FINAL TRANSCRIPT

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HPQ - Q1 2007 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first-quarter 2007 Hewlett-Packard earnings conference call. My name is Melanie, and I will be your coordinator for today. (Operator Instructions). As a reminder, this call is being recorded for replay purposes.

I would now like to turn the call over to Mr. Brian Humphries, Vice President of Investor Relations. Please go ahead, sir.

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

Thank you and good afternoon, everyone. I would like to welcome you to our first-quarter earnings conference call. Joining me today is our Chairman and CEO, Mark Hurd; our CFO, Cathie Lesjak; and Jim Burns, who has recently been appointed Vice President of HP Investor Relations.

Before we get started, I would like to remind you that this call is being Web-cast live. The Web-casts and the first-quarter earnings slide presentation, including non-GAAP reconciliation tables, can be accessed on the HP Investor Relations Web page under companyinformation@HP.com. A replay will also be available shortly after the conclusion of the call for approximately one year.

Next is my duty to inform you that the primary purpose of this call is to provide you with information regarding the first 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 risks described in HP's SEC reports, including but not limited to its annual report on Form 10-K for the fiscal year ended October 31, 2006. As in prior quarters, the financial information presented and discussed in connection with this call including tax-related items reflects estimates based on information available at this time. As such, these amounts could differ materially from the amounts ultimately reported in HP's Form 10-Q for the fiscal quarter ended January 31, 2007.

I would 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 pension curtailment gains. A presentation of GAAP financial information for the first quarter and a reconciliation of non-GAAP amounts to GAAP are included in the financial statements accompanying today's earnings release, which is also available on the HP Investor Relations Web page at HP.com.

Finally, I would like to remind you at the beginning of each fiscal year, HP conducts a review of its financial reporting structure and determines whether changes should be made to align its financial reporting more closely to its business structure. As a result of HP's fiscal 2007 review, HP has implemented certain fiscal 2007 organizational realignments.

This year we have two changes to report. These changes reflect only revenue shifts among the business units within the enterprise storage and server and HP services segments. There was no impact to segment level revenue, and none of these changes impact HP's previously reported consolidated net revenue earnings from operations, net earnings or net earnings per share. To ensure you have full visibility and comparability, HP has reflected these realignments in prior periods on an as if basis. Supplemental financial tables illustrating these changes for the past two fiscal years have been included in our earnings presentation and filed with the SEC.

Finally, before passing you to Mark, and with a view to allocating time for questions from multiple firms, I would like to ask you to refrain from asking multi-part questions or clarifications. With that, I will turn the call over to Mark.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Thanks, Brian. First, let me start by thanking Brian for his great work as our Head of Investor Relations. He's done a fabulous job during my tenure at Hewlett-Packard, and we're going to miss him.

I additionally want to make the comment that we've asked Jim Burns to take on this assignment, which is I hope you'll see a strong commitment on our part to placing senior leadership in the IR function. Our relationship with investors is very important to us, and therefore, the commitment we've made of a senior member of HP to that function to build on the momentum that we built under Brian's leadership.

So, with that, let me start and say I'm pleased with the first-quarter results that we had. We delivered solid revenue growth across all of our businesses and geographies. We gained share in our key businesses. We showed expense discipline, and we expanded margins.

In addition, we returned significant cash to our shareholders through share repurchases. While we continue to invest in the long-term health of our various businesses, we drove further operating margin improvements in our reportable segments with a year-over-year operating profit increase of 41% in the Personal Systems Group, 40% in the Technology Solutions Group, and 10% in the Imaging and Printing Group.

As I said before, cost discipline and revenue growth go hand-in-hand, and our share gains, solid topline growth and margin expansion reflect our ability to drive operating leverage and invest in growth by freeing up costs.

Financial highlights of the quarter include revenue growth of 11% year-over-year or $2.4 billion of growth to $25.1 billion. Non-GAAP gross margin of 23.7%, up from 23.2% in the prior year period. Continued year-over-year operating margin expansion in key businesses, with Personal Systems margins of 4.7%; Imaging and Printing margins of 15.3%; Enterprise Storage and Server margins of 9.3%; HP Services margins of 10.5%, and HP Software margins up 8.5%. Non-GAAP operating margin of 8.6%; that's up from 7.5% in the prior year period. Non-GAAP EPS of 65%; that represents growth of 35% year-over-year. And $2.7 billion of share repurchases in the quarter.

I'm particularly pleased we've been able to post another quarter of solid results while continuing to make progress on longer-term strategic initiatives that will strengthen HP's competitive position in the market, including substantially completing our restructuring program and continuing to work on other cost reduction opportunities such as data center consolidation, service delivery cost optimization and real estate management and continuing to reinvest in growth initiatives, including salesforce hiring and increased account coverage.

With regards to management hiring, we added three new members to our Executive Council in recent months -- Cathie Lesjak, who you're going to hear from in a little while moved from Treasurer to Chief Financial Officer; John Flaxman moved from Controller to Chief Administrative Officer, and Michael Holston will join HP as our General Counsel on Thursday.

We closed the acquisition of Mercury on November 6. We remain focused on successfully integrating Mercury into our software portfolio, and we're pleased with the early strength of Mercury's revenue and margin performance.

We also continue to build out our software and services capabilities with the acquisition of Knightsbridge Solutions and [Bitphone] Corporation. In recent weeks we announced our intent to acquire Bristol Technologies. Knightsbridge, which is part of our consulting and integration business, strengthens our expertise in Information Management and Business Intelligence Solutions. Bitphone develops software solutions for wireless mobile device management and enables us to accelerate our customer's ability to manage their mobility infrastructure in a reliable, secure and cost-effective way.

Bitphone technology brings business transaction monitoring technologies to HP, further enhancing our leadership position in infrastructure management software.

Now, let me turn to the business segments and the first-quarter results. Imaging and Printing had a strong quarter. Revenue grew 7% year-over-year to $7 billion with supplies revenue growth of 11%. Revenue and commercial hardware up 2% and consumer hardware revenue flat.

Over the past two years, we focused on accelerating supplies growth by driving hardware shipments in areas of high supplies consumption. We had another strong quarter of unit shipments with total printer hardware units up 18% year-over-year, driven by commercial printer hardware units growth of 21% and consumer printer hardware unit growth of 16%. Momentum and key growth initiatives continue with All-in-One unit shipments up 27% year-over-year. Appliance photo printers were up 49%, color laser printer shipments up 35% and printer-based MFP shipments up 8%. HP Indigo press printed page volume grew 40% over the prior year period.

We're confident that the strength of our unit shipment growth will extend our share leadership position in both the inkjet and laser markets. The consistent execution of our hardware placement strategy accelerated our supplies growth, which helped us drive margins to the high end of our operating margin range, allowing us to invest in short-term pricing and promotional activities, as well as growth initiatives.

Going forward, you should expect to continue to see us build upon our strengths in our core printer business and extend our brand technology leadership and price performance advantage into adjacent markets and capture further page growth. Segment operating profit was $1.1 billion or 15.3% of revenue, up from 14.9% in the prior year period.

Moving now to Personal Systems, which had an excellent quarter with strong revenue growth and market share gains and record operating margin. Revenue grew 17% year-over-year to $8.7 billion with unit shipments up 19% and double-digit revenue and unit growth in every region. We had a strong holiday season with consumer client revenue up 28% over the prior year period, driven by excellent unit shipment growth in consumer notebooks as we take advantage of a strong product lineup, improved branding and advertising, as well as the strength of our retail channels.

Overall notebook revenue growth was 40% over the prior year period with double-digit growth in consumer and commercial notebooks. Revenue in desktops was down 1% year-over-year, while revenue in workstations grew 23%.

We saw improved performance in our Commercial Client business where revenue grew 8% over the prior year period with strong growth in notebooks offsetting flat desktop growth. As we continue to reduce our cost structure, we are better able to price and win commercial accounts profitably and regain account control with a view up to selling the entire Hewlett-Packard portfolio. Our topline momentum continues to drive market share gains, and according to preliminary fourth-quarter data, HP grew units three times the market rate and extended our leadership in notebooks, desktops and total PCs in every region.

I'm particularly pleased that we posted these share gains while achieving record operating margins. During the first quarter, segment operating profit was $414 million or 4.7% of revenue, up from 3.9% in the prior year period. You should expect us to continue to balance revenue growth and profitability by managing our costs, investing in market opportunities and leveraging our strength in notebooks, consumer, and in emerging markets. Bear in mind that operating markets typically decline sequentially as we exit our seasonally strong back to school and holiday season.

Let me move now to the Technology Solutions Group.

Enterprise Storage and Servers grew 5% year-over-year to $4.5 billion. Operating profit was $416 million or 9.3% of revenue, up from 7.7 in the prior year period. We had a solid quarter in Industry Standard Servers with revenue up 10% year-over-year and share gains in every region. With Industry Standard Servers, we continue to show strong momentum in Server Blades with first-quarter revenue up 45% over the prior year period, reflecting strong customer acceptance of our c-class Blade offerings. Given our strong Blade growth, we expect this will drive significant share gains in the quarter.

Revenue storage grew 3% year-over-year, and while I'm pleased with the margin improvement we've seen in storage, we need to drive stronger topline results in the business. To this end, we will continue to invest in sales coverage and storage sales specialists, as well as aligning to enterprise VARs and investing some of our margin strength back into demand generation. Weakness in tape and in the high end was offset by ongoing strong acceptance of our flagship mid-range EVA external array business where revenue grew 18% year-over-year.

Business Critical Systems revenue decreased 6% year-over-year. We did continue to see strong Integrity momentum with revenue growth of 75% over the prior year period. In the first quarter, Integrity represented approximately 55% of Business Critical Systems revenue, up from 30% in the prior year period. Integrity momentum was offset by ongoing declines in PA risk and Alpha. On an operating system view, HP-UX revenue was relatively flat year-over-year, offset by continued declines in Tru 64 units UNIX and NonStop systems. We can do better in this business, and we are focused on driving improved revenue growth through better sales execution, account coverage and installed base leverage.

We had a solid quarter in HP Services with revenue growth of 5% over the prior year period to $3.9 billion. On a year-over-year basis, Outsourcing Services and Consulting and Integration grew 11% and 10% respectively. Revenue in Technology Services grew 1% year-over-year. HP Services generated $414 million or 10.5% of revenue, up 2.7 points year-over-year, despite pressure from startup expenses related to new customer engagements. We continue to make progress on reducing our unit cost of service delivery and strengthening our portfolio of standardized and automated offerings. There's a lot of work ahead of us as we optimize delivery and support costs of our services model. But we have seen progress, and we are focused on the opportunities ahead to enable us to drive improved revenue growth in the business.

HP Software revenue grew 81% over the prior year period to $550 million, reflecting solid organic growth, as well as the impact of our acquisition of Mercury Interactive. Revenue grew 7% year-over-year, excluding the effects of Mercury. On a year-over-year basis, HP OpenView grew 14%, excluding Mercury, and OpenCall grew -- declined, I am sorry, 6%. HP Software reported an operating profit of $47 million or 8.5% of revenue, up from a profit of $9 million or 3% in the prior year period.

First-quarter segment results include integration charges and certain purchase accounting adjustments from the Mercury acquisition, which offset improved operational performance. Mercury finished its fiscal year with strong revenue growth and margin performance. We are focused on executing the integration and remain on track to post 18 to 22% operating margins in HP Software in FY '08. You should see progress toward these targets as we get through the non-cash charges of the coming quarters.

HP Financial Services revenue was $547 million, up 10% year-over-year. Volume in net portfolio assets increased 4% over the prior year period. Operating margin was 5.9%, which is down from 7.7% in Q1 of last year and 6.4% in Q4. The year-over-year margin improvement decline reflects some asset write-downs and increased mix of operating leases from the prior year period. While we are encouraged with the growth in financing volume over the last several quarters, we know we have more work to do, and we are focused on continuing volume momentum.

I conclude my segment comments by reiterating that we had a solid quarter across the entire portfolio. Over the past two years, we have made solid progress in our cost discipline and market competitiveness. As pleased as I am with this progress, we know there are opportunities for further improvement ahead. We are faced with a dynamic industry, and we need to continue to execute with discipline to further strengthen HP's competitive position in the market. I think the good news is that we are not confused about what we need to do.

Before passing to Cathie, I wanted to address our decision to freeze our US Defined Benefit Plan for all employees currently accruing benefits. This is effective January 1, 2008. As a result of this decision, we will have a onetime pension curtailment gain of approximately $500 million. We will use these savings to offer impacted US employees the option to participate in an enhanced early retirement program. The cost of the early retirement program will approximately equal the savings from the pension freeze, effectively returning the onetime curtailment gain to many of the affected employees. Those employees who do not take advantage of the early retirement program will (technical difficulty) an increase on the Company match of their 401(k) contributions. We believe these changes strike the right balance with respect to offering competitive employee benefits and optimizing our cost structure.

Finally, benefits received by retirees or other active employees will not be affected by today's announcement.

With that, I would like to turn it over to Cathie who will address some of the financial assumptions behind the program during her prepared remarks.

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

Thank you, Mark, and good afternoon, everyone.

I will begin with a review of the total Company income statement. Revenue of $25.1 billion for the quarter was up 11% year-over-year or up 7% when adjusted for the effects of currency. On a revenue growth contribution basis, growth was led by Personal Systems, Imaging and Printing and HP Software, while Industry Standard Servers posted strong growth within Enterprise Storage and Servers, and Outsourcing and Consulting and Integration grew strongly within HP Services.

On a regional basis, revenue was up 6% in the Americas, up 14% in EMEA and up 15% in Asia-Pacific. When adjusted for the effects of currency, revenue was up 6% in the Americas, 7% in EMEA and 12% in Asia-Pacific. First-quarter gross profit was $5.9 billion or 23.7% of revenue, up from 23.2% a year ago, reflecting gross margin rate improvements in HP Software, Imaging and Printing and Services and the mix improvement of HP Software. These rate and mix benefits were offset somewhat by a mixed impact from the revenue strength in Personal Systems.

Sequentially, gross margin declined from 24.3%, reflecting mix and rate impacts in Personal Systems and Enterprise Storage and Servers and rate impact in HP Services, offset by improvements in HP Software mix and gross margin rate improvements in Imaging and Printing. Non-GAAP operating expense totaled $3.8 billion for the quarter or 15.1% of revenue, down from 15.7% a year ago and 15.3% sequentially.

In dollars, operating expenses were up 6% year-on-year and up 1% sequentially. Adjusting for currency, expenses were up 4% year-over-year and flat sequentially. The year-over-year increase primarily reflects volume growth, the effects of the Mercury acquisition and investments in growth initiatives, such as the continued hiring of sales resources. These increases were offset by position eliminations or relocations as part of our restructuring program.

Importantly, while we continue to show expense discipline, we continue to realign our costs by reducing our general and admin expense and investing more in field selling costs and marketing. Non-GAAP operating profit was $2.2 billion or 8.6% of revenues, up $457 year-over-year and down $45 million sequentially. Non-GAAP OI&E with pretax income up $121 million or roughly $0.03 per share after-tax at the lower end of the $0.03 to $0.04 per share we guided for the quarter. Our non-GAAP tax rate was 20% for the quarter at our guidance.

First-quarter non-GAAP EPS was $0.65 from $0.48 in the prior year period or a growth of 35%. GAAP EPS was $0.55, which included $279 million or $0.10 in after-tax adjustments that were not included in our non-GAAP results. The adjustments primarily relate to in-process R&D charges related to the Mercury acquisition and amortization of purchased intangibles.

Moving now to the balance sheet. HP-owned inventory came in at $8.4 billion, up $1.6 billion year-over-year and $630 million sequentially. Inventory days of supply stands at 39 days, up from 35 days last year and from 38 days sequentially. While we appropriately make inventory trade-offs, including some strategic buys to take advantage of deals and thereby reduce our overall bill of material costs, we need to do a better job in inventory management, and you should expect us to work on reducing inventory levels going forward.

With regard to channel inventory, we exited the quarter in good shape. Personal Systems ended the quarter with approximately five weeks, up about a week over the prior year period, reflecting some build of Vista-ready products at quarter-end to enable us to fulfill retail demand upon Vista's launch. We believe we are well-positioned to participate in Vista demand.

Enterprise Storage and Servers entered the quarter at roughly 4.5 weeks, down about half a week year-over-year. Imaging and Printing ended the quarter at roughly 5.5 weeks, up about a half a week year-over-year driven by supplies built ahead of the tax season.

Trade receivables ended the quarter at $10.4 billion, up $1.7 billion year-over-year and down $470 million sequentially. DSO now stands at 37 days, up from 34 in the prior year period and down from 40 days sequentially.

Next, Property, Plant and Equipment was up $699 million year-over-year and $182 million sequentially at $7 billion. Gross CapEx was $718 million, up 68% year-over-year and down 26% sequentially. On a net basis, CapEx was $579 million, up 80% year-over-year and down 33% sequentially. The year-over-year increase in CapEx reflects incremental investments in IT, as well as increases in financing assets which is consistent with our prior guidance. Net PP&E as a percentage of revenue now stands at 7.5% of revenue, up from 7.2% year-over-year and flat sequentially.

Regarding Accounts Payable, days payable closed the quarter at 53 days, up from 46 days year-over-year and down from 59 days sequentially.

Next, some comments on our balance sheet and cash flow. As mentioned in our prior earnings call, there was a significant cash flow impact from the bonus payout in the first quarter related to the strong operating performance of the Company in fiscal 2006. At the same time, when compared to prior year periods, we saw weak working capital metrics in this quarter related to some increases in levels of inventory and builds in Accounts Receivable given a stronger than expected month of January. Combined, this resulted in a cash flow from operations of negative $22 million for the quarter. As I said earlier, we will focus on improving inventory management, and I am confident that cash flow will return to more appropriate levels in the second quarter.

Free cash flow was negative $601 million, primarily reflecting weakness in operating cash flow and significant CapEx expenditure related to our investments in IT and real estate facilities. During the quarter, we had a net cash outlay of $4.5 billion for acquisitions, primarily related to the acquisition of Mercury. We purchased $2.3 billion in stock in the open market or approximately 57 million shares. In addition, we received 13 million shares under the prepaid variable share purchase program that we entered into early last year. So, a total of 70 million shares were acquired during the quarter.

In addition, we paid $218 million in the quarter for our normal dividend. We closed the quarter with total gross cash of $10.4 billion, up from $12 billion last year and $16.4 billion sequentially. Net cash was $4.6 billion, down from $6.9 billion last January and $11.2 billion sequentially.

With regards to the remainder of fiscal 2007, we expect growth in net capital expenditures to trend at or above fiscal 2006 levels as we continue to build out our data centers and deploy capital to consolidate and upgrade our real estate facilities consistent with our guidance at our December security analyst meeting.

I would now like to address our decision to freeze our US Defined Benefit Pension Plan and our decision to offer an enhanced early retirement program to eligible US employees. The major elements of today's announcement are as follows.

The US Defined Benefit Pension Plan will be frozen on January 1, 2008 for those employees currently participating in the program. Eligible employees may volunteer for an enhanced early retirement program. Employees who participate in the early retirement program will leave HP by May 31, 2007, and impacted employees not taking advantage of the early retirement program will move to an enhanced defined contribution program on January 1, 2008 with HP increasing its 401(k) match from 4% to 6%.

Note pension benefits received by HP retirees and the benefits accrued to date by current employees will not be affected by this announcement. We expect the changes to our US pension plan will give us a curtailment gain of approximately $500 million. We expect approximately 3000 employees to take advantage of the enhanced early retirement program, and while results may differ as a result of employee participation rates, we expect the cost of the early retirement program to approximately equal the curtailment gain. If necessary, we can limit the participation rate to ensure the costs to the program are not significantly greater than the curtailment gains. We expect to replace the majority of those who take advantage of the early retirement program.

We expect to report the impact of the curtailment gains and the cost of the early retirement program in our second-quarter GAAP results. We feel that excluding these items from our non-GAAP financials gives you better visibility into ongoing operations of the Company and the financial impact to the program. I will address any savings that will impact our non-GAAP financials in my outlook commentary.

Finally, in terms of cash flow impact, bear in mind that the cash consumption will be funded from the pension plan assets, and as such, there will be no short-term impact on our cash flow from operations. Of course, we will continue to periodically evaluate our pension plan funding, and while we are currently comfortable with the funded status of the program, we will continue to fund when appropriate.

Now, a few comments on our outlook before we take your questions. We now expect second-quarter revenue to be approximately $24.5 billion versus the current consensus estimate of $24.1 billion. Historically, revenue was roughly flat in constant currency from Q1 to Q2. However, given the strength of our consumer business and the holiday season, we expect our second-quarter revenue to decline sequentially.

For the full fiscal year, we now anticipate revenue of $98.0 billion to $99 million up from our prior guidance of $97 billion, reflecting our overperformance in the first quarter and the effects of currency.

Regarding earnings, there are many variables to keep in mind. We expect some normal sequential pressure on absolute cost and expenses as a result of Q1 to Q2 seasonality including the beneficial effects of the holiday season in Q1 baseline levels and the impact of our annual salary adjustments which became effective February 1st.

With regard to the pension plan changes and our early retirement program, there will be no impact to second-quarter non-GAAP earnings given the timing of the actions. However, we expect a $0.01 to $0.02 benefit to non-GAAP earnings in the second half of fiscal 2007, reflecting primarily the timing and replacement and to a lesser extent any labor or cost arbitrage. Once the program becomes effective in January 2008, we expect some ongoing savings from the changes to our defined benefit plans. However, bear in mind, that the population of employees affected by the program is quite small given prior actions, and the savings will be partially offset by an increased 401(k) match for those who do not take the early retirement program. Nonetheless, we expect a $0.01 to $0.02 benefit to non-GAAP earnings in fiscal 2008. Given our weak cash flow in the first quarter and reduced cash balances, we now expect non-GAAP OI&E to be about $0.10 for the remainder of the year or $0.13 for the full year versus our prior guidance of $0.03 to $0.04 per quarter. We expect Q2 non-GAAP OI&E of $0.03, a little bit below your models.

Regarding tax, we expect a non-GAAP tax rate of approximately 20% for quarter two '07 and full-year fiscal 2007. So we expect fiscal '08 to be 21% per our previous guidance at the December security analyst meeting.

Finally, we expect to continue to repurchase shares in the coming quarters. The effect on share counts will be impacted by the share price trends, option exercise patterns and common stock equivalents. However, at this stage, we continue to expect a modest decline through the remainder of fiscal 2007.

With this in mind and recognizing our ongoing investments in demand generation, salesforce hiring, etc., we now expect Q2 '07 non-GAAP EPS of approximately $0.63 to $0.64 and full-year fiscal 2007 non-GAAP EPS of $2.60 to $2.65, up from our prior guidance of $2.48 to $2.53 and versus current consensus estimates of $2.57.

With that, we will take your questions before Mark wraps up the call with some closing comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ben Reitzes, UBS.

Ben Reitzes - *UBS - Analyst*

Good afternoon. Thanks. Cathie, could you give a little more detail on inventory? Was there any particular components or what not that happened to raise the inventory number and/or any impact from Vista, and then just a little more detail on what you're going to do to lower inventory and have cash flow snap back?

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

In terms of inventory, the increase in inventory was pretty much across-the-board. There wasn't any one single business that was impacted by it, nor was there one specific reason for it. Some of the increase was due to what we discussed last quarter related to putting more inventory on boats from China in order to get cost of sales reductions. And so we definitely saw some increase in PSG as a result of that.

We also had some increase in PSG for Chinese New Year, and while some of you might smile at that, the reality is we source a lot of products from China, and when they go on vacation for Chinese New Year, we didn't want to be without products. So we do have some inventory build as a result of that.

We also have some inventory build in supplies and in hardware in preparation for the tax season in IPG. Plus, we saw an uptick in SAB 101 inventory. So in terms of what we're going to do -- what I would like to do and what we will be doing is basically scrubbing these inventory numbers going forward to make sure that we have absolutely the minimum amount of inventory that we need so that we are utilizing the capital to our best advantage. There will -- that is not to say that everything will come down. There are still good reasons to make trade-offs like I mentioned around the PSG boat inventory. And so we will continue to do those types of things as well.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

So then, let me make sure you are clear before we get off the phone. We are all over this thing. Right? So, at the same time, we're trying to look at an aggregate P&L view so that we get an optimal answer in terms of the performance of the business, and we're looking at return on invested capital on everything we do. So I think when you look at the rate of inventory relative to the margin drop, we feel pretty good about that dimension.

Secondly, we feel pretty good about the freshness of the inventory that we have relative to Cathie's points. You get the Chinese New Year effect, which I understand the smile point that Cathie made, but at the same time, we want to make sure we had inventory as we went into the coming quarter.

So, from a cash flow perspective, our big issues were we had an incremental bonus that we paid that we think was appropriate relative to the performance of the business in 2006 and the issue that you are describing. But I want to make sure you don't have any confusion. We are all over this thing.

Ben Reitzes - *UBS - Analyst*

And you expect a big snapback from cash flow?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

We sure do. We sure do.

Operator

Laura Conigliaro, Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

Last call you indicated that you really didn't know what the impact of Vista was likely to be. What would you say to that now? Your enormous number of PCs driven by notebooks obviously coincides with the holidays and Vista launch. How should we be thinking about your PC potential in a seasonally slower quarter?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

I think, Laura, I will do my best. But very bluntly, I mean Vista will have an impact in Q2, and we're talking mainly about Q1. I don't want to give you much about how the quarter started other than to say as we said before, we weren't forecasting any Vista moment so to speak in the context of how we were seeing this thing roll out. And I think at this point, while we have a couple of weeks of data, I don't have anything -- enough to give you any color, and I would be afraid to do that in the context of such a short period of time.

So listen, I think it's -- like we said before, we are optimistic. We think it drives a more robust configuration in terms of what gets sold, but we haven't forecasted any big change in terms of trajectory as part of the next couple of quarters.

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

And Laura, we would just reiterate that our FY '08 financial model called for 4% to 6% revenue growth for PSG, and we feel very comfortable with that.

Operator

Rich Gardner, Citigroup.

Rich Gardner - *Citigroup - Analyst*

Cathie, I wanted to go back to your guidance for the second quarter. As you said and gave several reasons for, you're guiding below normal seasonality for the quarter, but it does sound like the channel inventories are pretty lean, and we certainly have seen a big pickup in sell-through per the NPD data after the launch of Vista in early February. And I'm also a little bit unclear why EPS would be down sequentially, given that if revenue is down, that means you will see a mixshift toward supplies, which would tend to push up the margins and the EPS sequentially.

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

So let's tackle the revenue first. Our robust holiday season in PSG makes us think that, in fact, we will come off of that high in Q2, which is per my comments unusual but so is the tremendous pickup that we got around the holiday season for PSG. And so that's why we are guiding down a bit relative to seasonality.

And, on the guidance in terms of EPS, it is true that IPG margins pick up Q1 to Q2, but we also have to deal with the effect of lower revenue than what we typically see when we go from Q1 to Q2.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

I mean, Rich, listen. I think to your point, we feel pretty good about channel inventory levels. We feel good about how we are positioned. We have raised our guidance, and we feel good about our position. Listen, we hope we do better, but to be very blunt, that's kind of where we see things flowing at the current time, and just to be clear, we won't get any impact of this pension curtailment in the quarter either that's going to play out over the quarter. So I think it really is the revenue mix story that comes into play, and we will see how it turns out.

Operator

Bill Shope, JPMorgan. Can you comment on component pricing and availability during the quarter and potentially your outlook for some of the key components?

And also, in line with that question, do you see any risk given your inventory levels that you may get hit with some of these, or is the strategic inventory purchases may actually hit your margins in the second quarter given the component price declines we have seen in the past few weeks?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

We feel pretty good about the freshness of the inventory build. Again, we feel pretty good about it, so I think the answer to that question would be no, not really. We are seeing memory loosen up a little bit. Remember we went through a horrible time with memory for almost all of '06. It was a difficult thing for us at back to school and even through the Christmas season. So, memory has freed up.

We are concerned, though, that memory is going to go up and down in terms of availability during that timeframe. Processes were stable during the quarter. So nothing significant there. Hard drives were stable. There could be some tightness with hard drives as we go up in the first calendar year quarter of 2007 because there are some technology transitions in there. We expect some modest price erosion in panels, but again, there is some supply tightness in panels too. So memory has been a little bit of a change in that we are able to get a little more than we were. In the other spots, I would say roughly stable and a bit of concern.

Operator

Richard Farmer, Merrill Lynch.

Richard Farmer - *Merrill Lynch - Analyst*

Cathie and Mark, I just want to make sure I understand the curtailment and more broadly the financial effect of the headcount reductions both from the curtailment but also the anniversary benefit from your prior restructuring.

On the pension curtailment, I understand you expect roughly the $500 million gain to be offset by the expense of the employees leaving. But wouldn't that put the run rate of the savings significantly higher than the $0.01 to $0.02 benefit I think I heard you describe?

And then on the restructuring anniversary, I understand you are done with the actions, but you're still going to be comping on much higher cost orders from last year. So shouldn't we think of that as being roughly $700 million of gross savings from that original plan in 2007 over 2006 in terms of operating income growth? So combined, what I am asking is, what is the total effect year-over-year of the headcount change of the thing?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

First, we are going to send the Investor Relations discipline police after you for breaking the multiple question in a conference call rule. But given that, let me try to first tackle the new announcement that we've got.

First, do not assume that these jobs are eliminated. So, in many cases, when you establish one of these, Richard, you cannot pick and choose where you offer the program. So you have to offer it in a broad way. So we will have people in multiple functions across all of HP that may take advantage of this program. Many of those jobs will be replaced. So there will be a replacement factor. Will those jobs be replaced with a potential cost savings? Potentially.

And so what we have tried to do is model the timing of the replacement and the different cost structure of the replacement relative to the current situation that we've got, and that's what you see modeled out. So I think to your point, this is a one-time in and out from a gain perspective and then payment from the EER. The cash flow from this, of course, as Cathie mentioned, comes directly from the pension plan itself. So it has no categories to create, and it is beginning to have an impact for us.

So it isn't all just netting. There is some better situation from a cost structure perspective than we had in 2006, and I concur with your points there. But there also is some offset as it relates to reinvestment bank and demand creation.

Operator

Katie Huberty, Morgan Stanley.

Katie Huberty - *Morgan Stanley - Analyst*

Mark, how are you thinking about printer margins given you are above your target range for the past two quarters and can clearly afford to invest even more into new products and pricing going forward?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

I think you are right. We think about this a lot, and we're trying to make sure we are appropriately looking at this unit growth. And for us, unit growth is really a key in the consumer segment, and so we're trying to make sure we're going after the high usage segments in the appropriate markets.

One thing to be cautious of that our emerging market supplies connect is a little different than our mature market supplies connect with counterfeiting and fraud and some of the things that go into some of those markets so we need to factor that in. Secondly, we have some very important adjacencies, like the Enterprise market that we're trying to invest in, and we're trying to do all that at the same time that we deal with the short-term and optimize those margins.

So, I really think the team at IPG has done a pretty nice job of focusing on its cost structure, focusing on the short-term unit growth and then the supplies connect in relationship to that, and then at the same time investing in some of these adjacent markets that we think make sense. So I think right now we think of our range being roughly right and continue to stay in that range. But to your point, if we have opportunities, we will accelerate our ability to get after some of these incremental opportunities.

Operator

[Tony Sakanogi], Bernstein.

Tony Sakanogi - *Bernstein - Analyst*

I had a question about gross margin percentage. Over the last two quarters, it's gone down about 100 basis points sequentially due to -- on a GAAP basis. But I think you had commented that Mercury would add about 50 basis points to gross margin. So, it has actually gone down 150 basis points over the last two quarters, and mix alone certainly doesn't explain it. PCs are only 3% higher as a percentage of total during that time period. So I don't think that's the answer.

The question is, what is really driving the, I think you called them rate changes in gross margins? Are these conscious steps for you to drive revenue, or is the competitive environment getting tougher?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Tony, we feel pretty good about our gross margin rate. We're up 50 basis points year-over-year in our performance. We have a strong PSG component to your point, which is a big driver. So I know the numbers pretty well, and that is the majority of the driver.

Now, you have some compares you've got to be careful on the supplies connect, which get back to a different mix issue as it relates to the Q4 sequential compare. But overall, when you look at it differently than at the Company level, segment by segment and break it down into those various pieces, the continuity of gross margin rates I would say roughly right, no material change in gross margin rate on a segment by segment basis.

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

So, one of the rate benefits also, Tony, that we're getting is that we really got an uptick in supplies in the mix. So, in Q4 we had a relatively weak supplies position, and in Q1, it is much (technical difficulty).

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

The question is coming back to the cash flow. As I look at the cash flow statement, I think a lot of the things are pretty apparent based on both the outline of what you guys provided, but one of the categories I'm a little unclear of was the use of cash of $1.5 billion of other assets and liabilities and just would love to get a better sense of that and incorporate that within the sense of what kind of snapback we should expect in cash flow over the next several quarters.

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

So, that 1.488 billion was made up of a number of items. Certainly it includes our bonus payment, but it also includes that payables and receivables that, frankly, went against us this quarter, as well as some vendor rebates that were the (inaudible) as well they were up quarter-over-quarter.

Harry Blount - *Lehman Brothers - Analyst*

So, as we take a look at that number then, what you are saying is a lot of those were onetime items that we should not be recurring in the future quarters other than the bonus payment periodically?

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

So, again, those other items -- the VAT receivables and payables, as well as the vendor rebates receivables -- they go up and down with the business. So it's very hard to predict those. It really depends on the cut-off on a particular quarter. So then the bonus payment is well once a year.

Operator

Keith Bachman, Banc of America.

Keith Bachman - *Banc of America - Analyst*

I wanted to follow up on the gross margin comment, and Mark, just to get your perspective, or Cathie, as we look out over the next few quarters in the context of the guidance you've given, how would you anticipate the gross margin trends on a year-over-year basis? Are they going to remain roughly flattish? You have some tougher comps coming up with April and July of last year where you had pretty good supplies numbers. Just how should we be thinking about the gross margin trends as we look out, say, the next three quarters? And then, Cathie, you kind of faded out on the last answer. I'm not sure what happened there vis-a-vis the mike.

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

Sorry about that.

Keith Bachman - *Banc of America - Analyst*

No worries.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Let me make sure the last answer I think was pretty important. The bonus payment is a non-recurring payment from Q1, Q2 and Q3, so it is a true-up, so to speak, at the end of Q4. It is netted out of our income statement, but the cash hits all at one time.

So, just back on that too, we had modeled this pretty close to what had transpired from a cash flow perspective going into Q1. We were a little light because of the inventory positions we took, but we felt pretty good about that as well.

On gross margin, Keith, I think your point is right. This is all about mix. There is no segment change of consequence in absolute gross margin.

Now, to be very clear with you though, Keith, it will depend on what happens in the market. I don't want to predict for you how the market will behave as we go into the next future quarters. We certainly improved our position to the point that we have more flexibility to do various things in the market as you can see by the numbers we are producing. So, I can't predict for you how that pricing behavior and that market behavior will occur. But given current course and speed, no extraordinary changes -- we are not seeing any change in gross margin behavior by segment. So, it will come down to a mix issue and to what those mix numbers look like in the quarters ahead.

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

I would just add that Q2, of course, with the supplies percentage improving, which is normal seasonality for us, you would see some increase in gross margin in Q2.

Operator

Andrew Neff, Bear Stearns.

Andrew Neff - *Bear Stearns - Analyst*

My question is just on acquisition strategy. You have the acquisition obviously of Mercury. Do you have a sense about your thoughts, Mark, as you look forward -- are you interested in doing more acquisitions of this size? Can you talk about what area would it be in and what criteria -- just your general thoughts? How should we think about that?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Well, I think we've done some acquisitions as you know, but we are pretty aligned around this strategy that says we're not going to do anything that is not strategically sensible that financially makes sense and that we can operate the acquired property effectively. And while I know there are rumors that go on in the marketplace which occur, we take a pretty disciplined view toward this stuff. We do look at most of the properties that are out there like anybody does, but we're going to be very disciplined about what we do, and it's going to have to make sense across those three criteria.

So, again, I think we will never say never to anything, but you should expect us to do pretty much more of the same in an acquisition of the Mercury class to be more a rarity as opposed to a commonplace kind of activity.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Just a quick question about on what's going on with Kodak and its inkjet strategy. Mark, I am just curious as to your thoughts on their idea of taking down hardware -- well, taking up hardware prices and down the ink prices in order to be more competitive and gain share.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Well, I mean it's an interesting concept. We hope hardware prices go up, so that would be great. We would sign up for that and be glad to participate in that. And again, I think we like our position, Shannon. We've got a very strong position. You've seen it strengthen over the past quarters. We think we are in a great position from an innovation and a technology perspective, from a channel of distribution perspective, and we're going to continue to be very focused on our cost structure. So again, back to the earlier questions that we have had, we have flexibility to participate in any way that makes sense and is appropriate in the marketplace.

So, with that said, competition is great. I hope it will make us even sharper.

Shannon Cross - *Cross Research - Analyst*

But, no plans to follow them down in pricing in the near-term, though?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

No, I think in the end we will see what happens, but we really like our value proposition. We like our position, and we went to expand on it. Of course, there are other competitors out there other than the guys you mentioned. So we are also focused on them because there are some strong competitors in that market that we want to make sure we're doing our job.

Operator

Bill Fearnley, FTN Midwest.

Bill Fearnley - *FTN Midwest - Analyst*

Just one other follow-up if I could on the inventory question. Will this require additional promo spending MDF investments or price cuts to move the inventory through, and then when should we be looking for the improvement? Do you see dramatic improvement in the second quarter, or is this a second quarter to third quarter phenomenon? Thanks.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

No to your first question, Bill, in terms of all that. We feel good about our channel inventory, the freshness of it and feel good about what we did from a component acquisition perspective, and we look to improve our cash flow in Q2. So, we are looking for pretty immediate position here, and we feel good about what we've done.

Operator

Louis Miscioscia, Cowen.

Louis Miscioscia - *Cowen - Analyst*

It definitely seems like you gained a significant share in certain areas, so maybe you could give us a couple of comments on how you are viewing tech demand I guess both in the first half and the second half, and maybe if I could throw or sneak another one in there. Do you virtualization possibly affecting server business in the second half?

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Well, I think you know in the end, I guess I would say overall we see it okay. Demand is steady. The issue always is there are stories within the story. We felt much better about the situation in Europe, to be very blunt with you. Europe, we saw some good strength across a number of different dimensions, across a number of different markets in Europe in the quarter, which was encouraging.

We continued to watch the US consumer, and I think I said that for several quarters. The consumer has been strong, and we continue to watch that, and I can't give you anything more specific than that. I think the US enterprise is a place that we have always had some concerns, and I don't think that is a virtualization so much of an issue as it just is that people are being prudent with their spending now.

At the same time, as you've seen that, we are clearly gaining share. So we sometimes have to modulate what is the difference between our share gain and the macro demand environment. So we feel very good about our position, but we continue to monitor it. So I gave you a lot of data there other than to say overall I would say steady, but there clearly are stories within the story.

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

Okay. We'll take two more questions, please.

Operator

Dan Renouard, Robert W. Baird.

Dan Renouard - *Robert W. Baird - Analyst*

Just on the Enterprise side, Mark, you alluded to again putting more resources to work in the field, and of course, that is an easier said than done kind of proposition. Maybe you could just give us a couple of tangible examples of some things that you have done where you've seen some success that you expect will help pay off over the next several quarters or years.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

We have done some hiring. So clearly we have accomplished much of the hiring that we indicated that we would last year. To be very open with you on this thing, we just don't cover enough accounts, and so while we're covering more than we were, we don't cover enough. I am a strong believer that there is more demand for Hewlett-Packard in the marketplace than we are currently getting. We do not cover enough accounts. That is part of the reason that we have to get our cost structure right, and we have to get it right as fast as we can so that we can get to the market and compete for more business. I believe there is an opportunity for us.

Now to your point, we can't do this in 15 minutes. It takes time for us to source. We can't hire -- we have to hire great people. Then we have to train them. We have to get them assimilated to HP and get them into territories where they can go out and compete. At the same time, we need help from our partners because they can help us close the gap by covering more accounts as well.

So we're doing a lot of work here, Dan, on the total available market because we think there's an opportunity for us that plays out in later years with us being able to capture more share.

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

We will take one final question, please.

Operator

Our last question comes from the line of Chris Whitmore, Deutsche Bank.

Chris Whitmore - *Deutsche Bank - Analyst*

To follow up on that last question, I was hoping to get more caller on the weakness in high-end servers and high-end storage, probably the one blemish from a marketshare standpoint. What is the underlying driver of that share loss, and related to that, can you speak to the sustainability of margin improvement in that segment given the mixed downmarket? Thanks.

Mark Hurd - *Hewlett-Packard - Chairman & CEO*

Sure. I think storage is kind of a more complicated story, so I will start with that. Our EVA line, which is kind of our flagship mid-range line, grew 18%. So that was good performance for us, and so we felt good about EVA in the quarter. That was pretty well true across regions and segments. So very strong performance there.

We saw poor performance in tape, and you know, tape is the older part of the business. It is still a substantive part of our business, and tape declined faster than we would like. So, it's kind of a mix story that you've got to get into the piece parts and understand. So we feel very good about EVA. We think we could do better even though in EVA and some other parts of the core storage business.

In the business critical line, which is the higher end stuff, I actually think that's a different story than storage. And there, we just had a weak quarter. And I can't be any clearer with you than, I am just disappointed and we can do better than we're doing. And part of it is aligning our demand better, and we had some deals that slipped. I can tell you a whole set of long, sad stories but don't think you would have time nor care. We just need to do better. That's about as simple as I can make it.

Okay. With that, we are going to close up, and listen, first, thanks for your questions. I know we had a lot of data to put out today, and I can imagine it's tough as we raise our guidance and do this pension curtailment, etc., etc. But let me try to summarize today's call by saying that we had a solid quarter characterized I think by solid revenue growth, share gains in key businesses, expense discipline and margin expansion.

In addition, as we mentioned, we had 2.7 billion of share repurchase. We did this while continuing to make progress in our cost structure by substantially completing our restructuring program, executing the integration of Mercury and continuing to strengthen our solution portfolio with additional acquisitions and making further progress in our strategic initiatives that will strengthen HP's long-term competitive positioning. Given the solid fundamentals of our business, I'm pleased that we are increasing non-GAAP EPS guidance for the sixth consecutive quarter.

I want to make sure you're not confused, though. We know we have a lot of work ahead of us, and I have said before we are transforming the Company; we're not transformed. And we need to continue to execute against our cost reduction programs. We need to realign our costs to invest more in marketing and field selling costs. We need to invest in great technology and bring compelling solutions to the market that we service better than anybody else on the planet. And we need to do a better job on inventory management and return with the kind of solid cash flow that you should expect in the second quarter.

So all-in-all, we have a lot of work to do but lots of opportunities as well. I think it's a solid start to the year, and I am confident that we can continue to execute with discipline and deliver a year of strong financial returns. Thanks.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. That does conclude today's presentation. You may now disconnect.