FINAL TRANSCRIPT

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HPQ - Q2 2007 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Hewlett-Packard 2007 second-quarter earnings conference call. My name is Letitia, and I will be your coordinator for today. At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. (OPERATOR INSTRUCTIONS). As a reminder, this conference is being recorded for replay purposes.

At this time, I will turn the presentation over to Jim Burns, Vice President of HP Investor Relations. Please proceed, sir.

Jim Burns - *Hewlett-Packard - VP of IR*

Thank you. Good afternoon, everyone. I would like to welcome all of you to our second-quarter earnings conference call. Joining me today is our Chairman and CEO, Mark Hurd, and CFO, Cathie Lesjak.

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

Next, it's my duty to inform you that the primary purpose of this call is to provide you with information regarding the second fiscal 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 Quarterly Report on Form 10-Q for the fiscal quarter ended January 31, 2007, and 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, reflect 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 first quarter ended April 30, 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 purchased intangibles, restructuring charges and net pension curtailment gains or losses. A presentation of GAAP financial information for the second quarter and fiscal year to date and a reconciliation of non-GAAP amounts to GAAP are included in the tables accompanying today's earnings release, which is also available on the HP Investor Relations web page under Company Information at www.hp.com

Finally, and with a view to allowing time for questions from multiple firms, please refrain from asking multipart questions or clarifications.

With that, I will turn the call over to Mark.

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

Thanks. All that just so we can tell you the results. Good afternoon and thanks for joining us. HP delivered a strong second quarter. We had solid revenue growth, share gains in key businesses, expense discipline, margin expansion, record cash from operations and significant share buybacks. While we continued to invest in the long-term health of our various businesses, we drove further operating margin improvements across the Company, with a year-over-year operating profit increase of 68% in the Personal Systems Group, 36% in the Technology Solutions Group and 12% in the Imaging and Printing Group.

Financial highlights of the quarter include revenue growth of 13% year over year or $3 billion to $25.5 billion -- this represents our highest growth rate since 2000 and brings our year-to-date growth to $5.4 billion; year-over-year operating margin expansion in all of our nonfinancing businesses, with Personal Systems margins of 4.8%, Imaging and Printing margins of 16.3%, Enterprise Storage and Server margins of 8.8%, HP Services margins of 11.1%, and HP Software margins of 8%; non-GAAP operating margin of 9%, up from 8% in the prior-year period; non-GAAP EPS of $0.70, up 30% when you exclude a $0.15 favorable tax item in the prior-year quarter; $4.2 billion of cash from operations; $4.2 billion of share repurchases.

While posting these strong second-quarter results, we continued to deploy our capital into longer-term strategic initiatives that will strengthen Hewlett-Packard's competitive positioning in the market. We are investing heavily in our real estate and data center consolidation programs to significantly improve our cost structure in future periods. We made a number of acquisitions that extend our existing technology solutions to new markets and to new customers.

Turning now to the business segments and the second-quarter results, Imaging and Printing had a strong quarter. Revenue grew 6% year-over-year to $7.2 billion, with supplies revenue growth of 10%, revenue and commercial hardware up 3% and consumer hardware revenue down 2%. Total printer hardware units grew 11% year over year, driven by commercial printer hardware unit growth of 21% and consumer printer hardware unit growth of 7%. Commercial hardware shipments continue to be led by our strong lineup of printer-based MFPs and color laser printers, which grew 40% and 19%, respectively.

HP Indigo Press printed page volume continued to show solid growth, up 43% over the prior-year period. Supplies revenue grew 10%, which helped us drive IPG operating margins to 16.3%. This is the highest in 10 quarters. And while we are pleased with this bottom-line performance and may achieve this level of margin from time to time, on balance we expect operating margins to be in the 14% to 15% range that we have guided as appropriate for this business.

We'll continue to execute our strategy of leveraging the strength of our core printing business to aggressively invest in our growth initiatives, which we expect will extend our printing leadership into new markets. For example, in the second quarter we began shipping our Edgeline-based departmental MFPs and expanded our portfolio of business inkjet products, demonstrating our ability to scale our printing technology across multiple segments and categories.

Moving now to Personal Systems, which had an outstanding quarter, with excellent revenue growth, market share gains and strong margin performance, revenue growth 24% year over year to $8.7 billion, with unit shipments up 30% and double-digit revenue and unit growth in every region. Consumer demand for our products remains strong, with consumer client revenue up 41% over the prior-year period, driven by notebooks as we continue to take advantage of the market shift towards mobility and the strength of our retail channels.

Overall, notebook revenue grew 45% over the prior-year period, with double-digit growth in consumer and in commercial notebooks. Revenue in desktops grew 9% year over year, while revenue in workstations grew 19%. Our top-line momentum continues to drive market share gains, and according to the preliminary first calendar quarter data, HP grew units 2.5 times the market rate, extended its leadership position and gained share across each region.

While achieving these top-line and shipment results, segment operating profit was a record $417 million or 4.8% of revenue, up from 3.6% in the prior-year period. On a year-over-year basis, PSG grew operating profit $169 million, the largest increase of any of our segments. We will 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.

Moving now to the Technology Solutions Group, enterprise, storage and servers grew revenue 8% year over year to $4.6 billion. Operating profit was $407 million or 8.8% of revenue, up from 7.5% in the prior-year period. We had a strong quarter in industry-standard servers, with revenues up 17% year over year and share gains in every region.

Within industry-standard servers, we continue to show strength across server blades, with second-quarter revenue up 58% over the prior year. We expect these blade results will drive significant share gains for the quarter and extend our leadership in this important product category. In the future, we will also include Integrity and storage blades in our blade results.

Revenue in storage grew 1% year over year. Weakness in tape on the high end was offset by ongoing strong performance of our flagship mid-range EVA external array business, which grew 10% versus the prior year, recording the 10th consecutive quarter of double-digit growth. Based on preliminary data, we believe EVA will gain market share with these solid results.

Business-critical systems revenue decreased 6% year over year. We continue to see strong Integrity momentum, with revenue growth of 60% over the prior-year period. In the second quarter, Integrity represented 61% of business-critical systems revenue, and that is up from 36% in the prior-year period. Integrity momentum was offset by ongoing declines in PA risk and in alpha.

Across ESS, we continue to take leadership positions in the fastest-growing segments of the IP industry. We're building our operating model and aligning our resources to take advantage of these market shifts, which we believe define the future of IT and the next-generation data center.

We had a solid quarter in HP Services, with revenue growth of 7% over the prior-year period to $4.1 billion. On a year-over-year basis, outsourcing services and consulting and integration grew 12% and 8%, respectively. Revenue in technology services grew 3% year over year. HP Services delivered operating profit of $459 million or 11.1% of revenue, up 2.2 points year over year or an increase of $114 million. We achieved these results while continuing to make investments that we expect will improve our unit cost of delivery, increasing the standardization and automation of our service offerings and improving our competitive position. We are making good progress, but we have more investments to make and more work to do.

HP Software revenue grew 58% over the prior-year period to $523 million, led by strong growth from the businesses acquired in our purchase of Mercury Interactive. On a year-over-year basis, HP OpenView grew 6%, excluding Mercury, and HP OpenCall declined 13%.

HP Software reported an operating profit of $42 million or 8% of revenue, up from a profit of $3 million or 0.9% of revenue in the prior-year period. Second-quarter results include integration charges from the Mercury acquisition, which offset solid operational performance. We have worked our way through -- about through half the acquisition-related charges we expect to incur in fiscal year '07. HP Software performed ahead of plan, and I'm pleased with our efforts to date and the contribution of our integrated management team.

HP Financial Services revenues was $550 million or up 6% Year over year. Volume and net portfolio assets increased 8% and 6% over the prior-year period, respectively. Operating margin was 6.5%, down from 7.5% in Q2 of last year. The year-over-year margin decline reflects a decrease in net recoveries from bad debts relative to the prior-year period. We're encouraged with the growth in financing volume over the last several quarters and are focused on continuing volume momentum while balancing portfolio risk.

I will conclude my segment comments by reiterating that we had a strong second quarter across the portfolio. As a company, we are executing on the plans we have laid out, delivering on our commitments to customers and investors and effectively balancing our growth, investments and cost reduction opportunities. With that said, I don't want to confuse you. We're still transforming. We're not close to being done. We have many cost reduction opportunities. Let me give you an example about one.

We look at costs as everything between revenue and operating profit. As a result, we have a lot of costs. Our overhead costs, which is a piece of that cost, which includes IT, real estate and corporate support functions, will decline more from the beginning of fiscal year '07 through fiscal year '09 than they have from fiscal year '05 and fiscal year '06, decline more in dollars. And as we continue to scale our businesses even more on a cost per unit basis, we have more work to do, but we're not confused about what we need to do. We will get this cost out and we will continue to focus on growth at the same time.

With that, I will turn it over to Cathie.

Cathie Lesjak - *Hewlett-Packard - CFO*

Thanks, Mark, and good afternoon, everyone. As Mark just indicated, Q2 was a strong quarter for Hewlett-Packard, and I'm pleased with the Company's performance. Today I will walk you through our Q2 financial results, beginning with our view of the total Company income statement.

Revenue of $25.5 [billion] for the quarter was up 13% year over year or up 10% when adjusted for the effects of currency, which is within the guidance issues last week. On a contribution basis, Personal Systems contributed to the strong revenue growth. We also saw broad strength in our key focus areas, such as supplies within Imaging and Printing, HP Software, industry-standard servers within Enterprise Storage and Servers, and consulting and integration and outsourcing within HP Services.

On a regional basis, revenue was up 11% in the Americas, up 14% in EMEA and up 16% in Asia-Pacific. When adjusted for the effects of currency, revenue was up 11% in the Americas, 7% in EMEA and 13% in Asia-Pacific.

Second-quarter gross margin was 24.5% of revenue or down 30 basis points from a year ago, reflecting the revenue strength in Personal Systems and the mix shift to our Integrity and ProLiant platforms in Enterprise Storage and Servers. This was partially offset by the revenue strength in HP Software. Sequentially, gross margin improved 80 basis points over the previous quarter, reflecting normal seasonal patterns in Imaging and Printing, favorable component pricing in Personal Systems, and lower service delivery costs in HP Services.

Non-GAAP operating expense totaled $3.9 billion for the quarter or 15.5% of revenue, down 130 basis points from a year ago and up 40 basis points sequentially. In dollars, operating expenses were up 4% year over year. However, adjusting for currency and acquisitions, expenses were down approximately 2% year over year. We continue to optimize our cost structure as we are reinvesting the savings from our cost reduction programs into our growth initiatives such as hiring of sales resources and demand generation.

Sequentially, expenses were up 4% in dollars, reflecting normal seasonality, which includes the implementation of our annual salary adjustment effective February 1. Non-GAAP operating profit was $2.3 billion or 9% of revenue, up $508 million year over year and up $143 million sequentially. Non-GAAP OI&E was $100 million or roughly $0.03 per share after tax, which is in line with what we have guided for the quarter.

Our non-GAAP tax rate was 20% for the quarter, again at our guidance. Consistent with our updated guidance, second-quarter non-GAAP EPS was $0.70, up from $0.69 in the prior period or an increase of 30%, excluding the $0.15 one-time tax settlement gain in Q2 of '06.

GAAP EPS was $0.65, which included $145 million or $0.05 per share in after-tax adjustments that were not included in our non-GAAP results. This includes amortization of purchased intangibles, restructuring expenses primarily associated with the 2007 enhanced early retirement program, and a pension curtailment gain primarily associated with freezing our U.S. defined benefit pension plan.

Now some comments on our cash balance and cash flow -- cash flow from operations and free cash flow achieved record levels in Q2. Cash flow from operations ended the quarter at $4.2 billion and free cash flow was $3.6 billion. Capital expenditures related to our investments in IT and real estate facilities, as well as growth in operating leases within our financing business. During the quarter, we also had a net cash outlay of $372 million for acquisitions.

Q2 share repurchases totaled $4.2 billion. We repurchased $2.2 billion of shares in the open market and completed the prepaid variable share purchase program with the receipt of the final 6 million shares. In addition, we entered into an accelerated share

repurchase program for $1.8 billion. In total, approximately 100 million shares were acquired during the quarter. In Q2, we also paid $213 million for our normal dividend.

We closed the quarter with total gross cash of $12.3 billion, down from $14.1 billion last year and up sequentially from $10.4 billion. Net cash was $4 billion, down from $9 billion last year and $4.6 billion sequentially.

Regarding capital expenditures, we continue to expect gross and net CapEx to trend above fiscal 2006 levels due to the increase in mix of operating leases in our financing business, the buildout of our data centers and the deployment of capital to consolidate and upgrade our real estate facilities.

Moving now to the balance sheet, HP-owned inventory came in at $7.3 billion, down $1.1 billion sequentially and up $510 million year over year. Inventory days of supply stand at 34 days, down five days sequentially and down two days from last year. We're comfortable with our owned inventory position.

With regard to channel inventory, we exited the quarter in good shape. Personal Systems ended the quarter with approximately four weeks, which is flat versus the prior year and down one week sequentially as we fulfilled the retail demand of the Vista launch. Enterprise Storage and Servers ended the quarter at roughly four and a half weeks, up about a half a week year over year and flat sequentially. Imaging and Printing ended the quarter at roughly five and a half weeks, up about a half a week year over year and flat sequentially.

Trade receivables ended the quarter at $11.6 billion, up $1.8 billion year over year and $1.2 billion sequentially. DSO now stands at 41 days due to our revenue linearity, up from 39 days in the prior-year period and up from 37 days sequentially.

Next, property, plant and equipment was up $988 million year over year and $294 million sequentially at $7.3 billion. Gross CapEx was $758 million, up 45% year over year and up 6% sequentially. On a net basis, CapEx was $597 million, up 49% year over year and up 3% sequentially. The year-over-year increase in CapEx continues to reflect the incremental investments in IT, real estate facilities, as well as increases in financing assets. Net PP&E as a percentage of revenue now stands at 7.6% of revenue, up from 7.2% year over year and 7.5 sequentially.

Regarding accounts payable, days payable closed the quarter at 54 days, up from 53 both year over year and sequentially.

I would like to now follow up on the announcement we made in our last quarterly earnings call with regards to our decision to both freeze the U.S. defined benefit pension plans and to offer an enhanced early retirement program to eligible U.S. employees. We have now implemented these programs and are pleased with the success. Approximately 3000 U.S. employees participated in the program, of which roughly 20% were included from prior restructuring programs. These employees will leave HP by May 31.

The results of these actions are reflected in our GAAP results, which include approximately $500 million of a curtailment gain, primarily as a result of freezing our U.S. defined benefit programs, and approximately $400 million in restructuring charge. Keep in mind that the cash used to fund the enhanced early retirement program will be funded primarily from pension plan assets, and as such we do not expect any short-term impact on our cash flow from operations.

Finally, a few comments on our outlook before we take your questions. We expect third-quarter revenue to be approximately $23.7 to $23.9 billion, growing roughly 8% to 9% year over year, as we have previously guided.

On a constant currency basis, revenue typically declines sequentially as Q3 is seasonally our weakest quarter. While the sequential decline implied by our guidance is greater than the historical 3% to 5%, we do not believe it is prudent to [vet] investor expectations that our Personal Systems business can continue to grow 2.5 times the market rate, nor do we think it is appropriate to build a cost structure on that basis.

For the full fiscal year, we now anticipate revenue within the range of $100.5 to $100.9 billion, up from our prior guidance of $98 to $99 billion.

Regarding earnings, there are many variables you need to keep in mind. With regard to the pension plan changes and our early retirement program, we have included approximately $0.01 to $0.02 benefit to non-GAAP earnings for the second half of FY '07, consistent with the guidance we gave last quarter, reflecting the timing of replacement and to a lesser extent, any labor cost arbitrage.

Next, as part of our ongoing business operations, we expect to have workforce rebalancing in Q3 as we continue to optimize our cost structure. As previously communicated, these activities are considered part of normal operations and will be included in our business segment results. Our Q3 and Q4 guidance reflects approximately $0.02 per quarter in earnings per share associated with workforce rebalancing as we continue to adjust our cost structure.

We expect Q3 non-GAAP OI&E to be about $0.04 for the quarter and $0.07 for the remainder of the fiscal year, in line with our previous guidance. In addition, we expect a non-GAAP tax rate of approximately 20% for Q3 2007 and full fiscal year 2007. Per our previous guidance at the December securities analyst meeting, we expect the tax rate in FY '08 to increase to 21%.

Finally, we expect to continue to repurchase shares in the coming quarters. Of the $8 billion share repurchase authorization approved by the Board on March 15, 2007, we have approximately $7 billion remaining. Share count will be impacted by the share price trends, option exercise patterns, common stock equivalents, and of course, our repurchase activity. At this stage, we expect a modest decline to the remainder of fiscal 2007 from current levels.

With this in mind, and recognizing our ongoing investments in demand generation, salesforce hiring, etc., we now expect Q3 '07 non-GAAP earnings of approximately $0.64 to $0.65, representing 23% to 25% growth year over year, and full-year FY '07 non-GAAP EPS of $2.75 to $2.77, up from our prior guidance of $2.50 to $2.55.

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

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

Thank you, Cathie. We will start taking questions now.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Richard Farmer, Merrill Lynch.

Richard Farmer - *Merrill Lynch - Analyst*

Mark and Cathie, I'd like to ask a question about your gross margin -- trying to separate out the mix effects from the rate. In other words, if you separated out the effect of the mix shift in your revenues, especially towards PCs, and if we just looked at the aggregate apples-to-apples gross margin rate without that mix shift, can you comment on the trend in your gross margin in the quarter on that basis?

Cathie Lesjak - *Hewlett-Packard - CFO*

The gross margin year-over-year change is really all about mix. So there's not only the PC mix that puts a damper on gross margin, but also the trend that we have been seeing for some time now towards our ProLiant and our Integrity lines. There is a small -- there is an offset to that, although it is only partial, and that is in the improved revenue position of HP Software. So it is really impossible to separate out mix effects to get an apples to apples, since the effect is almost entirely mix.

Richard Farmer - *Merrill Lynch - Analyst*

So should we presume, then, that apples to apples, segment by segment, there weren't any significant rate improvements or downward trends in gross margins that --

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

Richard, the only place -- you have got to be careful in HP Services because most of their costs creates a margin. So when you see an operating margin, most of that gets affected by gross margin, right? So that is the one place you would want to be cautious. In the product segments, which is I think what you are trying to get at, when you looked at below the reported segment level, generally speaking, it is just all mix that drives it. And like anything, Richard, there are stories within the story. But at the HP level, it is a mix story -- that is the driver.

Operator

Laura Conigliaro, Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

On the printer side, overall printer unit growth was the lowest it has been in the last four quarters at 11%, with a particularly steep drop on the consumer side. Why should we expect this to lead to slower supply growth in a quarter or so -- a couple of quarters?

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

We will see how it goes, because within supplies growth, it is dependent on not just the printer growth, but the mix of the printer growth, what segment it comes from, what geography it comes from, etc. So I could give you a lot of complexity around it. But again, listen -- I remember the days when 11% unit growth in a quarter in IPG was one of our hopes and dreams. So the fact that it wasn't 17 or some of the numbers you have seen in the past, 11% is very healthy, and we're sure it is going to be a share-taking kind of position, or we think it will be, based on the numbers we are looking at. So we will see what happens on the supplies connect and how it lays out, but again, I would say 11% -- pretty strong number for IPG.

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

A question also related to the printing segment. You clearly were above, as you indicated on your comments, target margins. Can you help us a little bit in understanding whether that upside was principally related to better than expected supplies growth

versus your plan? Or was that related more to an underinvestment in some of the other targeted areas that you're looking at for future growth? And a little expansion on that would be great.

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

Sure, I will give you here -- it is like anything, I can't say yes to any of your questions, because it is a combination of the above. We have certainly got an objective. As you know, we see a lot of revenue opportunity for us in some adjacent segments. As has been discussed previously, publicly, we think there are segment that we can do a better job from driving growth. And we're investing into those segments as we go, and some of that is the timing of investments.

Some of it isn't just whether it is supplies, but it is actually the mix that occurs within it, because we get some different numbers, depending whether it's toner, whether it's ink, etc., as we go, and some of it also comes into the mix -- the hardware. And it was just one of those situations where all the dials spun so that the operating margin came a little bit higher.

My comments in my script were mainly around the fact that we're still going to pursue the investments that we think eventually drive significant growth for us, that we think can help the overall health of the business. So that dial we will get right. We will see, to Laura's earlier question, what happens with the unit growth and the mix as we go forward.

Cathie Lesjak - *Hewlett-Packard - CFO*

And I think it is also important to realize that Q2 is typically our strongest quarter for our printing business. So we would expect that Q2 would come normally a little bit above our range for the year.

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

And I'll give my last qualifying comment on top of that, that Q3 is usually our seasonally weakest quarter. So I think that the combination of the two is probably a little bit there as well.

Operator

Ben Reitzes, UBS.

Ben Reitzes - *UBS - Analyst*

Mark, really good cash flow in the quarter, higher than we expected. Can you talk about how you are tracking versus the goal you said in your analyst day of having free cash flow of about $7.9 billion or close to $3 a share in the year, and then how that flips back to your buyback decisions and/or acquisition decisions?

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

Listen, we feel good about certainly cash flow from operations. We set a goal early in the year and we talked about that. We have no change in our view of cash flow from operations on an annual basis. We will continue to look at the potential investments that we can make as it relates to buyback. We have tried to signal we are very positive on our shares, and so we were active in the market in Q2 as it related to share buybacks. We continue to evaluate everything from a capital strategy perspective against buying back shares versus making an acquisition that can lead to, we think, longer-term health of the business.

So we think we have got a very sharp capital strategy that takes into consideration that we're making the best use of our cash. We expect to produce more cash, as we have described. And we expect to use it against the capital strategy that we have laid out.

Operator

Andrew Neff, Bear, Stearns.

Andrew Neff - *Bear, Stearns - Analyst*

Nice quarter. Two things, I guess one thing, maybe if you don't answer that, there will be a second thing, is can you talk about -- do you want to give any thought at this point to how '08 can shape up at this point -- you've talked about the end of '07 -- in terms of any metrics, in terms of -- you've talked about growth metrics before, margin metrics, you talked about some of the expense savings -- can you give any thoughts on that? And if not, can you also give us a thought on what you would tend to do on the printer margins? Do you want to get back to 13% to 15%, and how do you expect to go about doing that?

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

I can't let your question go by about have I given any thought to '08, so just want to make sure -- look, have I given any thought to '08? I think about it, like, a lot. And I think about '09 a lot, and I think about 2010 a lot. So do I think about all that a lot? Yes, I do. Am I giving guidance for '08, which I think is really what you're trying to get to? No. So those are two separate answers, but I wanted to make sure I bifurcated the questions. So yes, we think about everything we do in the context of not just short-term delivery, but actually long-term health and long-term delivery of performance for the Company.

In terms of where we are headed from an IPG perspective, we have given out more of a 14 to 15 range, and I think that is an appropriate place for the business to be. And I think, to Cathie's point, you're going to see some seasonal differences in performance in the business, and some of it is going to relate to investment. Some of it is going to relate to our opportunity to take unit share as it relates to high-usage segments. Some of it is going to relate to where we are in emerging markets. Some of it is going to relate to our investments in adjacencies. I think, though, when you Rubik's Cube all that together, we think the operating margin targets that we gave are where we are going to land.

Operator

Toni Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

I had a question about software. I was trying to triangulate growth rates with what Mercury was doing as a stand-alone company. Your software grew about $190 million year over year. And it sounds like the legacy software, OpenCall, OpenView, was about flat. But Mercury was doing about $215 to $225 million a quarter last year in the first half as its run rate. So is the core Mercury business -- so the implication would be that the Mercury business actually shrunk. Can you try and reconcile the data points? Am I missing something? Was something reallocated in terms of how you account? Or how do we attribute what seemed to be pretty positive comments about your software business with those data points?

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

You are on some good points here. And I was all geared up for a currency question, too. So I'm disappointed because I've done extra homework. But that said, in software, you've got some points. First of all, Mercury was excellent, so Mercury was double-digit growth. Operating performance was what we expected. I won't go into more detail than that -- or better. So Mercury was solid.

OpenView growth was 6%, as we described I think in the script.

In OpenCall, which was down 13%, we actually have some hardware that was in OpenCall that we now don't report in the software business. It is not material enough to get into as it relates to the segments, but on a number of the scale you are talking about, it can throw off the metrics a bit.

But to get to I think the core of your question, Mercury was strong. OpenView was 6% growth in the quarter. And OpenCall was what it was.

Operator

Bill Shope, JPMorgan.

Bill Shope - *JPMorgan - Analyst*

Mark, as you know, there has been some discussion around Dell potentially entering the retail channel this year. Have you given any thought or can you give us some idea of how you think that could potentially have an impact on your retail shelf space as that occurs or potentially change the competitive landscape in general over time?

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

I don't. We think about all kinds of different things. We actually have a bunch of competitors that vie for that shelf space today. So obviously, they're going to make decisions that make the most sense for their company. We like our position. We like our relationship with those retailers and those channels. And we think, given the situation we are in today, which is also, by the way, a very global set of relationships, a pretty important asset for us. And so we'll work hard to do the best we can to be the best partner to those retailers that we can be.

Operator

Katie Huberty, Morgan Stanley.

Katie Huberty - *Morgan Stanley - Analyst*

Mark, you've bucked the trend of slower U.S. revenue growth that many of your competitors reported last month. And then if we look at your DSOs, clearly pointing to a back-end-loaded quarter. So can way extrapolate that you experienced a pickup in U.S.-based spending in the month of April?

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

No, I would not extrapolate there. And I understand how you got there by the numbers. I would say that U.S. enterprise behaved roughly as we expected. I wouldn't get exuberant about it, nor would I go the other way on it. It was roughly what we expected.

And the quarter behaved roughly as we expected as well in U.S. enterprise. So we did grow, as you described, in the U.S., and we feel good about it, but it behaved roughly as we expected.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Could you talk a little bit about the commodity pricing environment, and were there any strategic inventory buys during the quarter?

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

Well, we're always trying to make strategic buys. We're trying real hard to make less nonstrategic buys, to be frank. But anyway, I would tell you, memory declined a bunch over the past several months. And so we think the current prices of memory are unsustainable. But they have gone down. There has been some pressure upwards on panels. I would say processor hard drives, stable, roughly where they have been. So that is the way I would described the commodity environment right now. I hope that helps.

Shannon Cross - *Cross Research - Analyst*

Yes. Any thoughts about increasing your memory inventory, since the prices are so low right now and potentially hitting this current quarter?

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

Well, if there was, I probably wouldn't tell you in this call. So it is just one of those things. We're always considering where we think commodity prices are, and to some degree trying to make a judgment on what the optimal time is to take what position. So we will continue to do that as we go forward.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James - Analyst*

I just want to go back to the revenue guidance. For the second half of the year, it looks like you're guiding for decelerating revenue growth. You just did 10% in local currency. I think your guidance is more for 6%, which is still pretty reasonable growth for a company of your size.

I just wanted to be clear -- is all of that deceleration really coming from more normalized growth in the PC business or are there other segments where you're expecting slower growth? And if you could just kind of put that in terms of how you view the overall market environment for the back half of the year.

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

I think you got it right on. It's just us going back to a more normalized view of that. And again, we're going into our weakest quarter seasonally. It is typically our weakest quarter in Q3. So there's a little bit of that as well. That, of course, hits us.

So there is no strategic deceleration, using the term you used, across our segments other than in PSG. When you've got that kind of growth, we don't think it's prudent to build a model based on 2.5 times market growth from a unit perspective as we go forward. So that is not what we are doing.

Operator

Robert Semple, Credit Suisse.

Robert Semple - *Credit Suisse - Analyst*

Mark, just some comments on the impact of Vista in the quarter. I know last quarter you expected a kind of limited uptake in terms of units. Obviously, they were stronger than expected. And then you also said systems configurations were expected to improve. What was the end result?

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

Roughly what we expected. I think we built some inventory at the end of Q1 because of what we thought would happen from Vista, and it did. And you can see what happened back to our inventory levels after that.

At the same time, we did not expect there to be a Vista moment per se that was going to create this big elbow from a demand perspective. We thought that it would be really helpful the way you described it, in terms of the overall ASP environment moving forward. And I think it is still too early to tell whether that will be the case long run, but we have begun to see some help from Vista, and I think it was helpful to us in the quarter. But this is really a more of a longer-running opportunity we see as we go forward as opposed to something that was just unique for the quarter.

Robert Semple - *Credit Suisse - Analyst*

Any surprises on corporate uptake of this or was it pretty limited?

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

No, the good news about this quarter in that respect was it behaved roughly as we expected. And I think you can find any story you want to on Vista. I know companies that are planning to trade out their entire fleet of PCs in a short time frame to upgrade to Vista. I also know others that are going to be very slow. So I think you can find right now any story you would like to find out there to rationalize your opinion or to support your opinion. I think we're just going to have to see how it goes, and that's why I think we were prudent in our modeling for Vista. And I think it has kind of borne out that way. But clearly, it has been a benefit to us. So don't take me wrong, it has clearly been a benefit to us. We'll just have to see how it works going forward.

Operator

Bill Fearnley, FTN Midwest.

Bill Fearnley - *FTN Midwest - Analyst*

Two questions here in the enterprise space. You folks have talked about getting more aggressive in the data warehousing segment. Would you acquire another company in order to get significantly larger in that business?

And then in addition, could you talk about what you're expecting here for enterprise demand trends for the back half of the year? You said it was what you would have expected in the quarter just reported, but how are you viewing U.S. enterprise, in particular, for the back half, and the data warehousing question as well?

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

So we were trying to get to one question per guy, but okay, I will take both. On the data warehousing one, I will try not to get too technical about it, but buying companies that provide either hardware, standard hardware, standard database stuff would not be of keen interest to us. I'll never say never to anything, but it is just not where we would be headed. We would be looking for more things like, in that arena, Knightsbridge, like we already acquired, or things that actually add value above the core technology stack. So that would be more where our focus is as opposed to areas that I think you were trying to imply. But we're not working on that. Again, never say never to anything, but that is not our focus.

In the U.S. enterprise, I really don't have much to add to what I said earlier. The U.S. enterprise behaved roughly as we expected in Q2, and it looked steady to us from what we saw in Q1. So that would be roughly how I would describe U.S. enterprise.

Operator

Lou Miscioscia, Cowen & Company.

Lou Miscioscia - *Cowen & Company - Analyst*

Mark, you had commented this quarter and last quarter that you're still transforming the Company but not close to being done. And then you had provided, I guess, a couple thoughts on overhead. Could you possibly maybe reiterate those, provide maybe some more color, and if possible, maybe some numbers wrapped around that? Because it sounded like you are suggesting that you've got significant runway through '09 to take costs out.

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

We just had a lot of work to do, right? And I think that somehow -- and listen, I will put my hand up as maybe one that has contributed to this -- I think that there's been a lot of people who thought that in 2005 we had a lot of rationalization to do of our cost structure. We announced a reduction in our workforce that was significant. And I think there was a belief structure that this was some, like, one-time thing. And then, gee, everything is perfect, or they have run out of ideas, etc., etc.

It is just far from what we're working on. We're working on a long-term model, but our scale and our cost structure has to give us an extreme competitive advantage. It may not over a few, but it should over many. So for us, our overhead costs, which again, I want to rationalize is just one piece of total costs -- when we look at the cost envelope -- I actually had one investor one time that said, let me look at your OpEx, and how much can you remove from your OpEx to optimize your cost structure? And my first reaction was, why would you do that? Most of our cost sits above the gross margin line, not in the OpEx line.

So we look at every single line. And even a percentage of our overhead costs sits in our -- above the gross margin line because of the business structure that we are in, for example, HP Services.

So in the overhead cost category, and I will go back to that, we will actually take out more costs from the beginning of fiscal year '07 through the end of the fiscal year '09 than we did through fiscal year '05 and fiscal year '06. And it is because some of the investments that Cathie described in her script take time to take hold. Not all of those are people. Much of that is a change in our D&A, our depreciation and amortization schedules. And you have to line those up over a long-running period of time. And we are making the investments, and I think we have done the right job to look at this strategically as opposed to tactically.

And I'm not sure we have done a great job of describing that to the investor base, and we're trying to get better at it. And that is why I wanted to make the example that I used today. We just still have a lot of work to do, but we are confident we will get it done.

Jim Burns - *Hewlett-Packard - VP of IR*

We will take maybe two more questions.

Operator

David Wong, A.G. Edwards.

David Wong - *A.G. Edwards - Analyst*

Could you tell us a bit about your market share gains in PSG and x86 servers? Do you think these are coming from pricing or are there particular features that your customers want that are making them come to you?

Cathie Lesjak - *Hewlett-Packard - CFO*

I think the best way to articulate that is that we think we've got a really good product lineup. We certainly are not buying the share. We're focused on profitable growth, and we have clearly shown that at the PSG segment level, where our operating margins have expanded at the same time that we have grown that top line 24%. So it is really not pricing alone.

David Wong - *A.G. Edwards - Analyst*

Are you able to pinpoint any particular features, though, that you have that others don't seem to?

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

Again, it's different in different markets, depending on whether you're talking about -- you mentioned industry-standard servers and you separated that from PC products and notebook products and desktop products. There's a little different story in each one of those.

But again, there's no question that our margins are healthy at the same time as we are gaining share. And that happens in a lot. I think our unit costs are declining, so we are getting some advantage from unit costs that we have an opportunity to either take to the bottom line or invest in the marketplace.

But if you look at our lineup of products, our designs are much improved. And our ability to bring features, we think, to the market that customers want, inclusive of blades, which is helping our industry-standard server growth -- these are all things that have come out of our R&D labs. And again, R&D is at the center of -- we are a technology company. And the fact that we invest in R&D, we expect to be able to bring technology to market that people want to buy. And we have a lot of pressure, to

be very frank with you, on our R&D organization to show up with the best products in the industry. And we believe there are some examples out there today in both product lines that you referenced of true innovations the customers value.

Jim Burns - *Hewlett-Packard - VP of IR*

We will take the last question here, operator.

Operator

Shaw Wu, American Technology Research.

Shaw Wu - *American Technology Research - Analyst*

I'm just wondering if you had any comments and thoughts on Michael Dell's comments that he plans to enter the distribution channel more aggressively over the next couple quarters.

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

I don't have any comments on it. I think obviously that they need to do what is best for their business and what is best for their customers and decide. We need to do what is best for ours and best for our customers, and that is what we're focused on, is doing the best we can for HP and HP's customers. And that is what we will continue to focus on.

Jim Burns - *Hewlett-Packard - VP of IR*

With that, I'm going to turn the mike back here to Mark.

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

Listen, thanks for the questions. I appreciate that. I am glad we got a lot of them in. Let me just try to summarize the call by saying I think Hewlett-Packard had a strong quarter, characterized by solid revenue growth, share gains in key businesses. We had good expense discipline, we had margin expansion, we had strong cash from operations and significant share repurchases.

We did this while at the same time continuing the integration of Mercury, strengthening our business with the acquisition of Bristol, PolyServe, Tabblo and Bitfone, initiating our enhanced early retirement program and making further progress in investments on strategic initiatives that will strengthen Hewlett-Packard's long-term competitive positioning. Given the solid fundamentals within our business, I am pleased that we are increasing our non-GAAP EPS guidance for the seventh consecutive quarter.

We are off to a good start to the year and I'm confident we can continue to execute with discipline and deliver a year of strong financial returns. Thank you very much.

Operator

Thank you for your participation in today's conference. Ladies and gentlemen, this concludes the presentation. You may all disconnect, and have a good day.
