

FINAL TRANSCRIPT

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HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Thank you very much for your patience and welcome to the fourth quarter 2007 Hewlett Packard earnings conference call.

My name is Bill and I'll be your conference coordinator for today. At this time, all of our participants are in a listen-only mode. We will be conducting our question and answer session towards the end of today's presentation. (OPERATOR INSTRUCTIONS) As a reminder today's conference is being recorded for replay purposes.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

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

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

Thank you, Bill.

Good afternoon, and welcome to our fourth quarter earnings conference call with Chairman and CEO, Mark Hurd and CFO, Cathie Lesjak. This call is being webcast live. 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 July 31, 2007. The financial information discussed in connection with this call includes tax related items, reflects estimates based on information available at this time and could differ materially from the amount ultimately reported in HP's 2007 Form 10-K.

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 items including amortization of purchase intangibles and restructuring charges. The comparable GAAP financial information and reconciliation of non-GAAP amounts to GAAP are included in the tables and in the fourth 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, I would ask if you please refrain from asking multi-part questions or clarifications during the Q & A.

I'll now turn the call over to Mark.

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

That request of Jim's has never worked in any call, but I hope it works today, and with that I'll wish you a good afternoon, thanks for joining us.

HP delivered a strong fourth quarter to close out a solid fiscal year. We had balanced growth across all regions and executed well in key market segments. For the year we added over \$12 billion of new revenue, grew non-GAAP operating profit dollars 30%, and returned over \$12 billion to shareholders through share repurchases and dividends.

Let me walk you through some of the financial highlights of the quarter. HP revenue grew 15% to \$28.3 billion. Non-GAAP operating margins expanded to 9.9% of revenue which was up 90 basis points from last year. Non-GAAP EPS was \$0.86, up 26% versus the prior year period and we utilized our strong cash flow to repurchase \$2 billion of shares.

We generated these results while continuing to invest in our long term strategic initiatives which we expect will strengthen HP's competitiveness and efficiency. We did close 10 acquisitions during the year and recently announced three more. With McDermott Colorspan we expanded our portfolio of digital presses and wide format printers for our growing position in the graphic arts industry. With Atos Origin Middle East, we strengthened our consulting and integration capabilities in this fast growing market. And by acquiring EYP Mission Critical Facilities will further our ability to design and to support large scale data centers.

Next I'll try to spend a few minutes giving you some business highlights and then Cathie will walk you through the actual numbers. We saw meaningful improvement in the TSG Group, Technology Solutions Group which grew revenue 12% and operating profit 31% versus the prior year quarter. This performance generated \$1.4 billion of operating profit representing

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

approximately half the Company's profit for the quarter. HP Software, Blade Servers and Technology Services all finished the year with especially strong results. Our solution portfolio is stronger than ever and we are encouraged by the initial results of the enterprise sales force deployment. Building on this success we will be making additional sales coverage investments in 2008 to expand our share of wallet.

2007 marked an important year for HP Software. We doubled the size of the business and strengthened our portfolio with key acquisitions. I'm particularly pleased with the success of Mercury and the integration has gone well. In the fourth quarter we began to achieve the kind of operating margins expected from a scaled software business, one that is now the sixth largest software company in the world.

In addition we recently closed the acquisition of Opsware, a leader in run book automation and server and network configuration. Moving forward we'll continue to grow the business, as we integrate Opsware and strategically align our business intelligence and information management capabilities into the HP Software segment. The Personal Systems Group delivered an impressive fourth quarter to close out an excellent 2007. For the year revenue grew over \$7 billion and operating profit increased by \$787 million, more than any other segment at HP.

We continue to benefit as demand shifts towards mobility, the consumer, and emerging geographies such as Southeast Asia and Latin America. In China we are now selling at over 400 cities with more expansion planned in this key market. In the fourth quarter we also closed the acquisition of Neoware which will solidify our leadership in the thin client market.

The Imaging and Printing Group produced a solid fourth quarter with good momentum in key growth areas including graphic arts and commercial printing. For the year IPG revenue grew 6% and operating margins expanded to 15.2%. We saw meaningful growth in our enterprise printing business this quarter and will be expanding our sales coverage in this segment.

At the same time that we're investing in our growth markets we are rationalizing parts of our imaging and printing portfolio. As an example earlier this month, we announced that we are seeking an alternative camera business model, which will free up capital for more attractive categories such as marketing collateral and retail photo solutions. We have significant opportunities to further scale the business and we will focus our energies in these areas.

As a company, we are executing the plans we have laid out and delivering on our commitments to our customers, partners and investors. We are effectively balancing growth, investments and cost reduction initiatives. While our fourth quarter results show marked improvement we still have work to do and investments to make.

Next, I'm going to turn it over to Cathie so that she can give you some further detail on the numbers and I look forward to seeing you in New York City at the Analyst Day where we can give you more details of some of the things we've talked about.

Cathie Lesjak - Hewlett-Packard - CFO

Thanks, Mark and good afternoon everyone.

HP delivered another solid quarter of balanced revenue and operating profit growth. Revenue for the fourth quarter totaled \$28.3 billion, up 15% year-over-year or up 11% in constant currency. Non-GAAP operating profit grew 27% year-over-year to \$2.8 billion, or 9.9% of revenue. Looking at revenue by geography, each of our regions grew in double digits with Asia Pacific up 20%, EMEA up 19%, and Americas up 10%. We continue to benefit from our broad geographic reach with 67% of our revenue coming from outside of the U.S.

Fourth quarter gross margin was 24.7%. Compared to a year ago gross margin was up 40 basis points driven by a generally favorable commodity environment and disciplined pricing. Strong performance in HP Software, offset the negative gross margin mix impact of PSG's strong performance at the Company level. Non-GAAP operating expenses for the quarter were \$4.2 billion

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

or 14.8% of revenue, an improvement of 50 basis points compared with a year ago. In absolute dollars, operating expenses grew \$430 million driven predominantly by 10 acquisitions completed in FY '07 and the effects of currency as well as investments in sales resources. Going forward we'll continue to invest in new areas that have the potential to drive future growth while remaining focused on optimizing our cost structure.

Non-GAAP OI&E yielded income of \$67 million, or roughly \$0.02 per share. Our non-GAAP tax rate was 20% in Q4. Fourth quarter non-GAAP EPS was \$0.86, up 26% from the \$0.68 that we reported one year ago. GAAP EPS was \$0.81 which included \$132 million or \$0.05 per share in after-tax adjustments primarily related to the amortization of purchase intangibles that were excluded from our non-GAAP results.

For the full year, we reported revenue of \$104.3 billion, non-GAAP operating margin of 9.2% and non-GAAP EPS of \$2.93. On a GAAP basis, EPS was \$2.68 which includes \$690 million or \$0.25 per share in after-tax adjustments primarily related to the amortization of purchase intangibles, restructuring, net pension curtailment, and in-process R&D that were excluded from our non-GAAP results.

Drilling in on the performance by business segment, during the fourth quarter, imaging and printing revenue grew 4% year-over-year to \$7.6 billion, with supplies revenue growth of 6% and commercial hardware revenue growth of 5%. Consumer hardware revenue declined 5% year-over-year primarily due to the declines in appliance printers and cameras. Total printer hardware units were up 5% year-over-year.

This growth is slower than recent periods reflecting our decision to be more disciplined in our pricing of appliance printers and a tough prior year compare. Excluding appliance printers, total printer hardware units were up 9% year-over-year. In the consumer business, printer units were up 3% from the prior year lead by solid all in one unit growth. In the commercial business, printer hardware units were up 15% year-over-year lead by color laser printer shipments up 17% and printer based MFP shipments up 26%.

In the fourth quarter, IPG delivered solid operating profit of \$1.1 billion, or 14.5% of revenue including a charge of \$32 million reflecting changes in the camera business model. This change in our camera strategy will have unfavorable impact of approximately one percentage point on IPG revenue in FY '08. Going forward, you will see us strategically taking out costs and realigning resources to build on our core business and accelerate our investments in growth initiatives.

Personal Systems had another outstanding quarter with every region reporting double digit growth, market share gains, and strong margin performance. For the first time, revenue in the quarter topped the \$10 billion mark, increasing 30% year-over-year. Unit shipments were up 31% from the prior year period. The market growth continues to be lead by the shift to mobility, consumer demand, and emerging markets. These trends are playing to our strengths and in the fourth quarter we grew notebook units 57% year-over-year. Consumer client revenue was up 40% and total revenue from emerging markets was up 56% from the prior year period with revenue from China, our third largest market for PC's up more than 100%.

We continue to see momentum in the commercial markets with our commercial client revenues up 24%. Our workstation business grew 31% year-over-year as we leverage a solid product offering combined with strong sales execution and customer loyalty. Segment operating profit was \$589 million or 5.8% of revenue. Compared with the prior year period, PSG operating profit increased 75% or \$253 million demonstrating solid sales execution, increased attach and cost discipline. The favorable commodity environment also contributed to these strong operating margin results.

Moving now to the Technology Solutions Group. Enterprise Storage and Service continued to show strong growth in the fourth quarter with revenue growing 10% year-over-year to \$5.2 billion, and operating profit increasing to 13.5% of revenue. Within ESS, Industry Standard Servers revenue increased 14% year-over-year driven by 78% growth in X86 blades. Revenue in Storage was up 7% year-over-year with growth of 17% in the mid-range EVA business, partially offset by declines in our tape business. While there is still much room for improvement, we are pleased with the progress the Storage team is making.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Business Critical Systems showed growth in every region this quarter. In total, BCS revenue for the fourth quarter was up 5% year-over-year reflecting improvements in sales coverage and execution. While ESS margins were favorably impacted by component prices our margin expansion is also driven by improved sales execution, pricing discipline and our ability to reduce cost and invest in growth markets.

In the fourth quarter HP Services delivered revenue of \$4.4 billion, up 7% over the prior year period with balanced 7% growth in each of our three business units. Operating profit for the quarter was \$526 million or 12% of revenue. For the full year, operating margin expanded 140 basis points to 11% of revenue highlighting the sustained efforts of the team to reduce the cost of service delivery.

HP Software had an outstanding quarter with revenue of \$698 million, and operating margin of 25.4% or \$177 million reflecting strong operational performance of the OpenView and Mercury businesses as well as the benefits that come with scale. For the full year, HP Software delivered revenue of \$2.3 billion and operating profit of \$347 million. HP Financial Services had revenue of \$657 million, up 21% year-over-year and generated operating margin of 7.3%. We are encouraged with the growth in our core financing volume and portfolio assets over the last several quarters as well as the strong performance in end of lease renewals and equipment sales.

Moving now to the balance sheet. HP owned inventory ended Q4 at \$8 billion or 34 days of supply, down four days compared with a year ago. With regard to channel inventory, we exited Q4 in good shape. Personal Systems ended the quarter with approximately four and a half weeks in the channel, at the half a week compared with last year, and well within our target range.

Weeks of channel inventory for imaging and printing and Enterprise Storage and Servers were roughly flat year-over-year. Trade receivables ended the quarter at \$13.4 billion, DSO increased to 43 days in Q4 from 40 days one year ago. Accounts payable ended the quarter at \$11.8 billion. Days payable was 50 days down from 59 days last year. As we've discussed in prior quarters, we will continue to leverage our balance sheet to drive shareholder value.

Next, property, plant and equipment was up \$935 million year-over-year to \$7.8 billion. Gross CapEx was \$813 million, down 16% year-over-year. On a net basis, CapEx was \$748 million, down 14% from the prior year period. Capital expenditures were primarily in IT, real estate facilities and assets used in our leasing business. Net PP&E as a percentage of revenue now stands at 7.5% of revenue, flat year-over-year.

Moving on to our cash balance and cash flow. Q4 cash flow from operations was \$3.6 billion and free cash flow was \$2.9 billion. Share repurchases during Q4 totaled \$2.2 billion in the open market or approximately 42 million shares. At the end of the quarter, we had roughly \$2.7 billion remaining in the current share repurchase authorization. We announced today that the board has approved an additional share repurchase authorization of \$8 billion.

Finally, we paid our quarterly dividend totaling \$206 million. For the full fiscal year, we returned over \$12 billion to shareholders through share repurchases and dividends, at the same time we spent \$6.8 billion for acquisitions. We closed the year with a strong balance sheet, including total gross cash of \$11.6 billion and net cash of \$3.4 billion.

Now, a few comments on our outlook for both the first quarter and the full fiscal year 2008. We expect Q1 fiscal 2008 revenue to be approximately \$27.4 billion to \$27.5 billion. Similar to last quarter, we do not believe it is prudent to set investor expectations that our Personal Systems business can continue to grow at more than twice the market-rate, nor do we think it appropriate to build a cost structure on that basis. For the full fiscal year, we expect revenue will be approximately \$111.5 billion.

Regarding earnings, there are a few variables to keep in mind. First, we expect the component pricing environment to be moderately less favorable in Q1 than it was in Q4. Second, we estimate non-GAAP OI&E to be about \$0.02 per share in Q1 and approximately \$0.10 for the full year 2008. Third, we expect a non-GAAP tax rate of approximately 21% for fiscal '08. Finally, we expect to continue to repurchase shares in the coming quarters. Share count will be impacted by share price trend, option

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

exercise patterns, common stock equivalent and repurchase activity. Currently we expect a modest decline in weighted average shares outstanding in Q1.

With that in mind we estimate Q1 '08 non-GAAP EPS of \$0.80. For FY '08 we expect non-GAAP EPS to be in the range of \$3.32 to \$3.37. All in all, we delivered solid results in FY '07 and our increased outlook for fiscal 2008 reflects our progress to date.

With that, we will now take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you very much, ma'am. (OPERATOR INSTRUCTIONS)

Our first question comes from the line of Laura Conigliaro of Goldman Sachs. Please proceed.

Laura Conigliaro - Goldman Sachs - Analyst

Great. Well, starting with printers, printer unit growth has been coming down pretty noticeably over the past three quarters and supplies growth too. You've got another hard compare in the Jan quarter suggesting another mid-single digit unit growth rate in another weak supplies growth rate. How should we be viewing growth in these categories after that, and since you have been working at trying to separate supplies growth from unit growth, at what point might we start to actually see some benefit from that without the help of much incremental hardware unit growth?

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

Hi, Laura, Mark, I'll start.

First, I think good question. I think we're pretty comfortable with mid to high single digit supplies growth and I think that favorably helps our business model. We're also comfortable with sort of mid-range, mid-single digit unit growth. To your point, we gained a heck of a lot of share coming off of a pretty rough 2003, 2004, and we're also being picky about the categories we're competing. Some of the areas as Cathie noted in the appliance-printer area, we're not seeing the supplies connect rate that you might want and so therefore, we're putting our money into areas that we think give us better connect, so we feel pretty comfortable with where we're headed.

Cathie also mentioned that if you actually took out the appliance growth rate on units and then looked at the core Inkjet and Laser Jet, we had a pretty healthy unit growth rate in the quarter, certainly comparable to what we've seen in other quarters over the past two and a half years. So, I think you should think about those rates. If we get into those levels which we feel good about, we'll get favorable treatment in the business model, we feel good about that and we're continuing to be very tough in this IPG 2.0 transformation to be very focused on making sure that we look at every piece of the business and look at the value it brings so that we go to the real core places that we think we have opportunity to improve the business which is what you saw in the camera business model decision that we described.

We're also working very hard, Laura, and I don't mean to be too verbose with this but I want to make sure I give you a clear answer to this, we worked very hard to ensure that we have channel alignment on supplies inventory relative to the hardware opportunity during the quarter as well so it's really all of those dynamics tied up together and net-net you saw that if you took the camera charge out, IPG profit improved during the quarter, so we feel pretty good about our opportunities here but we still have a lot of work to do.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

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

Great, let's take our next question, please?

Operator

Thank you very much.

Ladies and gentlemen, next question comes from the line of Bill Shope of JPMorgan. Please proceed.

Bill Shope - *JPMorgan Chase & Co. - Analyst*

Okay, great, thanks. Can you give us a bit more color on what you saw in the component pricing and availability situation for the quarter? Particularly as you saw it in PC's and as you saw it in servers and how we should look at that relative to your guidance for next quarter?

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

I'll start, Bill.

I mean commodity pricing was a bit more favorable than we predicted, particularly in memory. As it relates to Q1, it's a seasonally tight market as we approach the holidays and supply usually tightens. Pricing environments is expected to be I'd say generally favorable albeit maybe a little bit less than Q4. We're navigating some tightness in some categories and yet there are other categories that there's pretty ample supply, so that's probably my best characterization of the commodity environment.

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

Great, thanks, Bill.

We'll take the next question, operator.

Operator

Thank you very much.

Next question comes from the line of Richard Gardner, Citigroup. Please proceed.

Richard Gardner - *Citigroup - Analyst*

Hi, thanks very much.

The thing that really stuck out to me in the quarter was the strength that you had in Business Critical Server, and I was hoping that you could provide some color on that?

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

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

Well, I mean, again, we're just doing better. I mean, I wish I could give you--we've been obviously looking at this quite a bit. When you look at BCS, which is what we call Business Critical Systems to your point, we spent a lot of time getting ISV's ported and we're up to over 13,000 was the last count I saw and it's taken us time to get those ISV 's ported.

It's taken us time to really get our sales force wrapped around it and it's also--you still, Richard, also have to look at the blend of BCS relative to blades, because there is some alignment of what happens within our user base in the construct of both and I think the really nice thing about the quarter is the fact that we got growth in BCS and still had the kind of blade growth at 78% blade growth. Those two numbers combined are actually a very, very impressive performance for us, so it's when you get both combined that you really start to feel good about the health of our market position out there.

Richard Gardner - *Citigroup - Analyst*

Mark is it just a combination of application ports and better sales execution and the fact that the old Alpha and PA risk stuff is getting to be a smaller part of the business?

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

You got it.

Richard Gardner - *Citigroup - Analyst*

Are there any particular customer segments or applications where you really are starting to see good traction with titanium?

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

Think is no one deal or two deals so I can put that to rest that drove that answer. It is everything you describe. We obviously had some PA risk in Alpha comps to have to get through, but I would tell you that sales execution is--I'll just word it this way, a great opportunity for us at Hewlett Packard and I think we saw a better version of that in Q4 and we certainly feel good about it.

Richard Gardner - *Citigroup - Analyst*

Thank you.

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

Thanks, Richard.

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

Thanks, Rich. Let's take the next question, Bill.

Operator

Next question comes from the line of Brian Alexander of Raymond James. Please proceed, sir.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Brian Alexander - *Raymond James & Associates - Analyst*

Yes, Mark, just on the revenue guidance for FY '08 of 7%, you've consistently talked about the business as more of a 4% to 6% growth rate. All the segments except software for the last couple years have been guided in that 4% to 6% range. Obviously you've done better than that, but I guess the question is with increasing economic uncertainty and the law of large numbers creating a bigger hurdle what gives you the confidence to step up the growth rate for the Company and specifically what segments do you expect to do better than you've guided before?

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

Well, we're not trying to step up expectations really too far beyond the model that we've described, so at the end of the day you have to peel back the currency impact and then really stare at those local currency growth rates and I think right now, what's in the numbers that Cathie described to you as she mentioned is a couple of things. We've looked at currency in Q1 and we've got a pretty good idea of where currency will fall given how we hedge currencies and how we look at them in the quarter.

We are more uncertain about currency in Q2, Q3, and Q4. We've seen obviously drastic changes in the Euro and other currencies that leave us without a precise landing point on where those will be throughout the rest of the year so think of us as giving you sort of a Q1 that we feel pretty good about from a currency perspective, with Q2 through Q4 with a little less certainty.

That said, I mean, at the end of the day, Brian, we like our position in many of the markets that we're in. We are working very hard on our cost structure. We're realigning within the context of the cost structure that you see and if you were to peel back our—even our SG&A, and took out acquisitions and took out currency, we've had very little increase in SG&A, and driving all of this growth with very little increase and yet even within that little increase, we've been able to put more feet on the street. So as Cathie mentioned, I think it's worth reiterating, we build business models that don't have exorbitant growth rates in them.

We build them on the model that you just reiterated back to me. We then put pressure on our expense structure and then we try to align as much go-to-market capacity and R&D capacity inside that tighter business model, and what that allows us to do is if the growth is there, we're able to take it and—or participate in it, let me put it that way and then able to see it roll within our business model.

So we're doing more of the same, Brian. That's what I would describe to you and that's how we see fiscal year '08, we'll let the economy work its way through, hopefully it's better than some of the doomsayers predict and if it is, we hope to be able to benefit from that.

Brian Alexander - *Raymond James & Associates - Analyst*

Thank you.

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

Great, we'll take the next question, please.

Operator

Next question comes from the line of Ben Reitzes of UBS. Please proceed.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Benjamin Reitzes - UBS - Analyst

Yes, good afternoon, thanks.

Just with regard to the economy Mark, could you just talk a little bit more about that and in context, are you still a third consumer, would you say, and can you talk about your exposure to financials and just in general, you're still guiding to--for the next quarter 9% to 10% growth so it seems like HP is plugging along. Just putting your own performance in context with the market a little more and talking a little bit more in consumer and certain segments especially financials would be helpful if you can.

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

Well, Ben, I'll do my best but I mean, again I don't want to be confused with an economist in any way, shape, or form. We're just--we know a lot about our company and we know a lot about our funnels and the visibility of that and frankly, that's what I'll comment on. We saw--again, if you looked at our performance, we saw solid growth across all businesses and regions and remembering our demographics, 67% of our revenue comes from outside the U.S. If you looked at it as I mentioned the BRIC countries of Brazil, Russia, India and China, we grew 37%, it's now 9% of our revenue and we saw strong growth in all of those--in all of those regions.

We're executing well in some of our key markets. PC's, blades, software, you've heard that story today, so, on a worldwide basis, to give you some context in Financial Services, we are probably not the best one to ask about that market, because we just--we have limited exposure to the financial services market. I won't give you a precise number but it's not a big number.

Now, within that "not a big number" we saw really no material weakness in Financial Services, and again, though, we're largely under penetrated in that market, so it's heard me say, big markets for us inside Financial Services or sub-segments like stock exchanges which even in this market are actually doing pretty well, so I wish I could give you more but we're not--we're actually trying to get more exposed to Financial Services by actually selling more into that industry. We see it as a big opportunity for us but currently it's not nearly as big as we would like it but again, we saw no material weakness in it during the quarter.

Benjamin Reitzes - UBS - Analyst

Thank you very much.

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

Thanks, Ben.

Jim Burns - Hewlett-Packard - VP of IR

Great, let's take the next question, please.

Operator

Next question comes from the line of Toni Sacconaghi of Sanford Bernstein. Please proceed.

Toni Sacconaghi - Sanford C. Bernstein & Company, Inc. - Analyst

Yes, thank you. I just wanted to follow-up on that previous question.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Mark, the United States was the only region whose growth rate actually decelerated in the quarter and your guidance is calling for revenue growth of constant currency to go from 10% this quarter to 5% next quarter. I appreciate the not wanting to get ahead of yourselves in terms of PC's, but to hit that revenue growth rate, PC's has to decelerate from about 30% revenue growth to a single digit number so are you being conservative overall or is there anything that I'm inferring about what we saw in the deceleration in the U.S., and your guidance that is causing you to be more conservative?

Cathie Lesjak - *Hewlett-Packard - CFO*

So, Toni, I think it's really the deceleration in PSG that is driving our guidance in Q1 and I'm--I don't really see it as single digit year-over-year growth deceleration but there is some deceleration, it still is faster than the market and we still expect to increase market share in Q1, but again, we've been cautious about our PSG business basically each and every quarter, not wanting to get a cost structure ahead of where our revenue is going to come in, and so that's really what's driving a lot of our revenue seasonality Q4 to Q1.

Toni Sacconaghi - *Sanford C. Bernstein & Company, Inc. - Analyst*

And any comment on the deceleration in the U.S. this quarter relative to all other regions in the world?

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

Yes, no, not really, Toni, it's kind of, again, a broad story, and I usually don't like to get into too much detail in all of this but I will for the sake of this call since I know there's interest. I mean, we did grow 7%, so overall it was faster than the high end of our 4% to 6% range that we typically give as a company so when we grow 7% overall, even though we've had other quarters better than that we don't feel too bad because it treats our business model very favorably.

Now, inside that, we had some better performance in the enterprise than we've seen in the past and again, I've heard a lot of comments about enterprise but if you looked at it sequentially, we actually saw some improvements in enterprise in the U.S. PSG continued along, roughly where it has been in the U.S., and then we did do some of our work in the printing segment in the U.S. that I described earlier to an earlier question, so that was kind of the story in the U.S. For us overall at 7% was not a bad quarter for us.

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

Great let's take the next question, please?

Operator

Next question comes from the line of Harry Blount of Lehman Brothers. Please proceed.

Harry Blount - *Lehman Brothers - Analyst*

Hi, guys. I'm actually going to come back to the full year FY '08 guidance, sorry to do this, but it looks to me like if we assume you guys do benefit from the dollar, say the dollar stays flat, just where it's at and take a look at where the average price of the dollar was in Fiscal '07 it looks like you might be getting three to four points currency benefit there and if you make another point or two of acquisitions it almost looks like the guidance is assuming very low single digit organic year-over-year growth and I'd love for you to comment on that a little bit.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Cathie Lesjak - *Hewlett-Packard - CFO*

So, as Mark mentioned, we feel pretty comfortable with the currency for Q1 and we factored that into our Q1 guidance, but it's just too uncertain on what Q2 to Q4 is going to look like and so we took a very conservative stance on currency. If currency turns out to be more favorable than what we've got, then we will have built a cost structure that will allow for some nice expansion on the bottom line with the increase in growth.

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

Yes, and so Harry, while Cathie gives you a great analytical answer I want to make sure I'm clear that I hope you don't just go bake in all of the current currency into your model because we're just unsure of where this thing is going to land. We've done that within the context of Q1 as I mentioned earlier because we think we've got pretty good visibility over the course of the next 75 days, but that's kind of where our visibility runs out.

Now, to your point, if currency stays where it is or gets a little better, we may do better, but again, our business model is what we've been describing all along. We try to make sure that we're very disciplined in our ability to align cost to growth and it's very easy to get into a currency model that justifies a whole lot of spending, and I can tell you that I have no--I am not up for that, so what I am up for is a disciplined approach through the year and within the cost structure that we can afford at a revenue level that we can have visibility to, that we realign our cost structure to put us in the best position to capture that revenue if it shows up. So we'll see how the year unfolds, but that's how we built our model and that's where we are.

Harry Blount - *Lehman Brothers - Analyst*

Got it. I was just--it looks like in the context of the overall marketplace, it looks like you guys are being very conservative on any assumptions for organic growth.

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

Well thank you, Harry.

Operator

Thank you very much, sir.

Ladies and gentlemen, your next question comes from the line of Andrew Neff of Bear Stearns. Please proceed.

Andrew Neff - *Bear, Stearns & Co. - Analyst*

Sure, I just wanted to go back to a question earlier that was asked about the consumer outlook. I guess if--Mark, if you could just sort of talk about the consumer side of the business, is it still around a third of your business, what were you seeing in different regions as to what consumer behavior was, any signs--you talked about the commercial activity that you weren't seeing any signs of weakness there? Just give us a sense about what the consumers are telling you at this point?

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

I'll do my best, Andy.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Yes, the numbers you described are roughly right within a third, a third, a third, that being a third consumer, a third being what the broader definition of small and medium business and then a third being the enterprise. Within that, I gave you some color. The color I was giving you was particularly on the U.S. enterprise earlier about seeing some improvement there.

Again, I wouldn't run away with excitement on that improvement, I just--when you look at actual numbers, we improved sequentially over the course of the year in our position in the enterprise in the U.S. Within the consumer market to try to give you more color, we saw strong growth in certain product categories, and this is again a little bit more depth than I usually give but I know it's a topic of keen interest. We saw very strong consumer desire for notebooks. So demand was strong.

Demand was strong in some printer categories more than others, so there was sort of a mix within the printer category as there was a mix in the PC category. I think when you knit the whole consumer segment together globally and across all product lines we saw steady demand across the consumer and that's a global across all product line sort of statement. So I know a lot of data but unfortunately, there's a lot of points to cover and that's roughly what I would describe our position as.

Andrew Neff - *Bear, Stearns & Co. - Analyst*

Did you sense any hesitance in part of the channel and carrying inventories or are they concerned about the consumer?

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

I think again, Andy, it goes back to, without taking into the individual retailer's position, so let's take that aside, on a broad statement basis, it still comes back to the categories. I think when you look at the categories, there are some printer segments where the channel is very excited.

There are some PC segments where the channel is very excited and I've tried to give you color so I think the channel behavior pretty much mirrors the consumer demand story that I just described and we're seeing no--if your question is given that consumer demand are you seeing [abhorative] behavior on the part of the retailers because of say the credit crunch and I'm putting words in your mouth and that's not what you asked, but my answer to that would be no, we're not seeing that.

Andrew Neff - *Bear, Stearns & Co. - Analyst*

Thanks, Mark.

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

Thanks, Andy.

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

Great, let's take the next question, please.

Operator

Next question comes from the line of Shannon Cross of Cross Research. Please proceed.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Shannon Cross - *Cross Research - Analyst*

Hi, good afternoon.

Looking at your cash flow, inventory was extremely solid quarter-over-quarter, but AR continued to trend up. How should we think about cash flow and working capital management as we go into Fiscal 2008 especially with the billion dollar share repurchase and what should we sort of think about, maybe we're jumping the gun here from what you're going to be telling us at the Analyst Day in a couple weeks but any color you could give would be great.

Cathie Lesjak - *Hewlett-Packard - CFO*

Sure. Shannon, we're going to continue to leverage our balance sheet to drive shareholder value. We've got a really strong balance sheet and we want to take the best use of it.

So we are making economic trade-ups to take advantage of cash discounts from suppliers, adjusting payment terms with our customers that will allow us to drive more profitable growth and we'll continue to look at these trade-ups we look at them very analytically to make sure they do in fact add value and that's really what has driven the extension of DSO and frankly, the contraction of accounts payable. The other item on accounts payable is that we did change the linearity of purchases in this quarter, and that was heavily driven by some strategic buys that we made early in the quarter that were really there to drive and assure us supply, especially in LCD's and so we made some very early and wise purchases in the quarter, which changes the linearity and of course then the math for how DPO is actually calculated.

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

Also, I would like to make sure that the inventory work we did over the quarter, Shannon, was a lot of work on the part of the Company. We've had some issues in Q1 and we wanted to make sure we really did the right job here and I would tell you we're not--this is not a demand signal either. This was just us trying to get the optimal inventory conclusion at the end of the year, so to Cathie's point, we are very mindful of the alignment between DSO, DPO, being payables of course, and then the inventory and how those asset metrics play again back into the total performance of the business.

I mean, inventory to just that one metric could be a very confusing metric, because you can describe that less inventory is good, but to be very blunt, you can in some cases have more inventory and increase your profit margins, so when you look at the way you use logistics and the way you leverage logistics across the globe. So we actually have a bit more complex process that we go through than just simply let's lower inventory and let's get payables to the highest number we possibly can.

We have to align the balance sheet metric and we have to align it with the income statement, and then we have to look at the best return on our invested capital that we get for the alignment of all those metrics, so it's a case where I like metrics but you can get over metricized in this area if you aren't careful. You have to look at the integration of these metrics and so what we do and Cathie and I spend a lot of time on this and I'll tell you Cathie has done a great job aligning the clarity of these metrics to make sure we clearly understand what drives more shareholder value.

Shannon Cross - *Cross Research - Analyst*

Okay, and so as we look at fiscal '08 to fiscal 2008--or sorry fiscal '07 to fiscal 08 is there anything that's dramatically changing from any of the metrics from a working capital standpoint or should we sort of assume business as usual and we factor in and try to figure out our cash flow numbers for '08?

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Cathie Lesjak - *Hewlett-Packard - CFO*

So, you should assume business as usual. There will be no--at this point we don't anticipate any big changes to our working capital metrics, but the reality is we look at this on a fairly realtime basis to make sure we make the right decision, to drive the best value for the shareholder but in general, we're basically calling for them to be about this level.

Shannon Cross - *Cross Research - Analyst*

Great.

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

I think Shannon, the big wildcard really is we have more success in the enterprise and the enterprise has some different DSO metrics and those can affect you. It's sort of like if you're successful, there are some things that come with the price of success that we have to deal with, so if we're very successful this year, it could throw us off a bit on those metrics, but again, I think that's not what we've got blended into our models. We think we know we're ahead in the enterprise and I would agree with Cathie this is business as usual for us and we're going to continue to be very focused.

Cathie Lesjak - *Hewlett-Packard - CFO*

And before we get off of the topic of receivables I think you should never walk away feeling that we have any concern about our ability to collect receivables. We don't see any degradation in credit quality, so our receivables move out with a conscience decision and a reflection of the enterprise growth that we're getting and we're very comfortable that we'll collect the receivables and generate the cash.

Shannon Cross - *Cross Research - Analyst*

Great, thank you.

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

Great, let's take the next question, please.

Operator

Next question comes from the line of Katie Huberty of Morgan Stanley. Please proceed.

Kathryn Huberty - *Morgan Stanley - Analyst*

Mark, do you have any insight as to whether the recent acceleration in emerging market PC unit growth is coming from real secular improvements and adoption rates that should continue into next year versus more short-term cyclical or currency factors that would be driving that incremental demand?

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

So they aren't currency factors, Katie, it's a very good question, one that you raised.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

I do think as we've mentioned in previous calls, it's--this explosion of content that's going on around the planet is a big driver, so when you think of the content, there's words out there and analysis out there that the sheer size of global content, whether it's produced by ESPN or News Corp., or coming off the web at Yahoo!, it's the content is doubling every 18 months, and when you get people across the globe that want access to that content and you take places in some of these markets you're describing, where the only access that the person has to that content is through a notebook and a wireless card, because land lines are not nearly as pervasive as what you'll see in markets like the U.S., and that's why I always caution people, U.S. is 5% of the world's consumers, 95% of them are not here and when you look at some of the emerging markets the necessity of some of this technology is more of a staple than I think what some of us typically think.

So we see good growth in those markets and our distribution in markets like China and in markets like India and markets like Eastern Europe are increasing, and so we feel very good about the trends we're seeing in terms of the number of people that want access to that content and our opportunity to compete for that. So, I feel good about it, I would not call any of this unit growth you're seeing there as currency driven at least from what we're seeing. We think it is strong natural demand based on the content and the access to it.

Jim Burns - Hewlett-Packard - VP of IR

Great. Why don't we take--we'll take two more questions, operator.

Operator

Okay, our next question comes from the line of Bill Fearnley of FTN Midwest. Please proceed.

William Fearnley - FTN Midwest Research - Analyst

Yes, good afternoon.

I wanted to shift gears if I could to Storage, Mark. Could you provide more color on the segments and the demand in the pricing environment for HP Storage in light of some of the cautious commentary from some of your competitors and should we expect any M&A moves by HP especially in Storage hardware or Storage software segments here in the upcoming year? Thanks.

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

So, while I know this is an intimate call I probably wouldn't go into much M&A detail on this call, other than to say we think we have a filter of something that makes strategic sense, it makes financial sense and we can actually run it and operate it. Storage, again given what's happening with the world's content, it's got to be created, it's got to be moved, it's got to be processed, it's got to be stored, it's got to be visualized and got to be printed and Storage is one of those key attributes so Storage is a place that we have interest in growing our position.

That said, organically our position improved. I mean EVA growth, our mid-range EVA systems grew 17%, which is one of the better numbers that we've seen and so we're happy with EVA growth. I continue to think you're going to see growth, Bill, more in that low end mid-range area particularly as those Storage capabilities begin to have more--I don't know what the right word for it is, reliability.

They're now more accepted in the enterprise not just through the mid-market so we feel good about our position there, but we grew 7% here in the quarter and while we feel good about that, we could do better. We still have a tape business that's not growing the way we'd like and the high end is still behaving more like the mainframe market, as opposed to like the mid-range market and the lower end of the Storage market.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

So even within Storage, Bill, there's a number of different dimensions you have to get under. We feel very good about our MSA which is our low end and our mid-range EVA line and our opportunity to scale on that market and we'll continue to invest into that.

William Fearnley - *FTN Midwest Research - Analyst*

Thanks.

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

Great, let's take one last question, please, Bill?

Operator

Okay, our final question comes from the line of Keith Bachman of Banc of Montreal. Please proceed.

Keith Bachman - *Banc of Montreal - Analyst*

Under the wire. Hi, guys.

Just Mark, a question on the profitability side, what was traditionally enterprise systems, or ESE, the systems and the software side had noticeable improvements and the operating margins software had some noticeable help from the Merck fall off on the accounting side, but how should we be thinking about sustained levels of profitability in these two divisions in particular? Thanks.

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

I'll start and let Cathie chime in.

I think on software, we gave a range a year ago of getting the software business to look like what a scaled software business ought to look like, and we gave ranges in '08 of roughly 18% to 22%, and we've done nothing to change that view. We believe that the software business has done a nice job integrating Mercury as well as several other acquisitions during the year, Keith, it wasn't just Mercury. They've also done a nice job organically of building up our organic capabilities at the same time as we've been doing some integration. So we feel real good about the operationalization of all of that and I think you'll see that platform that I described with the Mercury integration generating the kind of profit levels that we described.

Now, as Cathie mentioned in her prepared statements, that she mentioned, we've got a couple of things that we're going to move in, and that includes our business intelligence offering and our information management offering and those segments have typically been in ESS, and we're moving them in because we think they're strategically better aligned in the go-to-market model of software than they are in ESS, and they are embryonic in nature, which--or I could use the word strategic or embryonic. Most of them mean that they don't generate great operating income at the current time but we think they will in the future so we're going to move them into software so what you'll see in '08 is us reporting the traditional way we think of software as we reported this quarter which we think is healthy and projected to be healthy, relative to the models we described plus these new segments that come in. So, if you didn't fall asleep listening to all that I'm going to let Cathie give you some more color.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Cathie Lesjak - *Hewlett-Packard - CFO*

We will provide additional guidance in Q1 on exactly what the impact was of moving these embryonic businesses, from ESS and the support piece from HP Services but it's important to note that the software margin will be dampened by--at least at the beginning of the year, by the move of these assets into software for next year.

Keith Bachman - *Banc of Montreal - Analyst*

Okay, great.

Cathie Lesjak - *Hewlett-Packard - CFO*

Okay?

Keith Bachman - *Banc of Montreal - Analyst*

And how about on the systems side, Cathie?

Cathie Lesjak - *Hewlett-Packard - CFO*

So, we saw good improvement on system margins both from commodity prices but it was actually way more than that. We also had good warranty improvement, good attach, good channel--I'm sorry, not channel--supply chain efficiencies as well, and so we're feeling very good about the ESS performance and our ability to continue to improve in that area and frankly, take expenses out where appropriate with respect to our Business Critical Systems business, as its gross margin has come down, we've also been able to realign our cost structure in that area.

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

Keith, ESS did a very nice job from a productivity perspective. To Cathie's point, they generated the kind of growth that we reported today and did a very nice job in their expense structure as they did it, so again it's an example of us. The ESS is not a place, Keith, that we went out with big revenue projections going forward.

Now, they've delivered on that because we have been able to keep our expenses very, very contained and even within ESS, as I mentioned we've actually been able to align more of that to pure R&D and to the go-to-market model, and so as a result when we see the opportunity in blades or BCS, we're now able to go do more work and bring that revenue into the Company. So I think that's a group that I'll give it a short-term thing because they will probably listen to the call, I don't want to laud anybody too much, but in this quarter did what we really--we'd expect them to do.

Keith Bachman - *Banc of Montreal - Analyst*

Okay, thanks, guys.

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

Thanks, Keith.

Nov. 19. 2007 / 5:00PM, HPQ - Q4 2007 Hewlett-Packard Earnings Conference Call

Cathie Lesjak - *Hewlett-Packard - CFO*

Thank you.

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

Okay, let me close up from there and I really do appreciate your questions.

I'll summarize today's call by saying that we had a strong quarter, characterized by double digit growth across all of our regions, share gains in key businesses, margin expansion, expense discipline, and significant share repurchases. We did this while continuing to make progress on improving our cost structure and investing on our strategic initiatives that we believe will strengthen Hewlett Packard's long term competitive positioning.

Given the solid fundamentals within our business we are increasing non-GAAP EPS guidance for the ninth consecutive quarter, and I am pleased with our progress to date and I'm confident that we can continue to execute with discipline and produce another year of strong financial returns. Finally, we do look forward to seeing you in New York City, our annual securities analyst meeting on December 11th and I thank you again for joining the call.

Operator

Thank you very much, sir. Thank you, ladies and gentlemen for your participation in today's presentation. You may now disconnect. Have a good day.

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