FINAL TRANSCRIPT

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HPQ - Hewlett-Packard at Goldman Sachs Technology Investment Symposium

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PRESENTATION

Laura Conigliaro - *Goldman Sachs - Analyst*

Of course this is -- a lot of sessions that we have are important, but this one is singularly so partly because it's Hewlett-Packard and Hewlett-Packard is an extremely important company. But I think also because this is the first time that Cathie Lesjak, the new CFO of Hewlett-Packard, has been able to join us. And we are very pleased about that.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Thank you.

Laura Conigliaro - *Goldman Sachs - Analyst*

So if we can jump right in, I think as you probably are well aware, in this most recent earnings call Hewlett-Packard had a very good quarter, but also did -- there were some controversies. What I would like to do is really start off on some of the controversial areas and see if we can put some color around them, the cash flow side for example.

For the first time in a couple of years, Hewlett-Packard's cash flow from operations and free cash flow were negative, certainly not in the way that anybody really had expected. We understand the issue of bonus payments, but there were other issues as well. So maybe you can kind of give us some observations on that. But also how quickly should we expect to see this rebound? To what extent will this affect cash flow for the full year in comparison to last year?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

So let's first start with the bonus payments. I think I need to provide just a little bit of context to make sure that people understand what happens with the bonus. So prior to FY '06, we actually paid a bonus semi-annually. In FY '06, we changed to pay a bonus annually. So even if the bonus was at a comparable level in FY '06 to be paid in Q1 '07, you would see a much bigger impact than you would in Q1 '06. So that is an important thing to understand.

On top of that, we of course had a very good year in FY '06 and so we had a significant bonus payout. Larger than the previous year. That of course affected our cash flow from operations. This was completely expected. It was fully accrued in fiscal '06. When we went to the security analysts meeting in December and we provided the guidance for the full year of FY '07, we noted that cash flow from ops Q1 '07 would be down relative to history because of the large bonus we were paying. So there is nothing from our perspective nothing surprising about that impact on cash flows.

In addition to the bonus, though, we also had an increase in inventory from Q4 to Q1. Even a significant part of the inventory increase was frankly what we would call strategic. Strategic in the sense that it was either around strategic buys to get lower components, lower costs in our cost of sales, strategic in the sense that we wanted to make sure and do a prebuy relative to the Chinese New Year to make sure that we had assurance of supply going into Q2 from our Chinese suppliers. And then we also had kind of normal build in supplies for the tax season in Q2.

So none of those things were a surprise to us in our modeling, but it is also true that we did not execute in some other areas around inventory at the standards that we would like to. So frankly the good news is the inventory is fresh and Q2 inventory will be down relative to Q1. We also expect cash flow to bounce back significantly. So you'll see a real big increase from Q1 to Q2 in cash flow from operations. That is completely consistent with our guidance at the security analysts meeting in December around cash flow from ops being approximately $10 billion in FY '07.

Laura Conigliaro - *Goldman Sachs - Analyst*

Before we put the inventory issue to bed, you did indicate that you expect it to be down in the April quarter. Is there any way you can give us some sense in terms of order of magnitude -- let's say you had a days of inventory increase between last year and this from 35 days to 39. How much of that was due to the strategic things that you did such as moving from air to boats and the Chinese New Year buildup and so on?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

So there was a fairly significant impact when you look at Q1 last year to Q1 this year because we had not started to put inventory on boats and we also had an uptick in strategic buys. So that delta is frankly not going to reduce when we go from Q1 to Q2. It is really the more execution issues and the seasonality that we have going from Q1 to Q2 that will bring down Q2 inventories.

Laura Conigliaro - *Goldman Sachs - Analyst*

Okay, so maybe we can move on to gross margins. That also came up as a little bit of an issue because it has been sequentially down for a couple of quarters in a row. While mix certainly seems to be a very main factor involved here since PCs were a really big number in the quarter that you just reported, you also had -- you also indicated that gross margins within enterprise, hardware, and services were lower quarter-to-quarter and maybe you can talk to us a little bit about whether or not you think this is an indicator of some meaningfully more aggressive environments that we're seeing now pricewise or less favorable component costs or something that should be a contributor on ongoing basis?

Shouldn't we be viewing this as somewhat of a yellow flag about your ability to continue to show profitability particularly in improvements?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

We typically focus on year-on-year improvements in gross margin, and so we are very pleased with the gross margin improvement basically Q1 over Q1 and we are up 50 basis points. But it is true that sequentially gross margins are down 60 basis points. We have -- the reason for that is mix. It is almost entirely mix. So if you really look at our sequential quarter, you'll see that there is an upward movement on gross margin as a result of software mix specifically around license.

We also had improving supply positions, which also allowed the margin to expand a bit. But in fact the mix and growth in PSG that was phenomenal, 17%, as well as -- I'm sorry, 17% was the year-on-year, 11% quarter on quarter, strong ISS growth and weak BCS growth more than offset the upward pressure on the gross margins. So we view it as completely mix. It is tough to compare sequentially. We have a fair amount of seasonality in our different businesses and therefore you have got to kind of parse through all of the seasonality effects to really understand when you look at a sequential gross margin.

We do not view this as a real change at all in the pricing environment. It is a competitive industry. We have not seen a real change in that in terms of component pricing. We did have some supply issues around memory in Q4 and it led into Q1 as well. But as of the end of the quarter, memory has basically come back to a more normal level in terms supply, and so we are pretty comfortable with that as well.

Laura Conigliaro - *Goldman Sachs - Analyst*

And that is really a perfect segue to the next question I have, which is about strategic component purchasing. This has been something that Hewlett-Packard has done from time to time and in fact there certainly was a time not that long ago when some of the strategic purchasing that HP did was badly timed and it really turned out to bite you guys. What gives you so much confidence that you're not looking at that again? Maybe you can give us a sense of what is happening in key individual components such as you just did on the memory side?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

So if we look first -- let's talk about strategic buys, so we are actually very proud of the track record that we have in terms of our strategic buys. We do a really good job of monitoring and analyzing the trade-offs that we make around strategic buys. We think that we have gotten some good competitive positioning as a result of those. It is actually not an area that I'm overly concerned on. We do monitor it regularly and make sure that we're making the right business decisions.

In terms of component pricing, in general the biggest issue we saw was around memory. The other component prices have just not been significant, having a significant impact on us.

Laura Conigliaro - *Goldman Sachs - Analyst*

A lot of investors have mentioned after you reported the last quarter that it almost feels to them as if HP has this big bull's-eye painted on it right now as the result of big growth in areas for example like notebooks, where you had 40% revenue growth, and blades, where growth was 45%. The point being that it's going to be hard to see how things are going to get much better from this point; 19% PC unit growth as you mentioned and very high printer growth. How would you respond to that?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

First off, we are extremely proud of our results in notebook, in blade, in Integrity. But to your point, we agree with you. We do not think that it can continue and that basically brings us back to our guidance for FY '08 that we believe that the growth for Hewlett-Packard will be 4% to 6%. We think it is appropriate for the size of company that we are and the businesses that we are in. We also will continue to be focused on our costs so that we can take the costs out and be able to compete in this very competitive market and be able to grow based on price as well as other promotions that we might want to run.

Laura Conigliaro - *Goldman Sachs - Analyst*

I guess that is a good lead into the operating, to looking at operating margins, which were about 8.5% as you exited the January quarter, again overweighted with lower margin PCs and printer hardware. So it feels pretty logical that you should get a snap back as supplies become a bigger part of the mix. And to what extent does that kind of a snap back really argue in favor of your 9% to 9.5% operating margin target for fiscal '08 and you're still in fiscal '07 seeming awfully low?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

So I would say, Laura, it is a very competitive market for us. We do not want to underestimate our competitors. They are certainly tough. It is unclear on exactly how the markets will evolve. We are continuing to focus on cost-cutting so that we can be prepared to compete as aggressively as we need to in order to basically get to those margins and get to the growth that we have got in our FY '08 but by no means is this a slam dunk for us.

A number of our cost initiatives require frankly extremely good execution. We feel that we are good at that but that there is -- it is just not a slam dunk and so we are very comfortable that our margins reflect where we are going to end up.

Laura Conigliaro - *Goldman Sachs - Analyst*

You mentioned 4% to 6% revenue growth. You've talked to fiscal '08 targets. You've talked about PCs, printing, enterprise hardware, and services, all of them generally being in that range. Can you give us a sense which areas you would expect higher growth from, which areas lower growth? To the extent that you see situations like we just did where PCs were obviously much higher than you expected, shouldn't that really be something that would be a noticeable tailwind to your growth?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

We still feel very comfortable that 4% to 6% is the appropriate growth for HP. It is $5 billion-ish growth in terms of revenue -- that's significant. That being said, we do have a tailwind right now. We have a tailwind in basically notebooks as well as in blades and Integrity but we also have a headwind when you look at where we are in our more traditional PA-RISC servers and some of our [paid] storage. So we think this is a real balancing act between the tailwinds as well as headwinds and overall we think we will come out to be about 4% to 6%.

Laura Conigliaro - *Goldman Sachs - Analyst*

Sticking with but now looking at the printer area, you have actually been showing accelerating unit growth over the course of the last four or five quarters, growing at a multiple of the industry growth rate. And the industry is growing in low single digits and I think you did something like 18% unit growth in the printer space. How realistic is it for Hewlett even to continue to be able to hit double-digit unit growth, much less anything like you just did?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I think you are absolutely right. I think that mid to high teens growth in hardware is going to be very difficult to sustain. We think about more like the high single digits as a sustainable growth rate for us in hardware going forward.

Laura Conigliaro - *Goldman Sachs - Analyst*

Can you give us a better sense of how -- what is happening in the printer market now as far as competition is concerned and there certainly seems to be an increasing dividing line between companies that are doing very well in certain spaces and companies that are falling back.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I would say that HP is doing really well for three reasons. I think our superior technology puts us in a very good position. We have been very targeted in the promotions that we run in order to drive hardware placements in the right markets in terms of supply usage and we have also been frankly investing in feet on the street to try to drive broader growth within the printing business and into adjacencies. We think that that differentiates us. We are also able to with our technology and our brand drive premium pricing. So we have kind of got the best of both worlds.

Laura Conigliaro - *Goldman Sachs - Analyst*

You have been pretty clear about constrained growth. By the same token, you have margin opportunities not just from the expense reductions that you referred to, but kind of on a near-term basis, you've got supplies coming up and you just in this most recent quarter your supplies growth was 11%, but I guess we would not have referred to this most recent quarter as a really key supply growth quarter. So does that mean that we could actually not only see potentially some acceleration on the supply side, but that we have the margin lever there too?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

One of the things about the printing, our printing business and competition as well is that if we really want higher margins, all we have to do is slow down our shipments of hardware. So that is clearly not our strategy. We want to invest in this business for the long haul. So as a result of that we will constrain our margins by investing for broader growth in the adjacencies, more hardware placements, and so we really believe that the margin guidance that we have got out there 14 to 15% from the security analyst meeting in December is really the right margin guidance in order to drive the best long-term business in printing.

Let me comment on the fact that you are right, Q1 is not typically our strongest supplies quarter but Q2 is, so if you look at operating margins of 15.3 in Q1, it would be reasonable to expect that they will go up in Q2, but it also is reasonable there's a fair amount of seasonality than in Q3 and Q4 so that on average for the year we are really targeting 14% to 15%.

Laura Conigliaro - *Goldman Sachs - Analyst*

Moving over to servers, your high-end server business was disappointing during the quarter, down 6% year-to-year. Your legacy server business of course down more than that. Is this business really -- shouldn't it be viewed as a cash cow business where even there there's some margin possibility because I am presuming that you are selling -- you're not trying to sell to branded customers. You are selling to your installed base.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I would have to agree with you, we are very disciplined in the [DCS] performance in [Tier One]. But it is still a really large market. It is flat to down but we think there's still opportunity there for HP. We have to execute better and that is really where our focus is to be honest with you is in improving our position in that market.

In terms of installed base versus new customers, we do still -- we do blast our installed base but we also blast our new customers. But even within our installed base we're up against the competition in the RISC and mainframe market. We've got very worthy competitors there that are aggressively biding on our fees just as we are and we not only need to be able to invest in pricing but we also need to make the necessary investments in marketing and sales in order to win those RFPs. So it is really not the right time to pull back from there.

Laura Conigliaro - *Goldman Sachs - Analyst*

By the same token, your Itanium server growth was tremendous again, 75% year-to-year. Notwithstanding that, you do remain the only OEM that's using Itanium and it really seems like Intel and also AMD are making big strides in moving the focal point of their server business into another direction. Is there a Plan B if Intel really decides that it would prefer not to support Itanium?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

We have got a decades long Itanium partnership with Intel. We are both committed to the Intel platform -- the Itanium platform and see a lot of value in Integrity. So we are continuing on with that play. We also over the last probably three to four quarters have made a significant investment in building out the applications systems on Itanium and we now have over 10,000 ISVs and that has clearly been key to some of the Itanium growth that we have seen.

Laura Conigliaro - *Goldman Sachs - Analyst*

We continue to hear and granted some of what we hear may not really have a basis in fact, but perhaps some of it does. We continue to hear that Intel really would prefer to be able to deemphasize theirs but they have got the commitment to HP and therefore whether it is legal reasons or other they are unable to do that. But that does not sound like it is the greatest basis for a relationship.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I think the key point you made is it may not be based on fact. We feel very good about our Itanium partnership with Intel.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Tape, your tape business has been somewhat of a sore spot. What is it? It is an area that for the industry as a whole is a weak growth area. What is that you can do to really make this not necessarily to grow much faster, but to make it be a more productive part of your business mix?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

So we are still number one in a market for our tape business, but we are really managing this business for profitability, so if I go back to your question around business critical servers and it being a cash cow, that is probably the way we really view our tape business right now and we are seeing good margin expansion as we manage the business for profitability.

Laura Conigliaro - *Goldman Sachs - Analyst*

Okay, so PCs. PCs really lit up HP to a large extent in the most recent quarter. You said that -- you said even on the most recent conference call that your aim is still to balance revenue growth and profitability in PCs. So can you put some context around that? Which is more of a priority, profitability or revenue growth?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I think it is actually balancing the two. We want profitable growth. Some of the cost initiatives that we have within the company, whether that is at the gross margin line for PCs or around warranty, supply chain, or attach or its around OpEx, where we have got significant cost reductions based on the restructuring plan that we did in 2005 in the kind of G&A categories, both of those have really allowed us to significantly invest in pricing for some of the key large accounts.

So that is where you'll see us go after a bit more growth. It is profitable growth because we have the cost reductions that we can then plow back into it. That does put some pressure on our gross margins in PCs, but we've got the offset in OpEx as a percentage of revenues, so overall our margin still looks healthy.

Laura Conigliaro - *Goldman Sachs - Analyst*

Haven't you also been helped a lot by Dell's weakened position and the fact that certainly in the most recent quarter it is fairly clear that Dell wanted no part of aggressive pricing? So Dell may not get healthy instantly, but everything is a process. And as they focus more on the consumer business, as they get a little feistier or back to somewhat more normal stance on the commercial side, to what extent are you prepared to be dealing with a model might start to change a little bit?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Well I think first you need to look at where HP is strong and where the market is growing for PCs. So there is good market growth in notebooks, in the consumer segment and in emerging markets. Those are the key strengths that HP has. So we actually frankly like the hand that we've got here in the PC market. The cost-cutting initiatives that we have been doing will enable us to compete as necessary on price and continue to do well in that market.

Laura Conigliaro - *Goldman Sachs - Analyst*

You hinted on the call or I guess Mark did that Vista is having some kind of a positive impact. It seemed like it was sort of a moderate kind of a statement but nevertheless it was there. Was this more a comment about demand for Vista or is it more a comment about the configurations being richer and it is helping you and it is probably helping all the other PC companies as well?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I think we are still in a wait-and-see mode on Vista. I don't think we really know what the impact of Vista is going to be, but I think it is also fair to say that Mark's statement was that we were optimistic. We are optimistic because we do see that the likelihood is that we will get richer configurations and maybe less ASP decline. So we think that that would be very good for us.

We also think that in general the risks will happen for the entire market and HP will participate proportionately in that. I think the other thing I guess I would make clear is that we have not in our guidance for Q2 nor for in the rest of '07 forecasted any significant uplift as a result of Vista. So if Vista were to turn out to be significantly better, there is probably some upside there for us.

Laura Conigliaro - *Goldman Sachs - Analyst*

Just finishing up on the PC side, you are already approaching the high-end of the 4% to 5% operating margin that you targeted for fiscal '08 and we're still actually early in fiscal '07. In some of the other areas of your business, we would think of those targets as having considerably more upside. In the PC space, it is an uncertain area. You keep pushing those barriers higher, but we're not quite sure how much higher they can go. Is there still more expense opportunity in the PC space such that even if the market were to get a little bit more aggressive you could hold those kinds of margins?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Yes, we still think there is upside on both gross margin and OpEx, so if you look at gross margin again I mentioned earlier supply chain, warranty and Attach are real opportunities to frankly improve gross margins. But we also have OpEx initiatives and these initiatives are not only within the PC kind of owned OpEx frame, but also across real estate and IP which is helping the entire company. Those cost initiatives, which we have talked about pretty extensively on earnings calls as well as in the December security analysts meeting are really around our IT and our real estate.

Right now there is pressure on margins because we are investing in both of those. The return we're going to get in terms of lower IT costs or lower real estate costs are still out into the future. So we should see IT costs come down on a run rate basis basically exiting 2008 at about $1 billion for '09 and PCs will benefit from that, as will the rest of the company.

Then also in terms of real estate, while we have not quantified the benefit, I think we've gone out there and said directionally it is a bit less than IT. It is also further out into 2010. These are all opportunities for us to basically be able to compete if in fact the pricing environment becomes even more aggressive than it is today.

Laura Conigliaro - *Goldman Sachs - Analyst*

Your first quarter out of the gate with Mercury has gone very well. Revenues are strong. It kind of leads to the question as to having done it once, are you of a mind that you would now be more willing to take the plunge -- I'm not saying you are about to do it but rather since this looks like it could be successful, has the earmarks of that -- you would be more willing to do another software acquisition of some size?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

I think we first need to talk about Mercury. So we did have -- we were very pleased with the results in Mercury in the first quarter, but it is also fair to say that we have been pretty open with folks that we left Mercury pretty much alone in order for HP to complete its fiscal year that ended in December. So we really did not start the integration process until January.

So we actually expect that with the integration there will be a tapering off in growth in Q2 for Mercury. So we are really not done and I would say that we are confident in our integration effort but there's still a lot of heavy lifting that needs to be done.

So in terms of acquisitions, I would not -- I think (indiscernible) on the market is saying we would only look at digestible acquisitions and I think in the context of having just done Mercury, not fully having integrated it yet, another transaction of that size would not be digestible. So I don't think it is likely that we would do something right now in that space of that size.

You could see us doing smaller kind of buildout of technology holds in the software space where there is not as much integration risk.

Laura Conigliaro - *Goldman Sachs - Analyst*

So software actually is the area where you have the most margin opportunities or it seems that way. You are currently at high single digit margins. Your target is considerably higher than that, more than two times that level. I think 18% to 22%. What do you actually have to do to get to those kinds of levels?

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

In FY '07, the software margins are significantly down as a result of deferred inventory write-offs which we have been pretty open with folks about as well as the integration costs. So if those will continue through the early part, very early part of FY '08, but post that we're feeling very well-positioned to hit the 18% to 22% which was our guidance in the December security analyst meeting.

Laura Conigliaro - *Goldman Sachs - Analyst*

Just really quickly, is there a question? Thank you very much.

Cathie Lesjak - *Hewlett-Packard - EVP and CFO*

Thank you.