

# FINAL TRANSCRIPT

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## **HPQ - Hewlett-Packard at Morgan Stanley Technology Conference**

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## CORPORATE PARTICIPANTS

### Mark Hurd

*Hewlett-Packard - Chairman, President, CEO*

## CONFERENCE CALL PARTICIPANTS

### Katy Huberty

*Morgan Stanley - Analyst*

## PRESENTATION

**Katy Huberty** - *Morgan Stanley - Analyst*

Good afternoon. Thanks for joining us for the lunch hour. I'm Katy Huberty, Morgan Stanley's IT hardware analyst, and it is my absolute pleasure to have Mark Hurd, Chairman and CEO of HP, with us today.

Mark joined the company in 2005, and since then has had a maniacal focus on cost efficiencies. He has taken billions of inefficiencies out of the model, delivered on EPS over and over again, and in this environment, EPS defensibility is obviously top of mind, and I think this discussion today is especially relevant. So welcome, Mark, and thank you for your time.

Before we begin, I just have two disclosures to read. First, my own. Please note that all important disclosures, including my personal holding disclosures and Morgan Stanley disclosures, appear on the Morgan Stanley public website.

And second, for HP, I want to make you aware that this presentation may contain forward-looking statements that are subject to risks and uncertainties. Please refer to HP's SEC reports for a discussion of those risks.

So with that said, I have a list of questions. I want to make sure that we leave plenty of time for your questions. Let's make sure this is dynamic.

So with that said, Mark, I want to start on demand. You reported the January quarter a couple weeks ago, and you lowered revenue expectations for the year, about 12% to 13%. If you adjust for EDS and currency and possible impact of adjusting channel inventories, you are suggesting the core business will decline in the high single digits.

Help us get comfortable with how you got to that forecast. What have you seen over the last several months from a linearity standpoint?

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

Listen, Katie, I can simplify this for you. We basically guided that the rest of the year was Q1. So we are not advocating or forecasting any improvement in demand from what we saw in Q1. So think of netting all those factors you described, which I think are exactly right, of saying what we saw in Q1 is what we will see the rest of the year. And I would add that if we hit those demand models, we will do fine on the bottom line.

So we felt that Q1 for us was just a quarter where what we saw was a linearity that was reasonable inside the quarter. But sometimes -- and sort of once you got to sort of mid-November, it was relatively linear; maybe a little weaker in January in the Enterprise, but the rest of it pretty linear. We just don't see a catalyst to change it the rest of the year.

So our model is what we saw in Q1 is the rest of the year. I hope it is better, but that is not what our model is based on.

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**Katy Huberty** - Morgan Stanley - Analyst

Okay. As it relates to channel inventory, I think in IPG, arguably not something that you are happy with. But maybe walk through IPG, Enterprise Systems business and the PC business, where are you with channel inventory? How are you going to get that work done this quarter?

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

Let me start with, we'll fix it. First, PSG operated exactly within our models all quarter. ESS, Enterprise Service and Storage, for those of you that don't know what that means, we operated within our models roughly all quarter. We could have been a little heavy in one country and one product line, but we felt good about both those businesses.

IPG's supply chain just simply isn't as nimble as the other two, and that has worked for us to do long-term structurally, which we think is a big, big structural opportunity for the Company to improve. And we are working on it. We will get it right. It has material improvements for cash flow for us long-run sustainable when we get it right to the level of our other supply chains. That said, within the quarter, we have a supply chain that isn't as nimble, and we didn't execute as well as we should have.

Now, the good news on it is it is all -- there is no inventory in there that is not fresh. We believe we can align it within the quarter. So at the same time, Katy, I want to make sure I am clear with you. We will try to make sure the right product is in the right place, so it is not to our advantage to get it too skinny that we are losing demand as we do it. But we feel good about the freshness and we will get it -- we will get the channel inventory lined up within the context of the revenue guidance we described and [deliver] the earnings within the context of those two different metrics.

**Katy Huberty** - Morgan Stanley - Analyst

You mentioned cash flow. Can you just walk through the dynamics? Have you seen a change in DSOs? How do you feel about the payables level and then inventory?

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

Sure. DPO, days payable, hurt us in the quarter, mainly because we were buying more early than we bought at the end. So it hurts on the numerator of the DPO. So we were slowing down our supply chain on the inbound side.

DSO was fine. There was no material issue in DSO. We had some more owned inventory, again in the IPG supply chain, than we would have liked. None of that is systematic. None of it is structural. All of it is within the context of reshaping up in our cash flow for the rest of the year.

So I would say the biggest issue for us in cash flow starts with earnings. And the issue with earnings is demand going to be roughly the range we've described, which is no improvement for the rest of the year? If we hit that, drive that earnings model, we will drive a reasonable cash flow return. Nothing else in there is impacted for cash flow --.

**Katy Huberty** - Morgan Stanley - Analyst

So just to summarize, disappointed with the IPG, channel inventory, owned inventory issue. But you think you can go and fix that this quarter, and if demand is stable from here, you feel good about delivering on EPS, good about delivering on cash flow metrics.

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

So let me word it differently. We will fix it within the quarter, and I will leave it at that.

**Katy Huberty** - Morgan Stanley - Analyst

Okay, great.

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

I say that only in the context of -- we are not confused. I do want to give you the caveat that says when you go fix channel inventory, you don't want to do it in a clumsy way. You want to make sure you are doing it in a precise way. And when you get to markets like Russia or some of the Eastern European countries that shut down sort of in the quarter, you can wind up with too much channel inventory because it is a calculation relative to sales out.

So it is, again, a complicated numerator/denominator discussion. I would let the channel inventory run higher if it meant it was caused by a Russia-Eastern European freeze that didn't cost me business in China or India in the US.

So I only use it against that caveat, that says we are trying to optimize all of those metrics simultaneously. And when you think of IPG, you are looking at owned inventory, you are looking at channel inventory, you are looking at revenue, you are looking at operating profit and you are looking at market share. So you can't spin any of those five dials to the extreme at the expense of one of the other dials.

So you've got to get all those five dials lined up simultaneously. And I would just tell you that we will not spin one at the cost of getting a horrible answer at the other four.

**Katy Huberty** - Morgan Stanley - Analyst

One of the questions that I get, and I think you can answer it for us, is what is the risk that HP cuts too far, so that the business -- you cut too much cost out, you don't have the flexibility to see the upside when the recovery does hit? How are you managing that risk? And I think in the context of that, walk through what you are doing this year as it relates to salary adjustments, which allows you to take down cost but not take people out of the system.

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

Sure. So I think one, I believe every business has inefficiency and there will never be a day that we are not trying to drive inefficiency out of a system. I think it is very important to focus on your core, but even in the core things that we as a technology company do -- create demand, drive innovation and deliver service -- we have to be careful even in those three buckets that we are actually efficient in the way that we do it.

But what we tried to do cost-wise is keep that core intact, keep it focused. We are not cutting our sales force. We had more engineers at the end of the quarter than we had last year at this time. We are investing into our service business. But we are very focused at getting cost out at every other turn. So we are working very hard on changing processes.

And I won't go into it for the sake of time; I know we don't have a lot of time today. But we don't take cost out just by eliminating Mark or eliminating Katy. We actually try to change the way we do business. We actually try to take work out of the system. That is what drives our cost out. Our cost hasn't been cutting heads. Cutting heads is the result. The work is changing the work, simplifying the work, touching it as few times as possible.

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And when you touch it as few times as possible, things leave the business. And that is what we do every time. Katy, if you knew how we cut a bill, how do we invoice, how do we number a part. When I came to HP, we had seven -- count 'em -- seven different ways we could number a part. You know, the complexity that creates, simplifying that and fusing that takes cost -- immense cost out of the system. The way we service, the fact that we service out of four separate services systems instead of one service system, those are what are driving our costs.

So I actually would think that you should think of us cutting costs as a way to be more efficient, shorten our cycle time, deliver better service, improve our relationship with the customer. So we don't think of cost just in isolation of reducing it. We are investing into the market. Our core belief is that on a relative basis, HP will be stronger at the end of this on a relative basis, not weaker.

We are investing -- our sales force is now 23,000 strong, up from 16,000 basically three years ago. We've invested in that sales force. We are covering more of the total available market than we ever have. We still have more market we have to go cover. We've got more engineers than we had before.

We think with EDS, we now have a service organization that is second to no one on the planet. We have more work to do to finish that workforce optimization, but again, we think we've got some core assets now that put us in a very enviable position.

But I want to make sure you are clear, Katy, we are going to continue to remove cost. We are going to continue to eliminate every cost that doesn't make sense within the context of processes that help the Company run. And I'll try not to go on with this answer longer than I already have.

But for us, if there's any disappointment I have as CEO, it is not getting through this process work faster. We are a big Company. We've bought 38 companies to make the original problem harder over the course of the past four years, and there is still a lot of structural improvement we have at HP to make to be as efficient as we can. And even with as good a Q1 as we had on the cost line, we have more work to do.

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**Katy Huberty** - Morgan Stanley - Analyst

And the original target for '09 was \$1 billion plus of net cost take-out. Is that still the target?

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

No, we will obviously be doing better than that. But again, we've done it through a couple of ways. We haven't just done it with also cutting costs. Because we are trying to streamline our processes, eliminate work and eliminate the cost associated with it. We are also trying to take the remaining cost structure and make it as variable as we possibly can.

So the example of the actions we took a couple of weeks ago -- we've moved our 401(k) match away from an entitlement to a performance-oriented match. If a company performs, we get the 401(k) match. If it doesn't perform, we don't get the match. That's an example of -- I wouldn't call that reducing cost; I would call that variablizing cost and aligning that to performance. It's the same thing we've done with many things around the Company, which is to say we want to be able to make that a variable expense when appropriate.

If you look at what PSG did in the quarter, it showed a revenue decline that was fairly material, and yet it made its bottom line. How did that happen? It did so because the cost structure is now so variable that it really just relates to the fact of whatever that revenue demand is, we can align the cost, roughly speaking, to the revenue. So we are trying to do that all across the cost structure where it makes sense.

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**Katy Huberty** - Morgan Stanley - Analyst

Let's walk through some of the businesses. And I am going to start with IPG, because I think the deceleration in supplies was one of the biggest surprises last quarter. Tell us what you think changed so quickly and how we get comfortable that the deceleration is potentially behind us.

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

Well, for us, supplies typically moves with GDP. So it is a fairly -- two big things that drive supplies that are macro are GDP and unemployment. So when people are unemployed, people don't print. When people aren't working, people don't print. So that is a dimension that the models over the years certainly relate to.

Second dimension is we have pantry inventory declining at a relatively significant level, too. So for us, people that held [four] supplies now handle one supply instead of what they've had before. So there is a combination of factors that affect us. When we look at printing -- two things.

When we look at the installed base, the installed base is relatively flat. So for us, it says that people are keeping their printers longer. That is good news in one context, because we don't have to put money into the installed base to replace the unit. And as long as they keep printing long-run, that is good news. At some point, that installed base has to churn. So in some ways it's got it's true-up coming at some point in time. We are prepared for that. So we are prepared for the installed base true-up that naturally comes when you get the delaying factor in the hardware buys.

And secondly, when you look at the installed base, the cut sheet paper seems to be moving roughly linear with the installed base. So when you look at it overall, people are keeping their printers and people are printing. So for us, it is going to be continuing to align it, and when we look at it long-run, supplies looks to us as a mid-single-digit sort of growth model, whether it is 3.5 or 4.5 or 5, and maybe it's something in that range. But that is what the models tend to say.

We are going to have to move through this leaning of the inventory, and then we are going to have to deal with certainly the GDP and the unemployment issues, I think, to get back to the normal rate here over time. But we feel generally pretty good and stable about the supplies business.

**Katy Huberty** - Morgan Stanley - Analyst

And IPG was one of the last businesses that you attacked from an efficiency standpoint. You announced some incremental work last year. How much work is there to do? Because you can't control unemployment and GDP. You can control the cost structure of that business.

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

IPG has work to do. And I guess in one sense we've got still work left to do, and we've got a big opportunity. And like any business -- I've said this before -- IPG has made a lot of money for a long time. And frankly, they carried the Company way back before I joined it, and I've heard those stories for a while. And, you know, culturally, it has come from a different spot. And we have work to do and opportunity.

And I gave you one example solely in the supply chain. That opportunity is you have to look at a supply chain in the aggregate of days of inventory owned, as well as the channel. Culling that supply chain together is hundreds and hundreds of millions of dollars of cash flow for us, getting that lined up. And I look at that as just as big an opportunity as any part of the cost structure.

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We spent more in R&D in IPG in 2007 than Apple did. And when you start looking at the R&D, and you say, listen, did I get SKU production for that R&D or did I get true innovation that changed the game, you've got to start asking hard questions about those things. And I don't mean that as a negative, because we've certainly got big leaps in the graphics market. We've got big leaps in inkjet.

But at the same time, you have to ask all those hard questions about we may have done something a certain way in 2001 and 2002, but you have to always zero base the cost and start at zero and say, why did I spend that dollar? And because I spent it in 2001 doesn't mean I'm going to spend it in 2009. And working your way through it dollar by dollar by dollar and looking for that return across our businesses today is -- the two businesses we have the biggest actions that we have to take are EDS and IPG. Those are just opportunities that we've got work to do.

**Katy Huberty** - Morgan Stanley - Analyst

You mentioned in the PC business that the cost structure is largely variable. In that context, how comfortable are you that operating margins stay north of 5% this year?

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

Not north of 5. We produced 5 in Q1. I wouldn't necessarily think that everything will be replicable to that. Some of it will depend on what share we want to go get and what markets we want to attack.

But I would say again to your point, while I won't commit to an OP number, I would say to you that we feel well positioned. There is not a cost in PSG, Katy, we couldn't get out, save the operating profit it delivers and the overhead of the company that it has in its P&L. Virtually every other expense we could get out of PSG in six to eight months. It is that variable a model at this point.

So I won't commit to you anything like 5. I will commit to you they will deliver -- they could do better, they might do a little bit less. But they are going to produce a strong OP return in the range that you've seen in the past because of that leverage they've got on the cost structure.

**Katy Huberty** - Morgan Stanley - Analyst

And that business, just to be fair, went through a significant growth deceleration plus huge currency volatility last quarter and still delivered on (multiple speakers).

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

Katy, I think it's an excellent point. I'm not sure we actually described this that well on the call. And I'll take one second to tell you how proud I am of those guys. They took a demand number that was pretty tough, and they had currency.

Let me try to explain currency to you, just in the context of PSG. When the euro goes from 1.42, 1.43, 1.44 and goes down to the 1.26, 1.27, you have an inverse pricing that occurs. PSG would try to raise its price as that occurs. The speed by which you can raise price lags the speed by which the currency declines. When those lines cross, you have margin deceleration.

Inside of the quarter, that group absorbed 30 days of extreme margin deceleration because of the currency move and the pricing model, took the 17% decline in revenue on a dollar basis, then was able to get its inventory on owned and channel lined up simultaneously within their plan models, and deliver 5% margin at the same time. And I think it is not just a credit to the

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operating model and the variable expense. It is a credit to the nimbleness of the supply chain and the speed of the alignment of the supply chain and the realignment to the demand in the market.

So -- and I would tell you if you looked across enterprise servers and storage, you had sort of the same effect. And in PSG, we did that while gaining one full point of share. We gained one point of share in the quarter, with only having our netbooks basically in the market for 45 days in the quarter.

In ESS, we did roughly the same thing, not quite as good as PSG, and there is very competitive between the two. They didn't quite get to the same level as PSG, but in servers, they gained four points of share at the same time, unit shares. Three points of revenue shares. Half a point of storage share, at the same time as they dealt with that same currency deceleration and the same realignment in supply chain.

So I talk about IPG because I like to focus on opportunities, but I would be remiss if I didn't tell you that those two businesses -- and I'm not one who passes out lots of compliments, generally -- but those were two well done things in the quarter.

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**Katy Huberty** - Morgan Stanley - Analyst

You mentioned netbooks in the market for 45 days last quarter. What is your view on the market opportunity? Is it a (inaudible) to margins or is it an opportunity for growth?

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

I think it is yes and yes and yes, to all these things. It is clearly a new market. There is clearly new markets for netbooks that are taking part of the high-and phone market -- people that want a bigger screen, people that want to do additional applications, developers, people that are not PC pros that want a simpler device, but want to have a bigger screen. There is a certainly some low-end issues that will come from the low-end notebook market.

I see numbers that come out. I saw Paul Otellini make a statement, and he told me about 80% of it is brand-new, 20% of it is cannibalizing the market. I think we are too early to give you a number like that. I'm not going to say 80/20. I think -- I am optimistic, but I would probably wait for another three, four, five months of demand picture before I'd give you what it is.

But clearly, it is a new market, and we can clearly see it getting into places that we've never got into before. That's exciting for us.

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**Katy Huberty** - Morgan Stanley - Analyst

Let's shift to the Services business. This last quarter, you surprised at least the Street on the margins in Services. You can tell us whether it was a positive surprise for you. But more importantly, there is a revenue opportunity. Can you just discuss how has HP done retaining EDS customers, and have you been able to grow the pipeline with new deals since closing in August?

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

So, I will go back in history. In May, when we announced we were going to buy them, I think I was the only guy who liked the deal on the planet Earth. In September, when we closed it, I was very optimistic, very optimistic, because what we had seen in May was further validated through the closing process.



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Today, I can't imagine not having done it. I just can't tell you how pleased I am with the progress. Customers in the quarter, we announced this week, we announced Aviva, the win in the UK. Tremendous win for us, very competitive. HP could not -- let me declare Hewlett-Packard could not have won the deal if we didn't have EDS.

We closed another very large financial services company. I won't name them because it is not out yet. We couldn't have won it. Historical, good HP customer, not an EDS customer. We couldn't have done it without EDS's service delivery; EDS couldn't have won it without our demand creation capability.

We won another Fortune 50 logo in the quarter, another material company that again would not have happened without the combination of the two. Our funnel is rich right now. We are pretty positive on it. We are trying to do multiple things at the same time. We are trying to optimize the cost while we get our demand creation lined up between TSG and EDS.

Was I surprised on the quarter? You know, again, it is like anything, we have a plan that takes us out six to seven quarters in terms of actions that we are going to take, two years. And all it becomes is how fast can you get it done. Whether it happens in Q1 or Q2 or Q3, I don't care as long as you are ahead of schedule. And I want you to move as fast as you can, but at the same time be able to perform and operate the business.

So at the same time, Katy, our Technology Services business simultaneously delivered a very strong quarter, very strong. So both -- it wasn't just EDS. It was EDS and Technology Services together that drove a very strong result for us. Let me clear on both of them -- they can both do better.

So I don't know if there are reporters in here want to write something down. I don't want anything going back to anybody at HP that those businesses can't do better. EDS is just beginning to fight the fight, and Technology Services is incrementally better and has opportunities to improve.

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**Katy Huberty** - Morgan Stanley - Analyst

So the funnel for large outsourcing deals is strong. What have you seen in terms of the EDS assets pulling other HP products, whether it be servers or storage or software? Is it too early?

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

Let me try to answer that this way. I think the funnel is full right now -- because I want to give you some more color on this -- if I looked at outsourcing deals, application services deals, the funnel is big and full. What is not full is the little add-on service deals that go on around them. That is actually not so strong right now, because people are not doing new projects.

So you've got two sort of counter demand things going on, a lower what we call churn business and yet a higher outsourcing business. So the number of people that are kicking the tires and taking full proposals is very strong. I'm sure you are hearing that from other service companies -- maybe not. But we feel good about it.

On the pullthrough of product, we don't explicitly measure EDS on HP pullthrough. So we try to make it as easy for EDS to use HP product as possible and systematically it should be a competitive advantage for them because of the margin base and so forth. But we try to do what the customer wants and what is best for the customer. We want EDS to nail its customer engagement.

So to the degree we put the HP product business is to say, get EDS in a position to make their customer experience better, make it easier. So we are pushing the HP product businesses to make that happen. And is the pullthrough going up? Yes, it is going up and is going up not because we are incenting somebody to do something, as much as we are pushing our product businesses to understand EDS's business and make it easy for EDS to deliver quickly, make it easier for them to execute easily, make sure we're giving them the right margin profile and integrating our products into their solutions.

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**Katy Huberty** - Morgan Stanley - Analyst

Okay. So shifting to the hardware side of the enterprise business, you potentially will have one more competitor in the data center this year, blade servers, --

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

What are they doing?

**Katy Huberty** - Morgan Stanley - Analyst

You tell me.

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

I don't know. I don't follow it that close.

**Katy Huberty** - Morgan Stanley - Analyst

So we've all read the news. I think it is to be seen what exactly that product is going to look at. You honestly probably know more than I do. But how does Cisco's efforts to own more of the data center impact your relationship with Cisco? And do you think that a networking company or a systems company has a better chance of winning that battle?

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

Let me think. I think a systems company is in a better position than a networking company. So, I think technically -- listen, all seriousness, I think technically it is easier to take a server chassis and integrate networking to it than the other way around. I think it is pretty instinctive.

Now, we like -- and the server business is a different business model. So listen, we think we know how the model works. We think we know how to make money in that model. Again, remembering, our server isn't just our server business. 85% of the parts now are common between a PC, a server and a blade. That ecosystem is huge. That supply chain is \$55 billion to \$60 billion, depending on which time you are doing the temperature of it.

That leverage is huge. You cannot be in the server business without getting leverage on every supplier and every cost. We are the biggest consumer of hard disk drives, the biggest consumer of power supply, the biggest consumer of cables. I could go on and on, through the sheet metal. And you have to get that leverage to be able to compete. I would tell you that if you get out of the PC business -- others have -- you are basically out of the server business. It is just hard to stay in without the economies of scale and the leverage on the business model that you have to have.

So I think that is a point. Now I think to do it differently, you're going to have to have a very specific solution-oriented approach to be able to solve a certain problem. So I think there is a niche that you could go after, but you will have to be very focused and very specific with it.

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**Katy Huberty** - Morgan Stanley - Analyst

Fair enough. And as it relates to your partnership with Cisco in the (inaudible) that HP's ProCurve business is now \$1 billion in revenue, second-most profitable business. Does that become an incremental focus if Cisco is competing with you in other --?

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

I wouldn't say incremental. They've done a nice job. ProCurve team has done a nice job, built a nice business. We are very pleased with it. But again, we are going to partner with Cisco where it makes sense. So I think ProCurve is a good business. They've grown, as you've mentioned, Katy, tremendously, had tremendous success. They have a different value proposition than Cisco.

Now that said, are there places in the enterprise where it makes sense for us to partner? And the answer is yes. Will it be as big as it was in the past? I'm not going to sit here and predict it for you. I can tell you that we will have to see how all this shakes out. But we are not going into it with a big X on Cisco any more than I think John wants to put a big X on HP. We are both too big and too involved in too many customers.

And I think -- I can tell you at HP, we are very comfortable with the cooperative environment. We have to partner with a lot of different people on deals and in other deals we don't. And that is just the way of the world. So I think we will look for things that both make sense for us, as well as make sense for them. I think you should expect us to continue to try to invest in scale ProCurve. I think you should -- within the markets that it serves, which is not every market that Cisco serves.

At the same time is you can bet this, we will drive the server business very, very hard in terms of its level of innovation, continuing to reduce its cost structure and making it the -- it already is, I guess, the best and biggest server business in the world, but we will try to extend that lead.

**Katy Huberty** - Morgan Stanley - Analyst

You've made a number of both organic and inorganic investments in the software business. The margins are night and day versus when you came to HP, so on the cost side, you've done a ton of work. But how happy are you with the integration of all those assets such that HP is bringing one platform to the market?

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

I get this question all the time, and I can tell you -- I don't want to sound frustrated by it, but it is like when this Company was not part of HP, I had no expectations for integration. The day after you bought them, why doesn't all this stuff work together? And it has been work for us. We have more work to do, Katy, to integrate all platforms.

When you buy a software company, you typically let the release they are working on continue until it goes to the market. So whether it is Peregrine or Opsware or Mercury, those environments all worked on different development environments with different development tools, different code bases. And so it takes a period of years to get that stuff fused together.

We are doing better. Our next release that is coming out has Peregrine lined up pretty well now into the Mercury toolset, so we feel pretty good about that. But we still have work to do. To your point, the software business is now a material R&D spender. We've spent hundreds of millions now of R&D in the software business. 60%, 65% of our total R&D is in software across the Company, but the R&D in the software business is material.

And they are making great progress. I would be remiss if I didn't say they gained share again last year, did a good job in the quarter, 16% -- between 16% and 17% operating profit while they did it. Again, we have more we can do in the software business. We believe the management category, systems management, server management, storage management, data center

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management, the run time sitting on top of it, is just a category that has exploded. It is lined with a plethora of suppliers. We are the number one guy in the marketplace at 17%, 18% market share. And there is no market in the world, a mature market, where the leader has got 18%.

So we believe that there is a significant opportunity for us to scale up in the software business, and yet we've got more work to do to integrate these piece parts. But listen, we feel good about our position. We just have more work to do to make it be the crown jewel we think it can be.

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**Katy Huberty** - Morgan Stanley - Analyst

Okay, fair enough. I have one more question here and then I will open it up to the audience. As it relates to the balance sheet, the cash balance, how are you thinking about the desire to get back into a significant net cash position, paying down the debt from EDS, with the fact that there are so many assets in the market that look, frankly, cheap? How are you balancing just paying down the debt versus being willing to take on some more acquisitions?

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

Well, I think we have the same filter to M&A we've always had. We are not buying anything that doesn't make strategic sense, we are not buying anything that doesn't make financial sense and we are not buying anything that we can't run.

At the same time, while these valuations have gone down, which makes those assets much cheaper, our stock has gone down, which makes the bar harder to leap over as it relates to the alternative uses of capital. So we are continuing to look at balancing debt versus stock buybacks versus M&A. And so I don't think it is as easy a layup as you describe, Katy, that it is just the valuations went down and everything else is the same.

At the same time, money is relatively cheap right now. So when you look at what the commercial paper market is, it is very attractive. So you've got a reset of the capital structure that you have to look at. You can't look at it with the models you had two years ago. So we are continuing to look at it, but we look at it across a trade-off of all of those different dynamics.

I mean, to be clear, we are very focused with cash flow. So we are focused on operating performance and how the current business performs, drives earnings and drives operating cash flow. Once we get operating cash flow, we are very focused on how we invest it. And Cathy Lesjak, our CFO, spends a lot of time owning the capital model and the alignment of the capital model.

And I think you should just expect us to be disciplined as we've been, looking for good uses of capital. I don't think that we see anything that would say we are going to go student body left or student body right. We are going to try and stay focused on the core fundamentals and measure every use of capital against the fundamentals about which is the most attractive for us.

The M&A environment is an opportunity right now. But again, there are other alternatives that are just as attractive in some respects. So no commitment, other than the fact we are continuing to drive cash flow, continuing to take our debt down where it makes sense. We find our shares very attractive right now, based on the price they are at, so we've got to balance that against these valuations you are describing out in the market.

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**Katy Huberty** - Morgan Stanley - Analyst

Fair enough. With that, let me poll the audience, see if there are any questions.

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**Unidentified Audience Member**

As you speak to your customers, can you help us understand the prospects for a global recovery, both from a timing and scope or the growth rate perspective?

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

Well, there is one thing that I am very -- let me give you a quick anecdote on that, and I can tell you what customers tell me. I asked Cathy, our CFO, to send me a forecast for currencies across the planet over the course of the next year. She sent me a report from 29 firms, financial firms. One had -- the extremes was one had the euro at 1.04 and one had the euro at 1.74. They had the yen at about a \$0.30 or 30-point differential. I only tell you that because these 29 firms -- my conclusion after reading it, was no one has a clue.

So my -- when you talk to the customers, I think again, they are all very prudent. There are three types of companies that I typically see that go through these recessions. The leaders, who say we are going to power our way through this. If the market doesn't like us for a short period of time, so be it. But we are going to use this as an opportunity to change the answer and be stronger coming out of it.

There are those that just fall away. They go bankrupt, they can't make it. They weren't doing enough good work before this started to get through any tough times.

And then there is the bunch in the middle. And the real issue is what the bunch in the middle do. And I think the bunch in the middle generally wait for clear signs that you are going to see some kind of recovery. The old adage of when people start buying something from me, I'll start buying something from you.

So I would say right now what you have is caution, caution in the air. It's a little different by market. It's a little different by geography, but I thought the one thing in Q1 that I've never seen before was the absolute [eye-level] general consistency of it, consistency of it by country, by geography, by product segment.

So the way we forecast it, and it sort of tells you what I'm hearing, that Q2, Q3 and Q4 on the demand picture roughly what we saw in Q1. And that is the way we are modeling. Again, what we've done with our model as we've done before, we put the capacity in our model that if it is better, we will be able to execute from a supply chain and demand creation perspective. So that is for our view. When it recovers we expect HP to be stronger, not weaker. But I can't tell you that I feel any catalyst in Q2, Q3 or Q4 that's going to be much different from what we saw in Q1.

**Unidentified Audience Member**

(Inaudible question - microphone inaccessible) -- EDS is doing?

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

I couldn't hear the beginning part.

**Unidentified Audience Member**

To really judge, you say the integration at EDS is going well. That's great news, but how do we really track it? Besides you saying that things are great.

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

I'm sure that isn't as soothing an analysis as you would like to have. I am going to think about that, because we have not typically released signings, which is a metric. Again, you've got to get it in the context of the churn, too, to be able to look at the total position of the business.

Certainly you see an operating profit number from us, so that would certainly be another metric. But I will think about what you say, because we do want to make sure you have transparency about the improvement in it. And I can tell you that although I know you're not suited by just what I say, it is going to be a great opportunity for us and it's something that we feel pretty strong about. And I will think about how we get some indicators out there to give you that sort of -- those sort of headlights.

**Unidentified Audience Member**

(Inaudible question - microphone inaccessible)

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

I can probably hear you if you just --.

**Unidentified Audience Member**

(Inaudible question - microphone inaccessible)

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

No, I can't hear this at all -- I'm kidding. I think I heard what you said. You are asking how long I'm in for?

**Unidentified Audience Member**

(Inaudible question - microphone inaccessible)

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

Thank you very much. Listen, I would tell you that I have no plans that I'm working on right now. I'm a big believer that you have two speeds when you do these jobs, full speed and stop. And there isn't an in-between. And I can tell you right now I am full speed on HP, full speed. And when I think it is even not full speed, I will stop.

And I would tell you, the last piece, as corny as this sounds, it is the greatest honor of my career to work at HP. So I feel very committed to it, and I am -- as we speak, I am full speed on the job.

**Katy Huberty** - Morgan Stanley - Analyst

And I think it came up in this conversation through every metric we looked at, there is plenty more work to do.

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

Yes, I guess to Katy's point, if I felt like we didn't have so much opportunity, I might have a different view. Until I can get this thing -- I just feel the opportunity is still so rich. It is highly motivating. And I will tell you, we have a great -- you don't see them as much as sometimes I would like -- we have a very strong team, and they are very focused on this right now. So I'm full speed.

**Unidentified Audience Member**

Mark, you did a fantastic job of describing all the operational efficiencies, all the opportunities to cut costs and to drive greater efficiencies. What is next for HP beyond all of that? How do you change -- what is your vision for where enterprise IT goes, where consumer IT goes, and how is HP going to drive that?

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

Long pitch, to get in where this goes, and I will be to try to be concise. I think enterprise IT continues to go down the path in a big way, much like we've tried to do internally. How do I reduce my cost, how do I at the same time increase my level of innovation to change my business while I do it? So I don't only want to reduce it. I want to variabilize my cost of IT. I want to be buying as I use it. I want it to look like a utility.

And then within the combination of (inaudible) that utility spend. So think of me trying to turn my IT into an energy bill. So tell me about what it takes to maintain my existing infrastructure, close my books, do all of the perfunctory things that we have to do with IT. Then you tell me how I can get my cost -- anything I might choose to invest, I've got to align that to improve my business. What we have to do is be able to standardize that infrastructure to give companies the most performance we can possibly deliver them at the lowest possible cost and, where possible, variabilize that cost for them.

The leaps in performance -- I'll give you an example. We've halved our costs at HP on overall IT, halved it. At the same time, our aggregate performance of our IT infrastructure for all performance is up 70%. So we can drive 70% more performance through that halved cost environment.

Within that new budget, we've flipped our innovation from 20% -- actually 18% of our budget in the past we spent on innovation to now 70% of our new budget is on innovating the processes. These processes I tell you about that we've changed, we can't do it without IT, because we have to automate things to get cost out. So from an IT perspective, I still believe the answer is no different than it's been before. I've got to get my cost down, but I have the problem of I've got to get more performance. More data created in the next four years than the history of the planet.

So we think we are in an ideal position between the combination of servers, storage, and let me assure you, everything you've seen happen in the server business is going to happen in the storage business. The storage business has to get redefined. It will not be what you've seen over the past five years. It has got a huge Renaissance to go through.

All of that has to be connected with integrated software and get one ability to look through my entire infrastructure, which is why the management software piece is so critically strategic to us. And then it has to be serviced.

**Unidentified Audience Member**

So does EDS give you sufficient scale to get into those deeper conversations with customers, or do we need to see another step to really -- to go out and evangelize?

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

I tell you, I think it does give us -- certainly the way you asked the question, certainly it gives us sufficient scale. I'll use that term.

I think from there, you might see more things that would be unique clip-ons that would give us a specific vertical expertise. I say vertical in terms of industry, but vertical in terms of solution that we bring.

The demand creation issue is one that we need to continue to deal with. Because HP at its core has two huge core competencies that it has built for years, engineering and services. Service, whether they be enterprise services pre-EDS or post-EDS, and consumer services. Its ability to create demand to have those conversations that you were describing is where we work.

And I will tell you, if you know great consultative sales people, I have a company that would like to hire them. So that is a place for us to improve. Whether we need to go at a -- I think you are implying another level. I'm not sure that is the direction to go in. I think it is for us to turn our go-to-market capability into talking to that CEO and CIO about changing the way they do IT and the leverage we can bring them.

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**Unidentified Audience Member**

Two questions. First, you mentioned the PC business gives you scale in the server business, and you said once a company gets out of the PC business, they have to get out of the server business, so they will get out of the server business. So would you care to offer a prediction on how long it will take IBM to exit the x86 server business?

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

No --.

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**Unidentified Audience Member**

(Multiple speakers) Just one other question is -- you mentioned you don't see any reason, understandably, that we should see a pickup or you're not expecting a pickup in spending in Q2 through Q4. Are there any -- what areas would you look at or do you see having less overcapacity? Or are there any areas where customers are spending at unsustainably low rates? I mean, storage does go up over time (multiple speakers).

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

That's a great question. Let me go to that one first, because it is more interesting to me than the first question.

In terms of the market right now, I look at it in two forms. One, there are new projects. And what companies are doing right now is delaying new projects. So as we are still at HP, our IT budget right now is intact. We are undertaking new projects to change processes. But many companies are not. They are just saying new projects, we've got what we got, don't tell me about anything new.

When I look at the market from an existing infrastructure perspective, it is not overcapacity. So what you have is a lengthening of the time that I keep the infrastructure I've got. That lasts for only so long. So I do think you will see some pickup in installed base churn. But again, the market itself won't be healthy with just an installed base churn. It needs growth in new projects.

But right now, this is very different from 9/11 type timeframes when you had the dot-com boom and a lot of overcapacity in the industry. Right now, I would say aggregate supply chain inventory is down. I would say customer capacity is sort of right where it ought to be. I do not believe we have overcapacity in the marketplace.



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Back to your other point, listen, every company makes its own decisions for whatever reasons they want to. All I'm telling you is economically, the business is so leveraged today that if you don't have that leverage, it is just hard to compete.

#### Unidentified Audience Member

If you listen to the pundits, I think the two big trends in IT are cloud computing and virtualization. Both of them have negative ramifications for HP, both in the server side and the PC side. How do you navigate HP through this environment?

#### Mark Hurd - Hewlett-Packard - Chairman, President, CEO

Listen, I don't think there is anything new about cloud computing. Cloud computing has got a couple of different dimensions. One is the consumer side, which we've all gotten very used to. At HP, we have services like Snapfish, like MagCloud. We have a lot of different consumer services, and we are all, all of us -- I won't say all of us -- many of us in this room are very comfortable running our lives dealing with the cloud and dealing with applications out the cloud, and HP will continue to play there.

For example, printing. When -- make sure I got this right -- when the print button was originally put together on one of the popular -- very popular social forums out there for kids, there was no print button put together. So we've now installed a print button on one of those two very, very important forums. We now get one million hits a day. So it's really important for us. The cloud can be an enabler to many of our core infrastructure capabilities.

So for us, lining up with the cloud, it is a huge opportunity for us. Because those million hits per day, we wouldn't have got if there hadn't been that service coming out of the cloud.

The enterprise will be much more picky about how it deals with the cloud, and I think you will see specific vertical applications, but I don't think you will see a ubiquitous cloud of service for many reasons that we don't have time to go into today.

If I flip back to your question about virtualization, virtualization is one of several factors going on inside the enterprise. The enterprise at the same time needs more processing power than it has ever had before. So don't make it -- always I think the impression of virtualization is it must be bad. These are all tools that are trying to get the use of power and capacity down, so people can invest in what they have to go do, because there are more jobs to go do than they've ever had before.

#### Katy Huberty - Morgan Stanley - Analyst

Okay, let's wrap it up there. I just want to ask Mark if you have any last thoughts before we go to the next session.

#### Mark Hurd - Hewlett-Packard - Chairman, President, CEO

I'd say a couple things quick. To the point, Katy, that you had, we are cutting costs, but we are cutting costs, we think, thoughtfully. We are not cutting to the muscle of the Company. We believe there will be a recovery, and we believe we will take advantage of it when it does come. I would like you to think of the fact that HP is a services play that has a strong position in services and an opportunity in products when the rebound comes that we are going to take advantage of.

Second, I think to the point of the model today, we are not forecasting a revenue picture any different than what we saw in Q1, but I can tell you we are confident in our ability to deliver at the bottom relative to that guidance that we gave. And I would like to make sure you understand that. I think I will leave it with that.

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**Katy Huberty** - Morgan Stanley - Analyst

Great. Thank you so much for your time today.

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

Thank you.

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