

# FINAL TRANSCRIPT

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## **HPQ - Q4 2006 Hewlett-Packard Earnings Conference Call**

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**Mark Hurd**

*Hewlett-Packard - Chairperson, CEO*

**Bob Wayman**

*Hewlett-Packard - CFO*

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*UBS - Analyst*

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## PRESENTATION

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### Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter 2006 Hewlett-Packard earnings conference call. (OPERATOR INSTRUCTIONS). As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Mr. Brian Humphries, Vice President, Investor Relations. Please proceed, sir.

### Brian Humphries - Hewlett-Packard - VP, IR

Good afternoon, everyone. I would like to welcome you to our fourth-quarter earnings conference call. Joining me today is our Chairperson and CEO, Mark Hurd, and CFO, Bob Wayman.

Before we get started, I would like to remind you that this call is being webcast live. The webcast and the fourth quarter's earnings slide presentation, including non-GAAP reconciliation tables, can be accessed on the HP Investor Relations page under "Company Information" on HP.com. A replay will also be available shortly after the conclusion of the call for approximately one year.

Next is my duty to inform you that the primary purpose of this call is to provide you with information regarding the fourth quarter and fiscal year-end. However, some of our comments and responses to your questions may include forward-looking statements. These forward-looking statements are based on certain assumptions and are subject to a number of risks and uncertainties, and actual future results may vary materially.

I encourage you to read the risk factors described in the Company's Annual Report, on Form 10-K for the fiscal year ended October 31, 2005, the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended July 31, 2006 as well as other SEC reports filed after that date.

As in prior years, the financial information presented and discussed in connection with this call, including tax-related items, reflects estimates based on the information available at this time. As such, these amounts can differ materially from the amount ultimately reported in HP's Form 10-K for the fiscal year ended October 31, 2006.

I would also like to point out that earnings, gross margins, operating expenses and similar items discussed at a Company level are sometimes expressed on a non-GAAP basis and therefore have been adjusted to exclude certain items, including in-process R&D, amortization of goodwill and purchased intangibles, restructuring charges, pension curtailment gains and net investment gains or losses, the presentation of GAAP financial information for the fourth quarter and fiscal year-end and a reconciliation of non-GAAP amounts to GAAP are included in the financial statements accompanying today's earnings release, which is also available on the HP Investor Relations page under "Company Information" at HP.com.

Finally and with a view to allowing time for questions from multiple firms, please refrain from asking multipart questions or clarifications. With that, I'll turn the call over to Mark.

### Mark Hurd - Hewlett-Packard - Chairperson, CEO

Good afternoon. Thank you for joining us. Hewlett-Packard closed the year with a strong fourth quarter, driven by solid revenue growth across all our businesses and geographies, share gains in key businesses, expense discipline, margin expansion and record quarterly cash flow from operations.

We saw significant operating margin improvements in our reportable segments with a year-over-year operating profit increase of 68% in the personal systems group, 42% in the technology solutions group and 21% in the imaging and printing group. All

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of this resulted in our most balanced segment profitability performance in many years with the technology solutions group delivering a similar fourth-quarter dollar profit contribution as the imaging and printing group.

Financial highlights of the quarter include revenue growth of 7% year over year or \$1.6 billion to \$24.6 billion; non-GAAP gross margin of 24.3%, up from 23.5% in the prior-year period, continued year-over-year operating margin expansion in key businesses with personal systems margins of 4.3%, imaging and printing margins of 14.8%, enterprise storage and server margins of 10.7%, HP Services margins of 12.4% and software margins of 17.2%, non-GAAP operating margin of 9% up from 7.6% in the prior-year period, non-GAAP EPS of \$0.68 representing 33% year over year, and cash flow from operations of \$3.2 billion up from \$1.9 billion in the prior-year period.

The fourth quarter closed out a strong fiscal 2006 for Hewlett-Packard. On a year-over-year basis, revenue grew \$5 billion or 6% to \$91.7 billion. Non-GAAP operating margins grew 1.6 points to 8% of revenue. Non-GAAP EPS grew 47% to \$2.38 dollar. Cash flow from operations grew \$3.3 billion to \$11.4 billion.

During the year, we also made significant progress to strengthen HP's long-term competitive position in the market, including lowering our cost structure by substantially completing our restructuring program and beginning to work on other cost initiatives, such as our real estate consolidation initiative; bringing up capital for strategic growth initiatives, including sales force hiring; beginning to deploy capital back into the business in the form of increased capital expenditures, aimed at transforming our IT infrastructure; and strengthen our enterprise software offerings with the purchase of Mercury Interactive, creating one of the most powerful management software portfolios in the industry.

We also simplified our structure. We collapsed matrices, created greater clarity of responsibility, focused on accountability, attracted talent to our management bench and rewarded our employees for hard work and improved performance. I'm particularly pleased that we've been able to post another quarter of solid results while continuing to make progress on longer-term strategic issues.

Now, turning to the business segments and the fourth-quarter results. Imaging and printing had a strong quarter. Revenue grew 7% year over year to \$7.3 billion with supplies revenue growth of 9% and revenue in commercial and consumer up 8% and 2%, respectively.

Over the past 18 months, we've been focused on accelerating supplies growth by driving hardware shipment growth in areas of high supplies consumption. We executed well against this plan in the fourth quarter with total printer hardware units up 17% year over year, driven by commercial printer hardware unit growth of 20% and consumer printer hardware unit growth of 16%.

Momentum in key growth initiatives continue with all-in-one unit shipments up 22% year over year, appliance photo printers up 70% -- 70 -- color laser printer shipments up 40% and printer-based multifunction shipments up 160%. HP Indigo press-printed page volume grew 41% over the prior-year period. This unit shipment momentum has strengthened our share leadership position in both the inkjet and laser markets, and we're confident that today's results will further extend our lead.

The progress can also be tied back to the acceleration of our supplies growth rate, which in turn has helped us drive margins in the high end of the 13% to 15% operating margin range, thereby allowing us to reinvest in pricing and promotional activities as well as further technology advancements and new growth initiatives. We will spend more time on these initiatives in our forthcoming security analysts meeting in New York City on December 12.

Segment operating profit was \$1.1 billion or 14.8% of revenue, up from 13.2% in the prior-year period. And supplies' strength offset pricing and promotional actions taken to drive hardware replacements -- all-in-all, another excellent quarter in imaging and printing.

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Moving now to personal systems, which had a strong quarter characterized by solid revenue growth, market share gains and record operating margins. During the fourth quarter, revenue grew 10% year over year to \$7.8 billion, driven by unit growth of 16%. We continue to see strong performance in our notebook business with revenue growth of 24% over the prior-year period, driven by double-digit revenue growth in both consumer and commercial notebooks. Revenue in desktops was flat year over year, while revenue in workstations grew 10%.

We continue to execute well in our consumer business, leveraging a competitive product lineup and strong retail partnerships. Revenue in consumer appliance increased 19% year over year with revenue in commercial appliance up 4%.

Our topline momentum has driven market share gains in recent quarters. And according to preliminary data, HP took the number one share position in PCs during the third calendar quarter. But more importantly, we gained share while driving margin expansion.

During the fourth quarter, segment operating profit was \$336 million or 4.3% of revenue, up from 2.8% in the prior-year period. This represents our highest personal systems operating margins in a number of years. You should expect us to continue to balance revenue growth and profitability by being disciplined on costs and leveraging our strengths in notebooks, in consumer, in the commercial and retail channels and in international markets.

Moving on to the technology solutions group, where we continue to drive significant margin expansion, giving HP some of the best balance of segment profitability we have had in many years. We posted a solid quarter in enterprise storage and servers with revenue growth of 4% year over year to \$4.7 billion and segment operating profit of \$502 million or 10.7% of revenue, up from the 9% in the prior-year period. This margin represents our highest level in a number of years, and I'm pleased with the progress we have made in the last 12 months as we align ourselves to better compete in growth markets and better harvest the more mature markets in which we compete.

Within ESS, we saw an acceleration of growth in industry standard servers with revenue up 9% year over year, driven by 38% growth in blades. Revenue in storage grew 1% with growth of 11% in our mid-range EVA offerings, offset by declines in the high-end array and tape business.

While the growth profile of our storage business is negatively impacted by our mix towards declining tape market, we're not happy with our storage growth in the fourth quarter. And we need to do a better job of driving topline momentum in the coming year.

Business-critical systems revenue decreased 4% year over year with Integrity server revenue growth of 77%, offset by revenue declines in PA-RISC and Alpha. During the quarter, we did begin shipping Montecito-based Integrity servers, and this positions us well for growth in the coming quarters. We closed the year with approximately 9700 ISV applications ported to Itanium and with Integrity representing 45% of Q4 business-critical systems revenue.

We had a solid quarter in HP Services with revenue growth of 5% year over year to \$4.1 billion, led by managed services and consulting and integration growth up at 16% and 7%, respectively. Revenue in technology services was essentially flat over the prior-year period.

I'm pleased with the solid improvement in HPS margins. The segment posted fourth-quarter operating profit of \$505 million or 12.4% of revenue, up from 8.3% in the prior-year period.

Over the past three to four quarters, we have spent considerable energy working on various costs and efficiency leverage within HP Services. We have made significant progress reducing the unit cost of service delivery and strengthening our portfolio of standardized and automated offerings. At the same time, these efforts were supported by the other Company-level cost initiatives that served to reduce the cost burden allocated to the various segments within HP. Given the size and headcount density of HP Services, the segment benefited proportionately.

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I'm confident that we're in a better position to drive the appropriate operating leverage in this business. While we have more work to do, I feel that we're now in a better position to grow and compete in the market at acceptable margins.

We had a strong quarter in HP software, where revenue grew 14% over the prior-year period to \$349 million, driven by OpenView growth of 28%, which did benefit from the Peregrine acquisition. Revenue in HP OpenCall declined 11% from the prior-year period. Software reported operating profit of \$60 million or 17.2% of revenue, up from a profit of \$28 million or 9.2% of revenue in the prior-year period, reflecting the improvements we have been making to our model and associated operate leverage that comes with our scale.

On November 6, we closed the acquisition of Mercury, which significantly increases our scale and strengthens our software offering. Given Mercury's traditional fiscal year ends at December 31st, we have decided to operate it as a stand-alone, wholly-owned subsidiary of HP until early 2007.

However, we're focused on integrating Mercury as quickly and effectively as possible. And work is already under way on sales tools, go-to-market programs and crosstraining to enable HP OpenView and Mercury sales force to sell a combined portfolio in February.

We expect to launch an integrated product roadmap within 90 days of the close, and we have joint product teams working on product integration planning for HP OpenView and Mercury. We're pleased to see the improvements in our core portfolio and believe that the combined strength of HP and Mercury position us to help CIOs enhance the value and optimize the business outcome of IT investments. Executing against these goals will enable us to drive further revenue growth and margin expansion opportunities in HP software. Finally, bear in mind that the operating margin of the software business will be impacted by the write-down of deferred revenue and other integration costs associated with the acquisition of Mercury in the coming quarters.

I will conclude my segment comments by reiterating that we had a solid fourth quarter across the entire portfolio. I'm pleased with the progress we made over the past 18 months, and we know that we have opportunities for further improvement ahead.

With that, I would like to turn it over to Bob.

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**Bob Wayman** - Hewlett-Packard - CFO

Good afternoon, everyone. I will begin with a review of the performance of our financial services business. Revenue for HPFS during the quarter was \$545 million, up 6% year over year and 5% sequentially. The revenue increase reflects increased financing volume, which was up 1% year over year and 12% sequentially. The lease transactions contributed to the sequential increase.

Portfolio assets increased 4% year over year and 2% sequentially and are now at their highest level in several years. Operating margin was 6.4%, down from 10.1% Q4 of last year and 6.7% in Q3. The year-over-year margin decline reflects the release of certain accounts receivable reserves in the prior-year period. While we're encouraged with the growth in financing volume over the last several quarters, we know we have more work to do and are focused on continuing volume momentum.

Before getting into the key elements of the P&L, let me remind you that fiscal 2006 results including cost of sales, operating expenses, operating profit, net income and EPS did not include -- I'm sorry, 2005 results -- did not include the impact of FAS 123R stock-based compensation. Consistent with last quarter, to assist you in comparing results versus prior periods, we have included a quarterly historical EPS trend in the financial tables accompanying the earnings release. This should allow you to view the results as though all stock-based compensation had been included in previously-reported results.

Non-GAAP EPS for the quarter was \$0.68, including approximately \$0.04 from stock-based compensation, up from \$0.51 a year ago, which again excluded the impact of FAS 123R. GAAP EPS for the quarter was \$0.60, which included \$208 million or \$0.07

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of after-tax adjustments that were not included in our non-GAAP results. The adjustments primarily relate to restructuring charges and the amortization of purchased intangibles.

A quick update on restructuring. During the quarter, approximately 4200 positions were eliminated related to the July 2005 announcement, bringing the cumulative total to about 14,200. While the restructuring program is substantially complete, we do expect to eliminate approximately 1000 remaining positions in Q1 '07.

Now on to the P&L. Revenue of \$24.6 billion for the quarter was up 7% year over year and up 6% when adjusted for the effects of currency. On a retail basis, revenue was up 8% in the Americans, up 7% in EMEA and up 6% in Asia-Pacific. When adjusted for the effects of currency, revenue was up 7% in the Americans, 3% in EMEA and 7% in Asia-Pacific.

As to gross profit, gross profit was \$6 billion for the quarter or 24.3% of revenue, up from 23.5% a year ago and down from 24.8% sequentially. Gross margin improved year over year in each of our non-financing business segments, reflecting improved operational effectiveness in key areas, including option attach, delivery efficiency, utilization, and discount controls as well as favorable mix in certain businesses.

Non-GAAP operating expense totaled \$3.8 billion for the quarter or 15.3% of revenue, down from 15.9% a year ago and 17.2% sequentially. In dollars, operating expenses were up 3% year over year and flat sequentially. Adjusting for currency, expenses were up 2% year over year and flat sequentially. The year-over-year increase primarily reflects volume growth, the inclusion of FAS 123R expenses and investments in growth initiatives, such as the continued hiring of sales resources as well as additional demand generation, offset by position eliminations as part of our restructuring program.

Non-GAAP opening profit was \$2.2 billion or 9.0% of revenue, up \$470 million year over year despite the inclusion of approximately \$140 million of stock-based compensation in the current period. Non-GAAP other income and expense was pretax income of \$190 million or roughly \$0.05 per share after tax, above \$0.03 to \$0.04 per share we had guided coming into the quarter. The excess reflects the favorable impact of currency as well as real estate gains. Our non-GAAP tax rate was 20.5% for the quarter, slightly above our guidance.

One other item of note in the P&L. Unallocated corporate costs, excluding stock-based compensation, increased approximately \$25 million year over year and \$103 million sequentially. The sequential increase primarily reflects an increase in lease volume and a change in the operating lease mix within HPFS.

Intercompany profit on operating lease transactions is eliminated in this line item. As such, as volume and operating lease mix increased, the unallocated balance will grow as more eliminations are booked. Increased legal expenses also contributed to the increase both sequentially and year over year.

Next, the balance sheet. HPO and inventory came in at \$7.8 billion, up \$873 million year over year and up \$286 million sequentially. Inventory days of supply stands at 38 days, up from 35 days last year and down from 41 days sequentially. The year-over-year increase in inventory reflects volume growth, strategic buys and supply chain changes designed to optimize our cost structure. The sequential increase is in line with normal seasonality.

Now I know there is a lot of interest in channel inventories, so I'll add some additional perspective this quarter. Overall, we're very comfortable with channel inventory levels. PSG ended the quarter at roughly 4 weeks, ESS roughly 4.5 weeks and IPG at roughly 5.5 weeks. PSG weeks are flat year over year, and both ESS and IPG weeks are up slightly.

In terms of channel inventory dollars, ISS, which makes up the majority of ESS channel inventory, are up, in line with revenue growth. PSG channel dollars are up only slightly compared to a 10% topline growth. IPG channel dollar growth slightly outpaced revenue growth, reflecting increased supplies associated with significant hardware unit growth over the past year. Total Company channel inventory dollars are up roughly in line with topline performance and our outlook for the first quarter.

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Trade receivables ended the quarter at \$10.9 billion, up \$970 million year over year and \$1.2 billion sequentially. DSO now stands at 40 days, up from 39 days year over year and flat sequentially.

Next, property, plant and equipment was up \$412 million year over year and \$494 million sequentially at \$6.9 billion. Gross CapEx was \$965 million, up 85% year over year and 55% sequentially. On a net basis, CapEx was \$868 million, up 95% year over year and 123% sequentially. The year-over-year increase in CapEx reflects incremental investments in IT as well as increases in financing assets.

Net PP&E as a percent of revenue now stands at 7.5%, up from 7.4% year over year and 7.1% sequentially. Regarding Accounts Payable, days payable closed the quarter at 59 days, up from 52 days year over year and 58 days sequentially.

Now some comments on cash. Cash flow from operations and free cash flow were both very strong at \$3.2 billion and \$2.4 billion, respectively, for the quarter. For the full year, cash flow from operations was \$11.4 billion and free cash flow was \$9.4 billion, both up over 40% from fiscal 2005, which was a record cash flow year.

During the quarter, we repurchased \$1 billion in stock in the open market for approximately 30 million shares. In addition, we received approximately 13 million shares under the prepaid variable share purchase program that we entered into earlier this year. So a total of 43 million shares were acquired during the quarter.

For the full year, we repurchased 190 million shares in the open market and received an additional 34 million shares under the prepaid plan. In addition, we paid out \$219 million in the quarter for our normal dividend and \$894 million for the full year.

We closed the quarter with gross cash of \$16.4 billion, up from \$13.9 billion last year and \$16 billion sequentially. Net cash was \$11.2 billion, up from \$8.7 billion last year and \$9.2 billion sequentially.

In terms of cash usage for fiscal 2007, a significant bonus payout will occur in the first quarter related to the strong operating performance of the Company in fiscal 2006, and this will put pressure on operating cash flows in Q1 '07. Beyond impact on operating cash flow, we did have a net cash outlay of approximately \$4.5 billion earlier this month related to our acquisition of Mercury. In addition, we expect fiscal 2007 gross and net CapEx to trend at or above fiscal 2006 levels as we continue to build out our data centers and deploy capital to consolidate and upgrade our real estate facilities.

Now a few comments on our outlook. Historically, revenue declines a bit, over 2%, from Q4 to Q1 in constant currency. Given where our rates are today, we do not expect a significant sequential currency effect.

On November 6, we closed the acquisition of Mercury, and you should therefore begin to incorporate their results into your estimates for HP. However, as we indicated at the time the deal was announced, purchase accounting rules required a significant write-down of deferred revenue. As such, based on our expectations for Mercury and the results of the purchase accounting entries, we expect approximately \$800 million in revenue associated with Mercury in fiscal 2007. Taking these factors into account, we estimate Q1 '07 revenue will be approximately \$24.1 billion to \$24.3 billion and revenue for 2007 full year to be approximately \$97 billion.

Regarding earnings, there are a few variables to consider. Given the software P&L characteristics of Mercury, we expect the acquisition to have a positive effect on total Company gross margin of approximately 50 basis points and a negative impact on total Company expense ratio of approximately 50 basis points. On an overall basis, the Mercury transaction is expected to be approximately \$0.04 dilutive to our non-GAAP per-share earnings in FY '07.

In '07, we will continue to fund investments to drive short-term and long-term growth initiatives. We expect FAS 123R expenses of approximately \$0.04 in Q1 '07 and \$0.14 in FY 2007, up slightly from \$0.13 in fiscal 2006.



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Although we have reduced the number of options granted relative to prior-year levels, the fair value of each option granted in fiscal 2006 and expectations for fair value in fiscal 2007 grants have significantly increased, reflecting the rise in stock price and a slight increase in volatility from 2006 to 2007. This has caused related expenses to be higher than previously anticipated, notwithstanding the reduction in option grants.

With respect to restructuring as we continue to look for ways to optimize our cost structure, we expect expenses associated with any future actions to be absorbed by our business segments, barring any significant transaction or change in our business model. Accordingly, such expenses will be accounted for as normal business activity and will be included in our non-GAAP results. Any adjustments to previously-announced restructuring plans will still be treated as an adjustment in non-GAAP results.

We estimate non-GAAP OI&E to be about \$0.03 to \$0.04 per share per quarter in '07, which primarily reflects baseline net and trust income, given projected cash and debt levels. We will call out deviations from this baseline as appropriate.

Bear in mind that given the significant outlay of cash related to Mercury, we expect the interest income to be at the low end of the \$0.03 to \$0.04 guidance in Q1. We expect a non-GAAP tax rate of about 20% for Q1 '07 and the full year.

While we expect to continue to repurchase shares in fiscal 2007, given the current share price and our expectations for option exercise patterns and the impact on common stock equivalents, we expect a modest decline in shares outstanding in Q1 '07 with shares likely to be somewhat flat for the remainder of the year.

With that in mind, we expect Q1 '07 non-GAAP EPS of \$0.60 to \$0.62, which includes approximately \$0.01 dilution for Mercury. For FY '07, we expect non-GAAP EPS of \$2.48 to \$2.53, which includes approximately \$0.04 of dilution for Mercury.

So all-in-all, we closed FY '06 positively, and our increased outlook for 2007 reflects our progress to date. With that, we will take your questions.

## QUESTIONS AND ANSWERS

### Operator

(OPERATOR INSTRUCTIONS). Andrew Neff, Bear Stearns.

### Andrew Neff - Bear Stearns - Analyst

The question I wanted to ask was just one of -- as you look at the different business areas, is there room for further improvement? You make a lot of improvement in terms of the margins. Is it going to get better than this? Specifically, you can talk about how you're going to -- in terms of you have talked about the IT savings, when do we begin to see the impact of that?

### Mark Hurd - Hewlett-Packard - Chairperson, CEO

Listen, we've got to do better than this. This was a good quarter for us, clearly, in terms of how you would look at milestones along the way. As I've said in my comments, we've been successful, I think, at delivering on the short-term milestones we have had but frankly investing in the long-term. And that includes, to your point, being able to improve our cost structure.

Our cost structure has work left to do, and we have got to get that done at the same time as investing for growth. So we certainly are not taking any victory lap here. We have got work to do, but I will tell you at the same time I am pleased with the progress.

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**Operator**

Keith Bachman, Banc of America.

**Keith Bachman** - *Banc of America - Analyst*

I wanted to -- Bob or Mark, not sure who -- but talk about the inventories. If I heard you right, your comment was that it didn't impact the level of sales, since it was normalized compared to last year's. Can you just please confirm that?

My follow-up is it does look like, correspondingly, that account receivables was up sequentially more than I would have anticipated. So I just want to come back and see how that relates to your inventory comments and get any color there -- additional color, please, on how the AR bump might have been impacted by the sequential change in inventories.

**Bob Wayman** - *Hewlett-Packard - CFO*

So our fourth-quarter is always back-end loaded. August is slow, and October is big. As you saw, we exceeded revenue estimates. And frankly, some of that comes from the strength that we saw late in the quarter, and that strength in revenue is not yet collected. So receivables tend to be a little bit higher.

So we are very much impacted by consumer volumes this time of year, and it has been a strength to the Company. And that's reflected there.

We have built our inventory. Inventory has grown a little faster than revenue. It is, as I said, up. It stands at 38 days compared to 35 days last year. But we feel good about our inventory. It's fresh inventory; it's what we want.

The inventory build that we've actually seen in prior quarters and in this quarter have served us well in terms of meeting what continues to be a pretty decent market demand. So we have, I think, the right levels of inventory in the right places.

I mentioned strategic buys. We have talked about this for a number of quarters. We are buying inventory when we can get good prices on it. And that, too, has served us well. It has helped us achieve a better cost structure and a better gross margin to be more competitive in the marketplace.

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

I'd just say one thing on the owned inventory side. We're really looking at a total call structure as we look at inventory. So inventory is one dimension of an aggregated, optimized call structure to look at our overall COGS positioning.

So some of the owned inventory is literally positioned to lower our COGS. So this is not an accident, if you will, in terms of some of the stuff that you're describing.

On the channel inventory side, listen, we're trying to optimize the answer in the sense they're both being in a position to take care of future demand at the same time as we are taking care of the quarter demand. I think at the quarter overall, we're generally comfortable.

As anything, there are stories within the story, depending on what region you got to and what product line. But when you look at the Company overall, we feel pretty comfortable with where we are.

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**Operator**

Ben Reitzes, UBS.

**Ben Reitzes - UBS - Analyst**

Mark, could you comment on Vista and the PC market? You had a great outperformance in the quarter. You're the number one PC company in new world. What does Vista mean for HP and not only in the first quarter but as we go throughout the year?

As I look at your guidance, it means about 5% organic growth if you exclude Mercury, which is a deceleration from the 6% the last two quarters. I've got to think if Vista is any bit of an accelerator to the market, that's conservative guidance. So go ahead. That's all the questions.

**Bob Wayman - Hewlett-Packard - CFO**

I appreciate the color on the guidance, Ben. I think the point on the PC business is that when you look at constant currency, our performance has been pretty steady I think when you look at.

On Vista, right now, as it relates to the short-term, we just don't know what will happen as it comes up to the holiday and really even not just the holiday but post-holiday to introduction may be a window that we just can't forecast well enough to be able to tell you exactly how it will work out.

Now, as it relates to the long-term, we feel good about it. And we feel good about our positioning within Vista. We think we're well-positioned from an offering perspective. And clearly not just Vista but the collection of where we see demand based on what market segment, where we see it by region and our product line of combined, yes, we feel pretty good about how we're positioned.

**Operator**

Harry Blount, Lehman Brothers.

**Harry Blount - Lehman Brothers - Analyst**

I just want to circle back on the restructuring, Bob. You may have mentioned it in the comments, but I missed it. You guys are now largely complete with the headcount reductions, but the cost savings still should carry over into fiscal '07. Could you remind me a little bit of how much the incremental impact is going to be in fiscal '07?

**Bob Wayman - Hewlett-Packard - CFO**

I'm not going to give you a new update for '07. What I will say is that when you look year over year, certainly there's going to be significantly more cost savings in '07 than what we saw in '06.

So we have been coming down in headcount or I should say our restructuring effects have been a couple thousand a quarter until the fourth quarter, where it was 4200. Obviously, we have not seen the full-year benefit of that. So expect to see additional savings from the actions we have taken.

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**Harry Blount** - *Lehman Brothers - Analyst*

Right. What I was driving at was trying to get an understanding of how much of the EPS improvement year over year -- or guidance in '07 is coming from the restructuring actions of '06 versus just core continued improvement in mix and other areas.

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

I don't we broke that out.

**Bob Wayman** - *Hewlett-Packard - CFO*

The guidance we gave you a year ago in terms of savings of -- what was it -- around \$1 billion in '06?

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

About \$1.9 billion to \$2 billion.

**Bob Wayman** - *Hewlett-Packard - CFO*

Right. With around \$1 billion or so of that in '06 getting significantly higher in '07.

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

Just to give you a few data points, remember that part of that was a pension that we got early in the year in 2006. And then you've seen a -- I don't know what the right word for it -- a blending of the improvements in Q1/Q2 into some of our sequential quarter performance.

So clearly, the Q4 sequential -- our actions sequentially will begin to have some effects now in '07. But we had a one-time pension action that occurred at the end of '05. It went on in '06, and then we blended it in from there. So that's really where we're at with it.

Of course, as we discussed at the time, some of that will get reinvested back into the business in terms of whether it be pricing or competitiveness in proposals or going to hire sales resource, et cetera. But clearly, it will be a help to us.

**Bob Wayman** - *Hewlett-Packard - CFO*

Just one other item as well. We did say that those gross savings, that maybe half of it would fall to the bottom line. Certainly, some of the success that you're seeing in Q4 comes from investing some of that back and driving better topline results with demand generation spending. Hopefully, over the long-term, some of the hiring we are doing of additional salespeople will lead to additional growth as well.

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

Yes, I hear you. I don't think that should be lost here that part of what we're doing here is to try to do further work to variablize our cost structure. When we do see opportunities in the marketplace to grow and hopefully grow profitably, we will use some of that flexibility to take advantage of the opportunity. So we think we've made a bit of progress on this. We still got some work to do.

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**Operator**

Laura Conigliaro, Goldman Sachs.

**Laura Conigliaro** - *Goldman Sachs - Analyst*

Can you provide some observations on what's happening on the component front including pricing? For example, which components seem to be in short supply and where the situation has gotten worse or better? You had previously referred to the possibility, for example, of better CPU pricing, given the AMD/Intel competition. Are you seeing any of that yet?

**Bob Wayman** - *Hewlett-Packard - CFO*

Certainly, we did see memory pricing pressures and availability issues in Q4. We did get most of them resolved by the time we finished up. We did pay a little more money for memory than we had planned going into the quarter in a couple of our businesses. So memory has been the commodity of interest in Q4.

We also had a few issues on microprocessor, particular types of microprocessors. Panels have been in good supply, and pricing has been favorable there. Panels is one area where we have done some strategic buying, and it's worked to our advantage. Hard drive is really no change -- very competitive marketplace. Availability is pretty good.

**Operator**

Richard Gardner, Citigroup.

**Richard Gardner** - *Citigroup - Analyst*

Another question on the PC business if I could. It relates to what looks to be a pretty significant shortfall in motherboard shipments out of Taiwan, which I think -- desktop motherboards, in particular, which has led folks to believe that PC demand is deteriorating.

It certainly doesn't look like you saw that in your results, but I'd love to get your thoughts on the current demand environment and any color that you can give us by customer segment and geographic region would be helpful.

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

I would say that demand does differ a little by region and sometimes frankly within region. But if you aggregate it together -- stable, stable market demand. So from that perspective, we don't see that instability that you're describing. Again, I could go into lots of different stories by segment, by country. But when you net it all together, we saw stable demand.

**Richard Gardner** - *Citigroup - Analyst*

Could I follow up and just ask, Mark, if --

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

Isn't that against Brian's rules? But go ahead. Go ahead.

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**Richard Gardner** - Citigroup - Analyst

The question was whether you could give us any visibility of whether there was a sharp or significant downtick in commercial demand -- PC demand during the quarter?

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

No. I can't say I saw that. We saw pretty stable demand. Again, it can vary -- if you ask me corporate by country, I could get into a couple. But when you looked at the aggregate, no.

Our real issue in the quarter, if anything, on the supply said was in memory, as Bob has referenced, we paid up a little bit for memory. I wish we hadn't, but we did. Our overall macro demand picture was roughly stable.

**Operator**

Toni Sacconaghi, Sanford Bernstein.

**Toni Sacconaghi** - Sanford Bernstein - Analyst

Your gross margins declined about 50 basis points sequentially. If I look at your business mix, it looks perfectly neutral on a sequential basis. Supplies were up pretty well in line with Company revenue and the enterprise group, which also has pretty good margins, were actually up fractionally as a percentage of sales.

So it doesn't appear to be a mix issue. Were you incrementally more aggressive on price then, and can you comment across what product family?

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

I'll start. I think it is fair that in a couple of groups, we saw opportunity for growth and we took it. So for example, in IPG, and you looked at overall mix, the mix is sequentially different as it relates to supplies versus hardware, which shows up in our 17% hardware unit growth.

So clearly, there is -- I wouldn't describe it as an issue by underneath but certainly in the mix of hardware. And certainly, that did have an effect on our margins.

**Bob Wayman** - Hewlett-Packard - CFO

Mix within segment is also important. Again sticking with IPG, as we mentioned in the script, very strong growth in our basic-level printers. I think it was 60%. But anyway, it's in the script -- very large growth, very large growth in color laser. Both of those are lower-margin products than some of the other items in our line. So, while overall hardware may have been the same, we could definitely see a different mix of hardware within that hardware slice of the pie.

**Operator**

Richard Farmer, Merrill Lynch.

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**Richard Farmer** - *Merrill Lynch - Analyst*

Mark and Bob, you both talked about cash flow and cash generation in the quarter. Bob, you made some comments about the first quarter of '07 that the share count would modestly decline and about flat in all of '07 if I heard you right.

I'm just trying to reconcile -- you have \$16 billion of cash on the balance sheet, net cash \$11 million. I understand you have to pay \$4.5 billion for Mercury, but you're also generating \$9 billion in operating, \$7 billion in free cash flow.

So what are your priorities for the cash over the next couple of years? Why wouldn't you use the majority of the \$7 billion in free cash generation for buybacks? And why wouldn't share count go down a lot more than you articulated?

**Bob Wayman** - *Hewlett-Packard - CFO*

Of course, I have to say I don't know because it all depends upon what happens to share price and some other things. While we did spend \$4.5 billion on Mercury, that's just in Q1. Who knows what we will need for acquisitions throughout the year? So all of this is based upon a bunch of assumptions.

I will tell you my comments assumed that we would continue using a good hunk of that free cash flow for share buybacks. Keep in mind, though, that the share price is quite a bit higher today than it was on average for '06, and so it just doesn't go as far.

Furthermore, as the share price moves up, option exercises pick up. We've seen that. We saw that in Q4. We saw it throughout the year. We saw it again in Q4. My comments assumed that as we get into the 40s here, we will see even more option exercises.

So it's all of those variables mixed together. One other, I should mention -- of course, we have to calculate common stock equivalents, which again get directly driven by increased share price.

So there is a lot of dynamics here. It's my best guess that it comes down a little in Q1 and then stay roughly flat. Could it come down a little bit more? We'll see. Do we intend to keep buying -- I'll call it aggressively? Yes, unless something else changes in the world around us.

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

One thing, we're going to be active in the area. I think the point is we have worked real hard to get our option overhang down. We're working on it. We will continue to be active. So, to Bob's point, I don't think you should have any expectations that we won't be. But we've got other factors as we consider our aggregated capital strategy.

**Bob Wayman** - *Hewlett-Packard - CFO*

Yes, we do have \$5.6 billion remaining of the authorization that the Board acted on last quarter.

**Operator**

Rebecca Runkle, Morgan Stanley.

**Rebecca Runkle** - *Morgan Stanley - Analyst*

Mark, just a quick question following up on your storage performance and comments. Clearly, a phenomenal quarter across the board, but you noted storage is one area of weakness. Just as you sit here now and look at that business, what in your mind

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are the issues? Is it technology? Is it product? Is it go to market? What are the top strategies for turning that business around over the next four quarters?

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

There's a couple of different dimensions to it. First, it's a business that has worked hard to improve its operating margin, which it has done. I think that part is a positive, so I don't want to take away from that.

But to be very blunt, I'm disappointed in the revenue growth for the business. The market is a strong market for us. We're investing in the market. We think we actually have a pretty strong product lineup right now. We just need to do a better job from a demand creation perspective.

There's opportunities for us in the midmarket that we think are important for us to go get. As I go through our field checks, we feel about as good about our product lineup as we have in quite a while. We have done a decent job at improving the operating margin of the business.

We need to go get more business. We have invested in software. We do have the tape declines, but we still think we can do better. And we're going to go focus on it.

**Operator**

Bill Shope, JPMorgan.

**Bill Shope** - *JPMorgan - Analyst*

Can you guys comment on the pricing environment in PCs for both commercial and the consumer segments? There's been a lot of chatter that perhaps your largest competitor has eased up on pricing somewhat. I'm wondering if you saw any evidence of this throughout the quarter.

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

Nothing spectacular. I would say that the quarter was steady. We didn't see anything extraordinary from a pricing perspective. But I say that against the backdrop of a pretty aggressive environment period. We have more than one competitor out there.

So when you look at different markets, there is different people that show up as competitors. Obviously, we're very global and we're very competitive in many markets. So I think we would say there's nothing extraordinary. But there are multiple competitors out there. And so the environment, I would say was steady. That would probably be the best way I could describe it.

**Operator**

Brian Alexander, Raymond James.

**Brian Alexander** - *Raymond James - Analyst*

Just a clarification and then a question on service profitability. The clarification on the revenue guidance, I just want to make sure I understand. We should assume that you're looking for normal seasonality in the first quarter as well as normal seasonality in the PC business specifically to get to the range that you provided. Then, I have a follow-up.



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**Bob Wayman** - *Hewlett-Packard - CFO*

Yes, there's no particular new trend that we're trying to convey here. The guidance, I think, fits with normal trends.

**Brian Alexander** - *Raymond James - Analyst*

Great. Then on the service margin, can you just talk about the profitability that you saw in each of the segments within HPS? Where did you see the biggest increase in profitability than what I thought was actually a negative mix shift away from tech services and more toward managed services and consulting?

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

So, a couple of plants. We don't give the profitability numbers out by segment specifically. But I would say there are three kinds of costs in the service business.

As I mentioned in my prepared comments, there's overhead costs that comes from the corporation into services. Because of its headcount profile, it absorbs quite a bit of that overhead -- point one.

Point two, any services business, even across all three segments, has its own overhead, infrastructure, PBXs. You can go down a whole number of different characteristics.

Then, you have the actual service delivery itself, and we're working on all three lines. Those improvements in all three pieces have led us to improved profitability in both consulting and integration and in managed services that has also benefited, to some degree, technology services, even with the revenue performance we've had.

**Operator**

Louis Miscioscia, Cowen.

**Louis Miscioscia** - *Cowen - Analyst*

Maybe if we could stick with the services area in the sense you obviously had a very good quarter. Is this something that we should, from a revenue standpoint, expect to continue on a sequential basis? Because services is a little bit less seasonal to hardware and some other things. Maybe if you could also talk about the pipeline?

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

So let me begin first. Services is still a little seasonal. Q4 is usually our best quarter from a profitability point of view, and Q1 is often a bit more challenged, both on the top line and bottom line. So while it may be less seasonal, there are seasonal trends.

We're also being quite -- part of it is driven also by projects. And so while there is a lot of annuity run rate to the business, there are projects and managed services transactions that some we pursue. We frankly, right now, are very picky about what we do pursue.

We have two characteristics is that -- one, that we can make money; and second, that we can deliver the service we commit to. If either one of those are not there, we will typically walk away from a transaction. So that's the main reason.

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Again, I believe that costs drives growth and that we're trying to get our cost structure right. As we do, we will be in a better position to grow. But we're very particular about how we grow and can we grow profitably.

**Bob Wayman** - *Hewlett-Packard - CFO*

So let me just summarize a bit here. Certainly, the profit improvements that you saw in Q4 in services, some of them are quite fundamental and we expect them to continue. At the same time, I wouldn't extrapolate sequentially from Q4 into Q1 when it comes to profit.

**Operator**

Chris Whitmore, Deutsche Bank.

**Chris Whitmore** - *Deutsche Bank - Analyst*

I wanted to follow up on the inventory question. You have been making strategic buys now for the past several quarters. Should we think about your inventory levels as being structurally higher going forward? In other words, is it ongoing part of the business we should expect going forward?

Secondly, you mentioned your making strategic buys in panels. But availability and supply of panels is quite good. I wanted to understand that dynamic a little better.

**Bob Wayman** - *Hewlett-Packard - CFO*

Let me start, and Mark can chime in. So with regard to panels, as an example, there are times when suppliers come to us and say, I've got this inventory and I will give you a really good price if you buy it from me and take delivery in the next three days, even though we don't need delivery for 20 days or something like that.

If it's worth it, we will consider doing that kind of thing. Obviously, we have the financial capacity to do so. So we look at the trade-off between the inventory carrying costs, what we think the price trends would be and how much better this is than what we would predict trends to be. Frankly, it has helped us over the past year.

Whether it's structural or not, that particular one, I don't know. It just depends upon what vendors bring to the table. They could stop doing that, and then that would go away.

Other inventory investments that we have made, we mentioned, for example, some changes in the supply chain. We're moving product production around the world to get lower prices, but it adds to the inventory pipeline. That is probably going to continue not forever, but it is driven generally by country-based economics and is unlikely to change quickly. So that's probably going to be with us for a little while.

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

I think just to add to it, first on the panels -- sometimes more supply actually creates the best deals to Bob's point.

Secondly, we have had significant demand for consumer notebooks across the year. So it has been quite strong.

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I think, thirdly, we want to get away from thinking about inventory in an isolated metric. I like a lot of metrics, but you can get overmetrized in some of these areas. We want to look at the aggregated ability to get our capital leveraged at the same time as be able to get the best profitability out in the marketplace.

Inventory is only one component of the aggregated mix. So we're looking very hard at interrelating the inventory positions to take to our ability to get into a positive pricing environment or ability to go compete.

So long answer to your question. But the issue is we may keep these inventory levels at the way they are if we think it provides an aggregate economic benefit to Hewlett-Packard.

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**Operator**

Jesse Tortora, Prudential.

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**Jesse Tortora - Prudential - Analyst**

PSG operating margin increased to 4.3%, ESS to 10.7% in the quarter. What do you think the key drivers were behind this, and what is your outlook for these segments going forward?

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

Well, we will talk more about our outlook going forward when we get to New York, other than we're not going to give any more than the guidance we gave today.

I think, in PSG, we continue to have strong performance in notebooks and a strong mix. I think it's basically what we've said.

You have seen us take positions in inventory, and the strategic buys have helped us from a margin perspective. We benefited from a mix of and leverage between AMD and Intel, a series of things that we have talked about over the past quarters.

I think, in ISS, which has a main driver in terms of ESS, you've had the same kind of effect from an industry standard server perspective. It doesn't hurt when you grow because you leap over a lot of your fixed-cost structures. So when you get 9% growth in ISS, 38% growth in blades, it tends to have an effect for you.

So I think for us, it's a mix of growth. It's a mix of balance in our ability to leverage our supply chain. We feel we've made some improvement. I can tell you this that we are focused on trying to do better.

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**Operator**

Bill Fearnley, FTN Midwest.

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**Bill Fearnley - FTN Midwest - Analyst**

How should we be thinking about levers that drive corporate gross margin improvement going forward? What is the biggest lever? Is it mix? Is it component cost trends? Is it the buys that you are doing? Is it attach rate? How should we be thinking about gross margin improvement now?

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

I think you're on all the right points. For us, it's also -- remember, a big part of our gross margin is cost of service. So it isn't just what you see in the COGS line, which you hit I think quite effectively in terms of our ability to get the attach levels right and the ability to get the mix right.

So for us, Bob, I thought made a very important point about the mix of software. It's going to now start folding into our P&L. That is going to have an effect on our gross margin, and I think that's a positive.

We certainly are doing more work in intellectual property around all of our hardware segments at the same time as we're trying to optimize the mix of all components, whether it be microprocessor all the way through the supply chain, taking better inventory positions, better attach.

Cost of service, though, is mainly a headcount-driven model that we're also trying to work hard to not only leverage our labor model but also deal with automating our service processes. I think, with those we've said, we've hit a majority of the levers. At the same time, we have got some fixed-cost structure that goes up there too. So we're trying to pull them all.

**Operator**

Dan Renouard, Robert Baird.

**Dan Renouard** - *Robert Baird - Analyst*

My question is just on the sales hiring and your progress there. Can you maybe give us some metrics in terms of the success you have had or where you're at in terms of either number of salespeople added or just how you think about progress there and how much more you have left to do?

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

So I think the answer is sort of to your question. We don't give out the numbers by group and so forth in terms of that kind of metric. But I think it would be fair to say that we made significant progress. I'd say we got more than halfway to the goal that we were hoping to get to.

I can tell you internally we had all kinds of optimistic plans to get people in. But frankly, getting this done -- it's more important to us to get this done right than to just show up with a bunch of headcounts. So we're really looking for quality people that can really help us change the game.

And I'd say we made what I believe to be the expected progress you would make doing this. We have more to do. If you know of great people who know a lot about enterprise selling and things -- channel selling, we would love to talk to them.

We're going to wrap up. Let me just summarize today's call by saying that I am pleased with our progress in the fourth quarter. HP delivered solid revenue growth to gain market share in key businesses, drove significant growth in key initiatives, expanded our margins across our segments, delivered our most balanced segment profitability and posted record quarterly cash flow from operations.

We did do this while continuing to make progress on our cost structure by substantially completing our restructuring program and making further progress on strategic initiatives that will strengthen HP's long-term competitive positioning and increasing our non-GAAP EPS guidance for the fifth consecutive quarter.

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All-in-all, it was a solid quarter for HP, closing out a strong fiscal 2006. We do have more work to do though. That said, I do believe we're on our way to building a stronger, more competitive HP.

Finally, we look forward to seeing you in New York City at our annual securities analyst meeting on December 12. Thanks again for joining us on the call.

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**Operator**

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

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