FINAL TRANSCRIPT

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HPQ - Q4 2008 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Hewlett-Packard Q4 2008 earnings conference call. My name is Antoine, and I will be your operator for today. (OPERATOR INSTRUCTIONS) I would now like to turn the call over to Mr. Jim Burns, Vice President of Investor Relations. Please proceed, sir.

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

Thanks, Antoine. Good afternoon. Welcome to our fourth quarter earnings conference call with Chairman and CEO, Mark Hurd, and CFO, Cathie Lesjak, . This call is being webcast live, and a replay of the webcast will be available 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 third quarter 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 2008 Form 10-K. Earnings, operating margins, and similar items at the Company level are sometimes expressed on a non-GAAP basis and have been adjusted to exclude certain items, including amortization of purchase intangibles, restructuring charges, and acquisition-related charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables in the third quarter earnings slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations website at HP.com. I will now turn the call over to Mark with a final reminder to please refrain from asking multi-part questions or clarifications during the

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

Good afternoon. Thanks for joining us. Hewlett-Packard capped off a record year by delivering another solid quarter with revenue growth of 19% and non-GAAP EPS growth of 20%. These results demonstrate our ability to execute in a challenging market. Great companies excel in tough times, and in tough times, customers turn to great companies. I am confident in HP's ability to gain share, expand earnings, and emerge in the current environment as a stronger force in the marketplace. In Q4, we continued to benefit from our global reach, a broad portfolio of products and services and numerous cost initiatives. We believe we held or gained share in each of our segments while continuing to show discipline in our pricing and promotions. Software, HP Services, Notebooks, Blades, and Storage, each posted double digit revenue growth, highlighting both our market leading technology and improved execution. I'm especially pleased with the results of our Services segment and the solid performance in Technology Services, and in HP outsourcing. Technology Services grew orders in revenue double digits for the year, and the HP Outsourcing business had its best quarter in history with strong revenue growth, record profitability, and significant new wins. The EDS integration is at or ahead of the operational plans we shared with you in September. And customer response to the acquisition remains very positive.

Before I turn the call over to Cathie to review the financials, let me highlight three reasons I am confident in HP's outlook despite the macroeconomic challenges. First, our cost structure. Our Company is leaner and more flexible than ever, and yet we still have more work to do which is actually good news. As we have said many times before, regardless of the macro conditions, we are eliminating all costs that are not core to the Company's success. In 2009, excluding currency impacts, we expect to save more than $1 billion year-over-year through the previously announced initiatives relating to EDS and HP's corporate overhead. We expect additional savings through numerous initiatives in each of our segments, and we will be tightening discretionary spending given the environment.

Second, our business mix. We have approximately one third of our revenue and well over one half of our profits from recurring sources like services and supplies. Although not immune to economic factors, the future performance of these businesses is largely determined by the quality and scale of our customer install base.

Lastly, our execution. We have worked hard and invested heavily to improve the quality of our planning and the consistently of our performance. We now run the Company on 65% fewer applications, and a modernized infrastructure which not only reduces our cost but provides a simpler platform on which we can innovate and improve our business productivity. And this is a big deal for us while we still have many areas where we can improve our financial and operational discipline as a competitive advantage in all market environments, and especially in challenging ones. The market is getting tougher and less predictable. That said, an environment like this provides an opening for a Company like HP to improve competitive position, and we have every intention of taking advantage of that opportunity. With that, I will turn the call over to Cathie.

Cathie Lesjak - *Hewlett-Packard - CFO*

Thanks, Mark. Good afternoon, everyone. I have got a lot of ground to cover, so let me start by outlining the topics for today. First, I will review HP's overall and business segment performance. Then I will cover the impact of the restructuring activities on the P&L and balance sheet before moving on to cash management. I will conclude with a discussion of our outlook for the first quarter and the full fiscal 2009.

As a result of the closing of the acquisition of EDS on August 26th, HP's Q4 fiscal 2008 results include roughly two months of EDS financial results. Thus, I will also provide comparisons relative to HP excluding EDS to facilitate year-over-year comparisons. Let me get started, revenue for the fourth quarter totaled $33.6 billion, up 19% year-over-year or up 16% in constant currency. Excluding the impact of EDS, revenue increased 5% or 2% in constant currency. Looking at revenue by geography, we generated 68% of our total revenue from outside the United States. Revenue in EMEA was up 22%, the Americas increased 17%, and Asia Pacific increased 14%. Excluding EDS and the effects of currency, EMEA was up 3%, the Americas was approximately flat, and Asia Pacific increased 6%.

Fourth quarter gross margin for the total Company was 22.9% down 180 basis points from 24.7% one year ago. This decrease in gross margin was driven primarily by the addition of EDS which reduced gross margins by 140 basis points, and to a lesser extent by a more normalized impact from commodity pricing compared with a year ago. Non-GAAP operating expenses for the quarter were $4.3 billion, or 12.8% of revenue, down two percentage points from a year ago. Adjusting for currency and the EDS acquisition, total expense dollars also declined due to the continued expense discipline, even as we invested appropriately in R&D, go to market, and customer support. Non-GAAP operating profit increased 21% to $3.4 billion, or 10.1% of revenue. And non-GAAP EPS was $1.03, representing a 20% increase from the prior year quarter. GAAP EPS increased 4% to $0.84 which included $482 million or $0.19 per share in after tax adjustments, primarily due to the amortization of purchase intangibles and restructuring charges that were excluded from our non-GAAP results.

Looking at the performance by business segment, Personal Systems grew revenue 10% or over $1 billion to $11.2 billion. During the quarter, unit shipments grew 19% over the prior year period with double digit unit growth in every region as well as our consumer and commercial businesses. Growth in PSG continues to be driven by growth in Notebooks in emerging geographies. Notebook revenue grew 21%, and PC revenue in the BRIC countries grew 29%. Our innovative product portfolio combined with over 80,000 retail outlets and 140,000 distribution partners around the globe give us a sustainable competitive advantage. PSG Operating profit for the quarter was $616 million or 5.5% of revenue, down 30 basis points versus the prior year, reflecting a more normalized impact from commodity pricing.

Over the last five years, our Personal Systems team has made tremendous progress toward a more flexible cost structure by streamlining its operations, leveraging its scale, and building a more nimble organization. At the same time, they have invested in design and technology, bringing to market a collection of innovative new products. This has enabled them to effectively balance profit and growth, and positions them well for continued market leadership.

Imaging and Printing reported revenue of $7.5 billion, down 1% year-on-year. For the quarter, supplies revenue growth of 9% was offset by declines in Commercial and Consumer Hardware revenue of 10% and 21% respectively. Excluding cameras, Consumer Hardware revenue declined 15%. Segment operating margin increased 100 basis points to 15.5%, as strong supplies growth and cost reductions were partially offset by discounting. We gained share in calendar Q3 while total printer units were down 8%. And consumer and commercial printer hardware units declined 8% and 9% respectively. That said, we saw solid performance in key focus segments, in particular, multi-function printer units grew 25%, wireless printers increased 64%, and we gained market share in the over $80 ink jet printer segment.

Within IPG, we are focused on reducing our cost with on going initiatives to improve supply chain efficient and lower product costs. We are investing these savings in targeted growth areas, including the enterprise and graphic arts. We will continue to be prudent in our pursuit of lower end units, as well as focus on driving profitable growth and positioning ourselves for the long-term. Enterprise storage and server revenue was $5.1 billion, down 1% year-over-year. Blades continue to be a strong growth driver, total ESS Blade revenue increased 43%. Within ESS, storage revenue grew 13% driven by our mid-range EDA business, which outpaced major competitors with 16% growth.

Turning to our server businesses, Business Critical Systems revenue declined 10%, and Industry Standard Server revenue declined 3% from the prior year. Total ISS units increased 7%, led by strong Blade growth of 39%. ISS grew its market share 2 points to 35%, while maintaining good profitability. Enterprise Storage and Servers posted solid fourth quarter operating profit of $705 million or 13.9% of revenue. Revenue in HP Software grew 13% to $855 million, BTO outgrew its primary competitors increasing 15% from the prior year, as large Enterprise customers increasingly deploy our management and automation tools to more effectively enhance the value of their IT investments. Other software which includes Open Call, Business Intelligence, and Information Management grew 1% as the strength in the Information Management business was offset by declines in Open Call. In Q4, Software posted operating profit of $195 million or 22.8% of revenue. For the full year, the Software business more than doubled its operating profit to $461 million up from $221 million in fiscal 2007.

HP Services, with the addition of EDS, doubled its revenue to $8.6 billion and reported solid operating profit of $920 million or 10.6% of revenue. Excluding EDS, HP Services capped off the year with another strong quarter delivering revenue growth of 10%, with 15% growth in Outsourced Services, 10% growth in Technology Services, and 2% growth in Consulting and Integration. For the period between the August 26th acquisition date and October 31st, EDS delivered revenue of $3.9 billion. EDS performed well as customers across all regions continue to respond favorably to the combined services business. Demand remains solid with a healthy mix of new and existing customers. From an integration perspective, we are on track with our plans as we begin to capture the cost synergies we discussed at our September Analysts' Meeting. During the fourth quarter, we eliminated over 2,300 positions in connection with the EDS integration.

Technology Services has delivered strong results throughout fiscal 2008, reflecting continued focus on services attached, combined with operational improvements from our ongoing efficiency initiatives. HP Outsource Services and C&I showed consistent profit improvement as the year progressed. While we have more work to do, these improvements put us in a much stronger position to successfully integrate our HP Services businesses and EDS and realize the synergies of the combined Company.

And finally, HP Financial Services had revenue of $691 million, up 5% year-over-year, and generated operating margin of 7.4%. We continue to apply the same rigorous process for assessing the credit worthiness of our customers and the quality of our receivables. We are encouraged with the growth in our financing volume. The overall portfolio is performing well, consistent with the past few years.

Now, I'd like to spend a moment to update you on the impact of the restructuring program implemented in connection with the EDS integration. In Q4, we took a $251 million charge in our GAAP P&L, and another $1.5 billion purchase accounting adjustment to goodwill on our balance sheet. The cash impact associated with the Q4 charges will be spread over roughly the next two years, as the actual headcount reductions occur. We expect additional restructuring charges of approximately $150 million for fiscal 2009, and approximately $130 million in fiscal 2010 and beyond.

Now, on to the balance sheet and cash management. Days sales outstanding increased to 45 days in Q4 from 43 days one year ago. Excluding EDS, DSO was down two days year-on-year to 41 days. Days payable was 49 days, down one day year-over-year. Excluding EDS, days payable was up four days year-on-year to 54 days.

One of my focused areas since becoming CFO has been improving our management of the balance sheet. Over the last two years, excluding EDS, total inventory dollars are down despite nearly $23 billion of revenue growth. For the fourth quarter owned inventory was 27 days. Excluding EDS, days of inventory was down three days to 31 days. With regards to channel inventory, we ended the quarter with ESF flat, IPG up a week, half a week and PSG up a week year-over-year. Next, property plant and equipment was up $3 billion year-over-year, as a result of the EDS acquisition. With $1.1 billion of land and building, and $2.1 billion of equipment primarily related to EDS' data center.

Gross CapEx was $1 billion, up 26% from the prior year period. On a net basis, CapEx was $870 million up 16% year-over-year. Increased capital expenditures were primarily related to growth in our leasing and outsourcing businesses including EDS. Cash flow from operations was $3.3 billion for the quarter, and free cash flow was $2.4 billion. Share repurchases in the fourth quarter totaled $1.9 billion or approximately 45 million shares. At the end of the quarter, we had roughly $9.1 billion remaining in the current share repurchase authorization. Finally, we paid our normal quarterly dividend totaling $196 million.

For the full year, cash flow from operations was a record $14.6 billion, up 52% from fiscal 2007, and free cash flow was $12 billion up 68% from the prior year. During fiscal 2008, we returned $10.4 billion to shareholders through share repurchases and dividends and invested $11.2 billion of net cash in acquisitions. We closed the year with a strong balance sheet, including total gross cash of $10.3 billion. Our total debt at October 31st was $17.9 billion, including $7.4 billion associated with HP Financial Services, and $7.1 billion in commercial paper.

We funded the EDS acquisition through a combination of cash and commercial paper. Given our strong ratings, we have had no problem accessing the CP markets, and the interest rates on commercial paper have been substantially more attractive than rates on long-term corporate bonds. Our commercial paper program is backed by approximately $14 billion of committed lines of credit, the majority of which are from banks that have AA minus ratings or better. Additionally, we have signed up for the US government commercial paper funding facility, which provides us access up to approximately $10 billion of commercial paper with 90 day maturity. We are maintaining the flexibility to term out our debt and will likely do so at some point. Despite seasonal softness in Q1, we are expecting another solid year of cash flow in 2009.

Now, looking ahead to our outlook for Q1, and fiscal 2009. We don't know how the economy will evolve, but at this point we are expecting the market to be challenging in '09, particularly for discretionary IT spending. As a result, we are trimming our revenue outlook relative to typical seasonality. In addition, the dollar has strengthened significantly since our last earnings call, and thus at current currency exchange rates, we expect to have a year-over-year unfavorable impact on revenue going forward of approximately five points in Q1 and roughly six to seven points for the full year. Offsetting these impacts will be the positive revenue contribution of EDS. Taking into consideration the current economic climate, the stronger dollar, and the impact of EDS, we expect 2009 revenue of approximately $32 billion to $32.5 billion in the first quarter, and approximately $127.5 billion to $130 billion for the full year.

Regarding earnings, here are a few variables to keep in mind. Given the P&L characteristics of EDS, we expect the acquisition to have a negative impact on gross margin and a positive impact on OpEx as a percentage of revenue. As we move through the next two years, the cost structure improvements that we are making in that business will improve both of these metrics with the majority of the benefit occurring in gross margin.

With regards to costs, as Mark mentioned, it is our plan to cut over $1 billion on a constant currency basis from our cost structure in 2009. Given the current macroeconomic environment for fiscal '09, we are implementing a number of additional expense control initiatives to insure that we are well-positioned for continued success. A few of these actions are decreasing travel, curtailing hiring, and extending our scheduled holiday shut-down at certain sites. While we will launch appropriate expense management initiatives given the current climate, we will at the same time be making some focused investments that we believe will accelerate our competitiveness in the long run.

Due to a decline in pension asset values, we ended the year with pensions that in aggregate are approximately $2 billion underfunded. As a result, we expect to incur an incremental pension expense of approximately $0.06 or roughly $0.015 per quarter. We expect total after-tax amortization of purchase intangibles to be approximately $0.50 per share in fiscal 2009. With regards to OI&E, we now expect total expense of approximately $0.05 in the first quarter and $0.18 for the full year. We expect the tax rate for fiscal 2009 to be approximately 21%.

Finally, we expect to continue to repurchase shares in the coming quarters, with a modest decline in weighted average shares outstanding. With that in mind, we expect Q1 '09 non-GAAP EPS in the range of $0.93 to $0.95 and full-year 2009 non-GAAP EPS of approximately $3.88 to $4.03. With that, we will open up the call now for your questions.

QUESTIONS AND ANSWERS

Operator

OPERATOR INSTRUCTIONS). Your first question comes from the line of Ben Reitzes with Barclay's Capital. Please proceed with your question.

Ben Reitzes - *Barclays Capital - Analyst*

Good afternoon. Thanks a lot, Mark and Cathie. With regard to channel inventory, you mentioned that PSG and IPG, I believe, were up half a week year-over-year. With the current slowdown in the environment, are you comfortable with that? Half a week up year-over-year, in this environment actually even more? And how are you managing channel inventory to make sure you hit your numbers.

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

Thanks, Ben. All of that is included in our estimates that we gave you. Are we concerned about it? I guess we had rather not have it, but at the same time we had a little softening of sellout at the end of October which causes a bit of equational problems in the way you calculate the channel inventory. But no, we feel comfortable. We feel it is all inside our estimates, and we will go from there. Thanks, Ben.

Ben Reitzes - *Barclays Capital - Analyst*

So you calculate it on a forward basis?

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

We do, because you look at what you do at the end. It is a bit of a complicated equation, but what happens is -- if there's a little softening of the sellout at the end, it causes a little bit of the equation. So it is different. Trying to make this less complicated, you can wind up in a situation where even though it shows up half a week, the dollar calculation is less if it happens to be because of a sellout change in the way the equation works. That is the way our model works. So, it is sensitive to that. So, in dollars, it isn't as big as you might think, given the half a day. That's really the point, Ben.

Ben Reitzes - *Barclays Capital - Analyst*

Thanks a lot.

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

Thank you.

Operator

Your next question comes from the line of Richard Gardner with Citigroup. Please proceed with your question.

Richard Gardner - *Citigroup - Analyst*

Okay. Great. Thank you. Just a quickie. I was hoping that you could give us a sense, Cathie and Mark, of the market's reception to the price increase on supplies that you put through in July and August.

Cathie Lesjak - *Hewlett-Packard - CFO*

Well, certainly, one way to answer that question is to talk a little bit about the fact that we did have 9% supplies growth this quarter, and there are roughly two points of that growth came from price increases. A little bit of the two points is due to channel fill in advance of the effective date of the price increase. But the reality is for Q4, we only had one month, October, and that was only in countries where we sell supplies in U.S. dollars that actually had the price increase in it.

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

And I think Richard, the other day when you get the kind of growth rate we've had in supplies, our costs have gone up, as everybody's has, and we passed it through. And the price increase and we had, we had strong revenue in the quarter, in relationship to supply. So I think, overall pretty good numbers. So, and very little, no negative reaction out of the channel that I am aware of at all.

Richard Gardner - *Citigroup - Analyst*

Okay. It is probably a little early to tell, but nothing that concerns you about customers potentially moving more toward remands or third party?

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

You know, Richard, it is an interesting question because I would tell you that over the past two or three years -- that was a big issue, say when I came to HP several years ago. I would tell you that we have consistently been gaining share, relative to the aftermarket over the past several years. Our actual biggest issue right now in supplies is counterfeiting. So, if you asked us what keeps Cathie and I awake at night in the supplies market share, counterfeit way outweighs, and we are doing a lot to combat it. We had probably one of our best years from a counterfeiting or an anti-counterfeiting -- that is probably the right way to describe it, effort. But that's a much bigger issue to us than the remand. But no, we have not seen any effects of that at the current time.

Richard Gardner - *Citigroup - Analyst*

Okay. Thank you.

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

Thank you.

Operator

Your next question comes from the line of Tony Sacconaghi with Sanford Bernstein.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

Yes. Thank you. Mark and Cathie, if I look at your guidance, you are calling for about 0% revenue growth at constant currency ex-EDS. You did about 5% in '08. You did about 2% in Q4. So, it does seem to factor in, an economy that is certainly not getting any better, maybe at the margin getting a little bit worse. But you yourselves I think said, look we are not economists, we don't really know what the economy will do. The question is, let's say that the IT spending environment turns out to be 2 or 3 points worse than you have budgeted. Are you still confident in the EPS range that you gave? Will you be able to cut incremental costs so that you can still hit that range say if IT spending is 2 or 3 points worse than you forecasted?

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

So Toni, I am not going to get you into a per point basis, but let me say this. I understand your question, and first of all, I think your numbers are -- because I often tell you when I think they're not -- and your numbers are I think exactly right with what you are describing. And, yes, we can certainly sustain some different answer than the one we have given because we have got a lot of variability now in our cost model. I won't take you down to what if it is 2 points less or 3 points less or 4 points less? But certainly, we have some resiliency in our capability to still hit those numbers. And we wouldn't have given them out if we didn't think we could hit them. And, I think suffice to say, we are more confident on the bottom line than we are on the top line, and I will give more color to it. Just to make the top line, we are not going to run around and take bad deals, and there are plenty of those in the marketplace. So, unless a situation for us has a real long-term or aftermarket benefit for us, that is long term good for the Company, we probably aren't going to go spend a bunch of time chasing it. That said, we have done a lot of cost things to buttress the bottom line. So we are more confident in the bottom than we are in the top, and we could sustain some different answer on the top and still hit those estimates we gave.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

Thank you.

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

Thank you.

Operator

Your next question comes from the line of Brian Alexander with Raymond James. Please proceed with your question.

Brian Alexander - *Raymond James - Analyst*

Thank you. In IPG, what's happening to the install base in consumer and commercial hardware in light of the unit declines? And how do you see replacement cycles and supplies consumption trending next year given the tougher economy? It just seems like your earnings guidance for FY '09 incorporates IPG margins that are above your long-term model? Thanks.

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

Yes, I think, Brian, to your point, install bases staying installed longer. That is what is going on, and you can see us gaining share. We believe our install base is -- depending on what country and what segment and what price category -- we believe we are doing quite well. Certainly, you are seeing a trend toward wireless in the home which in some cases has fewer units doing just as much printing as the home used to. For us, that is not necessarily a bad answer. We like the answer where we can sale less hardware to effectively print as much as the ecosystem has been printing.

So again for us, we have to be cautious here because when we get too aggressive on price, in many cases, we are accelerating the movement of our own install base. And as I know you know, Brian, the reason we put the install base out there is to print. So for us, lower unit growth is not necessarily bad unless it means we are losing share. So, we look at the quarter, and we look at it as we gained share in the quarter. We look at install base as being installed longer. We look at the growth we have described in wireless printers, which is again a very strategic segment to us, as again being material. And so, as a result, I can't tell you I like the answer, but, in the end it is not necessarily Brian, to us a bad answer with the dynamics we are seeing today.

Cathie Lesjak - *Hewlett-Packard - CFO*

In fact, Brian as long as people continue to print on HP printers so that we have a healthy install base, having them hold on to their printers longer and delay upgrading is actually positive for earnings for us. They are buying the same amount of supplies and not having to make that kind of next investment in terms of placing a hardware unit that is either at a negative margin or at a very low margin.

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

So that is why, and Cathie's point -- it is a little different in a mature market than it is in a new growth market. So for us, we look very hard at where the new printing infrastructure is going versus where the existing market is going where the existing market is a replacement market. And the emerging market may be a brand new infrastructure market. So that's why for us, I won't take you through a lot of complexity which is our job not to do that, but we actually like in the mature markets the answers that we are seeing to Cathie's point. We are having to invest less money to be able to get the same printing done.

Brian Alexander - *Raymond James - Analyst*

Great. Thank you very much.

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

Thank you.

Operator

Your next question comes from the line of Katie Huberty with Morgan Stanley. Please proceed with your question.

Katie Huberty - *Morgan Stanley - Analyst*

Yes. Thanks. R&D expense is at the lowest level over the last six or seven years. Which product segments did it come down the most in the quarter, and is the new level sustainable?

Cathie Lesjak - *Hewlett-Packard - CFO*

So, R&D came down in two segments. Certainly came down in IPG, and what we are doing in the IPG area is frankly, we are not really driving to a lower number explicitly. What we are looking at is getting rid of all of the favorite science projects that are going on, and making sure every dollar is being very well spent in IPG. And as a result, it did come down. And then also, we are making conscious efforts in the enterprise storage and server space around OpEx in general, but specifically in R&D to make sure that we have got the right cost structure for a more industry standard server segment.

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

So, and I think, Katie, your point. Yes, I think the current level is sustainable, and R&D -- it is many different dimensions inside R&D. When we talk about cost initiatives, just to give you an example, you have to separate R&D intro true innovation R&D and into maintenance R&D. When you go look at maintenance R&D, for example, Cathie brought up IPG. One thing you have to do in IPG is understand how much R&D you're spending just to keep different [SKUs] alive, numbers of different pieces of firmware, all the testing regression and analysis work. All of the categories I am describing to you would be determined to be maintenance R&D streams, different from inventing a new product that's going to change the market. So you have got to be very cautious when you look at an aggregate number like R&D, because it breaks out into many segments.

We are trying to reduce the non-value add parts of R&D and increase the value add parts of R&D. That's, to your point, a separate issue than mix. So yes, we think it is sustainable, but we are trying within the R&D envelope to increase the amount of innovative R&D while bringing total R&D in some cases down. So I wouldn't want you to come away from that point that Cathie brought up that we are trying to reduce R&D. We are trying to reduce bad R&D or non-value R&D. Same thing goes on in software, for example, where we have bought many companies, and when you buy those companies, every company had their own development environment. They had their own development tools, their own quality testing. And so as a result, when you add those up across multiple acquisitions, the team in software has had to take out multiple pieces of this maintenance infrastructure so we could spend more money on BTO invasion. That might cause R&D aggregate dollars to go down, but the innovation percent of the new R&D is up. So that is what we are trying to get done.

Katie Huberty - *Morgan Stanley - Analyst*

Got it. Thanks.

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

Thank you.

Operator

Your next question comes from the line of Bill Shope with Credit Suisse. Please proceed with your question.

Bill Shope - *Credit Suisse - Analyst*

Great. Thanks. Mark, I was wondering if I could get your updated views on the Netbook market, and how you think it may impact the [BFG] strategy in '09, and over the longer term? Whether or not potentially in the near-term, this could be a material contributor to unit growth.

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

I don't know in the short-term, Bill, that I would call it material. We are going to have to see how it comes out because there's at least a couple dimensions to it. One, we have got to look at the market. Is it really an incremental market? Our early tests show that parts of the market are incremental, which is good news. There is no doubt there will be some blending of it though between incremental and being somewhat of a cannibalization of existing markets. We are not exactly sure on the margin, how those will line up. Adoption has been okay, and we are obviously coming out with some pretty -- we have released a string of products that we are very excited about that we think will do well. As you probably know in the early part of the year, when we released our first Netbook product, we sold out as quick as we announced it. I think it is still too early for us to give you enough definition and enough specifics to be able to give you the answer to that. I would not call it material in the short-term. But, we will see how it goes over the next several quarters, and we are pretty excited about our line-up of products in that area.

Bill Shope - *Credit Suisse - Analyst*

Okay. Great. Thanks.

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

Thanks, Bill.

Operator

Your next question comes from the line of David Bailey with Goldman Sachs. Please proceed with your question.

David Bailey - *Goldman Sachs - Analyst*

Great. Thank you. On the PC side, Intel has a pretty dire outlook for PCs in the final calendar quarter of the year. Is HP seeing something meaningfully different from what Intel is, from a demand perspective? And if so, what do you think is causing the disconnect?

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

Well, Intel doesn't show their stuff to us. So, I don't know. I know what they reported, and I know what they said about October in the public markets. And, we saw some things to be very blunt, David, were just different in our numbers. And that's why I always caution, David, people ask us for macro commentary. All we know is what we are seeing.

In some cases, I would tell you we did know know our share numbers would come out as strong as they have, to be very open with you. And we have seen that over the past several days. If you look at the Netbook market that Bill was referencing earlier. If you take the Netbook market out of the PC market, you are going to see a pretty strong share position for HP. If you look at what's happened to Industry Standard Servers, we obviously gained share there. We did very strong in the storage business which isn't directly related to Intel. So David, I can't specifically answer that to you, although we are aware of what they're seeing.

And we are aware of what Microsoft is seeing, and all I can say is we will do our best to be as competitive as we can be, given the market we are given and given the competitive position we bring to the market.

David Bailey - *Goldman Sachs - Analyst*

Thank you.

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

Thanks, David.

Operator

Your next question comes from the line of Keith [Buckman] with Bank of Montreal. Please proceed with your question.

Keith Buckman - *Bank of Montreal - Analyst*

Yes. Hi, guys, thanks. Cathie, in your prepared remarks, you indicated you thought cash flow or free cash flow for '09 would be very strong. I was hoping to pin you down to see if you could give us some thoughts on what you thought free cash flow targets would be for HP for '09. Thanks.

Cathie Lesjak - *Hewlett-Packard - CFO*

Let me give you some puts and takes. I'm not going to give you an overall number. Let talk a little bit about working capital. If you look at working capital and how we ended this quarter, we ended actually very strong. You have got to take out, by the way,P the EDS impact which is about 5 days negative on the cash conversion cycle.

Keith Buckman - *Bank of Montreal - Analyst*

Right.

Cathie Lesjak - *Hewlett-Packard - CFO*

So the cash conversion cycle for us pre-EDS is 18 days. In that number, looking out into next year, I look at inventory, and we have made great progress on inventory. Do I think there's a little bit more to be done there? Yes, I do think there is a little bit more to be done there. I think the on the AP side, we have made good progress over the last couple of quarters, and I think there's some room to improve in that number. Where I think we have got a headwind is more in the accounts receivables. And it is really the uncertainty that we have if as we look out into '09, around liquidity, Whether or not channel partners will take the cash discount or not take the cash discount, and obviously also then the layering on of EDS that brings with it an Enterprise customer base that typically put, pays on longer term. So, I think those are the kind of puts and takes that you need to think about, with respect to working capital.

And then with respect to CapEx, there's really two ways we look at CapEx. We look at it, the investments that we make in the infrastructure, and the bulk of those investments over the last two or three years have been investments to save.

Keith Buckman - *Bank of Montreal - Analyst*

Right.

Cathie Lesjak - *Hewlett-Packard - CFO*

Those are flattening out. And then the other context of course is, are there OpEx, and I'm sorry, the CapEx investments that we make to grow. And those are really in our Leasing business as well as obviously our Outsourced Services business. And those, of course, we would expect to grow. In fact, we want them to grow. And so those are kind of the ways I think about what are the puts and takes for cash flow for next year.

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

Yes, and I think, Keith, it starts with we just have to make our operating plan. If we make our operating plan -- the cash conversion stuff-- Cathie has brought a tremendous operating cadence to the inventory side. The good news I can tell you is, that we have made a lot of progress. The better news is, we are still not stopping.

I mean that in the context that we have a unique opportunity in that we can compare supply chains across various businesses, and we have some businesses that are extremely efficient, and we have other business with that just aren't. And the working capital we have tied up in days of supply and owned inventory give us opportunities to improve. But at the same time to Cathie's point, there is no question we are going to get more pressure from the channel and from our commercial customers for more DSO, At the same time as we will be pressuring on the DPO side. I think we are getting better in this area. We still have room to improve, and Cathie's point about the separation of CapEx is a key one because we look at CapEx very differently with its infrastructure buildout or growth.

Keith Buckman - *Bank of Montreal - Analyst*

Okay. Thanks, guys.

Operator

Your next question comes from the line of Jeff Fidacaro with Merrill Lynch. Please proceed with your question.

Jeff Fidacaro - *Merrill Lynch - Analyst*

Thanks. Great. Could you talk a little bit about the big picture demand for services in this environment? We saw core HP services, ex-EDS, about 10%, down a little bit but mostly in line with the last three quarters. So are you seeing any elevated levels of contract rescoping or pricing pressure?

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

First of all I would tell you that the reception to the EDS deal was probably a wrong thing for me to say. I have been doing this a long time, and I would tell you that it is pretty strong. This is on the demand side. It is just giving us an opportunity to compete that we just didn't have, and I think that part is very positive. We have be disciplined about the fact that we qualify well where we go compete and not get brought into too many things at the same time. I think in this environment, services in many cases is countercyclical. So what you have is people trying to take cost that could be capital and outsourcing that to somebody else so that they actually take the cost for them, and in some cases variabilize the cost where it makes sense. So that becomes an attractive value proposition for our customers. And certainly, we have done a lot of work in Technology Services. That is a market where our attach rate and our capture rate of the HP ecosystem, meaning the existing HP hardware and infrastructure that is in the marketplace today, has simply been too low. And the opportunity for us to increase our attach rate and then through technology, the fact that we are able to now solve our customers problems without a specific labor touch to it, is a tremendous competitive opportunity for us.

So, Technology Services, this is not a new story by the way in Q4, it has been a fairly steady incline of our performance in Technology Services. And HP Outsourcing, separate from EDS, has been on a path over the past three to four years improving its cost structure, improving its customer delight, and being able to grow. And so we are pretty excited about the opportunity for the aggregate services business to drive a lot of value for HP.

Jeff Fidacaro - *Merrill Lynch - Analyst*

Great. Thank you.

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

Thank you.

Operator

Your next question comes from the line of Shannon Cross with Cross Research. Please proceed with your question.

Shannon Cross - *Cross Research - Analyst*

Thanks, good afternoon. A question with regard to the pricing environment for PCs and printers. You are obviously in a strong position, and Mark said, you are not going to follow people down. But are you seeing much in terms of irrational pricing, and specifically within the printer business, it seems as if maybe there was some pretty aggressive pricing there. And then if I could just sneak in a second one, Cathie, can you just talk a little bit about cogs pressure from the yen? As it relates to the laser business?

Cathie Lesjak - *Hewlett-Packard - CFO*

Okay. So let me hit that one first. So the yen is definitely a headwind on the profit side for IPG. And as a result of that, I mean that's really one of the primary reasons why we have increased prices in supplies is to basically adjust for the fact that it has gotten a lot more expensive. So you just see that in price increases. We have done some price increases in Q4, and we have got more plans in Q1 for price increases in supplies to address that pressure.

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

Price unit environment, I tell you that if I looked at the PC market, we didn't see extraordinary changes in ASPs over the, if I look over the past several quarters. So, that would be the way ill describe the PC environment. Printer market, Shannon, is very different by market and by segment. So while I can give you the PC market on a more global basis, I am gun shy to give you one answer because if I went to an emerging market or if I went to a BRIC country and depending on what category I go to -- I can tell you about aggressive pricing, and I can tell you about pricing that frankly hasn't been that aggressive. So it is sort of a multiple set of dynamics there and something that I probably should not generalize on other than to say it is sort of averaged out to being an okay pricing environment, I guess, in printers. But probably more aggressive than perhaps we had seen sequentially. That is probably the best way to describe it, but I wouldn't run too far with that either because I can show you markets where there wasn't a very aggressive market.

It is important to note, we are being aggressive on the cost side in IPG. So for us, because of some of the areas that have been mentioned earlier, we think we are in pretty good position, as you mentioned, to be able to go deal with that, if appropriate. Our biggest issue is we don't want to go -- we have to look at it on a more micro-specific basis because we don't want to go in with a broad aggressive pricing that churns up our own install base that is already doing the printing. And so it requires a degree of precision to get this right.

Cathie Lesjak - *Hewlett-Packard - CFO*

So let me also just take up your question around the yen up a level because if you actually look at the total HP, the revenue that is yen-based roughly offsets the costs that are yen-based at the total Company level so we have got a nice natural hedge at the total Company level. Again, that is different at the IPG level. So as I mentioned, we increased supplies prices to address that as well as aggressive expense reductions.

Shannon Cross - *Cross Research - Analyst*

Great. Thank you.

Operator

Your next question comes from the line of Mark Moskowitz with JPMorgan. Please proceed with your question.

Mark Moskowitz - *JPMorgan - Analyst*

Yes, good afternoon. Thank you. I want to get back to the confidence regarding the bottom line, Mark and Cathie. Can you help us understand what is happening potentially with your recurring profit base? Are you seeing anything structurally different that gives you more confidence in terms of either your market share gains, some of your cost structure initiatives on the core business, or EDS, that lends to some of your confidence out for the next 12 months in terms of a higher level of recurring profits?

Cathie Lesjak - *Hewlett-Packard - CFO*

Certainly, with EDS we have a higher level of recurring profits and revenue. Right. That clearly adds to it. We think that roughly, I think it was in the early remarks that roughly one third of our revenue is recurring. So that obviously gives us more confidence than if we didn't have one third revenue recurring.

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

Yes, and Mark, we break down our revenue by business, by category, and so when we say recurring we don't mean it is in a segment that is recurring or that has got most of its revenue recurring. We actually mean contracted. So, when we get down there's a percent of our revenue that's actually just contracted where we know the answer. So we understand that piece. Obviously, we have hedges that also go into some of our businesses where we know the answer. And then we have some parts of our business where we don't necessarily know the answer. And we have well more than half of our profits that come out of a pretty healthy install base. Then you get into a debate in some of our product businesses where you can get more volatility. Some of those product businesses, in some cases, actually carry negative gross margins.

So in a strange way, it is actually a positive to the earnings model. It may not be the greatest long-term thing, but in the case of the guidance we are giving you it may be short-term, a good thing. As we mentioned earlier about the length of the printer install base. As long as that install base stays HP, and as long as people are still printing which all of the numbers tell us it is --

that is actually good news for us as it relates to the models that you can go deploy. So, there are a lot of dynamics, but I guess the only thing I would tell you is we do study this in a fair amount of detail. And we think we understand what the dynamics are of the various components revenue and earnings portfolio.

Cathie Lesjak - *Hewlett-Packard - CFO*

And Mark, I would just add a couple of comments. We spent a lot of time, obviously over the last few years, to get our cost structure to be as lean as it can be. And we still have got opportunity in that as we have talked about taking over $1 billion more out of the cost structure, but also within that cost structure, we have also been working on making it very variable. So that if revenue doesn't perform the way we think it is going perform, we have levers to basically take down our cost structure. And some of the things we have done in that context are using more contracts, contracted labor, using a lot of contract manufacturers and ODMs, moving our total rewards or our compensation base from not being so heavily dependent on salary and more on performance-based variable costs. Those are some of the things we have done. We have also done a lot more in the marketing programs to take away from fixed headcount in marketing, and we have done a lot of these across all of our segments that gives us, again, some opportunity to move down if revenue isn't as we are expecting it to be.

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

You are probably getting more data than you wanted here, but it is important to note that we are still not happen happy where we need to be, and it has taken us several years to get to this point. Do we feel better than we ever have? Yes. We do. Do we have more work to do to get to where we think we can get to? The answer is yes. But yet, we think we understand the decomposition if I can use that term of the revenue, and the impact it will have across segment and earnings and then again what it would look like at the HP level. We have some resiliency. I guess that is the way to describe it that are in the models that we are describing to you.

Mark Moskowitz - *JPMorgan - Analyst*

Thank you.

Operator

Your next question comes from the line of Bill Fearnly with FTN Midwest Research. Please proceed with your question.

Bill Fearnly - *FTN Midwest Research - Analyst*

Good afternoon, Mark. If I could ask another question here on IPG, how should we be thinking about the balance between IPG margins and unit growth here for laser and inkjet? Should we expect negative unit growth here for the near-term and an operating margin target of 15, 15.5 plus? Is that reasonable for FY '09? And looking here near-term, you have the benefit of a really good install base, but could others get a lot more aggressive to grow their install base as they get more desperate and promotional to grow their units to drive their ink annuity going forward.

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

I think, yes, yes, and, maybe. To the point of, do I think you are going to see negative unit growth with the trends we are seeing? I think the answer is possibly, and it is probably more of a probable than a possible at this point. Do I think that will have an effect on IPG margins because there are a couple effects going on in IPG. They are getting the benefit of lower overhead costs at Hewlett-Packard.

Second, they are lowering their own costs as they go to market. They have some unfavorability as was mentioned earlier with the yen, that we are describing earlier. And they're getting the benefit of the install base continuing to print and not having to place as many units so the key issue, Bill, to your earlier point or of our earlier point is -- IPG gained share in total printer units in the quarter and did that with lower unit growth while the install base continued to print. To your point, could somebody try to change that dynamic, the answer is sure. But it is going to depend on what competitor and what segment and what market. And we will respond and try to respond within the degree of rationality. I guess that's probably the best way that I could describe it.

Bill Fearnly - *FTN Midwest Research - Analyst*

Does say, rationality become a near-term risk here as you face the double whammy of a heavy consumer end-of-year here in December going into January. And an end-of-year going for the Enterprise as well? Do you think that things will get crazy?

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

We have tried to blend in some of that into our model. We can never -- I am not sure you and I on the phone, can calibrate the degree of craziness. So I don't know how to do that particularly, but I do think that what we have tried to do is get variability into IPG and with that achieve some level of flexibility in IPG, figure out aggressive as it would be appropriate. That said, this market has the consumer hanging on to their install base longer, for the benefit of not trying to put out this or that. And frankly, the consumer is not reacting to the couple dollar promotion and continuing to print. So listen, could those dynamics change. That's what we are seeing right now, and we will have to see how that trend continues as we move forward.

Bill Fearnly - *FTN Midwest Research - Analyst*

Appreciate it. Thanks.

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

Thanks, Bill.

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

Why don't we take two more questions, Operator.

Operator

Your next question comes from the line of Maynard Um with UBS. Please proceed be your question.

Maynard Um - *UBS - Analyst*

Hi, thanks. Can you just talk about the impact of currency to pricing and margins in your PSG business internationally? And in particular, as your short-term hedging rolls over and given the big swings in currency, can you just talk about how much of the gross margin impact you can actually offload to either your suppliers or contract manufacturers or offset by raising price without impacting demand? Thanks.

Cathie Lesjak - *Hewlett-Packard - CFO*

So Maynard, just to clarify you were talking about Personal Systems Group. PSG, right?

Maynard Um - *UBS - Analyst*

Yes.

Cathie Lesjak - *Hewlett-Packard - CFO*

In PSG, it is actually one of the businesses that the prices adjust fairly quickly to the strength of the dollar. So, we are seeing that take place in the market now. If you look at the competitive landscape for personal systems, it is heavily driven by companies that are going to be motivated by dollar results, and that of course, gives us an opportunity to also increase prices and flow that through the market. And you have seen us do that.

Maynard Um - *UBS - Analyst*

Even with a 20% or 30% swing in the currency, you would still be able to raise the -- your prices by that amount to offset the currency?

Cathie Lesjak - *Hewlett-Packard - CFO*

So we have, in essence what we have really been doing, is holding prices, and not taking them down as much as we would have otherwise with the commodity declines so effectively as a price increase. And so far have had no difficulty doing that.

Maynard Um - *UBS - Analyst*

I see. Great. Thanks.

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

I think that's true, Maynard, too. You can extrapolate to many of our other business that are on short cycle times, so to speak, where the pricing environment as we have said doesn't give us tremendous lift, and it doesn't hurt us tremendously. There are other areas where you have a different effect. Where you have contracted backlog, for example, which is going to be a different answer. You have to, if the currency goes up, we actually have to deliver at a higher cost. For example, if we take an outsourcing deal or a TS deal at a lower currency level, we will actually have to deliver at this price. So, there are multiple dynamics as it relates to currency, but PSG, most of it flows through pretty quick.

Maynard Um - *UBS - Analyst*

Great. Thank you.

Operator

Your next question comes from the line of Lou Miscioscia with Cowen and Company. Please proceed with your question.

Lou Miscioscia - *Cowen and Company - Analyst*

Okay. Thank you. Mark, can you give us some idea what your conversations with customers have been over the last couple of months? Obviously, September and October were crazy. Here, we are almost done with November. Does it seem like things are starting to get back to normal? Obviously, the numbers that you just printed and you are guiding to really suggest that maybe things aren't that bad? Or as you mentioned before, maybe you are just gaining a ton of share?

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

Well, I think things are different, Lou. So, I don't think things are normal. I think people are prudent. I think they are thinking about what they spend money on. I think our guidance has been again as was mentioned earlier, we have continued to guide down, as it relates to local currency rates. We have gone to what is basically -- I think Toni said it correctly -- 0 in local currency growth. And yet, we have some segments that are growing well and some markets growing well. So, we are really giving you, we hope, a fairly realistic we think revenue base to grow on. And no, I am not hearing people all excited about spending and thinking that November is a lot better than October.

Now that said, we have a different environment than we had, say, back in 2001. We don't have the infrastructure buildout that we had at that timeframe. I think people are more cognizant, that at a TCO level, keeping stuff too long is not a great thing either and from a total cost perspective. And in addition to that, I think the portfolio of offers we bring to the market primarily have cost reduction at the core of what our value proposition is that we bring to IT. Whether it is in the services segment that was brought out earlier, whether it is in the virtualization of infrastructure that is what is driving our Blade sales that you see. Or the radical move we are trying to make in storage where, if you will, bring in a more industry standard approach to storage. The left-hand acquisition that we brought, the extreme storage release that we announced. The fact that we bring the ability to have some flexibility innovation in our printing and PC solutions.

We feel like we bring a pretty attractive portfolio that's helping the customer think through how they lower their cost. And those are the conversations that I am having, Lou, which is customers saying I know I have to make some changes, what can you do to help me lower my overall cost as I do it? And that's where you are seeing traction in the marketplace today. So, I would not say that you are seeing customers saying, hey, I have some extra money, how can you help me invest it? It is all about how I lower the total cost of my operation over time. And those are the conversations that we are having.

Lou Miscioscia - *Cowen and Company - Analyst*

And are customers able to get funding? It seems. obviously credit has been tight, it seems like that is not affecting you all as much.

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

Depends who the customer is, Lou. It depends what market you are in. I think if you get, certainly if you, if I was to make a broad macroeconomic issue, certainly the moves that have been made in the CP market have been very extremely favorable. You have seen liquidity return in many areas. And that is helped particularly in the mid-market. We had some period of time, I think in early October, where we definitely saw some challenging times. I don't want to tell you everything is getting great though, Lou. We have got some time to work through in this economy. We are certainly seeing it otherwise you wouldn't see us guiding down on a rate basis the way we have over the past couple of quarters. We do think in the context of the world that is there, we feel well-positioned relative to it.

Lou Miscioscia - *Cowen and Company - Analyst*

Okay. Thank you.

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

I am going to summarize from there. First, I think we feel like we had solid market performance. We showed good financial discipline. We continued to make progress on the cost initiatives that we have described. I think to the last question -- I think market conditions are tougher. It is possible they could worsen. We see this period as an opportunity, however, to leverage the strength of our model, to expand our penetration in the market, and we will accelerate our cost actions. Our confidence is in the EPS guidance given based on our cost savings, the EDS integration which is going well for us, and our diverse and recurring business mix. So, I thank you for your attendance, and obviously, we will look forward to talking to you all again soon.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect.