

FINAL TRANSCRIPT

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HPQ - Q2 2006 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Welcome to your Hewlett Packard second quarter 2006 earnings conference call. [OPERATOR INSTRUCTIONS] This conference is being recorded for replay purposes. I would now like to turn the presentation over to your host for today's conference, Mr.

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Brian Humphries. Please proceed, sir.

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

Thank you, and good afternoon everyone. I'd like to welcome you to our second quarter earnings conference call and 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 second quarter earnings slide presentation including non-GAAP reconciliation tables can be accessed on the HP Investor Relations page under company information at HP.com. A replay will also be available shortly after the conclusion of the call for approximately one year.

Next it's my duty to inform you that the primary purpose of this call is to provide you with information regarding the second 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 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 January 31, 2006; as well as other SEC reports filed after that Form 10-K.

I'd also like to point out that earnings, gross margins, operating expenses and similar items discussed at the 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 purchase intangibles, restructuring charges and net investment losses. The presentation of GAAP financial information for the present quarter and fiscal year-to-date 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 multiple questions, please refrain from asking multi-part questions or clarifications. With that I'll turn the call over to Mark Hurd.

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

Thanks, Brian. Good afternoon and thank you for joining us. I'm pleased with our second quarter results. We posted solid revenue growth. We control cost and expenses. We expanded margins, and we generated record cash flow. This was another solid quarter in the long term plan and while we clearly have more work to do, we are building a stronger, more competitive HP.

Financial highlights of the quarter included revenue growth of 5% year-over-year or 8% in constant currency. Operating margin expansion in key businesses with personal systems margins of 3.6%, image and printing margins of 15.5, enterprise storage and service margins of 7.5 and HP services margins of 8.9%. Non-GAAP operating margin of 8%, up from 6.1% in the prior year period. Non-GAAP EPS of \$0.54 representing growth of 46% year-over-year and cash flow from operations of 3.6 billion.

During the quarter we also made progress on key initiatives. Including completing a comprehensive review of our enterprise sales coverage model with a goal to create more demand for HP products and services. This is an area where we can make more progress and we are determined to strengthen our customer relationships and in doing so, expect to gain a greater share of their IT budgets. We'll do so by increasing the number of HP sales people calling on our largest global customers which will benefit demand for HP and for our channel partners. As part of this we've already started to build out our sales force both in the enterprise segment and in the commercial printing market. This investment which will take place over several quarters, will allow us to take better advantage of market opportunities by increasing the frequency in which we touch our customers and drive greater customer satisfaction. At the same time, 1,600 positions were eliminated as part of our restructuring program that will improve our core structure and allow us to become more competitive and as you'll recall most of the reductions associated with our restructuring program are non-customer facing.

Turning to the business segments. InkJet and printing had a solid quarter with revenue growth of 5% year-over-year led by supplies growth of 10%. Commercial Hardware growth of 4%. Consumer hardware revenue declined 8% from the prior year

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period. Segment operating profit was 1.04 billion or 15.5% of revenue reflecting gross margin expansion and expense discipline. Over the past year we've taken steps to strengthen the financial and competitive position of IPG via disciplined expense management, technology innovation, and targeted acquisitions. These actions have strengthened our core printing business where units have grown 8% over the past four quarters, and allowed us to enter and compete in adjacent markets such as photo kiosks and the photo copier market.

We continued to see solid momentum in our growth initiatives in the second quarter. Colored laser unit shipments increased 38% year-over-year and printer based MFP shipments grew 44% as we continued to see demand exceed our expectations. HP Indigo press cell printed page volume growth of 42% led by new product introductions. In terms of our core printing business we shipped approximately 12 million units in the second quarter. Unit growths flowed to 3% year-over-year given a tough compare and our continued focus on targeting unit growth in the areas of high supplies consumption. We do expect unit growth to accelerate in the second half as we drive more promotional activity. We will continue to focus on investing in growth and profitability going forward through our commitment to research and development, targeted share gains, and the building out of our commercial printing sales force. We continue to see 13 to 15% operating margin as appropriate for this business.

Personal Systems continue to post solid results with revenue up 10% year-over-year to 7 billion. During the quarter, shipments grew 16% over the prior year period with double digit unit growth in our consumer and commercial businesses and in every region. The market growth continues to be led by the shift in mobility, strength in emerging markets, and consumer. These secular trends are clearly playing to our strengths and in the second quarter we grew notebook shipments 48% year-over-year. We also saw strength in our consumer business with shipments up 30% over the prior year period.

The momentum is showing up in market share results. In the first calendar quarter and according to preliminary estimates HP gained 1.4 percentage points of share year-over-year on a worldwide basis and 2 percentage points in the United States. We continue to post solid margin expansion in Personal Systems with second quarter operating profit of 248 million or 3.6% of revenue up from 2.3% in the prior year period. Given our focus on reducing our cost structure coupled with our strength in notebooks, stronger than national presence and consumer presence, we are confident we can continue to show the appropriate balance between revenue growth and operating margins. However, I ask you to bear in mind that the third fiscal quarter is our seasonally weakest quarter in Personal Systems.

Enterprise storage and server revenue grew 2% year-over-year to 4.3 billion. With ESS industry standard server revenue grew 4% with strong growth in Blades where revenue increased 60%. Revenue in Storage grew 8% with ongoing strength in external arrays where revenue in our high end XP and mid range EVA offerings grew 8% and 46% respectively. Business critical systems revenue decreased 7% year-over-year with integrity server revenue growth up 93% offset by revenue declines and TA risk and Alpha. Enterprise storage and servers posted a strong second quarter operating margins of 322 million or 7.5% of revenue up from 4.3% in the prior year period, led by margin expansion and disciplined expenses. We have been focused on driving margin expansion in Enterprise Storage and Servers and we're pleased with the progress we have made. However, we need to do a better job driving growth and you'll see us take actions in the form of pricing and go to market initiatives. As part of this effort we are currently reviewing our Enterprise sales model to better understand our sales account coverage and deployment. We have room for improvement and you'll see us adding more resources in our large accounts to ensure better coverage and to serve our customers better.

Revenue in HP services declined 2% year-over-year to 3.9 billion, reflecting the impact of currency and a focus on profitability improvements. Excluding the effects of currency revenue in HP services grew 2% year-over-year. Within HPS and on a year-over-year dollar basis revenue grew 2% in managed services and declined 4% and 2% in technology services and consulting and integration respectively. HPS reported operating profit of 345 million or 8.9% of revenue up from 7.3 in the prior year period. Reflecting margin expansion and expense discipline. We saw margin expansion in all businesses within HP services and I'm pleased with the continued progress we're making in managed services and in consulting and integration margins. We remain focused on driving operational improvements in the business and as we head into the second half of fiscal year '06 we'll continue to focus on reducing our costs via labor management and efficiency measures as well as process standardization and automation.

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This cost structure discipline margin expansion will allow us to be more competitive in the market in fiscal year '07 and you should expect to see a pick up in revenue growth rates in '07. Revenue itself grew 20% over the prior year period to 330 million, with revenue in HP OpenView and HP OpenCall increasing 25% and 11% respectively. HP OpenView growth was fueled by solid momentum in the business associated with Peregrine acquisition which adds TI service management components to the HP OpenView portfolio. Software reported an operating profit of 3 million or 1% of revenue. Although I'm pleased that we got off to a good start with the Peregrine integration and that it is our third consecutive quarter of profitability we have to improve our operating performance. Software is strategic for HP and we're focused on driving margin expansion to levels more consistent with the profile and the size of this business. I'm going to leave my segment comments at that for today and with that I'd like to turn it over to Bob.

Bob Wayman - Hewlett-Packard - EVP, CFO

Thanks, Mark. And good afternoon, everyone. Let me begin with the review of the performance of our financial services business. Revenue for HPFS during the quarter was 518 million, down 5% year-over-year and up 4% sequentially. The year-over-year revenue decrease reflects lower used equipment sales and declining financing volume which decreased 14% year-over-year and 7% sequentially. Portfolio assets increased 1% year-over-year and sequentially. Operating margin was 7.5% down from 10.7% in Q2 of last year and 7.7% in Q1. Bear in mind that operating profit last year was aided by the reversal of approximately \$16 million of reserves relating to certain aged receivables.

We're focused on reaccelerating volume and revenue growth by making appropriate investments in our financing sales force while continuing to balance the risk profile of the portfolio which remains in very good shape. Before getting into the key elements of the P&L let me remind you that fiscal 2005 results including cost of sales, operating expenses, operating profits, net income, and EPS 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 \$0.54, including approximately \$0.03 from stock based compensation up from \$0.37 a year ago which again excluded the impact of FAS 123R. GAAP EPS for the quarter was \$0.51 which included 97 million or \$0.03 in after-tax adjustments that were not included in our non-GAAP results. The majority of the adjustments relates to the amortization of purchased intangibles.

A quick update on restructuring. During the quarter approximately 1,600 positions were eliminated related to the July announcement bringing the cumulative total to about 8,100. Revenue of 22.6 billion for the quarter was up 5% year-over-year and up 8% when adjusted for the effects of currency. On a regional basis revenue was up 10% in the Americas and down 2% in EMEA and up 7% in Asia Pacific. When adjusted for the effects of currency revenue was up 9% in the Americas, 6% in EMEA, and 10% in Asia Pacific. Gross profit was 5.6 billion for the quarter or 24.8% of revenue, up from 23.8% a year ago and 23.2% in Q1. Gross margin improved year-over-year and sequentially in each of our non-financing business segments reflecting improved operational effectiveness in key areas such as option attach, delivery efficiency, utilization, and discounting.

Non-GAAP operating expense totaled 3.8 billion for the quarter or 16.8% of revenue, down from 17.7% a year ago and up from 15.7% sequentially reflecting normal seasonality and the implementation of our annual salary adjustment effective February 1, versus prior year implementations on May 1. Adjusting for currency, expenses were up 1% year-over-year and 6% sequentially. The year-over-year constant currency increase reflects employee bonus accruals this quarter given the improved financial performance of the Company as well as the accelerated effective date of salary increases. Non-GAAP operating profit was 1.8 billion or 8.0% of revenue of 478 million year-over-year and 92 million sequentially. Despite the inclusion of approximately 120 million of stock based compensation in the current period. Non-GAAP other income and expense was pretax income of 157 million or roughly \$0.04 per share after-tax. Above the \$0.02 per share we had estimated coming into the quarter. The excess reflects significant currency gains during the quarter following significant currency losses in the prior quarter.

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OI&E primarily consists of net interest income which is somewhat predictable in nature. Currency impacts which are more volatile and one-time items such as gains or losses on land and building sales which are difficult to predict. Given projected cash and debt levels and our expectations for currency, we estimate non-GAAP OI&E to be about \$0.03 to \$0.04 per share per quarter for the remainder of FY '06 which primarily reflects baseline net interest income. We will call out deviations from this baseline as appropriate. Our non-GAAP tax rate was 20.5% for the quarter slightly above the guided number of 20%. Going forward we expect a non-GAAP tax rate of 20% for the remainder of FY '06.

Next, the balance sheet. HP owned inventory came in at 6.8 billion up 304 million year-over-year and 37 million sequentially. Inventory days of supply stands at 36 days up from 35 days last year and sequentially. We will continue to actively manage inventory and are comfortable with current levels across each of the businesses. Regarding channel inventory, we continue to be pleased with management of channel inventory in all of our businesses in both weeks and dollars. ESS and PSG ended the quarter at roughly four weeks and IPG at five weeks while channel inventory dollars were at appropriate levels across-the-board. Trade receivables ended the quarter at 9.8 billion up 517 million year-over-year and 1.1 billion sequentially in line with normal seasonality. DSO now stands at 39 days flat year-over-year and up from 34 days sequentially.

Next, property plant and equipment was down \$318 million year-over-year and essentially flat sequentially at 6.4 billion. Gross CapEx was 521 million down 8% year-over-year and up 22% sequentially. On a net basis, CapEx was \$401 million up 6% year-over-year and 25% sequentially. Net PP&E as a percentage of revenue now stands at 7.2%, down from 8.0% year-over-year and flat sequentially. Coming into FY '06 we expected full year gross capital expenditures of 2.8 billion and net CapEx of 2.2 billion. Which assumed CapEx would be heavily weighted to the second half of the year.

We remain roughly on track with capital spending in IT and our product segments, however given the slowdown in financing volumes within HPFS, full year capital expenditures may be somewhat less than our initial expectations. Regarding accounts payable, days payable closed the quarter at 53 days up from 47 days year-over-year and 46 days sequentially.

Next, a few comments on cash. Cash flow from operations was excellent at a record 3.6 billion for the quarter. Free cash flow, that is operating cash flow less net CapEx was 3.2 billion up 62% over last year. Year-to-date, cash flow from operations was very strong at 5.5 billion up 39% year-over-year and free cash flow was 4.8 billion up 52% year-over-year. During the quarter we repurchased 1.3 billion in stock and paid 226 million for our normal dividend. In addition to our open market share repurchases of approximately 40 million shares, we received approximately 7 million shares under the prepaid variable share repurchase program that we entered into last quarter. So a total of 47 million shares were acquired during the quarter. We closed the quarter with total gross cash of \$14.1 billion down from 14.5 billion year-over-year and up from 12.0 billion sequentially. On a weighted average, shares outstanding, our weighted shares out standings declined slightly to 2,887 billion, from 2.893 billion in Q1. Going forward, we expect weighted average shares outstanding to remain roughly flat with potential increases or decreases dependent on our continuing share repurchase activities, HP stock price, option exercise patterns, and common stock equivalence.

Now, for a few comments on our outlook. On the constant currency basis revenue typically declines approximately 4 to 4.5% from Q2 to Q3. In recent years, we have been negatively impacted by currency from Q2 to Q3. Assuming exchange rates stay roughly where they are today, and taking into consideration our hedging strategies, we expect revenue to benefit from currency somewhat sequentially. However, given the tiny rate used in Q3 of '05 and the hedging contracts that we have entered into, we do not expect a significant year-over-year currency benefit in Q3.

In addition to currency movements and seasonality our guidance takes into consideration the current competitive environment which contains some uncertainty particularly related to pricing dynamics. Taking all of these factors into account we estimate Q3 '06 revenue to be approximately \$21.75 billion and full year FY '06 revenue to be approximately \$91.0 billion in line with current consensus analyst expectations. Regarding earnings, our results this quarter reflected good operational effectiveness and progress on several key initiatives. Offsetting this, let me remind you that Q3 as you know is always a tough quarter for us. Our mix includes a significant portion of revenue from Europe as well as the consumer segment, both of which are seasonally weak in the third quarter. Further, as Mark indicated, we will continue to fund investments to drive long term growth initiatives which include building out our Enterprise sales force, both in the Enterprise segment and in the commercial printing market.

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The process of selecting, harboring, and deploying these resources will take time and the associated costs will ramp accordingly, as such for FY '06 we expect these investments to impact Q4 more heavily than Q3.

With that in mind we now expect Q3 '06 non-GAAP EPS of \$0.45 to \$0.48 which includes approximately \$0.03 of stock based compensation. For total year FY '06 we expect non-GAAP EPS of \$2.04 to \$2.08 which includes approximately \$0.13 of stock based compensation. And with that, we will take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. [OPERATOR INSTRUCTIONS] Our first question is from the line of Ben Reitzes with UBS.

Ben Reitzes - UBS - Analyst

Good afternoon. Thanks a lot. I wanted to ask about pricing, Mark. What is in your guidance and thinking for pricing with regard to the PC market as well as what you said about the Enterprise market that you're going to make some pricing investments? In particular you know we're all thinking about what Dell may do or may not do and if you could make a comment on that particular situation we would appreciate it as well.

Mark Hurd - Hewlett-Packard - CEO, President

Sure. I'll give you the best I can. I mean, first of all let me make a statement that we're very focused on running a good business and share for us is while important, it is not the primary driver of how we think about the business. So we really do think about the business in the context of the improvement and overall profitability and our ability to deliver great products and great services while we do it. We've seen continued aggression so I don't think Q2 was much different than what we've seen over past several quarters in terms of aggressive price points, so we factored that into the model that we've given you in terms of Q3 guidance. So the best I can tell you is in our Q3 guidance, both in the context of ISS and in the PC market is our best view of where we see the market not only in Q2 but where we see it in Q3 and given our emphasis as I've described.

Ben Reitzes - UBS - Analyst

Have you seen the market get more aggressive as we went throughout the quarter or you thought it was pretty steady state?

Mark Hurd - Hewlett-Packard - CEO, President

The only difference I'd say, Ben, is that it's just always been aggressive, I hate to give you that answer, but it was an aggressive market in Q2, and we expect it to continue to be. So if your question is did I see an accentuation point at the tail end or somewhere in there? No, I didn't see that but I don't want you to take that as meaning -- this is an aggressive marketplace and it's been aggressive for awhile.

Brian Humphries - Hewlett-Packard - VP, IR

Thank you, Ben.

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Ben Reitzes - UBS - Analyst

Thank you.

Brian Humphries - Hewlett-Packard - VP, IR

Next question, please.

Operator

Sir, our next question is from the line of Rich Farmer with Merrill Lynch.

Rich Farmer - Merrill Lynch - Analyst

Thank you, Mark, or Bob, on the restructuring progress, last quarter I think you said you were about 40% of the way through the restructuring. If I heard you correctly, Bob, you said 8,100 positions, I guess against the target of 15.3 thousand, that implies around 53%. Is that the right way to think about it? In other words how much of the restructuring is complete in terms of the actions as well as the flow through to the P&L and given, Mark, that you're already at your previous long term margin target at 8% here, doesn't that suggest that the margin targets need to go up?

Bob Wayman - Hewlett-Packard - EVP, CFO

Let me start with the restructuring. Yes, your understanding is approximately correct. I would only remind you that, it is very much effected by the geographic mix of people and all of that. So you can't just take the number of headcount and come up with the right answer. And let me remind you that our overall cost savings included the benefit plan changes which are already fully reflected now in our run rate in Q2. So that parts fully behind us. We're 53% done with the headcount reductions and so there is still some more to go.

Mark Hurd - Hewlett-Packard - CEO, President

Yes. And a majority of that is in Europe. And to Bob's point, some of the early parts of the savings came in the early part of the year with the pension stuff as he described. On the model, I gave you my Q3 and back half of the year and we'll have to see how the rest of the year goes and how things unfold. Clearly, we've still got a lot of work to do here, Richard. You've mentioned it just in your statements, we've got more of our -- we've part of our restructuring left to do, we've got hiring to do as it relates to our ability to be able to cover the accounts in the market the way we would like to to be able to grow our revenue over time. So I think before we go delivering any new models let's get through Q3 and Q4 and see where we land.

Bob Wayman - Hewlett-Packard - EVP, CFO

Yes, and Q2 is just one quarter. It's not the full year, so when we gave you '07 guidance we were talking about full year guidance which takes into account weak quarters like we seasonally expect in Q3.

Mark Hurd - Hewlett-Packard - CEO, President

Yes. And I think one last one on Q3, I mean when I look back over history here, Q3 is not a strong quarter for Hewlett-Packard, so we've got to -- let's get through Q3 as we've described and we'll talk about '07 after that.

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

Thank you, Richard. Next question, please, operator.

Operator

Sir, our next question is from the line of Richard Gardner with Citigroup.

Richard Gardner - *Citigroup - Analyst*

Thank you. Was wondering if you might be able to provide any additional detail on the impact, the headcount impact of the ramp up of the commercial sales force. In other words how many people are you planning on hiring and over what time frame, and are there any other changes in in the coverage model that you intend to make? Thank you.

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

Sure. I'll try to give you some color. I'm not going to give you numbers other than to say that, I feel that we are undercovered and it's not undercovered to the tune of 25 or 30 people or I wouldn't bring it up. So for us, it's a significant movement and it requires I will tell you is in the hundreds that we need to hire. We will hire as quickly as we can, but I would only remind you that it's in the context of we need quality people. People that can do the job that have experience in this area, so as a result, it's not as simple as us just going out and putting a sign out or putting an ad out and hiring people so we're going to go do the hard work to make sure we hire quality people and attract the best people in the industry, it's also important for us to assimilate them and to train them. So for a period of time we not only will bear the expense, but we will not have gross margin from them as they get productive and that can take in some cases, six, nine, ten months once they get hired. So, again, we've factored that into the guidance that we've given you for Q3 and Q4 which we would expect to have some of that headcount in place with frankly no productivity from that headcount.

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

Thank you, Richard. Next question, please?

Operator

Sir, our next question is from the line of Rebecca Runkle with Morgan Stanley.

Rebecca Runkle - *Morgan Stanley - Analyst*

Good afternoon. Thanks. Just a quick clarification if I could, Mark, on software. If I recall you were looking for continued improvement quarter to quarter in the software returns. You alluded to some of what happened in the quarter, but hoping that you could provide a little bit more context and clarity and then what specifically you're doing, if anything, in addition to what you've already laid out to get that to ramp the way you'd like to see it.

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

Sure, thanks Rebecca. We need to get the breaking point down, so real simple, the break even point here with, at 327 is not acceptable in terms of a break even point, and for us, in the quarter there were a couple of factors that occurred. There was a

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mix factor that occurred in terms of more OpenCall as it related to OpenView which has some mix impact on margins. We certainly had to take into consideration some of the expenses associated with the Peregrine acquisition. Both of us, both of those things, if you will, raised our break even point, but for us, Rebecca, this business is more important than a \$1.3 billion software business. It's strategic to us in many dimensions and strategic to us financially, from a growth perspective and the way it aligns with the rest of our business and we're going to go get this business performing the way it should. So I think you should expect to see us continue to drive on operational improvements in software.

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

Thanks Rebecca. Next question, please, operator?

Operator

Sir, our next question is from the line of Andrew Neff with Bear Stearns.

Andrew Neff - *Bear Stearns - Analyst*

Thanks. Could you go into a little more detail about what's going on in Europe? That's been a historical area of strength and take out currency it was underperforming to the other regions, could you talk us through what you're doing there and how you plan to address the issues in Europe and maybe just a general comment about demand trends in different geographic markets?

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

Sure. I'd be glad to talk a little bit. Bob can add some color to it if he would like. It's a mixed bag, Andy, would be the way I would describe it. There is good growth in Eastern Europe, so when you go into the Eastern Europe segments you'd see growth that you'd feel very good about it. Clearly our growth in areas like Russia and other places has been strong. When you go look at it on a dollar basis, our growth in traditional western European countries has not been exciting. It's been flattish kinds of numbers and the numbers differ a little bit by country.

Now, when you get into a constant currency bases all those numbers go up a bit obviously, because we have effective several points of currency but I would describe it as Eastern Europe pretty healthy, Western Europe, pretty blah and certainly some effect on currency effect there. They are not any different, Andy, than I feel about the rest of the Company given that we have a coverage -- as good as we are in Europe and as big as we are in Europe, and as important a player as we are over there, we are undercovered in Europe as well and we just have got work to do as we do across the rest of the Company.

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

Okay. Thanks, Andy. Next question, please.

Operator

Sir, our next question is from the line of Tony Sacconaghi with Sanford Bernstein.

Tony Sacconaghi - *Sanford Bernstein - Analyst*

Yes, thank you. Your revenue guidance for next quarter is about 4.8% year-over-year revenue growth. I know you said you wouldn't get much benefit from currency but even if you got a little, you're really guiding to 4 to 4.5 % revenue growth versus

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the nearly 8% that you did this quarter on a year-over-year basis. Can you help explain what went into that? You mentioned a little bit of caution about what might happen on the pricing side in PC's. Is there anything else that's -- and again this is year-over-year so there's nothing to do with sequential, with sequential seasonal patterns. Is there anything else that you're cautious about? Was there anything about the linearity in the quarter or what you were seeing in the Enterprise business that appears to be making your guidance somewhat conservative and quite frankly even for the year currency has flipped around pretty nicely and yet you retained the currency guidance despite the revenue guidance for the full year despite the fact that currency has become much more favorable.

Bob Wayman - Hewlett-Packard - EVP, CFO

Well, the guidance that we've given, Tony is right in the middle of the 4 to 6% kind of range that we have provided for the overall company. There was no particular trend within Q2. That is to say we didn't see any change in trend in the month of April and they are just in general reasons to be cautious. We just heard a question about Europe and the weakness there. We had lots of comment around what some of our competitors are talking about so we think that it's prudent to set a number that we feel solidly about.

Mark Hurd - Hewlett-Packard - CEO, President

Tony, listen. We hope we do better to be clear with you on that but when we look at what's out there, first of all we don't get a lot of benefit for, at least for a part of Q3, we're not going to get much benefit from currency given our hedging strategies, so some of it also is where -- take the euro for example, where is it going to land and we don't have a crystal ball on that either. So I think that we'll see where we land. We think that we're right in the middle. We've been saying we want to grow the Company in the range that we've described, we think we're right in the middle of that guidance with what we are giving here today.

Brian Humphries - Hewlett-Packard - VP, IR

Thanks, Tony. Next question, please.

Operator

Sir our next question is from the line of Bill Shope with JP Morgan Chase.

Bill Shope - JP Morgan Chase - Analyst

Okay, great. Thanks. Your printing margins have broken out of your targeted range now and I think earlier in the call you said you planned to increase promotional activity to stimulate unit growth in the second half of the year. Should we assume that this means you're going to try and reinvest the upside versus your targeted range of 13 to 15% to reinvigorate the installed base?

Mark Hurd - Hewlett-Packard - CEO, President

Well, I think -- we've had 8% unit growth over the past rolling four quarters and I think again our strategy is to target high usage segments for that unit growth, so you should think of us continuing to try to operate in that range of 13 to 15. Looking to reinvest is appropriate again to stimulate the install base especially in the appropriate segments. We're not trying to lead a pricing war or anything like that. We're just trying to make sure we target the right segments and I think at the same time you've seen the benefits of that in what's shown up over the past couple quarters and I would tell you that the IPG story is kind of a multi-prong story. I mean the work that's been done in transformation of the business from a cost and expense perspective has

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been good work done over the past several quarters. Certainly what we've done at the rest of the Company has helped and certainly our unit growth has helped over the past rolling four quarters so we think that we'll continue that. We think we'll see accelerating unit growth which will have some effect on margins as we go and we think we're roughly doing what we told you we would do.

Bill Shope - *JP Morgan Chase - Analyst*

So your promotional activity won't change from a prior action?

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

It will depend on the market, depend on the segment and again, we'll obviously monitor demand and monitor pricing as we go. I think you should expect us to be well positioned certainly in those high use segments and that -- but I wouldn't call anything we're going to do , extraordinary at least with our current plans.

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

Thanks, Bill. Next question, please.

Operator

Sir, our next question is from the line of Laura Conigliaro with Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

Yes, thank you. With Intel recently indicating that everything is on the table for review, how confident are you that Itanium will ultimately not end up on the cutting board and what if anything is plan B should Intel actually put an end date to its Itanium involvement?

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

Well, I mean I have no indication, nor do I want to speculate on anything like that, Laura. I mean, I think that we've had no indication of Intel. In fact I think the last big Itanium discussion that we had was Paul Otellini and I out in the marketplace talking about the investments we're making together in the Itanium eco system both across Intel and Hewlett-Packard so we continue to try and grow our integrity server line and I think the best medicine for any of that is for us to go out in the marketplace and scale the business and grow it.

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

Thanks, Laura. Next question, please?

Operator

Sir, our next question is from the line of Harry Blount with Lehman Brothers.

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Harry Blount - *Lehman Brothers - Analyst*

Hi, guys. Quick strategic question. The number one issue that I consistently hear from investors is can HP continue the momentum on the revenue growth side of the equation once we get past some of the cost cutting. Mark, you've alluded to increasing the coverage, but as I take a look at the software and services business, could you potentially comment on some of the other levers that you're looking at pulling on the revenue growth side broadly and then a little bit more detail specifically on the software and services. Thanks.

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

Sure. I think, frankly, the levers kind of integrate Harry. For us, we really work on optimizing our cost and taking cost out of other things and putting in things that help us grow. So we're doing a lot of work as you know, in areas like IT and areas of corporate overhead and realigning those dollars into areas that help us grow the Company. Certainly sales coverage is a part of that and we're working, we think that there's a lot of market uncovered that I've given you kind of the cost side of going out and building that out, but the opportunity for us is significant if we're successful over the long term in being able to drive more market share and I think that market share when you've got our situation, I, just to be very open with you, sales as a discipline is not the hallmark of the Company. We're an engineering driven Company and we're very good at it. We build great technology at Hewlett-Packard and we just have to build the same kind of discipline and capability in our Enterprise sales capability and go to market model that we have in that other aspect of the Company and I think we'll be able to go do that and I do that that effects growth.

At the same time when you talk about services there is a direct correlation between services cost and leverage, the integration of software and automation of processes and our ability to scale out our services business. So back to my point earlier, you want to go -- if you have too much cost, you can't compete for multi-year transactions. You have to get your cost structure in line because you get it multiplied when you have a flaw in your cost model, it gets multiplied multiple times over multiple years. So for us it's very important to get our corporate cost right and to get our cost within services right and one of the ways to do that is to automate processes which is what we're doing through our integration of OpenView into our service delivery process. That puts us in a better strategic position to grow grow the Company.

So I think, Harry, the way you should think about it is us trying to get our cost right to be able to continue to invest in unit and commercial printer market share, to grow to get our sales force right both in commercial printing and in the Enterprise sales growth discussions that we described earlier to continue to drive on getting our services business lined up from a cost perspective and automation perspective so we can go to the marketplace and grow and we are focused equally on getting our cost right and growing the Company.

Harry Blount - *Lehman Brothers - Analyst*

Okay.

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

Thanks, Harry. Next question, please.

Operator

Sir, our next question is from the line of Shannon Cross with Cross Research.

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Shannon Cross - Cross Research - Analyst

Hi. Just wanted to ask a question about the cash flow. Obviously strong this quarter. How should we think about cash flow as we go through the remainder of the year and also that segues into obviously use of cash question. Share repurchase dividends are already there. Any thoughts on more acquisitions? Thanks.

Bob Wayman - Hewlett-Packard - EVP, CFO

Well, in terms of the rest of the year, there's not a lot that we expect to be different from the first half to the second other than as I indicated, capital spending will be a little back end loaded. So if you're looking at free cash flow, we would expect a little uptick in capital spending, but frankly all of the working capital measures that we're looking at right now seem to be in line with where we want them and I don't expect huge changes as we move into the second half.

Mark Hurd - Hewlett-Packard - CEO, President

I think to your question on the use of our cash, I mean, I think you hit the right levers. Obviously, we've been and we'll continue to be active in the repurchase of HP shares and we'll continue to look for acquisitions that are strategically aligned with where we want to take the Company and you've seen us make acquisitions in storage and in services and in Blades, over the past several quarters and IPG and we'll continue to look in those areas for things that make sense for us. So and again we're not going to go after an acquisition just to spend money. It's going to have to be an acquisition that aligns to where we want to take the Company strategically.

Brian Humphries - Hewlett-Packard - VP, IR

Shannon, thank you. Next question, please.

Operator

Sir, our next question is from the line of Cindy Shaw with Moors & Cabot.

Cindy Shaw - Moors & Cabot - Analyst

Thank you. I'd like to go back to the topic of revenue growth. It's been much better in the last two quarters than we had seen for a number of years beforehand. Mark, you laid out in the December analyst meeting a number of basically tactics and strategies for doing that. Is that kicking in already or have we got other elements that are helping the revenue growth in the last six months?

Mark Hurd - Hewlett-Packard - CEO, President

Cindy, as I indicated, I think what you've seen is good work in terms of our ability to align our cost and our ability to go put that into the market and have it work for us. Certainly you've seen that in our unit growth and in IPG. You've seen it show up in PSG to a degree. We have work to do in the Enterprise sales force and this not only hits PSG but also hits IPG. So for us, we need to be able to do a better job in those accounts from a coverage perspective and I would say as I mentioned in my comments earlier, some of that work has not kicked in and that's work that we've got to do to be able to go source and hire, assimilate, and train the people so I'd say we're pulling some of the levers and I would actually argue some of those levers we're pulling quite well. We have to make sure we're pulling all of them as we look forward into the future.

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Cindy Shaw - *Moors & Cabot - Analyst*

So is it fair to say the mobility plan is going pretty well for you then?

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

Well, I mean I think you saw our strength in notebooks in the quarter was good and certainly when you're up, 48% when you look at the units, I mean those are big numbers and particularly, it's not like we're growing off a small base either. So I think even in IPG, while I wish we'd had a little bit more unit growth, we certainly were coming off one of our strongest quarters a year ago. I think we're were at like 12% unit growth prior year. So again, to your point, I mean it's very important for us to get our cost right so we stay as competitive in the marketplace as we can. We've just got -- we've also got to get the sales force thing going our way and that's going to take us some time to get that right, but I'm confident we've got a shot.

Cindy Shaw - *Moors & Cabot - Analyst*

Thank you.

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

Thanks, Cindy. Next question, please.

Operator

Sir, our next question is from the line of Bill Fearnley with FTN Midwest Securities.

Bill Fearnley - *FTN Midwest Securities - Analyst*

Yes, Mark, quick question for you regarding the channel. When you talk about increasing the sales staff, should we expect a change in the direct and indirect sales mix and does your view change as you look at geos and does your view of the channel change here as you cross your one year anniversary at Hewlett?

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

Okay, well that was one of Brian's rules to not ask a multi-part question but I'll do my best to deal with that. Listen, I think the channel is a key asset for us. I think they're in a lot of places that we can't get to, I think they give us a lot of support. We have all kinds of different channel partners across different segments across different geographies so it's hard to generalize about them but if I were to generalize I'd call them an asset and has my view changed since I got here? Not really. We're continuing to try and align our channel compensation to channel performance and we believe that to be working and feel good about our alignment in that respect. Should you take any of my comments in terms of building out of the direct Enterprise Sales force as some message to the channel? No. I think the message you should take to the channel is we're going to go create demand for Hewlett-Packard and that's going to be an opportunity for our channel partners to get more demand at the same time. We are not making a fulfillment directive by what we're doing with our folks. They're going out to create more demand for HP and that's going to benefit the channel as much as it's going to benefit any of our direct options.

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

Thank you, Bill. Next question, please.

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Operator

Sir, our next question is from the line of Chris Whitmore with Deutsche Bank.

Chris Whitmore - *Deutsche Bank - Analyst*

Good afternoon, couple questions. Hoping first of all to get more color on the deceleration in unit shipments and the printer space. Is that broad based market phenomenon et cetera. And tied to that I was a little surprised to see inventory increase sequentially entering the summer slowdown. Could you give us any color on the inventory on your balance sheet? Thanks.

Bob Wayman - *Hewlett-Packard - EVP, CFO*

Well, let me start with inventory. We feel very good about the inventory position. We did increase our, what we call our strategic inventory, our strategic buys in PSG. This is focused on areas where we want to assure supply at good prices so there is a bit of an uptick that is not seasonal in nature. But that's really the only area of inventory that is going a little differently than what one would normally model.

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

Yes. I also think to Bob's point you're going to see us where we think it makes sense, do spot buys like Bob described, but I wouldn't take that as some other kind of inventory message at all. And IPG, I think the question is a bit more complicated and without trying to get into a ton of detail on this call, we are targeting high usage segments so we give you a overall unit growth number as opposed to a unit growth number by segment, so take my comments to mean I am pretty pleased with what IPG did in the quarter from a unit growth perspective. I would have liked to have seen more unit growth but I wouldn't interpret totally the three because there's some low usage segments that we frankly don't get as aggressive in depending on what's going on in the marketplace so again let me message one more time. We do expect accelerated unit growth in the back half of the year in IPG.

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

Okay, we'll take one more question, please.

Operator

And sir, to that question is from the line of Keith Bachman with Banc of America.

Keith Bachman - *Banc of America - Analyst*

Hi, guys. Just under the wire.

Bob Wayman - *Hewlett-Packard - EVP, CFO*

Keith, I'm afraid we can barely hear you. Could you speak up, please.

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Keith Bachman - Banc of America - Analyst

Yes, can you hear me now, Bob.

Bob Wayman - Hewlett-Packard - EVP, CFO

Much better.

Keith Bachman - Banc of America - Analyst

Okay. Was hoping you could talk a little bit more about the PC dynamics in terms of trying to separate out some of the opportunities or revenue growth that you had in the quarter from the U.S. versus the international market and how, if any, the pricing dynamics differed there because again this actually relates back to Dell and just trying to understand what the future may hold here if Dell gets more aggressive on pricing.

Mark Hurd - Hewlett-Packard - CEO, President

The best way that I can describe it, Keith, is it was pretty balanced overall. I mean the U.S. was -- it's pretty balanced overall. It's the best that I can give you. I can't come up with a tremendous difference in geography. As I mentioned in my prepared comments, we had strong growth across really all geographies. And that's the way we saw it.

Bob Wayman - Hewlett-Packard - EVP, CFO

If you look at ASP's for Personal Systems, overall year-over-year we saw a 5% decline in ASP's which is really very similar to what we saw in Q1, so it's just -- there's just no news there and if you look at it by region, I'm not going to give you the exact details but there's not much deviation around that 5% by region.

Keith Bachman - Banc of America - Analyst

Okay.

Mark Hurd - Hewlett-Packard - CEO, President

There's not, Keith, much there. I mean we had double digit unit growth in every region. There's just -- that's about all I can give you on it.

Keith Bachman - Banc of America - Analyst

Bob, is there any color you can give us on what the spot buy was, what was that product?

Bob Wayman - Hewlett-Packard - EVP, CFO

It was in a few areas but the largest once again was in panels.

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Keith Bachman - Banc of America - Analyst

Okay, many thanks, guys.

Mark Hurd - Hewlett-Packard - CEO, President

Thank you, Keith. Listen, thank you very much. I appreciate all your questions. Before wrapping up, I want to summarize today's call by again saying I'm pleased with HP's second quarter results. We posted solid revenue growth. We controlled cost and expenses, expanded margins and generated strong cash flow. The quarter represented another solid quarter in a multiyear plan and while we clearly have more work to do and we know that, we're well on our way to building a stronger more competitive HP and while we got to get after that work and I think we'll continue to align our expenses and continue to optimize our investments in growth, we're encouraged with our progress to date so I'll leave my comments at that. Again thanks for joining us for the call.

Operator

Ladies and gentlemen, we thank you for your participation in today's conference with HP. This concludes your presentation and you may now disconnect.

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