

FINAL TRANSCRIPT

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HPQ - Q4 2005 Hewlett-Packard Earnings Conference Call

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PRESENTATION

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Operator

Good day, ladies and gentlemen, and welcome to the Hewlett-Packard Q4 FY '05 earnings conference call. My name is Rachel, and I'll be your coordinator today. [OPERATOR INSTRUCTIONS.] As a reminder, ladies and gentlemen, 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, VP of Investor Relations.

Brian Humphries - Hewlett-Packard - VP, IR

Thank you, Rachel, and good afternoon, everyone. I'd like to welcome you to our fourth quarter earnings conference call. Joining me today is our CEO and President, Mark Hurd; and CFO, Bob Wayman.

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

Next, it is my duty to inform you that the primary purpose of this call is to provide you with information regarding the fourth quarter. 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 quarterly report on Form 10-Q for the fiscal quarter ended July 31st, 2005, as well as subsequent SEC filings after our FY '04 Form 10-K for an understanding of the factors that may affect the Company's businesses and results.

I'd also like to point out that earnings, gross margins, operating expenses, and similar items discussed at the Company level are generally expressed on a non-GAAP basis and, therefore, have been adjusted to exclude certain acquisition-related charges, in-process R&D charges, amortization of goodwill and purchased intangibles, restructuring charges, and net investment losses. A presentation of GAAP financial information for the present quarter 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 hp.com.

Finally, we have a lot of people on today's call, and with a view to allowing time for multiple questions -- for questions from multiple firms, please refrain from asking multi-part questions and please save clarifications for call-back after the call.

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

Mark Hurd - Hewlett-Packard - President and CEO

Thanks, Brian. Well, good afternoon, and thank you for joining us. I'm pleased with our fourth quarter results. We delivered solid operational results, saw margin expansion in some of our key businesses, had good cost discipline, generated strong cash flow, and continued to make progress on key initiatives. The employees of HP have been working hard, and our efforts are paying off. Let me give you some highlights of the quarter.

First, net revenue growth of 7%, year-over-year, or 6% in local currency. Non-GAAP EPS growth of 24% year-over-year. Continued operating margin expansion in key businesses, with Personal Systems' operating margins of 2.8%, Enterprise Storage and Servers' margins of 9.1%, and Software margins of 8.7%. Our third consecutive quarter of solid printer hardware unit growth in Imaging and Printing, one of the leading indicators of future supplies growth. Cash flow from operations of 1.9 billion, bringing the year-to-date total to 8 billion, and share repurchases of 1.4 billion, bringing the year-to-date total to 3.5 billion. Our performance in the fourth quarter, coupled with a solid third quarter, triggered significant employee bonuses for the second half of fiscal 2005. And the fourth quarter impact of this is reflected in the segment results.

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Now turning quickly to the business segments. During the fourth quarter, Imaging and Printing revenue grew 4% year-over-year, to 6.8 billion, with Consumer Hardware revenue down 4% and Commercial Hardware revenue and Supplies revenue up 4% and 7%, respectively. Segment operating profit was 896 million, or 13.2% of revenue. During the quarter, overall printer hardware unit growth was 8%, with consumer printer hardware unit shipments up 6% and commercial printer hardware unit shipments up 16%. Within these categories, we saw strong unit shipment growth in key initiatives, with All-In-One unit shipments up 25% year-over-year, color laser unit shipments up 41% year-over-year, and enterprise multi-function printer shipments up 83%.

We are focused on driving unit growth of high-ink consumption units, and we're confident that this will drive solid supplies growth. We've also seen strong acceptance of products based on our recently introduced, Scaleable Print Technology, a breakthrough in the architecture and manufacturing of the ink jet printhead. This allows us to deliver record print speeds in the home and office, and can be scaled to a broad set of high-volume printing applications, making it one of our most significant announcements in recent years.

We're also focused on success in the high end, with our digital press wide-format graphics initiatives. On November 1st, we closed our acquisition of Scitex, expanding our leadership in large-format printing into the industrial super-wide category. And at PRINT 05, we announced major advances in the digital transformation of the graphics art industry, further consolidating our leadership position. This is a significant opportunity for HP, and we're aligning significant resources behind the commercial print opportunity.

Moving now to Personal Systems, we continued to show a balanced approach to revenue growth and operating margin improvements. Revenue grew 9% year-over-year, to 7.1 billion, with particular strength in notebooks, where revenue increased 23%. Our consumer business had another excellent quarter, with revenue growth of 14% year-over-year and strong operating margins. Consumer notebook shipments increased 48% over the prior year period, demonstrating HP's competitive strength and strong retail presence, as well as the shift to mobility. Revenue in commercial clients increased 8% year-over-year, with notebooks posting strong growth and profitability improvements. Our workstation business continues to post solid results, delivering share gains, strong year-over-year revenue growth, and excellent profitability.

Segment operating profit was 200 million, or 2.8% of revenue, representing the fifth consecutive quarter of operating margin improvement in Personal Systems. The team has done an excellent job turning around the profitability of the PC business, and operating margins have now increased for each of the last four quarters, with full year fiscal '05 margins at 2.5% of revenue.

Enterprise Storage and Servers had a strong quarter, with revenue up 10% year-over-year, to 4.5 billion and operating profit of 405 million, or 9.1% of -- 9.1% of revenue. Over the past 12 months, the Enterprise Storage and Server team is focused on various operational levers to improve the momentum and profitability of the business. This quarter's results reflect their efforts in turning around the business and demonstrating the financial leverage of the model.

Within ESS, revenue in industry-standard servers increased 12% year-over-year, reflecting continued, solid execution on a number of fronts, including discount controls, option attach rates, and unit mix. We continue to see strength in server blades, where revenue increased 65% over the prior-year period. Revenue in business critical systems declined 1% year-over-year. We continue to see solid momentum in Integrity servers, with revenue up 70% year-over-year. And this was offset by weakness in PA-RISC and Alpha.

Storage revenue increased 17% year-over-year, reflecting improved execution and solid growth in every product category and every region. We saw ongoing strength in the mid-range, with EVA revenue up 44% year-over-year. We also had solid growth at the high end, where XP revenue increased 32% over the prior-year period. We will continue to work hard on key initiatives, such as sales specialists hiring and our alignment with enterprise VARs to drive sustainable momentum in Storage.

Revenue in HP Services grew 6% year-over-year, to 3.9 billion, within HPS, Technology Services grew 4%, Managed Services grew 9%, and Consulting and Integration revenue grew 11%. We're working on driving greater efficiency and leverage in the

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Services organization, be it delivery model improvements and investments in lower-cost locations. We are also working to leverage the R&D investments in OpenView to reduce the cost structure of Services, and to optimize our R&D road map.

Segment operating profit was 322 million, or 8.3% of revenue. As in the third quarter, HP Services' margins were pressured by the Company bonus accrual, given the headcount intensity of the business. If you exclude the fourth quarter bonus accrual, operating margins in Managed Services and Consulting and Integration were at their best levels in two and three years, respectively. And operating margins in Technology Services were at their highest levels in fiscal year '05. However, we need to deliver solid margins, while absorbing the Company bonus payments, and will continue to work hard on the operations of the business to drive to this goal.

Turning to Software, revenue grew 11%, to 311 million, with growth in OpenView and OpenCall of 16% and 3%, respectively. Software delivered its first ever operating profit, with segment operating profit of 27 million, or 8.7% of revenue. We are pleased to be in the black, and will continue to work on revenue growth and productivity initiatives, as well as cost discipline.

During the quarter, we continued to strengthen our Software offerings with the pending acquisition of Peregrine. The acquisition will add key asset and service management components to the HP OpenView portfolio, a distributed management software suite for business operations and IT. Peregrine's capabilities include -- asset tracking, expense controls, process automation, service control, service alignment, and enterprise discovery, IT executive dashboard products, as well as outsourcing business continuity, and consolidation management.

I'll leave my segments comments at that for now, and I'd like to turn the call over to Bob.

Bob Wayman - Hewlett-Packard - CFO

Thank you, Mark, and good afternoon, everyone. Let me begin with a quick review of the performance of our Financial Services business. Revenue for HPFS during the quarter was 514 million, up 3% year-over-year and 5% sequentially. Operating margin was 10.1%, up from 3.8% last year, and down from 11.9% in Q3. The improvement in margin is largely due to the fact that Q4 '04 results were adversely impacted by the recording of reserves for certain receivables. During the course of FY '05, the risk portfolio -- risk profile of the portfolio has steadily improved, and the reserve levels have been adjusted accordingly. Financing volume decreased 1% year-over-year, and was up 21% sequentially. Portfolio assets decreased 3% year-over-year, and increased 1% sequentially.

Now, onto the key elements of the P&L. Non-GAAP EPS was \$0.51, up from \$0.41 a year ago. GAAP EPS for the quarter was \$0.14, which included 1.1 billion, or \$0.37, in after-tax adjustments that were not included in our non-GAAP results. The majority of the adjustments relate to pre-tax restructuring charges of 1.6 billion, which is a more significant charge than the 1.1 billion that we estimated when we announced our restructuring in July. The increase over our initial estimates is due to the following -- approximately 250 million, primarily associated with higher U.S. early retirement program costs versus our original estimates, and incremental expense from the acceleration of vesting and extension of exercise periods on stock options; approximately 200 million, primarily arising from differences in the job mix of terminated employees versus original estimates; and we now expect to include approximately 15,300 employees in our announced restructuring program, approximately 800 more than our original estimate.

While some of these additional costs will not yield additional savings, we do expect roughly 150 million in incremental annual gross savings beginning in FY '07, above 1.9 billion in gross savings that we estimated in July. Consistent with our announcement in July, we expect roughly half of these savings to fall to earnings. Note also, that although we took a significant charge in the fourth quarter, we will not begin to yield savings until employees have left the Company. Approximately 4,700 employees left the Company in the fourth quarter related to the July announcement. We still estimate that we will be executing on the plan throughout '06, and savings will increase accordingly.

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Revenue of 22.9 billion for the quarter was up 7% year-over-year, and up 6% when adjusted for effects in currency. On a regional basis, revenue was up 5% in the Americas, 8% in EMEA, and 12% in Asia-Pacific. When adjusted for the effects in currency, revenue is up 4% in the Americas, 8% in EMEA, and 9% in Asia-Pacific. Gross profit was 5.4 billion for the quarter, or 23.5% of revenue, up from 23.4 a year ago, and 23.2% sequentially.

Year-over-year gross margin improvements in ESS, PSG, and to a lesser extent HPFS and Software were partially offset by gross margin declines in IPG and HPS. Non-GAAP operating expense totaled 3.6 billion for the quarter, or 15.9% of revenue, down from 16.4% a year ago, and 17.5% sequentially. Adjusting for currency, expenses were up 3% year-over-year, and 1% sequentially. Given that bonus accrual significantly pressured OpEx relative to the prior year, I am overall pleased with the progress we've made in OpEx, and we'll continue to focus on expense management.

Non-GAAP operating profit was 1.7 billion, or 7.6% of revenue, up 245 million year-over-year, and 543 million sequentially. Non-GAAP other income and expense was income of 135 million, or roughly \$0.04 per share, above the \$0.02 per share we had estimated coming into the quarter. The increase reflects more favorable net interest income and currency impacts than our original estimate.

Given current interest rates, projected cash and debt levels, and currency dynamics, we estimate OI&E to be about \$0.03 per share per quarter for FY '06. While we may experience some one-time gains or losses from this baseline, these items are difficult to predict, and we will just call them out if and/or when they occur. Our non-GAAP tax rate was 20.0% for the quarter, in line with our guidance. I expect a non-GAAP tax rate of about 20% for fiscal 2006.

Next the balance sheet. HP-owned inventory came in at 6.9 billion, down 194 million year-over-year, and up 233 million sequentially. Inventory days of supply stands at 35 days, down from 39 days last year, and 38 days sequentially. Inventory was managed well across each of our businesses.

Regarding channel inventory, we ended the quarter in excellent shape across the board -- across the board, with ESS and PSG at roughly 4 weeks and IPG a bit over 5 weeks. Quarter IPG channel inventory dollars were down year-over-year, while PSG was roughly flat. PSS dollars were up from unusually low prior year levels.

Trade receivables ended the quarter at 9.9 billion, down 323 million, or 3% over the prior year, and up 1.1 billion, or 13% sequentially, in line with normal seasonality. As a percentage of revenue, trade receivables were 11.4%, down from 12.8% year-over-year, and up from 10.3% sequentially. DSO now stands at 39 days, down from 43 days last year, and up sequentially from 38 days.

Next, property plant and equipment was down \$198 million year-over-year, and up 21 million sequentially, to 6.5 billion. Gross CapEx was 522 million, down 29% year-over-year, and up 57% sequentially. On a net basis, CapEx was 446 million, down 30% year-over-year, and up 114% sequentially, primarily reflecting a lease reclassification that I mentioned last quarter. Financing assets accounted for a significant portion of CapEx during the quarter.

Net PP&E as a percent of revenue now stands at 7.4%, down from 8.3% year-over-year, and 7.5% sequentially. Regarding accounts payable, days payable closed the quarter at 52 days, up from 51 days both sequentially and year-over-year.

Next some comments on cash. Cash flow from operations was 1.9 billion for the quarter, despite paying approximately 900 million in funding to the pension plans and 300 million in tax payments related to repatriation. For the full year, we generated 8 billion of cash from operations, up 58% up year-over-year. Free cash flow, that is, operating cash flow, less net CapEx, was 6.6 billion, up 93% over last year. Both operating cash flow and free cash flow are the highest in the Company's history. For Q1 cash flow planning purposes do keep in mind that we expect significant cash outlays associated with our restructuring actions and Company bonus payment.

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During the quarter, we repurchased 1.4 billion in stock, and paid 229 million in our normal dividend. For the full year '05, we repurchased 3.5 billion in stock and paid over 900 million in dividends. We closed the quarter with total gross cash of 13.9 billion, down from 14.6 billion sequentially, and up from 13.0 billion year-over-year. Our weighted average shares outstanding remained flat from Q3 to Q4, in line with the guidance we gave you last quarter.

Going forward, I expect weighted average shares outstanding to remain about flat with our Q4 exit level of 2,915,000,000. This expectation takes into account our continuing share repurchase activities and the current year appreciation in the stock price. There will, of course, be some variation based on our level of share repurchases and on the subsequent share price and its impact on option exercise patterns and common stock equivalents.

Now, a few full year P&L highlights. For the full year, revenue was 86.7 billion, up 8% year-over-year, or 6% when adjusted for the effects of currency. On a full-year basis, non-GAAP EPS was \$1.62, up 22%, from 1.33 last year. GAAP EPS for the year was \$0.82, which included 2.3 billion, or \$0.80 in after-tax adjustments that were not included in our non-GAAP results.

Now for a few comments on our outlook for Q1 and the full year fiscal '06. On a constant currency basis, revenue typically declines by approximately 2 to 3% from Q4 into Q1, in line with normal business seasonality. However, given the significant currency movements over the last few months, we are faced with an additional sequential headwind of approximately 1% in Q1, if exchange rates stay roughly where they are today. With this in mind, we expect revenue of 22.3 to 22.6 billion in Q1 '06.

The full year impact of currency fluctuations is more difficult to predict. However, given the euro traded in the 1.25 to 1.35 range for the majority of FY '05, we expect an adverse full year currency impact of approximately 2 to 3% for FY '06, with our current modeling suggesting that Q2 '06 growth may be the most adversely affected. When looking forward to the full year and taking these currency effects into account, we estimate FY '06 revenue growth of roughly 3 to 5%, suggesting FY '06 revenue of approximately \$89.5 to \$91.0 billion. On constant-currency basis, this would reflect similar growth to the 6% constant-currency growth we achieved in FY '05.

Before addressing EPS guidance, a few comments on stock compensation. Effective Q1 '06, we are adopting FAS123R, which requires us to include expenses related to stock compensation based on their fair values. We are providing non-GAAP EPS estimates with and without option expenses for comparability purposes. However, we will include stock compensation in our reported non-GAAP results and ask that all analysts include stock compensation expense in their officially submitted estimates.

We are adopting FAS123R prospectively, and as such, we will not be restating prior period financial results. To assist you in analyzing trends in our stock compensation, we have provided two slides in our earnings presentation which include stock compensation functionalized between cost of goods sold, and operating expenses for the last eight quarters. Also, for FY '06 we currently intend to hold FAS123R expenses at the corporate level and not allocate them to our operating segments.

We expect Q1 '06 non-GAAP EPS of \$0.46 to \$0.48, excluding stock compensation, or \$0.42 to \$0.44, including approximately \$0.03 or \$0.04 from stock-based compensation. For FY '06, we expect non-GAAP EPS of \$1.88 to \$1.95, excluding stock compensation, or \$1.75 to \$1.82, including approximately \$0.13 from stock-based compensation.

With that, I'll turn it over to you, Operator, to begin the Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. [OPERATOR INSTRUCTIONS.] Our first question today comes from the line of Laura Conigliaro with Goldman Sachs.

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Laura Conigliaro - *Goldman Sachs - Analyst*

Yes. Just -- considering where we're seeing printer margins right now, how should we think about printer margins as targets going forward? That is, with margins near the low end of your 13 to 15% operating margin target range, should we, in fact, be thinking that they will shift down a little bit?

Mark Hurd - *Hewlett-Packard - President and CEO*

Laura, this is Mark. Thanks for the question. I think we're sticking with our 13 to 15 range. In the 13.2 that we reported, there is some effect for Company-wide bonus that Bob described in some detail. So we think that's the range to continue to stick to.

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

Next question, please.

Operator

Thank you. Our next question comes from the line of Bill Shope with JPMorgan.

Bill Shope - *JPMorgan - Analyst*

Okay. Great. Thanks. Looking at the enterprise profit, that was certainly far above what I was expecting for the quarter. Looking here, I mean, is this -- how persistent, or how sustainable is this margin level, obviously, factoring in seasonal issues? And were there any events in the quarter that helped you that you may not see again going forward? And, I guess, how much restructuring was factored into that number this quarter?

Mark Hurd - *Hewlett-Packard - President and CEO*

Bill, thanks. This is Mark. I'll let Bob add color. No specific, unique one-time events that were in the numbers that would cause it to be different in a forward-looking period. I do agree with your point about seasonality effects that definitely affect the performance of the business, so I wouldn't extrapolate you'd see the same result in a Q1. But no unique event that occurred in the fourth quarter that would -- that artificially pumped up results.

Bob Wayman - *Hewlett-Packard - CFO*

And the profit performance was pretty balanced within the various elements of the segments, as well. As you know, we had seen, certainly, some weakness in our storage business, and as that product line has been refreshed, we saw, as Mark mentioned, nice growth, but with that, improved profitability. Been a lot of hard work in these segments, and it paid off in Q4. But due to -- reinforce what Mark said -- Q4 is always a very strong quarter for this highly-leveraged business. So don't extrapolate that level going forward.

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

Thank you, Bill. Next question, please.

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Operator

Thank you. Our next comes from the line of Tony Sacconaghi with Sanford Bernstein.

Tony Sacconaghi - *Sanford Bernstein - Analyst*

Yes, thank you. Can you comment on gross margin expectations? They were down year-over-year for the full year for the third straight year. Can you provide any sense on where you expect those to be? And, then, also, you have repeatedly alluded to significant employee bonuses being a drag on various segment profitability and overall profitability. I think the implication is that you feel that those bonuses can be a smaller hit to profitability next year. If that's the case, can you define or dimension the size of the employee bonus impact in '05 and what you're expecting for '06? And if it is dramatically lower, what kind of impact will that have on morale with employees?

Bob Wayman - *Hewlett-Packard - CFO*

Tony, I'll start with the gross margin. We, of course, are not going to give you any quantitative guidance on gross margin. You rightfully note the trend in gross margin, and some of that is just out there. We need to continue to take costs out, which we have plans to do, but we also believe that we're going to have to reinvest some of that improved competitiveness in lower prices, and that's going to continue to keep pressure on margin. Furthermore, we've seen, and may continue to see, strong growth in those elements of the product line that are a bit lower margin, be it PCs or industry-standard servers, whatever. So, we expect continuing pressures. We'll leave it open as to how much of that can offset by our efforts to take costs out.

Mark Hurd - *Hewlett-Packard - President and CEO*

Yes, and, Tony, just one other piece of commentary on gross margins. I mean, there's nary a business in HP that has the gross margin that we report as a Company. So it's really a mix. So as much depends for us on where we get our growth and the mix of that growth by product line to determine what happens in overall HP gross margin. So it gets back into our discussion about our performance in storage and many of our other businesses, Software, that really can have a positive effect on gross margin over time. So that mix is a critical component.

As it relates to bonus, I think what we're just trying to do is illuminate the fact that there is a bonus number in the results. Part of what we're doing is, there hasn't been a significant bonus here for a while. So I think that, back to your question on morale, it's probably a good-news thing. And I think the Company has worked very hard over the past several months to earn that. So that's point one.

Point two, in the future, though, we're going to continue to index the bonus to improve performance of the Company. And so to the degree that we'll have a bonus, it will be based on the fact that we perform in a way that earns that bonus as it relates to our overall results. So I can't predict that for you at this point in time, other than to say we hope to pay a bonus. We like to expect to pay a bonus. But based on the fact that we, as a Company, perform on an ever-improving basis.

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

Thanks, Tony. Next question, please.

Operator

Thank you. Our next question comes from the line of Richard Farmer with Merrill Lynch.

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Richard Farmer - *Merrill Lynch - Analyst*

Thank you. Mark, if I could ask a question on the printer pricing environment, and I guess related issue that I think you could argue is caused by the aggressive pricing that we've seen, and that would be install base churn. So in the first sense, we've seen Lexmark lower prices again. Is that something that you think you need to respond to? And then on the churn part of the question, given the lower prices that we've seen and, arguably, that printers are more disposable now, do you think that the average life of the printers in the install base is shrinking, which would imply a shorter duration of the annuity stream of supplies per unit of hardware investment?

Mark Hurd - *Hewlett-Packard - President and CEO*

Hi, Richard, thanks. You had a little buzzing on the line as you were talking, but I'm pretty sure I got it. So, first, on the pricing, I will say, I do hear a lot of commentary about pricing, but we're not trying to be the quote-unquote the price leader in the marketplace. We have certain segments that are high-consumption segments that we target. We think we know what the premium should be relative to competition, and we work within those models to try to get to the best destination that we think makes sense.

So, I think overall, our view is that the pricing has got different factors in different parts of the market. We try to target where we take our price action. We think we know our model. And it isn't just relative to the competitor you named. There are several other competitors and several other segments, obviously, that we target as well. In terms of what's going with these -- I don't have a data point to share with you that I can give you about the average length of time that a printer stays installed. So I wish I could help you, but I just don't have any data on that to share with you. Thanks.

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

Thank you, Richard. Next question, please.

Operator

Thank you. Our next question comes from the line of Ben Reitzes with USB.

Ben Reitzes - *UBS - Analyst*

Yes, good afternoon. Thanks. Could you talk -- a little more about PSG, Mark, how sustainable is the -- are the improvements there? And what is unique about HP's business model there that's delivering this improvement, and is it sustainable? Maybe talk about your dual-sourcing of processors as well as, maybe, some of the product lines you're offering there. It seems that you're doing better than some of your competitors in the consumer space, and that's helping your results.

Mark Hurd - *Hewlett-Packard - President and CEO*

Sure, I mean, a couple of points. One, I think that coming to the Company, just to make a brief bit of commentary, you really -- I really haven't heard of a lot of illumination about the consistent improvement in the PC business in the PSG organization. The improvement, Ben, has really been going on over a period of time. So when you go look at what's happened over the past four years, it's been really steady improvement year by year, and, frankly, quarter by quarter. And I think it reflects a number of disciplines going on simultaneously.

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So you've got, certainly, a situation where I think we've done a good job with our supply line, I think we're doing a good job building things that people want to buy. We certainly got good strength in retail, which gives us good strength in consumer, and we've certainly got a strong situation in various global and international markets. So when you look at our ability to deal with multiple international markets where HP Co., has a very strong footprint, it's certainly a key strength for the overall PC business. But again, Ben, I would say, this hasn't been a one-quarter story. This has been a multi-quarter story, and, frankly, a multi-year story. And when you say, "is it sustainable," we expect the business to continue to perform.

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

Thanks, Ben. Next question, please.

Operator

Thank you. Our next question is from the line from Andrew Neff with Bear, Stearns.

Andrew Neff - *Bear, Stearns - Analyst*

Sure. Thanks. I guess, I could just ask, when you look at your priorities, Mark, for the Company, I mean, one of the things you've done, the Software business, getting that to profitability is obviously one of the high priority items. Maybe you could talk us through how you got that business to -- and how they got it to profitability, and what your highest priorities are over the next quarter or so?

Mark Hurd - *Hewlett-Packard - President and CEO*

Well, [indiscernible] talk about Software, and then I can talk about that. I think the Software business grew, which was the major driver of its improvement in profitability. If you looked at its sequential profitability, its break-even point actually went down by about 5 million sequential quarter-to-quarter. So that has a piece of it, in terms of its performance. But it would have been profitable, even if the break-even point had stayed at the same sequential point it had been in Q3. So I think it's a combination of growth, Andy, in addition to its ability to reduce its break-even point.

We are working on both at the same time. And we're looking at refining our Software maintenance model -- and when I say refining, just making sure that we run the business effectively, that we get a capture rate for Software maintenance and that we deliver great service as we do it. And as you do that, you begin to mature your Software model, you will see improved performance. So we're very focused on that business at growth, at the same time as being able to deliver a strong operational model.

Overall for the Company, I would tell you that what we've been talking about for the past several months is, we're still working on the same things. And that's the fact that we're trying to get our costs right, we're trying to be efficient. And we announced what we did in July 19th, and we've got to continue on getting that executed. Bob described much of the action that we've taken, but we still have more to do to finish off the work that we've already announced. That's point one.

Point, two, we're really trying hard to focus on driving growth and expansion, not just overall for HP, but in some of the key markets, and you mentioned one of them, Andy, in Software. So I think we're trying to do two thing at the same time, which is the fact to be efficient in our cost structure, be as efficient as we can at the same time as we focus on trying to grow the Company in key segments as well.

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

Thanks, Andy. Next question, please.

Operator

Thank you. Our next question comes from the line of Richard Gardner with Citigroup.

Richard Gardner - *Citigroup - Analyst*

Hi, thank you. Mark, I was hoping you could follow up on an earlier question regarding the improvement in Enterprise Server and Storage margins, and just maybe give us a sense of which products primarily drove the uptick in margins? Whether it was more related to improving gross margins or reductions in operating expense? And, then, finally, give us an update on where you are in the process of winding down proprietary processor and platform spend within that group, and whether wrapping up some of that proprietary spend had a significant impact on the improvement this quarter? Thank you.

Mark Hurd - *Hewlett-Packard - President and CEO*

Well, Richard, I wish I could give you a crisp answer to your question, and I guess the good news about the answer is it's been -- it was pretty broad-based performance. If I could give you one thing I would, but it really is a combination of the fact that we grew revenue, point one. Point two, we were more disciplined in our approach to dealing with pricing, which was point two. And I think the team did a marvelous job of trying to improve their performance in that area, which did have an effect on gross margin. And we were prudent in the way that we dealt with our expense structure. Some had to do with proprietary situations you've described, but at the same time, we were just tighter with a buck, would be the best way I would describe it.

At the same time, when you look at Company R&D, Company R&D overall was roughly flat. So I think it's a combination of stories at the same time. And when you can put up good growth numbers you can be disciplined in your approach to the marketplace, and then you can be careful with what you're spending and make sure it's aligned appropriately. Good things tend to happen to the P&L, which is what happened in ESS.

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

Thank you, Richard. Next question, please.

Operator

Thank you. Our next question comes from the line of Rebecca Runkle with Morgan Stanley.

Rebecca Runkle - *Morgan Stanley - Analyst*

Good afternoon. Thanks. Just, Mark, if you could talk strategically about some of the new channel programs that you launched in November, and just what some of the key messages were, and reaction from your channel partners?

Mark Hurd - *Hewlett-Packard - President and CEO*

Sure. We began the process of really trying to align our channel programs into channel performance. So I think the best way to think of it, Rebecca, is nothing more than what we would do in the Company, in the fact that if you're a channel partner and

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you're performing, meaning, not just higher volume, but more strategic content, that we align around that higher volume. We're going to align our channel compensation and try to align that to the performance of the partner.

And like anything else, we do get the question a fair amount, are you going all direct, are you going all direct? And as we say, that's not our -- that's not our situation at all. We're trying to focus on getting into the kind of partnerships that really aligned around where we want to take the Company. So the reaction to it, I think has been pretty good amongst the key partners, because the key partners who are really performing really deserve a better opportunity in the marketplace. So we've had, generally, good reaction to it, and we're also trying to be focused at the same time as having greater predictability in the channel at the same time. And so all of these programs are aligned around performance, predictability, and we think will be a positive for the Company overall.

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

Thank you, Rebecca. Next question, please.

Operator

Thank you. Our next question comes from the line of Shannon Cross with Cross Research.

Shannon Cross - *Cross Research - Analyst*

Hi. Good afternoon. Just a quick question following up on your comments about commercial printing. I'm curious as to sort of the level of where commercial printing is running for your business right now, margins you expect, growth rates, and how do you see this growing over the next few years?

Mark Hurd - *Hewlett-Packard - President and CEO*

Well, I probably won't go to gross margins and a few of those things, but what you've in the commercial printing world -- and I'll particularly talk about the high-end printing market, but typically go to small and medium businesses. These are companies that typically do a lot of printing in a community, they typically have a high-end, perhaps, analog press. Most of that analog printing base is beginning to move to digital. And as that base moves to digital, we believe we're very well positioned with both our Indigo platform, which is, we think, the best digital printing press in the world. We believe we've added capability to that with Scitex, which really delivers big print, it allows you to -- banners that would go across streets, that would go across buildings.

So we think we can now come in with our traditional print offerings that you might think of from the Company in addition to Scitex, in addition to Indigo and really deliver the full experience for a printer. And there are numbers, tens of thousands of these printers, just in the United States, in addition, another group of tens of thousands that sit in Europe and around the world. And we want to bring that integrated proposition to those customers. And that includes, not only the printer, the supplies, and the service experience at the same time.

So as a result, yes, it does have a positive opportunity for us in gross margin. I think the biggest issue that we've got to deal with there, though, is dealing with our go-to-market model and ensuring that we get to the marketplace and make sure we're participating in those decisions as that market does move from analog to digital.

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

Thanks, Shannon. Next question, please.

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Operator

Thank you. Our next question comes from the line of Harry Blount with Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

Hi, guys. Quick question on the Services business. Mark, you mentioned that you had the best profitability in the last two or three years, ex-the bonus accrual. I didn't hear you say, though, that Consulting Integration and Managed Services were profitable, however. And given the fact that you guys have been focused on maybe slowing the top-line growth to drive profitability up faster, I was hoping you'd give a little bit more perspective on that. That does seem like an area of possible improvement. And, then, also on the cash front, the acquisitions you've made recently have been mostly software focused. Is that likely where we're going to continue to see activity?

Mark Hurd - *Hewlett-Packard - President and CEO*

Okay. I'll let Bob take the second one, but I'll give you the first one. So to your point, there were improved performances in both of those organizations. And so I would say that probably the best performance -- I got to be careful with this Harry, but call it, roughly the best performance over the past several periods in both Consulting and Integration and in Managed Services. Now, I only caution you to say that didn't say they were great results. All I said, they were improved results.

So I think that would be the best way to characterize it. And we've been working on trying to improve. And do I think we have more opportunity to improve, the answer is, yes. But at the same time we did show some improvement in the quarter.

Bob Wayman - *Hewlett-Packard - CFO*

With regard to use of cash for acquisitions, very hard to forecast any number. We will see some cash outflow for Peregrine and a couple others here in Q1. The areas of focus, though, are no different than what we've talked about in the past, certainly software remains a field of interest. You've seen us do a couple of things in the printing space. Certainly, in Services we continue to look. We'll just have to see.

Mark Hurd - *Hewlett-Packard - President and CEO*

I want to add just a little bit of color too, Harry. I mean, I think to Bob's point, I mean, we're -- what you've seen from us is a relatively reasonable predictor of our behavior. I mean, we're certainly not trying to sneak up on anyone here. I mean, we've got areas of focus that are keen for us, and we want to deal with acquisitions that we believe are digestible and manageable. And I think our behavior has been indicative of that.

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

Thanks, Harry. Next question, please, Operator.

Operator

Thank you. Our next question comes from the line of Andy McCullough with CSFB.

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Andy McCullough - CSFB - Analyst

Thanks. Mark, within your revenue guidance for Q1 and the full year, can you just shed some light on what your expectations are for demand trends in the various markets, i.e., consumer, enterprise, SMB, and federal? And, then, also, just from a geographic perspective? Thanks.

Mark Hurd - Hewlett-Packard - President and CEO

Well, I think that the message that's the best I could give you, is that within the reason of little bit of difference based on geography, a little bit of difference based on some product segments and some customer segments, demand is roughly steady across the way that we -- that we look at things, are stable, maybe that's a better word. So that's how we view things. They're, obviously, are a little different story in Western Europe than you may see in Eastern Europe. A little different story of a consumer than what you would see in high-end commercial. But in the end, I think the best way I could summarize for you, based on what we see, is a roughly stable local currency kind of environment.

Brian Humphries - Hewlett-Packard - VP, IR

Thank you. Next question, please.

Operator

Thank you. Our next question comes from the line of Keith Bachman with Banc of America.

Keith Bachman - Banc of America - Analyst

Hi. Thanks, guys. Bob, I wanted to go back to the share buy-back. What I thought I heard you say is you thought shares would be relatively constant. Was, A, that for the next quarter? Or were, B, you making comments as you talk about the '06 outlook, because I would assume that, in fact, with the pace of the recent buy-backs that share count would continue to work down. Would you help to clarify? Thanks.

Bob Wayman - Hewlett-Packard - CFO

Sure. I meant to communicate a statement around expectations, steady state throughout '06. Now, obviously, something could change as we go forward. But to the second part of your question, keep in mind that we spent 1.4 billion in cash on share buy-back this quarter, and it just stayed constant. So it's -- we're fighting with the increasing stock price.

We're fighting increased issuance for stock option programs, as well as -- an even bigger factor -- is this common stock equivalent, which went up this past quarter over 20 million shares. So even though it's just an accounting entry, it does affect the EPS calculation. It all depends, whether we stay even, get ahead, or fall behind, that depends upon, primarily, what happens to the stock price, because that will drive, exercise behavior and it will drive the CSE calculation.

Brian Humphries - Hewlett-Packard - VP, IR

Thanks, Keith. Next question, please, Operator.

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Operator

Thank you. Our next question comes from the line of Cindy Shaw with Moors & Cabot.

Cindy Shaw - *Moors & Cabot - Analyst*

Thanks, very much. I was wondering if you could quantify for us the impact of the bonus on the quarter in terms of the margin?

Bob Wayman - *Hewlett-Packard - CFO*

No, Cindy, we are not going to quantify that. We have said what we're going to say about it. It was a significant number. Certainly, you saw how the -- how much improvement we had in our results, and that drives a significant number, but we're not going to quantify it.

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

We'll take the next question, please, Operator.

Operator

Thank you. Our next question comes from the line of Chris Whitmore with Deutsche Bank.

Chris Whitmore - *Deutsche Bank - Analyst*

Thanks. Wanted to come around to the revenue guidance question. Looks like the midpoint of guidance for the top line is about 4, 4.5% revenue growth. Can you talk about the expectations from contribution, from acquisitions, and, then, tied to that, it looks like you're expecting a bit of deceleration in Q1 versus Q4. Can you talk about what areas or what product lines you expect slower growth? Thanks.

Bob Wayman - *Hewlett-Packard - CFO*

Well, let me start with a bit of refuting the premise of the question. We, basically, are calling for steady, stable, constant currency growth. We had 6% constant-currency growth in '05, and we're calling for that same in '06. It's not going vary on a constant-currency basis, in our model anyways, much by quarter. So there's really no intended message about quarterly trends in all of this. It's, obviously, unknown exactly where currency will end up. And the growth rates will end up being different depending upon what happens to currency. But that's what we're looking for.

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

We'll take two more questions, Operator.

Operator

Thank you. Our next question comes from the line of Brian Alexander with Raymond James.

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Brian Alexander - *Raymond James - Analyst*

Thanks. Just a question on the working capital. It's at its lowest level as a percentage of sales in years. How much of the improvement in the trade cycle, Bob, would you say is more structural versus a function of mix? And can you just give us an update on how much more improvement you might expect, particularly on the DSOs and inventory turns? Thanks.

Bob Wayman - *Hewlett-Packard - CFO*

Well, first, with regard to receivables and DSO, the improvement that we've had is large largely structural. It does, of course, depend upon the environment, the credit environment, if you will, and how able people are to pay. And as you know, certainly U.S. businesses are in pretty healthy financial condition these days. But putting those kinds of factors aside, we have made structural improvements. It's not -- it's not really a mix issue. And we should, therefore, expect things to continue at about the same level going forward. We are not predicting any noticeable improvement in DSO from this point forward.

Inventory, we've also made good progress this past year. I should point out that after not doing quite as well in the prior year, so we needed to make that progress. But in the case of inventory, there still is room for further improvement in inventory. And don't want to go into now, all the efforts that are underway, but we're still not world-class in our inventory management.

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

We'll take one more question, Operator.

Operator

Thank you, sir. Our final question today will come from the line of Steven Fortuna with Prudential.

Steven Fortuna - *Prudential - Analyst*

Yes, two quick things. One is, I didn't hear any commentary around SMB versus large enterprise, kind of relative strength. Maybe you can comment on that. And, then, secondly, Mark, maybe you could give me your thoughts on how you think the timing of Vista might impact business in '06.

Mark Hurd - *Hewlett-Packard - President and CEO*

I'm sorry, how the timing of what?

Bob Wayman - *Hewlett-Packard - CFO*

Vista.

Mark Hurd - *Hewlett-Packard - President and CEO*

Oh, okay. Let me go into the -- I'll make a comment on the Vista thing first. I think we factored that into what we delivered to you today in terms of guidance. There is some buzz out there about Vista, we'll see how it -- we'll see how it evolves.

Second question, SMB versus the enterprise. Yes, I mean, again, I could tell you some stories about SMB in the Americas versus in Europe, and I could tell it to you versus the enterprise in both, but I think, while there is some color I could add, it's been

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relatively steady across those segments. So I can't give you any defining difference between the segments that would, I think, give any illumination.

So let me stop there for today and say, first, thanks for your questions. Before wrapping up, I wanted to summarize today's call by saying that I am pleased with the Company's execution in the fourth quarter -- that we had solid revenue growth, we saw improved momentum in margin expansion in some of our key businesses, we had good discipline, and we generated strong cash flow. We began the implementation of our restructuring program that will improve our cost structure and allow HP to become more competitive. We returned \$1.6 billion to shareholders in the form of share repurchases and dividends. And we rewarded employees for their hard work by paying our first significant bonus in many years. That said, we know we have more work to do, but we are pleased with our progress today.

We'll conclude today's earnings call with this -- that we do look forward to seeing you at your Securities Analyst Meeting in New York City on December 13th. And let me thank you, again, for joining today's call.

Operator

Ladies and gentlemen, thank you for today's participation in today's conference. This does conclude your presentation. And you may now disconnect. Have a wonderful day.

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