

FINAL TRANSCRIPT

Thomson StreetEventsSM

HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Event Date/Time: Aug. 16. 2007 / 5:00PM ET

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

CORPORATE PARTICIPANTS

Jim Burns

Hewlett-Packard - VP, IR

Mark Hurd

Hewlett-Packard - Chairman and CEO

Cathie Lesjak

Hewlett-Packard - CFO

CONFERENCE CALL PARTICIPANTS

Richard Gardner

Citigroup - Analyst

Ben Reitzes

UBS - Analyst

Bill Shope

JPMorgan - Analyst

Harry Blount

Lehman Brothers - Analyst

Laura Conigliaro

Goldman Sachs - Analyst

Brian Alexander

Raymond James - Analyst

Bill Fearnley

FTN Research - Analyst

Toni Sacconaghi

Sanford Bernstein - Analyst

Louis Miscioscia

Cowen & Company - Analyst

Richard Farmer

Merrill Lynch - Analyst

Rob Semple

Credit Suisse - Analyst

Keith Bachman

Bank of Montreal - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen. Thank you for standing by, and welcome to the 2007 third-quarter Hewlett-Packard earnings conference call. At this time, all participants are in a listen-only mode. We will facilitate a question-and-answer session towards the end of today's presentation. (OPERATOR INSTRUCTIONS).

I would now like to turn the presentation over to your host for today's conference, Mr. Jim Burns, Vice President, Investor Relations. Please proceed, sir.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

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

Good afternoon and welcome to our third-quarter earnings conference call with Chairman and CEO Mark Hurd and CFO Cathie Lesjak. This call is being webcast live, and a replay of the webcast will be available shortly after the call for approximately one year.

Some information provided during this call may include forward-looking statements that are based on certain assumptions and are subject to a number of risks and uncertainties, and actual future results may vary materially. Please refer to the risks described in HP's SEC reports, including our Form 10-Q for the fiscal quarter ended April 30, 2007.

The financial information discussed in connection with this call, including tax-related items, reflects estimates based on the information available at this time and could differ materially from the amounts ultimately reported in HP's third fiscal quarter Form 10-Q.

Earnings, operating margins and similar items at the Company level are sometimes expressed on a non-GAAP basis and have been adjusted to exclude certain lines, including amortization of purchased intangibles and restructuring charges. The comparable GAAP financial information and a reconciliation of non-GAAP amounts to GAAP are included in the tables and in the third-quarter earnings slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations web page under Company Information at www.hp.com.

Finally, please refrain from asking multi-part questions or clarifications during the Q&A.

And with that, I will now turn the call over to Mark.

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

I am actually okay with the multi-part questions. It is just Jim that doesn't like those.

Anyway, let me start by first thanking you for joining us. HP delivered a real strong quarter in Q3. We had our strongest revenue growth since 2000. We had share gains in our key businesses. We had expense discipline, we had operating margin expansion, and we did do significant share buybacks.

We also continued to invest in the long-term health of our businesses. We increased operating margins and demonstrated strong operating leverage across the Company with a year-over-year operating profit increase of 89% in the Personal Systems Group, 45% in the Technology Solutions Group, and 11% in the Imaging and Printing Group.

Let me walk you through the financial highlights of the quarter. It includes revenue of \$25.4 billion. That is up 16% year over year, or in dollars, \$3.5 billion. This brings our year-to-date growth in dollars to \$8.9 billion. Year-over-year operating margin expansion in all of our non-financing businesses, with Personal Systems margins of 5.8%; IPG margins of 14.5%; Enterprise Storage and Server margins of 10.2%; HP Services margins of 10.3%; and HP Software margins of 14.6%.

Non-GAAP operating margin of 9%, up from 7.6% in the prior-year period. Non-GAAP EPS of \$0.71, and that is up 37% versus the prior-year period. And we did do \$2.5 billion of share repurchases.

We posted these strong third-quarter results while continuing to deploy our capital into longer-term strategic initiatives that we expect will strengthen HP's competitive positioning in the market. We remain focused on our cost initiatives in order to create a more competitive company for the long term. We've completed the construction of our six new data centers and are executing against our plans to consolidate our infrastructure and applications to these new sites. In addition, we announced

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

several new acquisitions this quarter that will add market-leading solutions to areas of our business that will drive future growth and profitability.

This quarter, we signed definitive agreements to purchase Opsware and Neoware and closed our acquisition of SPI Dynamics on August 1. Each brings leadership to our already powerful management software and business PC portfolios. They are expected to enhance our ability to help companies embrace automation and virtualization and realize structural advantages in the areas of cost, reliability and data security.

We also expect that the Opsware acquisition will significantly enhance our capability in end-to-end data center automation. SPI adds application security, testing capabilities to quality management, and Neoware will provide added competencies in client virtualization.

Now let me turn to the business segments and the third-quarter results. IPG had a solid quarter. Revenue grew 8% year over year, \$6 billion, with supplies revenue up 9%, or growth of 9%; commercial hardware revenue up 6%; and consumer hardware revenue up 10%. Demand for our products remains strong, with printer hardware shipments exceeding 13 million units in the quarter, representing 10% unit growth year over year. Commercial printer hardware units grew 17% and consumer printer hardware units were up 8%, both off tough prior-year compares.

[Thankfully], technology that we bring to the market, along with industry-leading technology, commercial hardware shipments units continue to be led by our strong lineup of printer MFPs, which grew 76% versus the prior-year period, while our consumer business saw increasing acceptance of all its All-in-One products.

Segment operating margin grew to 14.5%. That is up 30 basis points versus the prior-year period, in line with our guidance last quarter.

Sorry about the noise on the line right now. Let me catch up here.

We expanded our operating margins while continuing to invest in unit placement and product innovation, highlighting the strength of our core printing business and solid expense discipline. We expect these investments to extend our printing leadership and help us drive the market transition from analog to digital printing.

Moving to PSG, which had an outstanding quarter with excellent revenue growth, market share gains in every region and strong margin performance, revenue increased 29% year over year to \$8.9 billion, with unit shipments up 33% and double-digit revenue and unit growth in every region. These results bring PSG's year-to-date revenue growth to nearly \$5 billion. We had strong momentum, driven by our notebook business, which grew revenues 54% and units 71% versus the prior-year period.

According to our estimates for the second calendar quarter, we increased HP's notebook market share lead by over 5 points versus the prior year. Consumer client revenues jumped 46% over the prior-year period as customers continue to value our innovation, service and the ability to purchase at more than 80,000 retail storefronts worldwide.

We also saw continued solid performance in our commercial client business, with revenues up 19%, including improved results from the public sector, where we have been traditionally underpenetrated.

Revenue in desktops grew 12% year over year, with double-digit growth in both consumer and commercial and share gains in every region. Workstation revenues were up 30% versus the prior-year period.

Segment operating profit was \$519 million or 5.8% of revenue, up from 4% in the prior-year period. On a year-over-year basis, PSG grew operating profit \$244 million, demonstrating solid sales execution, increased attach and cost discipline.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

While we're pleased with these operating margin results, we did experience a benefit this quarter from lower component prices, which we do not expect to be sustainable in future periods.

Moving on to TSG, enterprise servers and storage grew 10% year over year to \$4.5 billion. Operating profit was \$464 million or 10.2% of revenue, a sharp increase from 7.2% in the prior-year period. Industry (technical difficulty)

Jim Burns - Hewlett-Packard - VP, IR

Well, we will continue. Sorry, everybody, for the technical difficulties. We're not sure exactly what happened. But we are not alone in terms of getting dropped, if you were dropped on that. So this will be a continuation of the call that we started. Mark was in the middle of talking about our ESS results. And we're just going to go ahead and start from the top with ESS. We will try to get through quickly and have Cathie go through some financial results so that we can have ample time for Q&A. And again, my apologies for the technical difficulties here.

Mark Hurd - Hewlett-Packard - Chairman and CEO

Yes, sorry about that. The telephonic technology hasn't quite caught up with the opportunity here. So we will try to get through this. And we really will try to get as many Q&A or parts of Q&A done as we can.

In ESS, revenue did grow 10% to \$4.5 billion. Operating profit was \$464 million or 10.2% of revenue, a sharp increase from 7.2% in the prior-year period. Industry Standard Server revenues grew 16% year over year, with share gains across all regions. x86 blades were [up -- new growth] accelerated to 81% over the prior year as customers continued to embrace the power and cooling management and virtualization advantages of our c-Class blades.

Revenue in Storage was up 6% year over year, with a solid performance in our external disk products, which grew 7%, partially offset by a decline in tape. Our flagship midrange EVA revenues increased 14% versus the prior year. And in May, we introduced the new lineup of our high-end XP storage systems. While we have a lot more work to do, I am encouraged by the improvement in the top-line performance of the storage business.

Business Critical Systems revenue decreased 3% year over year. Integrity server revenue grew 71% and represented 67% of Business Critical revenue, up from 38% in the prior-year period. Integrity momentum was offset by ongoing declines in PA-RISK and Alpha. While ESS margins were favorably impacted by petroleum prices, our margin expansion also highlights warranty improvements, pricing discipline and our ability to align our cost structure investments to deliver the next-generation data center to our customers.

We had a solid quarter in HP Services, with revenue growth of 8% over the prior-year period of \$4.2 billion. On a year-over-year basis, Outsourcing Services and Consulting & Integration each delivered 11% top-line growth, while Technology Services grew at 5%. HP Services' operating profit was \$430 million or 10.3% of revenue, up 0.9 points year over year. This marks the seventh consecutive quarter of year-over-year operating margin expansion in HP Services, and I am pleased with the improved consistency in this business. Looking ahead, we will continue to focus on executing our plans to streamline our cost structure and improve our delivery tools and processes to become more competitive in the market.

HP Software revenue grew 74% over the prior-year period to \$554 million, which reflects the impact of the acquisition of Mercury Interactive in the first quarter of the year. On a year-over-year basis, HP OpenView was up 14%, and that excludes Mercury.

HP Software reported an operating profit of \$81 million or 14.6% of revenue, up 10.5 points versus the prior-year period. HP Software performed as planned, and I'm pleased with our efforts to date and the contribution of the integrated management team.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

HP Financial Services revenue was \$582 million or up 12% year over year. Volume and net portfolio assets increased 7% and 8% over the prior-year period, respectively. Operating margin was 6.7%, flat with the prior year.

We are encouraged with the growth in our core financing volume and portfolio assets over the last several quarters and results in end-of-lease renewals and equipment sales.

I will conclude my comments on segments with that, reiterating we had a strong third quarter across the entire portfolio. And as a company, we're 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.

And while our third-quarter results showed marked improvement, I want to make sure you are clear -- we still have significant investments and opportunities ahead of us. The initial results of our Enterprise sales force deployment are encouraging. However, we're still not adequately covering this segment, and we will be adding additional feet on the street to expand our share of wallet. At the same time that we're investing to grow our business, we will need to take the necessary actions, which include incremental workforce reductions, to lower our cost structure. I'm pleased with our progress, but as a company, we still have plenty of work ahead.

And with that, I would like to turn it over to Cathie.

Cathie Lesjak - Hewlett-Packard - CFO

Thanks, Mark, and good afternoon, everyone. HP had another strong quarter in Q3, with solid revenue and operating profit expansion in each of its businesses.

Revenue for the third quarter totaled \$25.4 billion, up 16% year over year or up 12% in constant currency. And non-GAAP operating profit grew 38% year over year to \$2.3 billion or 9% of revenue.

Looking at revenue by geography, each of our regions grew in double digits, with Asia-Pacific up 22%, EMEA up 16% and Americas up 14%. Adjusting for currency, revenue was up 18% in Asia-Pacific, 9% in EMEA and 13% in the Americas. We continue to benefit from our broad geographic reach, with 65% of our revenue coming from outside the U.S. In fact, revenue from the BRIC countries -- Brazil, Russia, India and China -- grew 35% in Q3 and now accounts for 8% of total revenue.

Third-quarter gross margin was 24.5% of revenue, unchanged from Q2. Compared to a year ago, gross margin percentage was down by 30 basis points, driven by strong growth in the Personal Systems Group and by shifts in product mix within imaging and printing. These factors were only partially offset by favorable pricing of commodity components and by a higher percentage of the Company's revenue coming from software.

Non-GAAP operating expenses for the quarter were 15.5% of revenue, an improvement of 170 basis points compared with a year ago and flat sequentially. In absolute dollars, operating expenses grew only 4.5% year over year to \$3.9 billion, less than one-third the rate of revenue growth. Adjusting for currency, expenses grew by only 2.3% year over year, even as we absorbed the operating expenses associated with eight acquisitions.

Going forward, we will continue to invest in new areas that have potential to drive future growth, while at the same time remaining focused on optimizing our cost structure.

Non-GAAP OI&E yielded pretax income of \$170 million or roughly \$0.05 per share. The increase reflects gains on real estate transactions during the quarter. Our non-GAAP tax rate was 22.4% in Q3, reflecting roughly \$0.02 per share in incremental tax expenses associated with nonrecurring items. We expect our non-GAAP tax rate to return to 20% in Q4, and then, as we've previously discussed, to go up to 21% in FY '08.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Third-quarter non-GAAP EPS was \$0.71, up 37% from the \$0.52 that we reported one year ago. GAAP EPS was \$0.66, which included \$134 million or \$0.05 per share in after-tax adjustments primarily related to the amortization of purchased intangibles that were excluded from our non-GAAP results.

Moving now to the balance sheet, HP-owned inventory ended Q3 at \$8 billion, up \$728 million sequentially and up \$542 million year over year. Inventory now stands at 38 days of supply, down three days compared with a year ago, but up four days sequentially. We believe that our current inventory levels are appropriate as we head into our seasonally strongest quarter.

With regard to channel inventories, we exited Q3 in good shape. Personal Systems ended the quarter with five weeks in the channel or flat compared with last year. Imaging and Printing ended the quarter at approximately six weeks of channel inventory or up about 0.5 weeks from last year. And Enterprise Storage and Servers ended the quarter at roughly 4.5 weeks or down about 0.5 weeks year over year.

Trade receivables ended the quarter at \$11.8 billion, up \$2.2 billion year over year and \$268 million sequentially. DSO increased to 42 days in Q3 from 41 days in Q2 and 40 days one year ago. Our strong finish to the quarter was a significant contributor to the increase in DSO.

Next, property, plant and equipment was up \$1.1 billion year over year and \$140 million sequentially at \$7.5 billion. Gross CapEx was \$751 million, up 21% year over year and flat sequentially. On a net-net basis, CapEx was \$548 million, up 41% year over year and down 8% sequentially. The year-over-year increase in CapEx was primarily the result of increases in assets used in our leasing business. Net PP&E as a percentage of revenue now stands at 7.4% of revenue, up from 7.1% one year ago and down from 7.6% last quarter.

Regarding accounts payable, days payable closed the quarter at 55 days, up from 54 last quarter and down from 58 days one year ago.

Moving to our cash balance and cash flow, cash flow from operations ended the quarter at \$1.9 billion and free cash flow was \$1.3 billion. Capital expenditures were primarily in IT and real estate facilities and assets used in our leasing business. Q3 share repurchases totaled \$2.5 billion in open market or approximately 55 million shares. In addition, we completed the accelerated share repurchase program announced in Q2, receiving approximately 2 million additional shares. At the end of the quarter, we had roughly \$4.8 billion remaining in the current share repurchase authorization.

Finally, we paid our normal quarterly dividend totaling \$209 million. We closed the quarter with total gross cash of \$12.5 billion, down from \$16 billion last year and up sequentially from \$12.3 billion. Net cash was \$3.9 billion, down from \$9.2 billion last year and \$4 billion last quarter.

Finally, a few comments on our outlook -- we are raising our revenue and EPS guidance for the fourth quarter. We now expect Q4 revenue to be approximately \$27 billion to \$27.2 billion, growing roughly 10% to 11% year over year. While the sequential increase of 6% to 7% implied by our guidance is less than the historical 10% to 12%, we do not believe it is prudent to set investor expectations that our Personal Systems business can continue to grow at almost three times the market rate, nor do we think it appropriate to build a cost structure on that basis.

Regarding earnings, there are many variables to keep in mind. First, we will continue to fund investments to drive long-term growth and to make workforce rebalancing investment at levels similar to those in Q3.

Second, we expect the component pricing environment to be less favorable in Q4 than it was in Q3. In fact, we have already seen memory prices beginning to incline.

Third, we estimate non-GAAP OI&E to be about \$0.02 per share in Q4, down from \$0.05 in Q3, which included about \$0.03 in one-time real estate gains.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Fourth, as mentioned earlier, we expect a non-GAAP tax rate of approximately 20% for Q4.

Finally, we expected to continue to repurchase shares in the coming quarters. Share count will be impacted by share price trend, option exercise patterns, common stock equivalents and repurchase activity. Currently, we expect weighted average shares outstanding to decline slightly in Q4.

With all this in mind, we now expect fourth-quarter non-GAAP earnings per share of \$0.80 to \$0.81, representing 18% to 19% growth year over year.

With that, we will take your questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Richard Gardner, Citigroup.

Richard Gardner - Citigroup - Analyst

Mark, the obvious question on everybody's mind is whether you have seen any changes in demand out there related to the recent turmoil in the financial markets. So I guess if you could give us your assessment of what demand looks like by geography and customer segment, to the degree that you are willing. And then also, does your guidance for the fourth quarter reflect any change in the demand environment that you have seen here of late, given how far below normal seasonality you're guiding?

Mark Hurd - Hewlett-Packard - Chairman and CEO

Just opening, I am not an economist, just so we get that on the record. We saw steady growth across all regions and all segments. So it was pretty broad-based from that perspective. I don't have any data that would indicate to me any material change in demand in any segment or any market. So I will just leave it at that. Obviously, we will continue to monitor things. But that is what we have seen. So I will leave it there.

Operator

Ben Reitzes, UBS.

Ben Reitzes - UBS - Analyst

If you could just talk a little bit about -- I guess this is sort of in line with the demand question, but as we go into back to school and whatnot, in terms of IPG and PSG, what do your channel inventory levels look like? It looked like IPG is at the higher end of your ranges. And talk a little bit more about how comfortable you are going into back to school, particularly when the consumer is the particularly big area that picks up for you in the next quarter?

Cathie Lesjak - Hewlett-Packard - CFO

We are very comfortable with our channel inventory position. Our PSG channel inventory typically goes up from Q3 just to be ready for this kind of uptick in back to school. And we're ready for it. Our IPG inventory is at the higher end of our range, but

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

most of the increase was in supplies, so that is really the product that you don't mind having out in the channel because you don't want any opportunity to sock out. So we are very comfortable with channel inventory.

Mark Hurd - Hewlett-Packard - Chairman and CEO

The ESS, just adding to it, is in exceptional shape. So we feel good about ESS. We feel good about -- I won't add any more to Cathie's points, I just think we feel good about where we are.

Ben Reitzes - UBS - Analyst

And PSG, I guess, as well.

Mark Hurd - Hewlett-Packard - Chairman and CEO

PSG we thought was in superb position.

Cathie Lesjak - Hewlett-Packard - CFO

Absolutely.

Mark Hurd - Hewlett-Packard - Chairman and CEO

I think, again, given the demand signs we have seen and the data we have got, we feel really good about where we ended the quarter from a channel inventory perspective, and for that matter, from an owned inventory perspective. So I think overall we feel really good about things.

Operator

Bill Shope, JPMorgan.

Bill Shope - JPMorgan - Analyst

Mark, can you help us understand a bit more some of the drivers of the ESS margin upside, and in particular to help us understand how much of it is sustainable? And also, should we expect normal seasonal increases in the margins on that segment going into fourth quarter?

Mark Hurd - Hewlett-Packard - Chairman and CEO

Let me be clear, too -- we had some good component help. But this whole story is not a component story. There's a bunch of things going on here, starting with just the fact of us just getting disciplined on our pricing. The fact that we could be disciplined on pricing at the same time as we have this kind of growth is good news. And so pricing discipline is probably number one.

Secondly, we have been very good with product quality. And that has helped us on the warranty line. Warranty is a big driver, as you know, of -- or potentially can be a driver of product costs. In this case, it really helped. And then you add the component prices to it.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Some of the component pricing issues -- it is kind of interesting, because we are the largest customer of most of these folks, so we're not sure how much component pricing we get when you're already at the best pricing, or at least we think we are. But those are the drivers. And so it will depend on the market and depend on different factors at different times and how this goes. But I wouldn't want you to leave with the thought that there's one big component pricing -- it is a mix of things that occur. We will do our best in the areas that we can sustain to sustain.

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

Staying on the margin question, you guys are tracking a fair amount, I think, ahead of what some of your plans were that you laid out at Analyst Day. Beyond the component side of the equation, you appear to also to have done pretty well on the services side, on the margin side, and also upsid on revenue on the IPG side. So perhaps you could comment a little bit on your thoughts around margins for those two segments, as well as the success of the IPG salesforce.

Cathie Lesjak - *Hewlett-Packard - CFO*

We're very pleased with the operating margin expansion that we saw this quarter. As you mentioned, it is broad-based. In many of the segments, it is coming from improved gross margin position, but it is also coming from great OpEx discipline. So we're getting a lot of this growth on a very stable OpEx structure that is allowing us to really, basically, from our perspective, do a great job on operating profit. And we expect a lot of that to continue. To Mark's point earlier, the commodity prices were a nice tailwind in Q3. We are not expecting that much of a tailwind in Q4, but we still expect operating margins (technical difficulty).

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

And to your point about IPG's Enterprise sales force, we're just getting started. We've got them in place now. They have been in place for a period of time. But, you know, it takes roughly a year, nine, 12 months to get these guys really productive. So we have ramped it up. There would be, fair to say, some pressure on them now to participate in helping the Company improve. So we are very optimistic about the segment and we expect good performance from them. But now is about the time, as you go into '08, that we start to see hopefully some contribution there.

Harry Blount - *Lehman Brothers - Analyst*

On the margin trend overall, though, the fact that you guys are tracking a fair amount ahead of where you guys set Analyst Day expectations, I was wondering if you guys had any thoughts on maybe sustaining a higher level going forward?

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

Well, it is a great reason to come to the next Analyst Day, because that is probably where we will revisit all of this. And obviously, we have internal plans. And I understand exactly the analytical point you're making. As I've said to you before and said to the group before, we have a lot more work to do at HP. We're anything but a finished product at this point. And we have got work to do, and in some cases, it depends on the speed by which we make some of those plans that we have made come true. We just have a lot more work to do. So we will calibrate between the end of (technical difficulty) Analyst Day, in that window we'll have an opportunity to recalibrate our trajectory. And I'm sure Cathie and I will start describing that to you somewhere in that timeframe.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Operator

Laura Conigliaro, Goldman.

Laura Conigliaro - *Goldman Sachs - Analyst*

You talked about component tightness and components. And certainly, tightness looks like it is becoming more of an issue. Can you give us more color on which components are in fact the tightest? And as the largest customer, have you been able to line up what you need so far, especially given the fact that your inventories are higher? And do you expect that you might end up with any kind of problem, given a seasonally strong October and I guess January quarter as well?

The media is reporting this as a situation where component tightness might be bad enough that even a company as large as you might end up not being able to ship what you need to ship. How do you view that?

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

I view that, at least in our case, as probably not reporting that would be accurate. So we feel good about our supply. And obviously, we go to try to secure supply. It could get to an issue if there wound up to be upside beyond that, but again, we feel pretty good about our position from a supply perspective. We lock in a lot of that supply before the quarter starts.

To your questions on commodities, panels are tighter than they have been. Memory was a very advantaged position. Obviously, the industry tries to realign itself from a capacity perspective. We feel good about processor supply. Hard disk drives are in supply. So we feel pretty good about our situation. I can't think of anything more specifically to give you in that area other than we feel like we can meet the guidance that we have described, at least based on the current data that we have gotten.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James - Analyst*

Maybe just shift the focus to the balance sheet -- Cathie, I appreciate the explanation that the DSO increase was driven by a strong finish to the quarter, but I think it is up year over year for the last six quarters. So just wondering if there's any other explanation for the DSO increase such as change in mix or maybe an increase in aging of AR or the quarter simply just becoming more back-end-loaded than it used to be.

Cathie Lesjak - *Hewlett-Packard - CFO*

The first impact was what I mentioned, which is the strong finish to the quarter. But there is also the impact on, basically, to -- there's a number of impacts to DSO. One is the linearity in the quarter, which we talked about. We also should say that acquisitions are a factor. And then the third one is, frankly, some of the terms that we are offering both to our direct and indirect customers, in certain situations where we think it is beneficial to HP, we have in fact offered extended terms or changed the cash discount that we offer in order to drive, for example, more channel business in high-margin space. We made some changes in the EMEA channel. All of those things are really putting pressure on DSO. Obviously, the strong finish to the quarter is one that may not repeat. The other ones will still be there.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Brian Alexander - *Raymond James - Analyst*

So just to follow up, how should we be thinking about the range of DSOs going forward?

Cathie Lesjak - *Hewlett-Packard - CFO*

I would think about the range in the 40- to 42-day space.

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

The other thing, too, when you look at the alignment of DSO to growth, I think where you're headed, when you look at the aggregation of the working capital metrics from payables to receivables to cash flow from operations integrated with the revenue growth on our inventory, that whole ecosystem of metrics looks pretty darn healthy to us. When you're growing at the rate that we are, you use working capital to drive that growth. So we feel pretty good about the aggregation of those metrics. So we will leave it at that, I guess.

Operator

Bill Fearnley, FTN Research.

Bill Fearnley - *FTN Research - Analyst*

A quick question here on the IPG environment. Could give your thoughts on IPG performance and what you're seeing here for the pricing and promotional environment? And are you happy with the unit growth and the balance between unit growth and the operating margins that you have here? So it is a question about the competitive environment. And then how should we be thinking about unit growth and profitability here for the next couple quarters for IPG?

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

They actually did better than we really had modeled. We'd said at the last conference call kind of mid- to high-single-digit unit growth because we are going to these really tough compares. And we felt that was a good thing. We saw the unit growth, though, in the high-usage segments and we took it.

I have heard -- I don't know how to describe the kind of noise -- that we are leading the pricing effort, though we don't feel like we are. We feel like we are pricing rationally. And the only thing I can tell you is that with the work we're doing on the cost side, it may be that what seems irrational to somebody else seems rational to us. That is the only way I can explain it to you, because it does not look like irrational pricing to us. And we are going after high-usage segments that we think have strong aftermarket, as I am sure I know you know.

So we feel good about it. And then the operating margin thing -- listen, we've put the Company in a position to perform better so that when opportunities like this unit growth, particularly in inkjet, show up, that we can take advantage of them. So that is what we did and we feel really good about it. Remember, at the same time, IPG is making investments in an Enterprise salesforce as well. So I think when you look at the IPG isolate story, it is a healthy one.

Cathie Lesjak - *Hewlett-Packard - CFO*

I think the only thing I would add to that is that we actually saw some ASP inclines in the consumer hardware space this quarter. We had revenue up 10% while units only grew 8%. And what we are seeing is that the consumer is moving -- some of the

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

consumers are moving up and moving away from single function into some of the All-in-One technology that we have that is helping to increase average selling prices. So in terms of aggressive pricing and competitiveness, for us, there's really no change in our perception of that.

Operator

Toni Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

I was wondering if you could comment on whether supplies yield is consistent with your model and what you believe should be happening, given your unit sales. Let me tell you why I ask that.

In eight of the last 10 quarters, your hardware unit growth has been double digits. And despite that, supplies grew about 5% or 6% in constant currency this quarter. They decelerated for the second straight quarter despite easier compares, and your supplies inventory sounds like it crept up. So maybe you didn't sell through as much as you had thought.

Can you explain, especially given this focus on higher yield units, when you are getting the supplies yield that your model tells you, and how do we think about what 10% unit growth on a sustained basis should translate into sustainable supplies revenue growth?

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

Well, as always, you never disappoint me with these questions. I think you're exactly right with what you say. The model is precisely built the way you describe -- we look at it by segment, by unit, by region, and then we look at the attach and yield. And the model is -- I will use this term (technical difficulty) -- roughly right. That would be the way I would describe it. That is a trailing metric, as you know, so you have to compare what is typically three-quarters-back unit growth relative to the supplies mix. I don't want to go into too much more detail on the algorithm, but I would say roughly right.

Now it depends on segment, it depends on channel, etc., but I would say net-net, out of everything you said, the model looks roughly right to us, and that's where I will leave it.

Cathie Lesjak - *Hewlett-Packard - CFO*

The only other thing I would add is that there is zero impact from the foreign exchange on supplies. So that is not one of the dynamics that you need to model. But you definitely need to take into consideration the installed base. Some of these units are basically going into a base that already has HP printers. And we're trying to maintain our franchise in some, situations, in which case you're not going to see tremendous supplies growth off of those units.

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

I think that, since Cathie went and gave you a little more detail, I will comment with the fact that you have to look at the speed and velocity of the installed base moving and then how the market share works relative to the velocity of the installed base. So it isn't a perfect model just to look at it the way you described. The FX, to Cathie's point, you have got to take out of that. The model you're working on is roughly right. And we would say it looks roughly right to us. I think that is the best way we can describe it.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Operator

Louis Miscioscia, Cowen.

Louis Miscioscia - Cowen & Company - Analyst

Obviously you guys have been rebuilding your data centers and I guess creating what you would define as a next-generation data center. Last week, Ann Livermore was at a conference and presented on this topic, and she identified six areas. One of them was IT systems or servers, power and cooling, virtualization -- I think we've got a pretty good understanding of that -- but three other ones were management, automation and security. Obviously you did the Opsware for that. Maybe you can just comment on how far along you think you are in delivering this, solution, what customers are telling you about next-generation data center, and where you think you might be competitively.

Mark Hurd - Hewlett-Packard - Chairman and CEO

I have only a few minutes left on this call, and I am sure Anne did this a heck of a lot more justice in the presentation that she was giving. But let me try to be as concise as I can be. Opsware helps us a lot in the automation space. Management, we feel very good with the integration of OpenView and Mercury. Security, we've got various initiatives, but we still have more organic work to do to go build out our offerings. And I am not doing this justice at all with the description I'm giving you, but think of us as really maturing, we think, our management suite of capability. There's always more areas we can do. Maturing in automation -- what Opsware really gave us was not only server management and storage management pillars, but also gave us the workflow run book that really moves across the pillars. So you typically see network automation, storage automation, server automation, and then there is really this workflow that connects those capabilities. And Opsware is the world leader at doing that and has done a great job.

So it really gives us a pretty strong portfolio. I'm not going to tell you here we are done or it is a perfect game, so to speak. But the strength of where we are now versus where we were is significant. So we feel good about where we are.

Louis Miscioscia - Cowen & Company - Analyst

And just competitively real quick?

Mark Hurd - Hewlett-Packard - Chairman and CEO

Well, competitively, we feel great. So the problem is in this market, and we believe this whole category of management, morphs into one integrated kind of enterprise category, which is I am sure what Anne was describing to you. The problem is today that while we are the leader in the market, the leading market share is still rather low market share because there is just a plethora of these tools that have populated the enterprise. So this is really a market that needs leadership and consolidation. And as we has said before, we are volunteering to lead it and to bring it through.

I think not only -- I don't want you to think of us as just being acquisitive in this space, because we are now spending as part of these acquisitions a pretty substantive amount of organic R&D that we believe now can bring out of our capabilities now more organic capabilities than we have in the past with not only the money we're spending, but the skills that have come as a result of the Mercury acquisition and what we hope will come and think will come as a result of the Opsware acquisition. So we feel very good about it.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Louis Miscioscia - Cowen & Company - Analyst

Thank you. Very helpful.

Operator

Richard Farmer, Merrill Lynch.

Richard Farmer - Merrill Lynch - Analyst

Mark, I think one of the factors, if I heard it right, that you mentioned in the PC margins was increased attach. I'm just wondering if in general you could give us an update on the progress and the upsell in attach programs that you have in PCs and in the Industry Standard Servers -- basically, how much margin effects do you think you have already achieve there and how much is in front of us? Essentially, what inning are we in in the upsell and attach?

Mark Hurd - Hewlett-Packard - Chairman and CEO

Well, we are better at it, Richard; we're just not great at it. We are doing better than we have. I think we're doing better in the mix, not just in hardware attach, but also software attach. There's a whole other issue around services attach.

And when you look at the series of opportunities across those, we just have room to improve overall. We're better at the hardware attach than the software attach and far better than we are at the services attach. So I hate to give you an inning, because it is a very early-inning kind of process for us to get the kind of ecosystem attach rates that I think are appropriate. And I don't think -- that is, by the way, not a channel-centric kind of message either. We can do better even with our partners than we're doing today. So that is where I would leave that. We still have a lot of opportunity there and a lot of work to do.

Operator

Rob Semple, Credit Suisse.

Rob Semple - Credit Suisse - Analyst

If I could just go back to demand for a second, from a vertical perspective, you talked about government. But were there any other verticals, either positive or negative, that stuck out in the quarter?

Mark Hurd - Hewlett-Packard - Chairman and CEO

The line didn't go dead. We are just thinking through it. I just don't think of any vertical that I have seen pop out of the analytics. I looked at them, but nothing -- the answer must be no or it would have stuck -- I don't know, Cathie, if you saw anything?

Cathie Lesjak - Hewlett-Packard - CFO

No.

Mark Hurd - Hewlett-Packard - Chairman and CEO

No, sorry. I just don't have anything to report on that front.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

Rob Semple - *Credit Suisse - Analyst*

And then, I guess, if I could just move it to a geographic perspective, I know Europe was very strong on a constant currency basis. Did you see any pickup in any specific regions? Maybe you can comment a little bit on Germany. We've heard about strength there from several of your competitors.

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

I would just reiterate what I said earlier. We had really good solid performance across all of our regions and our segments. And so I would tell you that one of the positives was that we had good performance across all of our regions, and I would just leave it at that. It was a pretty broad-based performance. And again, that helps us because we are fairly -- very global in nature. There's nothing there in any geography that I would point out as anything substantive. It was really solid across the board.

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

We have time for one more question, operator, so let's take one more.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - *Bank of Montreal - Analyst*

Cathie or Mark, I was wondering if you could just comment a little bit on the buyback versus cash flow. For the last couple of quarters, your buyback has exceeded your free cash flow, and your net cash is hanging around \$4 billion. How should we think about this relative to -- is the \$4 billion number a net cash that you want to keep? How should we be thinking about the amount of buyback that you would be willing to undertake over the next couple quarters? Is it gated by the free cash flow? Are you willing to take on some debt? How should we be thinking about the metrics here?

Cathie Lesjak - *Hewlett-Packard - CFO*

Our share repurchase program, the first priority is to offset dilution from employee benefit plans. And that is the minimum amount of share repurchase that we do in a quarter. And then we will look at market conditions, as well as opportunities within the Company for cash, to determine how much we would buy opportunistically. It is really not constrained overly by cash flow. We believe that we have got plenty of cash. And I think we have been pretty public about the fact that we are willing to go down in cash and to do the right things for the Company.

We could talk a little bit, if you wanted to get a little bit more specific, about the debt situation with the Company. We have a financing business. And by far, the bulk of our debt goes to the financing business. So what I would call the industrial company has very minor debt and plenty of opportunity to increase its debt positions.

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

Thanks for your questions. First of all, again, let me apologize for the telephonic issue that came up earlier. I hope it didn't distract from the call.

Aug. 16. 2007 / 5:00PM, HPQ - Q3 2007 Hewlett-Packard Earnings Conference Call

But let me try to summarize it by saying we had a strong quarter characterized by our strongest revenue growth since 2000, share gains in our key businesses, solid expense discipline, operating margin expansion and significant share repurchases. And we did it while we made progress in improving our cost structure and investing in our strategic initiatives that we believe will strengthen Hewlett-Packard's long-term competitive position.

Given the solid fundamentals within our business, I am also pleased that we are increasing our non-GAAP EPS guidance for the eighth consecutive quarter. I am pleased with our progress year to date and I am confident that we can continue to execute with discipline and post a strong close to the year. Thanks again.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.

DISCLAIMER

Thomson Financial reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON FINANCIAL OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2007, Thomson Financial. All Rights Reserved.