and we are now selling 3PAR solutions in 23 new countries.

Overall, HP storage revenue increased 3% from the prior year, with strong growth in our scaleout products and data deduplication technologies, partially offset by lower EVA revenue as some customers wait for the new product refresh this summer.

HP remains number one in the blade server market and grew ESS blade revenue 20% year-over-year. HP Networking grew 118%, including the acquisition of 3Com, and 14% year-over-year on an operational basis. While our major competitors are seeing declines in their networking businesses, we delivered double-digit growth in our switching and routing businesss.

We saw continued expansion of our proof-of-concept program and our recently launched FlexNetwork architecture significantly outperformed the incumbent's equivalent products.

Leo talked you through some changes we are making to our Services business, but let me provide a bit more color, including the impact to our outlook. HP Services delivered revenue of \$9 billion, up 2% from the prior-year quarter. We delivered operating profit of \$1.4 billion or 15.2% of revenue, down 60 basis points from the prior year. IT outsourcing revenue was up 2% year-over-year. The business had good long-term contract signings driven by renewals, and continues to drive healthy double-digit product pullthroughs.



Application Services made progress in the second quarter, with revenue up 2% year-over-year and some improvement in its short-term project work. Technology Services revenue also grew 2%, and Business Process Outsourcing revenue was down 6%, or up 1%, excluding the impact of the divestiture of ExcellerateHRO.

In Q3 of fiscal '11, we expect Services margins to be 13.5% to 14% as a result of lower revenue growth in local currency, unfavorable mix and investments we are making to further enable higher-margin business.

For Q4, we expect Services margins to be a bit higher than in Q3. To better position ourselves for the future opportunities, we will need to invest in building value-added services, increasing our bench and building new delivery capabilities for these services. We expect Services revenue to grow in the low single digits on a reported basis in fiscal 2011.

We are pleased to report the strong performance in HP Software, with revenue of \$764 million, up 17% compared with the prior year, led by 29% license growth, 22% service revenue growth and 8% support revenue growth.

We see tremendous opportunity in our security portfolio and in our recent acquisitions, ArcSight, Fortify and Stratavia. In fact, we gained almost a point of market share in the security and vulnerability markets. Second-quarter operating profit was \$154 million, or 20.2% of revenue.

Turning to Personal Systems, PSG delivered revenue of \$9.4 billion, down 5% from the prior year. We have firm traction on the recovery in China, and PSG revenue in China was up several digits sequentially and roughly flat year-over-year. We also gained nearly 2 points of share sequentially in China and have a good mix of new products in the channel.

Across all geographies, however, we continue to see softness in the consumer PC markets that offset the strength in commercial clients.

By form factor, desktop revenue was down 4% and notebook revenue was down 9% year-over-year, both impacted by the consumer. Total consumer client revenue was down 23% versus the year-ago quarter.

In commercial, the refresh continues. Commercial client revenue grew 13%, led by another strong quarter in workstations, which generated 28% growth. Segment operating profit totaled \$533 million, or 5.7% of revenue, up 100 basis points year-over-year, as PSG benefited from favorable component pricing and product mix.

Moving on to Palm, which is included in Corporate Investments. There is a lot of anticipation about the upcoming launch of the TouchPad and the buildout of the webOS ecosystem. We remained in the investment phase in terms of completing the software builds, working with the developer community on the application ecosystem and making sure that we get the product right. We are on track to ship the TouchPad this summer, as previously announced. WebOS is a differentiated platform that will redefine the user experience across HP's device solutions, from consumers to enterprise and from smart phones to tablets and other devices.

The Imaging and Printing business delivered solid performance in the second quarter, with revenue growth of 5% to \$6.7 billion, led by commercial revenue growth of 7% and supplies revenue growth of 7%. Segment operating profit totaled \$1.1 billion, or 17% of revenue, while we continue to invest in innovation and growth.

Total printer unit shipments increased 12%, with commercial and consumer printer units up 41% and 4%, respectively, as we gained market share in laser printer hardware. We are seeing solid momentum in our growth initiatives as we continue to lead the market with innovative new products. Indigo Digital Press page volume was up 22% year-over-year. Our color laser and multifunction printer units grew 26% and 60%, respectively, while business ink unit shipments increased double digits from the prior year, and shipments of wireless printer units more than doubled.



In addition, we shipped more than 3 million web-connected printers in the quarter. We will continue to target these markets aggressively, leveraging our technology leadership to drive the shift from analog to digital printing.

HP Financial Services continues to deliver strong, consistent results. In the second quarter, financing revenue grew 17% to \$885 million. Financing volume increased 14%, and net portfolio assets increased 18%. Operating profit of \$83 million is up 20% year-over-year to 9.4% of revenue.

Now on to the balance sheet and cash flow. Our balance sheet remains strong. We closed the quarter with total gross cash of \$12.8 billion. Our second-quarter cash conversion cycle was 25 days, up eight days from the year-ago period due to a higher proportion of sales occurring late in the quarter.

In Q2, days sales outstanding increased 10 days from the prior year, inventories were up one day and days payable increased three days year-over-year. [Panel] inventories in each business ended the quarter within acceptable ranges.

We continue to generate strong cash flow, with operating cash flow of \$4 billion and free cash flow of \$3 billion, each up over 28% from the prior year. During the second quarter, we returned \$2.9 billion to shareholders through share repurchases and dividends. At the end of the quarter, we had roughly \$5.9 billion remaining in our current share repurchase authorization.

And now a few comments on our outlook for the third quarter and full year. We are mindful of our colleagues and business partners that have been affected by the tragedies in Japan, and we respect the courage and resiliency of those who are working to address the situation. Our teams have been working around the clock to implement contingency plans. Together with our partners, we are working as quickly as we can to minimize the impact to our channel partners and customers, but the situation remains fluid.

We are expecting a temporary, near-term impact to revenue and operating profit due to the events in Japan. We expect revenue to decline due to reduced demand in Japan and certain supply-chain constraints imprinting hardware and supplies. The total impact will be roughly \$700 million of Company revenue, or about 1% of Company revenue in the second half, with about two-thirds of the impact in the third quarter.

In addition to the margin loss on the revenue, there will be incremental costs due to the higher supply-chain costs across the Company related to securing parts and increased use of air freight and other costs relating to logistics. We expect the business to recover back to a normal run rate by the end of the calendar year, and we have incorporated these expectations into our revised guidance.

Due in part to the expected supply chain impact from the earthquake and tsunami in Japan, as well as continued softness in consumer PCs, we now expect Q3 revenue of \$31.1 billion to \$31.3 billion. For the full year, we expect revenue to be \$129 billion to \$130 billion.

With respect to earnings, keep in mind the following. First, we have revised expectations for the operating profit in the Services business of 13.5% to 14% of revenue in Q3. Second, a [Y&E] expense of approximately \$150 million per quarter. Third, a tax rate of approximately 22%. And finally, weighted-average shares outstanding for fiscal 2011 of 2.175 billion.

Thus, we expect third-quarter non-GAAP earnings-per-share to be approximately \$1.08. For the full year, we now expect non-GAAP EPS to be at least \$5.00 per share. With that, we will now open the call for your questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Katy Huberty, Morgan Stanley.

Katy Huberty - Morgan Stanley - Analyst

Good morning. Leo, you talked in your opening remarks about companies that will fail because they protect legacy businesses. And with two guidance resets in a row, is it time, in your view, for HP to reconsider whether you really need to participate in some of the businesses that are dragging down performance? Or do you think you can invest fast enough in new growth segments to offset declines that we are seeing like in PCs right now?

Leo Apotheker - Hewlett-Packard Company - President, CEO

Good morning. At HP, we do a high (inaudible) portfolio review to assess the performance of each one of our businesses. We assess these businesses according to their contribution to the business and their contribution to our strategy and the value it can generate to our customers.

It's interesting that you point out PCs. If you look at the performance of PCs, it has a two-phased approach and a two-phased execution. On the one hand, on the commercial side, we see a continuous demand for PCs, 12% growth. Again, we are the market leader in this business. And we see some weakness on the consumer side.

We believe that we have a great strategy to execute towards our connectivity approach, and we are very excited about our TouchPads coming out in particular in the summer. And as we all believe that there will be a convergence of these different form factors over time -- TouchPads, PCs, et cetera, and in particular, notebooks -- we believe this is a great opportunity for HP to participate in this. Of course we will continue to assess the value of each element in the portfolio as we continue to look at our business, but right now, I believe we have a balanced portfolio.

Katy Huberty - Morgan Stanley - Analyst

Just as a follow-up to that, any sense for timing as to when we could see you step up and make some acquisitions?

Leo Apotheker - Hewlett-Packard Company - President, CEO

We are, at the same time as we look at our portfolio, of course are looking at acquisitions as well, in particular in areas where we want to grow faster, such as software. But we will not abandon our prudent M&A approach. We want to make sure that we are financially prudent and strategically wise and that we are mindful of shareholder value.

But we are scanning the market. We are actively engaged, and as in the past, we will be looking at acquisitions in order to [further] the portfolio or at organic growth or at partnering.

Steve Fieler - Hewlett-Packard Company - VP of IR

(multiple speakers) move to the next question, and I will remind the analysts, let's keep it to one question, please.



Operator

Ben Reitzes, Barclays.

Ben Reitzes - Barclays Capital - Analyst

Thanks a lot. Leo, you recently laid out a \$7.00 earnings figure for 2014. After doing \$5.00 this year, I think it takes 12% EPS growth each year to get there. So my question is can you still get there, based on what we heard today, and how?

And then I just was hoping Cathie could clarify the near-term guidance. It seems like the cut for 3Q versus the Street is two-thirds Services, one-third Japan and Consumer. I just wanted to clarify that. Thanks.

Leo Apotheker - Hewlett-Packard Company - President, CEO

So let me answer your question first. We are making tough decisions today to set us up for the future. And in the long term we have multiple levels to drive our EPS growth. But investments we are making today will help create sustainable growth, including sustainable EPS growth, and we are focused on improved business mix and continued operational excellence, including a better mix in each one of our businesses.

For example, in Services, as demonstrated by today's public decision. Our long-term model is to grow operating profits faster than revenue and EPS faster than operating profit. So yes, I can confirm that we are maintaining our \$7.00 EPS target.

Cathie?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Sorry, Ben, I forgot the second part of your question. You wanted to basically get a bridge on the guidance. I'm sorry -- is that when you are asking for?

Ben Reitzes - Barclays Capital - Analyst

Yes. When you do the math on the cut in Services, it seems like \$0.09 to \$0.10 due to Services versus the Street, and then there is \$0.05 or \$0.06 left over. I just wanted to confirm that that math is in the ballpark of how you guys were thinking of it.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

So let me talk a little bit about revenue and the EPS bridges. So we continue to be prudent in our Q3 and our FY '11 revenue outlook. And there is a couple main reasons for that prudence.

The first one is we are expecting this temporary near-term impact to revenue and operating profit as a result of the events in Japan. We do expect revenue to decline as a result of reduced demand in Japan, as well as certain supply-chain constraints that is in our printing, hardware and supplies business.

The total impact for the half is roughly \$700 million of revenue, Company revenue, or about 1% for the half of revenue. And two thirds of that impact is going to hit in Q3.

Then the past quarter, we also saw consumer PC growth or decline more exaggerated than what we had expected when we gave our guidance at the end of Q1. And this continued softness in consumer PCs is now reflected in our revenue guidance.



From an EPS standpoint, we factored in both the impact from the revenue guidance and the associated profits, as you would expect, that relate to Japan and the PC consumer weakness. And then in addition, we've got incremental supply chain costs across the Company that are related to securing parts, and also the fact that we will increasingly use airfreight as opposed to sea shipments in order to meet customer demands.

And then we've also revised our expectation around the profitability for our Services business. And as I mentioned in my prepared remarks, you should look at an operating margin in Services in Q3 of roughly 13.5% to 14% of revenue. And then going into Q4, it should get a bit better.

Ben Reitzes - Barclays Capital - Analyst

Thanks a lot.

Operator

Richard Gardner, Citi Investment Research.

Richard Gardner - Citi Investment Research - Analyst

Okay, great. I would just love to get a little bit more detail on the reduction in the Services operating margin assumptions for the third quarter. Could you provide a little more detail on how much of that is new deal ramps versus the investments that you are talking about?

And then maybe talk about how long, Leo, you think it will take to execute this transformation in Services and whether it is going to be organic or at least partly acquisition-led?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Let me start with some of the headwinds that we see in the Services' margins for the second half. Really, as we talked about last quarter, revenue in the Enterprise Services business has really not grown as fast as it can or it should. And as we start up new ITO deals, we do defer some of the revenue and costs associated with the data center transformations. But ultimately, there is a mismatch between the revenue and the cost in the early phases of the project, and so the margins are significantly depressed in these early phases.

And then we've got much of the strong ITO signings have been renewals, which obviously come with additional price concessions and, in some cases, additional runoff.

The second factor is unfavorable mix, and we talked a little bit about this last quarter as well. The revenue in signings have been heavily weighted to the lower-margin ITO business, and we have not been ramping up the value-added application services business basically fast enough. And that is why we are making some of these decisions this quarter to reset the margins and make investments. So finally included in our plan is the continued investment in building our delivery and sales capability, and also enhancing our portfolio in these higher-value-added solutions.

And as an example, in our Application Services business, we will be increasing our bench with a number of people who are available in accounts to basically sell add-on application services business. And then it will allow us obviously to respond better to customer demand.



And this has left us with -- the sum total of these has really left us with a higher fixed cost structure than what was expected originally in Services, and frankly, not a very rich margin until some of these ITO deals get through the transformation and transition phase.

Leo Apotheker - Hewlett-Packard Company - President, CEO

So let me just pick up where Cathie left it and try to answer the other part of your question. As you can see, we are about to engage in a significant transformation of the Services business and, to be totally candid with you, in fact we are now going to execute the strategy that was outlined on the Services business years ago.

It should have been happening quite some time ago that we would have been -- we should have been moving into these higher value-added businesses and it didn't occur in the past. So it will happen now, there is no doubt about that. So we will execute starting as of today.

There is a number of things that we have already planned and that we can talk about in our organizational set up. For example, we have started a search for a new EVP for our Services organization. That person will report to me. Ann Livermore, who is here today as well, will be the interim Head of Services.

Our Technology Services will move together with our ESSN business, under the leadership of Dave Donatelli. We formed a Business Solution and Industry Services group led by two very senior executives. The Business Solution Group will be developing industry-specific IP. It will be taken to the market and sold as IP or delivered as a service by the Industry Services Group.

So all of these steps are being taken. It has a bit of an impact on the margins, as Cathie has just outlined, in the second half of this year. And going forward, this is going to be a solid business that will perform. And by the way, just to make sure that you all have a good benchmark, even after the reset of the margins, we compare favorably with our main competitors in this business from a margin perspective.

And going forward, our Services business, particularly as of FY '12, will be a solid, strong, additive business to our mix, and we look forward to see the value that is going to be generated there.

Richard Gardner - Citi Investment Research - Analyst

Leo, could I just ask you to address the questions regarding how long the transformation might take and whether it is organic versus acquisition-driven?

Leo Apotheker - Hewlett-Packard Company - President, CEO

We are talking about an essentially organic change. All of the things that we are talking about will be organic. There might be a small acquisition here or there, but consider it essentially as an organic change.

And Services transformations take some time, which is why we give you clear guidance on the second half of the year, and will be happy to talk to you again in September when we do the analyst meeting.

Steve Fieler - Hewlett-Packard Company - VP of IR

Next question, please.



Operator

Toni Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - Sanford Bernstein - Analyst

Thank you. I just wanted to follow up on the Services expectations. It sounds like these are largely professional services transformations. So your PS business, which is about half of your Services business, feels largely unaffected, and organizationally you're actually migrating it. So that would be supportive of the fact that it is unaffected.

So my sense is you are calling for maybe a 200 or 250 basis point reduction in operating margins on half of your Services profit. So that is about a 500 basis point decline on your professional services side of the business, which I think probably has single-digit margins today. That seems like a pretty dramatic reset.

So one, can you confirm that TS is unaffected and that my interpretation of the reset is indeed the case? And then, perhaps you can -- I'm still not sure whether this is because of deals that you've signed recently that need time to ramp, which doesn't feel like a change, or it is because you are going to make substantial investments to the tune of 400 or 500 basis points on a go-forward basis. Perhaps you can clarify that.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

I can confirm that the TS business is unaffected by the changes that we are making right now on what we call the Enterprise Services side of the house. But it is important to understand that the TS business is not half of the total Services business. It is a smaller percentage than that.

Toni Sacconaghi - Sanford Bernstein - Analyst

(multiple speakers) Of the gross margins?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Pardon me?

Toni Sacconaghi - Sanford Bernstein - Analyst

Not of revenues -- of operating margins. It is not close to half?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Actually, that is better -- it is a different question.

Toni Sacconaghi - Sanford Bernstein - Analyst

Okay. That was the assertion -- it is half of the operating margins, and therefore the reduction that you are calling for in overall Services margins for the remainder of the business is double that, which is about 500 basis points.



Leo Apotheker - Hewlett-Packard Company - President, CEO

Let me maybe step in here for a second and Ann can chime in, as well. Our Enterprise Services business has higher margins than what you seem to be alluding towards. We usually don't discuss that, but I can assure you it runs at a higher margin than what you are describing.

Let me maybe try to give you some color on what is really happening, and then you can draw your own conclusions.

The reasons why we are taking actions is not because we can't continue driving the business as it is today. We could probably do this for a certain number of quarters going forward. And then we would probably be sitting here with a business that is running out of steam. And that is certainly not something we intend to do.

So we are taking action to align our Services business model to our long-term enterprises strategy. And we want to offer our customers higher value-added solutions and we want to help them migrate to and manage the hybrid cloud versus traditional environment.

Our current Enterprise Services mix is weighted to slow growing -- I insist on that -- slow growing and relatively lower-margin areas of the services market. And we need to add some higher IP and intellectual capital content, and we need to increase the automation using our HP technology, so that if we do all of this, we expect to change the mix of our Services business to a faster-growing and higher-margin areas of the services market.

And if we do all of this, then we will position this business well, we will grow it at or above market, while delivering unprecedented value to our customers and better return for our shareholders. That is the strategic intent, and that is what it is we are going to execute.

Toni Sacconaghi - Sanford Bernstein - Analyst

Thank you for the clarification, Leo. I was just trying to probe a little further on the magnitude of the investment. Because if it is unaffected in TS, that suggests a substantial investment. And I'm trying to understand is it really incremental investment in terms of new businesses and feet on the street, or is it some of the things that Cathie appeared to be alluding to on previous questions, about well, you've signed a bunch of ITO deals recently and they are low-margin and they are going to take some time to climb higher? That actually doesn't feel like an investment. That just feels like a lifecycle thing.

So I would appreciate a better clarification of what is going to cause this pretty significant depression in margins in the near-term.

Leo Apotheker - Hewlett-Packard Company - President, CEO

As Cathie was describing, the root cause was why we need to make some changes. And what we are going to do -- and I'll let Ann give you some color on that -- is that we are going to make some investments in order to move towards higher-margin areas. Ann, would you like to comment?

Ann Livermore - Hewlett-Packard Company - EVP of Enterprise Business

Sure. Tony, to your point, we do have, as a result of the great ITO signings that we've had, these upfront investments. So there is an aspect that are the lifecycle costs for where we are on some of these deals and how many we've had starting up.

There is also an aspect, in the ITO market, we want to make some additional investments around building out further security capabilities, because we have huge demand here. That is an area we will be investing in with some additional resources. And



also, some of our cloud-based services inside ITO. And those are the higher-margin, additional services we can sell on top of or alongside ITO deals. So that is one area of investment and also some comments on your lifecycle point.

The other investments are -- Leo mentioned investments in our industry-focused solutions, both in the services aspect, as well as in some intellectual property we are developing around our industry-based solutions.

And then finally, with the Application Services market, that is a big, attractive market for us. And we've been performing very well in the applications management part of that market. But we have strong customer demand and not enough capability yet today in other aspects of that market. So we are taking some actions to redouble our focus there and make some investments in it. We've added some new people to the team in terms of the leadership, and we are also investing to have more capabilities in apps modernization and our Cloud work around the application space and mobility in things like business analytics.

So these are resource and capability development investments that we are making.

And then you also heard the comment that Cathie made about investing in the bench. We actually had too tight a bench in our Application Services business. We needed more people on the bench. We had customer demand, but we couldn't sell into it because we couldn't immediately address that demand. And what we figured out was we actually need to run with a little heavier bench. And we know that this is the practice that many of our competitors do that allow us to do more of the short-term signings.

So all of those are actions we are taking that I would consider investments in addition to just where we are in the ITO deals.

Steve Fieler - Hewlett-Packard Company - VP of IR

Next question, please.

Operator

Scott Craig, Bank of America Merrill Lynch.

Scott Craig - BofA Merrill Lynch - Analyst

Thanks. Good morning. Maybe switch gears and go over to the printing business for a minute. When you look at the supplies revenue, it sort of seems stuck in the mid-single-digit area year over year, despite the fact you are seeing really solid hardware growth, especially in commercial. So typically would have expected some acceleration by now.

So has something changed in the supplies buying pattern or pricing or usage or anything like that that you can point to? And do you expect to see an acceleration maybe over the next couple quarters, given the hardware placements? Thanks.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Scott, I think you go back to other calls that we've had, we've basically said that we think that the long-term growth of the supplies business is low to mid single digits. And so this being kind of in the mid-single digits is in fact maybe a bit higher than we had expected on a sustainable basis at 7%.

But we've talked about low to mid, and that is really what we think is what the supplies growth you guys should think about on a long-term basis. And again, from quarter to quarter, we may have things that are a bit higher, a bit lower, but that is kind of how we think about the business.



Steve Fieler - Hewlett-Packard Company - VP of IR

Thanks, Scott. Next question, please.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - Bank of Montreal - Analyst

Sorry about the background noise, but I need -- you can go back to Services for a second. And Ann, maybe this is for you.

When I hear about the deployments and investments you are making, Services is a long lead time turnaround. It sounds more the activities that you are pursuing would help in mid-FY '12 since the sales cycle on a Service deal is a long time.

So I just wanted to see if you could get some clarification around what the potential timing impact is. And related to that, Ann, you alluded to the fact that you are doing things that your competitors have been doing. How does this really position HP in competitive advantage? It sounds more like you're striving for competitive parity.

Ann Livermore - Hewlett-Packard Company - EVP of Enterprise Business

On a couple of your points. All of the actions that we are taking are within the guidance that Cathie has provided for you, in terms of expected revenue and EPS, and not just EPS, but operating profit for Services. So we've taken into account the amount of time some of these investments and actions take to ramp in the guidance that you've got. And some of them, of course, provide shorter return than others.

In some cases, where we are adding resources in the security space, there is immediate demand for those resources, so it is a lot shorter return for us in areas like that. So we feel very good about that.

We've hired a number of people inside our Services organization from across the industry over the last year. And when they come into HP, they are almost in awe of the portfolio and capabilities we have, and, in fact, are surprised by, in our Services business, how much capability we have.

What we are talking about now is being able to invest in a lot of the new areas that our competitors don't have a better or stronger position than we have today. If you look at the areas like the services we can do around security and the software assets we have, it is a huge differentiation.

So one of our Services areas of differentiation is very closely tied to the technology and applications and IP that HP has inside our software business, inside our product business. So I think that is a very differentiated position that I would stand up against anybody. And it is the combination of the software assets, those products and the services we can build around them that gives us a very differentiated capability.

The other thing we've got is we've got an installed base of customers who want to buy more from HP, and are very interested and eager for us to provide these additional services. And many of our competitors don't have that. We've got an installed base who want us to provide more of these services.

So I think those are quite differentiated opportunities for HP, and particularly the IP that we are developing around the industries and that we have based on our software portfolio is quite differentiated.



Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

I think the other thing to remember in the Services business that doesn't show up in the Services segment is a lot of the pullthrough that we get because of the relationships that we've got within those accounts. And the pullthrough again this quarter was up significantly in the double digits. So we continue to see good improvement in the pullthrough that helps our entire portfolio.

Steve Fieler - Hewlett-Packard Company - VP of IR

Thanks, Keith (multiple speakers).

Keith Bachman - Bank of Montreal - Analyst

Cathie, just to clarify --

Steve Fieler - Hewlett-Packard Company - VP of IR

Next question, please.

Operator

Bill Shope, Goldman Sachs.

Bill Shope - Goldman Sachs - Analyst

Given that you've determined that you have previously underinvested in Services and you're appropriately increasing investments to address this, can you comment on how you are thinking about other elements of the Enterprise business? Do you believe historical investment levels were appropriate in these segments, and are you comfortable with your current investment levels there?

Leo Apotheker - Hewlett-Packard Company - President, CEO

Let me try to answer that question. As I said in my opening comments, we have been looking at all of our businesses rather carefully, including Services, and have reached the conclusion that you've just heard about.

The good news is that if I look across the HP business, there are other businesses where we are doing really well and where we had made some of the good decisions, and we are actually now getting some of the benefits of that. Let me just give you two good examples for that.

One is Networking, where we see great performance happening and where we outgrow our competition. We produce much better product at a significantly better price performance ratio than anyone else, and that is why we are winning so much. We are adding a lot of innovation there as well with new products, including our FlexNetwork software. And as we are adding IP to our various businesses, we are creating the differentiation.

Let me point out another business that we are doing extremely well that hasn't been talked about too much today, our software business. And while we talk about the overgrowth of the software business, as you know very well, you should measure software



businesses by the growth in licenses, and there, we grew by 29%. Which shows that once you start going into differentiated aspects of the business, you start to invest in IP, you reap the benefits of it. So overall, I think we are well-aligned.

Steve Fieler - Hewlett-Packard Company - VP of IR

Thanks, Bill. Next question, please.

Operator

Shannon Cross, Cross Research.

Shannon Cross - Cross Research - Analyst

Thank you. A question for Ann and Leo. I'm just curious as to how the decisions that are being made on the Services side sort of mesh with the \$1 billion charge that you took back in June. And I know, Leo, you weren't there at the time. But I'm just curious as to if there are things that were incorporated within the restructuring that you did in the Services that you're sort of backtracking on, or was that just one of the steps in getting to a more optimized business?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

Let me just provide some context. There were really two components of the transformation -- the charge that we took for the transformation last June. There is a labor element and a nonlabor element.

In terms of the nonlabor investments or actions we took, including data center consolidations and network rationalizations, we are a bit ahead of plan. On the labor side, we are a bit behind in the plan. And what we are doing is we are evaluating migrations, basically contract by contract, to make sure that we are getting the right return on those migrations. And this is taking longer than we had originally intended.

But there are certainly aspects of this transformation that are very much in line with the actions that Leo has talked about that we need to continue to do.

Ann Livermore - Hewlett-Packard Company - EVP of Enterprise Business

I think Cathie summarized that well. Another part was the standardization of some of the tools that we actually use in our IT delivery, and that is something that is on track and we are pleased with, as well.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

I would also say, there is more in this area that we had planned to do in 2012. And we certainly would love to be able to pull some of that forward, and are looking at what we can pull forward so we can get done more quickly. But there is just a lot of activity on the Services side, both on continuing to focus on the cost structure and making sure we've got the right cost structure in the right locations, as well as the investments that we need to make to get us into more higher-value-added services that tend to be the higher growth areas within the services market.

Steve Fieler - Hewlett-Packard Company - VP of IR

Operator, we will take two more questions here.



Operator

Brian Alexander, Raymond James.

Brian Alexander - Raymond James - Analyst

I guess using the midpoint of your third quarter and your full-year outlook, it implies that the fourth-quarter revenue is up about 10% sequentially, which is in line with historical seasonal trends. And it implies operating margins are up about 100 basis points, which is also, I think, seasonally normal.

So it looks like you are anticipating just a one-quarter reset, followed by business as usual. I understand Japan is temporary and maybe some of the improvement in the October quarter is due to less of a drag from Japan. But what gives you the confidence that beyond the July quarter, it will be business as usual, given what appears to be more of a multi-quarter transformation in the Services business, where you don't even have a leader in place to set the direction?

And I realize you're not guiding for next year, but back to Keith's question, as you think about the Services business next year, are you assuming that it grows low single digits in line with your long-term trends, and are you assuming margins will be no worse than the 13.5% to 14% you talked about today? Thanks.

Leo Apotheker - Hewlett-Packard Company - President, CEO

You said it very correctly. We are not giving guidance for FY '12 or forward. But I just want to reiterate a few points we made earlier.

First of all, we reconfirmed the target that we set out for ourselves during the Summit of \$7.00 EPS for FY '14. We maintain that target. And the reason why we believe we will achieve this is, among others, the investment we are making today in the Services business.

The Services business can be leveraged, in particular, as Ann mentioned before, through our IP. And we will need to add IP to our Services business. On the one hand as IP and on the other hand as intellectual capital that differentiates ourselves from others. I believe that we can achieve this over the next coming quarters, and we have the delivery capability and the sales capability to bring this successfully to customers.

There is demand out there. It dovetails really well with our cloud strategy and the huge demand that we see in the market for cloud migrations, cloud adoptions and cloud transformations. So we are dovetailing into this.

We are also generating new revenue streams. I mentioned software earlier on. There are others that are coming. So I believe that we are well-positioned. And as we are making these changes today, we will be able to capture the wave tomorrow, i.e., and FY '12, and we will be able to discuss this in much greater detail when we meet in September for the analyst meeting.

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

If I can just be a little bit more tactical. So in Q3, I said the Services margins would be 13.5% to 14%. And then what I said for Q4 is that it is a bit better. It does not get back up to the high 15% to 16% range that we saw in the first half.

Brian Alexander - Raymond James - Analyst

But Cathie, does it get a bit better next year off of that Q4 level?



Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

I'm sorry, pardon?

Brian Alexander - Raymond James - Analyst

Does it get a bit better off of the Q4 level next year?

Cathie Lesjak - Hewlett-Packard Company - EVP, CFO

We will talk about next year when we have our security analyst meeting.

Steve Fieler - Hewlett-Packard Company - VP of IR

Operator, actually, we are out of time here. So I think I will hand it over to Leo for some final comments here, and then we will end the call.

Leo Apotheker - Hewlett-Packard Company - President, CEO

Thank you, Steve. HP delivered a solid quarter in Q2, with earnings and cash flow expansion, driven by aggressive execution and continued success with our customers. Looking forward, we see a world where technology is changing and significant market opportunities are being created. And as we outlined today, we are making the right decisions to best position HP for the long-term, including a deliberate focus on accelerating the higher-value mix of our Services business. I'm excited about our future and look forward to updating you on our progress. Thank you.

Operator

Ladies and gentlemen, this concludes our call for today. Thank you.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2011, Thomson Reuters. All Rights Reserved.

