

Hewlett Packard Company (HPQ)
Raymond James 27th Annual Institutional Investors Conference
March 9, 2006

<<Brian Alexander, Analyst, Raymond James>>

Okay, we will get started with our next presentation. Again I am Brian Alexander, I cover technology hardware and distribution for Raymond James, and I am very pleased to have Hewlett-Packard with us this morning. The first presentation at our March conference, hope we want as many to come. And without further due, I will turn it over to Brian Humphries, Vice President of Investor Relations.

<<Brian Humphries, Vice President of Investor Relations>>

Thanks Brian and good morning everybody. My name is Brian Humphries and I am the VP of Investor Relations at HP. A lot of changes in the last year in HP as you can imagine and I think we've made progress in many, many fronts, but I will still talk to you about HP being a working progress. We have made progress, we have a lot more to do I think in the coming years and generally however we feel very confident thereon our position in the market. In each of the various segments in which we compete, we generally have a number 1 or number 2 percent market share. And for us number 1 and number 2 is a positive sustainable revenue growth and profitability.

Our revenue growth has been quite strong over the last two years, 6.8 billion in FY '05, 6.8 billion in FY '04 as well. So, 13.6 over the last two years. We want to continue to drive revenue as a financial (inaudible) corporation. But of course importantly we want to get more revenue in our higher margin businesses to get greater financial leverage through to P&L. as you know, when I am going to bring it through this into more detail on the second, we are going through some cost initiatives, we announced restructuring program in July, that program is on track. Margins are improving in many, many businesses and as a total company, last quarter our operating margin was 7.5 percent operating. So not only we are reducing operating expenses on a business by business level, but we are actually also increasing – able to increase gross margins in many of our businesses. And importantly, HP has got a very strong balance sheet. Last quarter we closed the quarter with 12.0 billion in gross cash. Last we generated \$6.6 billion in free cash flow and \$12 and \$8 billion on a cash from operations basis. But the fundamentals of HP I think are quite strong. Of course companies are never as bad as people expect them to be in the bad times and over the last few years, I think we made a lot of progress, and much of that progress has been hidden of course given some of the short comings we have relative to our stated goals, but the need to cover is the fundamentals we are actually very, very strong.

On the revenue basis, we are now coming up to \$90 billion on an annualized basis. About 30 percent of our business is in personal systems which is our PC division, and about 30 percent is our imaging and printing business. And remaining 40 percent is

between the enterprise areas of the business. Frankly no doubt, personal competition, IBM or more study more study more than 50 percent services and though are more than 70 percent PC. So our revenue mix if you will is more balancing those people in the market. On the regional basis, the US last quarter was only 35 percent of our sales. so, we are broadly international, we think that is the competitive advantage coming from emerging markets and international markets relative to the more developed western markets. And again, you will see an impact obvious international presence in the form of local currency adjusted revenue growth. Now, we split this (inaudible) quarter-by-quarter basis and I will talk to you three hours as we go through the presentation.

Again I mentioned 13.6 billion in growth over the last two years. Certainly some of that has been benefited by foreign currency movements, but even last quarter and local currency, we grew 8 percent. Now this year for the first time in our history, generally I believe and IBM will not be the biggest type company in the world. We will surpass IBM in revenue this year. So, for IBM who are traditionally larger than us growing in local currency (indiscernible) acquisition 0 to 1 percent or 3 to 5 percent and indeed last quarter 8 percent local currency growth started up very, very well.

I just wanted to bring in through the past, I also want to talk to you today around whoever trying to go in the market and also the various steps and means of progress that you can track us on as we go forward. But here is a slide that looks like there are various segments of HP and reviews the revenue growth and the revenue in absolute dollars over the last four years and you will see again most segments actually had increasing revenue growth momentum over the last four year period. Now similarly if you look at the same slide on an operating margin basis, the fundamentals of the company have been improving for the last four years and particularly if you look at the PST side which is the top left quadrants that's 30 percent of our business and even in FY '01 which is an obvious slide, the business lost \$700 to \$800 million. So we've not gone through 4 to 5 years of operating margin expansion that PC division is indicative of 1.2 billion or 1.4 billion turnaround and you are seeing similar trends in many, many of our businesses as well. the one field which has changed dramatically is services profitability, I want to take you throughout in the second. Imaging and printing profitability did decline last year into the 13 range, I think last year was their period of transition first in our most recent quarter it rebounded to 14.9. But importantly, those margin ranges are still by far back in across the industry. So, net, net HP is a company that is growing and the fundamentals of each of the businesses are improving.

Now, in our December securities (inaudible) conference, we actually talked about FY '07 model, which highlighted revenue takers and operating margin ranges business by business as well as on (inaudible) HP. And you will see from this slide that not only we have we made progress in the last four years and virtually every business, but we expect our progress to continue.

Now, we've aligned a company growth assumption of 4 to 6 percent top line with the bottom line in FY '07 of 7.5 to 8 percent operating margin. We are off to a good start, kind of in the first quarter, as we go through the results overview, you will that PHT has

3.9 percent operating margin which was a highest level in many, nay years already at the high-end of the 3 to 4 range. Imaging and printing and 14.9 percent operating margin at the high-end of our FY '07 range. The ESS business or the Enterprise Storage and Server business have 7.7 percent operating margin again towards the high-end of the range. Now we've got more work to do in other areas including software, including services and they remind importantly that our business like many other companies you will see present has a (inaudible) seasonality and so you should not necessarily expect the operating margin ranges in the first quarter to translate through the rest of the year. so, to give you an example of that, the PC division of 3.9 percent benefited by the seasonally strong volume quarter and the seasonally strong mixed quarter with consumer typically as you know being strong and back to screw thanksgiving and would a holiday season which benefits our Q4 and Q1 PC division. In Q2 and Q3 we go to a seasonally weaker North American quarter Insitu and Q3, we are impacted by that as well, but coming back into Q4, you should expect to see to see a nice rebounding margins again. So the margins will continue to increase on a year-over-year basis, but you should necessarily assume a sequential increase quarter in, quarter out.

The strategic framework of HP is really established around premise of establishing HP as the world's leading IT information company, perhaps it sounds like a (inaudible) to you but frankly at the end of this year as I said earlier, we will be the largest revenue IT company in the world, we need to improve the operations of the company to ensure that we are also delivering very strong bottom line profitability, strong market capitalization, strong presence in the various markets etc. We are focused on inventing and developing technology solutions for our customers, not technology for technology sake. Technology that we can actually go for it and commercialize and win in the market with. And if we can't commercialize it ourselves, perhaps we will develop a license stream or we get a high revenue gross margin stream as we license our technology to others. Last year we spent about \$3.5 billion in R&D. We are trying to capitalize on industry trends and actually in many cases, trying to derive industry trends into all areas of strength such as turbo blades etc. In the enterprise we envisage, a automated 24/365 live type data center for security and automation and virtualization are key. Servo blade technology will be part of that. So, it will storage early networks etc. In the PC division, we envisage a world of always ready, always on mobile computing, leveraging interconnect and relationships with content providers which digital media leveraging strong presence in the home.

And in imaging and printing, they are saying in the coming 5 years, you will know HP less and less as a printer company and more as an imaging company as we move towards the next generation of our printing opportunity, which is things like industrial printing, outdoor signage, the photocopying markets, marketing collaterals etc. and not just consumer printers or commercial printers and all of these provided tremendous opportunity for us. Bearer mind HP's huge presence, are huge procurement leverage, our huge install base. Every year we ship more than 30 million PCs, more than 50 million printers, more than 2 million (indiscernible) servers, more than 100s of millions of cartridges and that provides us with a tremendous plus point for the various customers that we serve. The HP hasn't always being very good of taking advantage of this

opportunity. And in many cases in the last few years you have seen us with a number one or number two share position although losing some momentum in this share categories. I think right now we are very, very focused on driving and operating model to be (inaudible) on a cost basis to free up capital to reinvest in the top line until we invest to be more competitive.

Our operating framework therefore consist around targeted growth, the efficiency and capital strategy. And for us cost and growth are one and the same, they are synonymous. A company cannot grow on a sustainable basis, it is just not a cost structure base to allow it to report that growth initiatives, we had pricing we are reinvesting in the sales force or otherwise. And so every time you hear HP talk that growth, we will enter same center (inaudible) cost, they are one and the same. Somebody from a capital strategy point of view, we have a number of priorities, share repurchase, dividends, we are investing in the business, targeted M&A activities etc. And these will be some of the levers that we have at our disposal to continue to be successful in the years ahead.

There is a slide called revenue growth which focuses on HP's local currency under the constant dollar growth over last 8 quarters or so and importantly you will see that in local currency growth, our growth rates have been accelerating. Now, first to deliver 6 to 8 percent local currency growth of a baseline revenue base of \$90 billion is a significant growth. Some people said to me why don't grow on double-digits anymore. Well, HP growing 4 to 6 percent in dollars create Fortune 200 companies every year. so, don't be confused with the law of large numbers, we are growing at scale, 13.6 billion over the last two years and our growth rates are accelerating in local currency levels.

And one thing you won't have heard over the years is that HP has best in class sales model. People get hung up on direct versus indirect, but I think we have a lot more work to do. We spent \$3.5 billion creating great technology year-in, year-out. We don't always bring into market in the most effective manner and certainly direct versus indirect is important, but we will go to market using a hybrid approach. Channel partners are extremely important to us, particularly those who add value and we will also continue to drive our director on a go forward basis. Now part of what we are doing as we are taking out cost is to reinvest that cost back into the top line growth and that is not just a basic blocking (inaudible) pricing, but we would expect for any large company, but we are also trying to free our capital to spend money, to save money ultimately and a great example of that is our IT initiative that we have underway at the moment. We recently hired the CIO from DEL, Randy March who joined DEL after 20 years of Wal Marts and he has been charged with completely overhauling our IT infrastructure in HP moving from 85 plus data marks, data centers to 6.

Moving from 100s of data marks to one enterprise data wear has. And the object of that is a) on an absolute basis to reduce IT costs per employee; b) to allow us to have at our finger tips information and data and our customer install base and our financials etc to better up sell and cross sell and to take advantage of our install base which is a huge opportunity and see importantly if IT company to be able to have a reference IT infrastructure in HP whereby we can bring enterprise cost customer and HP and say we

can do the same for you that we have done for ourselves. And that provides us with huge opportunity from a cost basis but those who provides us with huge opportunity from the revenue generation or going to market approach and so you will see us spend a lot of efforts in this area going forward and this is one of the unpacked opportunity for HP candidly. We have a heritage as an engineering company of developing great products. We don't necessarily have a heritage of bringing them to market in the most cost effective or the most productive manner.

From a cost perspective, it's being very, very interesting to see how things has lot of last 9 months and I want to talk to you on my next slide around a restructuring initiative, but I think we've really tried to move now to a zero based costing model where everything is questioned. And before instead of this question going well our cost base is 100 can we get it at 97 or can we perhaps get it at 96. Instead we approach differently we say. Question maybe 70, question maybe 60. Start to zero and work up and I think Mark Hurd is coming board, been very very draconian from an cost of you is starting to get traction in HP. So, we are making a lot of progress on cost. We are not taking a cost for the sake of taking a cost. We are taking a cost to free our capital for investments in a top line. And one of the greatest financial levers as a corporation is top line growth.

On July 19th, we announced restructuring program it consisted of two major parts. A change in our pension program from the fine benefit to define contribution. We estimated that would save us on an annualized gross basis \$300 million as of FY '07. And also the elimination of 15,300 roles in the company which we estimated would save us about \$1.7 billion as of FY '07 on gross savings. Now we set overlong that we will reinvest approximately 50 percent of these savings. Again we don't want simply be a serial restructure who flows through significant EPS expansion for three, four quarters and then goes back to the same old flood business model issues that we had previously. We want to leverage some of these savings to create a more sustainable high margin high return business model at HP; things like reinvesting in the sales force, things like spending hundreds of millions of more CapEx per year to build that six brand new data centers to start from scratch, things like pricing in the market etc.

Now, we initiated this in Q4 FY '05. We are now in currently in Q2 FY '06. In the fourth quarter, we eliminated 4,700 jobs. And most of those came out at the end of month two and at the start of month three. So, per sand of fourth quarter, you certainly didn't get an annualized growth savings or a quarterized gross savings of about 4700. You did for the first time in Q1. Also, in Q1 which was our last previously announced quarter, we eliminated to further 1800 jobs. But again we did not come out on day one of the quarter. They come out over the course of the quarter. So, as of the end of the first quarter which we had recently announced, we had eliminated 6500 jobs less than half of the head count reduction we have 8,800 to go. But even of those 6500 jobs you've yet to get your full quarter (indiscernible) savings from those. So, in terms of where we are from a restructuring cost saving initiative on a head count basis, we are in very early days much more to go.

In terms of the pension plan change, that became effective in January which was month three of Q1. The first quarter you will get a full quarter of saving from that will be Q2 which we are currently in. So, net from a restructuring point of view. We are in very early stages of the cost savings that we won't get from the program. A lot of the EPS expansion you have seen in HP over the last few quarters has been less to do with the restructuring program and frankly more to do with better execution. That will help not only (indiscernible) but those also help the gross margin expand.

From a capital allocation point of view, we will continue to spend on CapEx. Traditionally this has been running around 2 billion per year. Right now it's up closer to \$2.5 billion to \$2.8 billion as we build that supplies lines in our printing business. And as we continue to build that IT infrastructure as we move to six brand new data centers. On R&D basis we spend about 3.5 billion per annum. Again that is being zero based cost as going forward a lot of orders on a research and development plan to understand can we be the commercialize this? Is the market worth winning? Is it winnable by HP? Can we be successful with this spend. We paid 32 cents per year and dividend on our share repurchases have been picking up. Last year was \$3.5 billion and I am going to spend a little bit more time on that in a second as well.

In the fourth quarter, we would purchase \$1.4 billion in the open market. In the first quarter we also spend \$1.4 billion in the open market. However, in the first quarter we entered into a collar transaction with a third-party investment bank which effectively hedges our share repurchase price over approximated at 12 month periods (indiscernible) to \$1.7 billion. So, even if we repurchase zero shares in the open market for the rest of the year, the remaining 9 months, this year we would have repurchased \$3.1 billion. And clearly, we intend to continue to taking our chairs at these levels. For us share repurchase is a discussion run by creation versus destruction. We want to continue to repurchase shares.

Going into the segments, personal systems is our PC division. This is a hardware P&L. Over the last five years, the profitability of this segment has turned around to the tune of \$1.4 billion. And contrary to the market we've been successful at increasing gross margins in this business. Now I have gone through six or seven quarters of operating margin expansion, Netta market has been strong. PC market has grown in excess of 15 percent for the last two years and many many investors ask me, what will be the growth rate going forward? I would argue that more importantly the source of the growth is the interesting discussion. Growth rates are coming from emerging markets consumer and notebooks. And all of that is actually playing to HP strength and due to the strength of some other players like ACER etc. and frankly less to the strength of people like Dell. I will give you two scenarios. Dell would love a growth fueled market from the US commercial PC desktop market. That is their strength. As growth comes from consumer, HP has a better playing. Our consumer business has been very very strong. It's also our most profitable business. As growth comes from emerging markets, we stand to benefit from that more than others given only 35 percent of our business is in the US. And giving emerging markets tend to purchase in directly rather than directly. So, the trends in PC space and this is \$175 billion market. We are actually playing to our strength both

from a profitability enhancement point of view because notebooks are more profitable for us than desktops. Consumer is more profitable for us than commercial. Very often some of the non US markets are more profitable for us than the US because Dell has less entrenched in those markets. That's also helping us from a share perspective.

Accountably we've been very very focused on operating expansion in this business. Even today that's the amount share over the last few years. And as you've seen we've made significant progress. Last quarter we reported 3.9 percent of revenue operating margin up from 2.1 in the prior year period. Now, we think we can still grow at market rates and expand margins to 3 to 4 percent by FY '07. And we are well on our path to get there given the Q1 result of 3.9 percent again a seasonally quarter but nevertheless we should improve profitability on a full year basis up from last years 2.5 percent operating margin as well. We feel very proud about the progress we've made here and we feel very good in terms of competitive positioning. Imaging and printing business is also 30 percent of our revenue. Now there's many ways of the golden goose of HP. Importantly for HP however this business no longer accounts for over 100 percent of our segment operating profit. We have greater balance of profitability in HP portfolio now we had never had in the last five to ten years.

Last quarter imaging and printing was 29 percent of revenue with 57 percent of our segment operating profit. So, although we have maintained best in class margins in this business, the profitability enhancements in the rest of HP portfolio makes us less dependent on this business to make EPS in a quarter in quarter out basis. This is razor razor blade model. Of course the easiest thing to do to increase margins is to sell less units and that unfortunately is the wrong thing to do for the sustainable (indiscernible) in the business.

On the next chart you will see on the right hand side of the chart that about a year and half ago we on a unit basis were increasing year over year in some categories and frankly slowing in others. That three major categories of items dry supplies and supplies is the profit of the business. One of them store based growth (indiscernible). Two is the usage pattern within your installed base and three is how successful you compete with the remanufacture refill market.

And I think when Mark Hurd came on board about four quarters ago, we went very much back to basics in this business because again our supplies line you will see on the left hand side of this chart had been slowing. So, too had units growth and revenue growth. And we knew we had to go back to reinvest in this business. And Mark gave to our image and printing theme fair marching orders go back and reclaim share in areas of high consumption. That will in turn drive supplies six to nine months later; the supply is being the most lucrative part to the P&L. So leading up to the fourth quarter, we did exactly that and you can see the progress we started to make on the right side of this chart as growth rates on a unit basis continued to accelerate again. And importantly for us, we didn't just price across the boards, we grow units in every category; we selected certain battles that we wanted to win. All of those were areas of high consumption, all in one; color laser, digital photography, etc. The benefit of that showed up this quarter. So,

leaving into this quarter, we had grown units, 12 percent, 10 percent, and 8 percent on a year-over-year basis in the imaging and printing business, and that showed up this time. We reported the supplies of 11 percent, up from the mid to low single-digits last year. Now supplies are 56 percent of the buy, so when supplies grow 11, by definition, total imaging and printing will grow quickly as well. Supplies are the profit of the business. So, when supplies grow 11, by definition, operating margins will increase because of the mix. And even more importantly, this last quarter we continued to again gain share growing units 12 percent year-over-year when Lexmark's units declined, Dell's units declined, etc. So, we have really stepped up our efforts in this business. And I would argue this business is stronger than it has been in a number of years.

We've also taken out lot of costs. Even before Mark Hurd came on board, the imaging and printing (indiscernible) 10 percent of its work force, and Mark Hurd has substantiated that with further cost reductions last year. So, as we are going forward, you will see this business continue to fire in all cylinders, and we will continue to grow into newer categories like outdoor signage, the commercial print opportunity, the photocopying market, etc.

The ESS Server business for us, Enterprise Storage and Servers is about 18 percent of our revenue. We have been successful in this business as well increasing our operating margin. About 59 percent of this business is our Proline Executive Server business, which has been improving gross margin percentage in bottom line, operating margins as well, and that business for us is very very competitive. The storage business, which is 20 percent of the supply, has been underperforming for a number of years. We are improving that. And the Business Critical Servers is a \$20 million market, a UNIX market which has been improving as well recently for HP albeit we are still buying IBM and continuing to try to close the gap to them.

In terms of the server landscape, the growth category of the market is x86 servers. It's about \$24 billion in size with a CAGR of 5 percent; blades are sweet spots. And blades are playing directly to our strength. Companies who invested are indeed in software and in services. And so we with IBM and Apple, we are 70 percent of the blade market playing directly away from Dell's advantage, which has typically been hardware distribution and price, and this is where technology matters. So, we will continue to do everything possible to drive the market away from Mainframes and into areas of our strength, which is x86.

Our Proline servers have market share in excess of 30 percent. And importantly, as you move to blades, it's important to begin to look at this category in terms of factory revenue share akin to have people look at the UNIX market. We make good progress there, and we are continuing to hold this strong lead over the nearest competition.

In storage, we went through a few tough years. After the merger we have reinvested in sales specialists rather than the generalist sales force and we have refreshed our product line. Over the last three quarters, our storage business has grown 15 percent, 17 percent, and 4 percent. Three quarters of growth after a number of years of decline or stable

revenue base. So, we are making more progress there. Importantly, about 45 percent of our storage is intake good news/bad news. The good news is that it's a strong profitability business; the bad news is that it is a business in a market that decline at about 5 percent year-over-year.

So, as you track HP storage business, please be advised as well, it's important to look at the various segments of the market. Our storage tape business competes with StorageTek, IBM tape Quantum, etc. External ray business competes more with EMC network appliance, (indiscernible) at IBM, etc. So, our growth rate in storage is not by definition given its addressable market double-digits. However, we are making good progress there and we have more works to do.

From the UNIX side of things, importantly, we are migrating towards Integrity-based servers or Itanium based servers, which will allow us to end-of-life Alpha, PA-RISC, MIPS, and spend more of our R&D and/or other areas. The real important data point in this slide is that at the end of -- recently, actually at the end of the first quarter, we now have 7,100 ISV applications on Integrity and on Itanium. And that is the leading indicator of the acceptance of Integrity and Itanium in the market. Integrity is now 30 percent of our business. Last year, it grew 81 percent year-over-year. So, it's ramping very well, and we are of the opinion that in the enterprise space you will have two processor architectures going forward; Power from IBM and Integrity from Intel that we will leverage.

HP Services is closely related to our enterprise hardware business given 62 percent is break/fix maintenance, hardware supports, 38 percent of our business is in either managed services or outsourcing or consulting and integration. Now, our mix of businesses are very different from that of many of the service competitors that you look at. We need to spend more time getting more and more of our mix towards the higher growth categories of outsourcing of managed services and consulting and integration. And in the shorter-term this year, services top line will be challenged as we work on standardizing processes, doing remote diagnostics, continuing to work in offshore initiatives, etc. However, next year, with a better cost structure in place, will we go back into a growth phase, and you should expect services growth up 4 to 6 in the top line and operating margin of 8 to 10.

Software is 1 percent of our revenue; it's very strategic for us. You will continue to see us build this out with some targeted acquisition as well as strong organic growth. We have now returned the business to profitability and you should expect this business to be profitable henceforth.

Just before closing, I would add just a few quick comments on the balance sheet. We are making good progress on payables, receivables, and inventories. I think we have more work to do from an inventory perspective, and given our focus on margin expansion we are paranoid of balance sheet inventory and channel inventory. From a cash flow basis, last year's 6.6 billion free cash flow, 8 billion cash from operations, I am of the opinion cash is king, this is very very important; we can use this in form of capital allocations.

We are off to a good start again this year, \$1.5 billion of free cash flow in the first quarter. We ended the first quarter with \$12 billion in gross cash, \$6.9 billion in net cash. Importantly, the HP manufacturing company has no debts. Our debt is associated with our losing portfolio. So, we are cash rich and generating a lot of cash on a year-in year-out basis.

So, I leave my comments as that. Just to wrap up again, this is a company that is growing, this is a company that is taking out a lot of cost, creating a huge financial leverage opportunity, and this is a business that is generating gross margin expansion; all of that with a very strong balance sheet and very strong cash flow.

So, I look forward to taking your questions in the breakout room thereafter. Thanks.