

FINAL TRANSCRIPT

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HPQ - Q2 2008 Hewlett-Packard Earnings Conference Call

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Hewlett-Packard - VP of IR

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Hewlett-Packard - Chairman, CEO and President

Cathie Lesjak

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CONFERENCE CALL PARTICIPANTS

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Citigroup - Analyst

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second-quarter 2008 Hewlett-Packard earnings call. My name is Melanie and I'll be your coordinator for today. (OPERATOR INSTRUCTIONS). Also, please note today's call is being recorded for replay purposes.

I would now like to turn the call over to Mr. Jim Burns, Vice President of Investor Relations. Please proceed, sir.

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

Good afternoon and welcome to our second-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 January 31, 2008.

The financial information discussed in connection with this call, including tax-related items, reflects estimates based on information available at this time and could differ materially from the amount ultimately reported in HP's Form 10-Q for the fiscal quarter ended April 30, 2008. 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 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 the second-quarter earnings slide presentation accompanying today's earnings release, both of which are available on the HP Investor Relations website at HP.com.

Finally, please refrain from asking multipart questions or clarifications.

I will now turn the call over to Mark.

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

Good afternoon. Thanks, Jim. Thanks for joining us. Hewlett-Packard delivered a strong second quarter. It was strong in most every dimension we measure. We grew revenues 11% and earnings per share 24%. We generated \$4.8 billion in cash from operations and returned \$3 billion to shareholders through share repurchases and dividends.

As I said last quarter, our performance continues to be driven by three important factors -- cost savings from initiatives across the Company, our deployment of additional sales resources, and a diverse customer base and a broad portfolio that's aligned with the growth areas of the market.

While we have become more efficient, and I'm pleased with that performance, don't be confused. Our cost initiatives are ongoing and they are significant. We expect them to create additional leverage in our operating model.

While we primarily want to focus this call on our quarterly results and outlook, before I pass things to Cathie, let me summarize what we discussed last week regarding our definitive agreement with EDS.

First, we expect the acquisition of EDS to accelerate our reach into key enterprise accounts. As I've said before, we are a great engineering and a great customer support company, but we have a market coverage problem. I've spoken to you many times about our efforts to improve our enterprise account presence, especially in the U.S. We expect this deal to significantly improve our enterprise share of wallet and create a platform that gives us opportunities for new business growth.

Second, we believe that the cost synergies from this business combination are significant and make this transaction very financially attractive, even without the expected revenue benefits. The cost opportunities take many forms. From overhead costs to scale efficiencies to service delivery automation, we have opportunities to materially improve the margin performance of our combined outsourcing businesses. Make no mistake, we will get the costs down and we will create value for shareholders.

With that, I'll turn it over to Cathie, who will review the numbers from the quarter.

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

Thanks, Mark, and good afternoon, everyone. For the second quarter, revenue totaled \$28.3 billion, up 11% year over year or up 5% in constant currency. Non-GAAP operating profit was 10% of revenue or \$2.8 billion, up 22% year over year. Looking at revenue by geography, EMEA and Asia-Pacific were each up 16%, and the Americas increased 4%. We generated 70% of our total revenue and all of our growth outside the United States.

Second-quarter gross margin was 24.8%, up 30 basis points compared to a year ago. This gross margin increase was driven by a generally favorable commodity environment and disciplined pricing.

Non-GAAP operating expenses for the quarter were \$4.2 billion or 14.8% of revenue, down from 15.5% a year ago. Adjusting for currency, expenses were up just 1% as we maintained expense discipline while investing in sales and go-to-market resources and absorbing acquisitions.

Non-GAAP OI&E yielded income of \$3 million in the second quarter, down from the prior year, primarily as a result of lower net interest income and net losses from our currency hedging program. Our non-GAAP tax rate was 21% in Q2.

Second-quarter non-GAAP EPS was \$0.87, up 24% from \$0.70 one year ago. GAAP EPS was \$0.80, which included \$172 million or \$0.07 per share in after-tax adjustments, primarily related to the amortization of purchased intangibles that were excluded from our non-GAAP results.

Looking at the performance by business segment, during the second quarter, Imaging and Printing revenue was up 6% to \$7.6 billion, led by supplies growth of 8%. Commercial hardware revenue grew 6%, while consumer hardware revenue declined 3% year over year. Excluding cameras, consumer hardware revenue increased 2%. Segment operating profit was \$1.2 billion or 16.2% of revenue.

In terms of our core printing business, we shipped more than 14 million units in the second quarter, an increase of 6% year over year. We continued to see solid momentum in our growth initiatives in the second quarter. Our graphic arts business, which is now roughly 10% of IPG revenue, grew in double digits again this quarter. Colors laser unit shipments increased 22% year over year, and printer-based MFP shipments grew 41%, buoyed by the introduction of new products this quarter.

Within IPG, we are also focused on reducing our costs and have a number of ongoing initiatives to improve supply chain efficiency and lower product costs. At the same time, we will continue to invest for growth and profitability through our commitment to research and development, targeted share gains, growth in graphic arts and expansion of our enterprise printing salesforce.

Personal Systems continued to post solid results, maintaining the number one worldwide market share position in calendar Q1, with revenue growing 16% to \$10.1 billion and unit shipments increasing 21%.

PSG maintained balanced growth across the businesses, with consumer client revenue up 16% and commercial client revenue up 17%. Notebooks continue to be strong, with unit shipments increasing 46% year over year.

Segment operating profit for the quarter was \$544 million or 5.4% of revenue. PSG operating profit increase 30%, reflecting solid execution and, to a lesser extent, benefit from a favorable commodity environment. You should expect us to continue to balance revenue growth and profitability by managing our costs and investing in growth.

Moving to the Technology Solutions Group, Enterprise Storage and Servers revenue was \$4.8 billion, up 4% year over year. Industry-standard server revenue was flat versus a tough 17% year-over-year compare. ISS blade growth continues to be strong,

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with revenue increasing 64%. ESS growth was driven by the strength in storage and business-critical systems, which each grew faster in Q2 than they have in the last 10 quarters.

Revenue in Storage grew 14% to just over \$1 billion, with the midrange EVA business growing 17% and the high-end XP business posting 21% growth. The robust Storage results reflect the continuing improvements in our coverage and go-to-market model and positive reception of the new EVA and MSA storage products.

Business-critical systems revenue posted 7% year-over-year growth, with Integrity server revenue increasing 35%. BCS grew in every region, with significant wins in the United States. Business in markets such as India and China also posted strong growth as these markets build out their infrastructure.

Enterprise Storage and Servers posted solid second-quarter operating profit of \$655 million or 13.7% of revenue, up 390 basis points from the prior-year period, led by stronger performance in storage and BCS, favorable component pricing and expense discipline.

We had a solid quarter in HP Services, with revenue of \$4.6 billion, up 12% over the prior-year period. Technology Services delivered strong revenue growth of 10%. Outsourcing and Consulting & Integration revenues increased 14% and 15%, respectively.

Operating profit for the quarter was \$508 million or 11% of revenue, up 10 basis points year over year. The contribution of strong revenue performance from technology services was partially offset by workforce rebalancing in Q2 as we initiated a plan to simplify the organizational structure within services. We're pleased with the progress we have made in reducing costs and accelerating growth.

HP Software revenue was \$727 million, up 28% from the prior year. We continue to take share in the management software layer, both organically and through acquisitions. BTO maintained its momentum with 36% year-over-year growth. Other Software, which includes OpenCall, Business Intelligence and Information Management, grew 2% to \$134 million. Solid growth in Information Management was largely offset by year-over-year declines in our OpenCall business.

Software reported operating profit of \$93 million or 12.8% of revenue, up from \$7 million in the prior year. Strong operating performance within BTO was partially offset by integration costs and investments in business intelligence.

HP Financial Services had revenue of \$685 million, up 25% year over year, and generated operating margin of 6.9%. We're 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 Q2 at 32 days of supply, down two days compared with a year ago. With regards to channel inventory, we ended the quarter with ESS down roughly a half a week, PSG up roughly a half a week and IPG approximately flat year over year. Days sales outstanding increased to 43 days in Q2 from 41 days one year ago. Days payable was 53 days, down from 54 days last year.

Next, property, plant and equipment was up \$567 million year over year and down 40 basis points as a percentage of revenue. Gross CapEx was \$704 million, down 7% from the prior-year period. On a net basis, CapEx was \$599 million, roughly flat year over year. Capital expenditures were primarily related to assets used in our leasing business and our investments in IT.

On to our cash balance and cash flow -- cash flow from operations accelerated to \$4.8 billion for the quarter, and free cash flow was \$4.2 billion. Year to date, cash flow from operations was a very strong \$8 billion, up 92% year over year, and free cash flow was \$6.8 billion, up 131%. During the quarter, we also had a net cash outlay of about \$1 billion for acquisitions.

In addition, we spent \$2.8 billion on share repurchases during the quarter, representing approximately 66 million shares. At the end of the quarter, we had roughly \$4.5 billion remaining in the current share repurchase authorization.

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Finally, we paid our normal quarterly dividend, totaling \$197 million.

We ended the quarter with a strong balance sheet, including total gross cash of \$11.8 billion and net cash of \$3.5 billion.

Now a few comments on our outlook for both the third quarter and the full fiscal year, neither of which includes any impact from the acquisition of EDS we announced last week. We expect Q3 fiscal 2008 revenue to be approximately \$27.3 billion to \$27.4 billion, in line with typical seasonality. Given our significant international exposure, our results may be favorably or unfavorably impacted by currency. Assuming exchange rates stay roughly where they are and given our assumptions about hedging and pricing, we expect full-year revenue will be approximately \$114.2 billion to \$114.4 billion.

Regarding earnings, there are a few variables to keep in mind. First, we expect that the component pricing environment to be less favorable in Q3 than it has been in the last several quarters. Second, we estimate non-GAAP OI&E to be approximately zero for the remainder of the year due to lower interest income and higher costs of currency hedging. Finally, we expect to continue to repurchase shares in the coming quarters, with a modest decline in weighted average shares outstanding in the second half of the year.

With that in mind, we expect Q3 '08 non-GAAP EPS in the range of \$0.82 to \$0.83. For the full year, we expect non-GAAP EPS to be in the range of \$3.54 to \$3.58, representing growth of 21% to 22% on revenue growth of roughly 9.5%.

Overall, we delivered solid results in Q2 and increased our outlook for the year, reflecting the strength of our business model and our progress to date.

We will now open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Richard Gardner, Citi.

Richard Gardner - Citigroup - Analyst

Mark, I just wanted to ask a quick question about the ISS performance in the quarter. I know that Cathie mentioned that you were up against a difficult 17% or 18% year-over-year compare, but it still looked like you were down a little bit more than normal seasonal in the quarter, despite the solid growth in blades, and was hoping that you could provide some color there.

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

Sure. Yes, I think, down a little, but seasonally, you are on it. It was against a tough compare, 17% the year before. Good blades growth within it, but very frankly, we picked our spots. We saw some spots where we thought we could take advantage of things, and we did, that were also in there, Richard, blades being one of those. There were a couple deals we missed that we would like to have had, and that's an execution issue that we'll be looking through. But I'd say it's really the tough compare. We picked our spots -- some good numbers in there, for the example of the blades that we described, and a couple deals that we would like to have had that we didn't get.

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Richard Gardner - Citigroup - Analyst

Mark, would you say that there's been any significant change in the competitive environment in terms of pricing or how your competitors are approaching the marketplace that's factored into the performance?

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

Yes, spotty. I would not say globally; I would say we saw some spotty stuff in different markets. But as I always tell you, Richard, I have a hard time with the -- I can't remember when it wasn't competitive as opposed to when it is. But yes, a couple of spots where it was a little bit more competitive than perhaps what we've seen in the last couple quarters.

Cathie Lesjak - Hewlett-Packard - EVP and CFO

I think I'd also add the fact that we ended channel inventory in really good shape for ISS and ESS. So we're going into the quarter in good shape.

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

Yes, I think, Richard, it's another point that Cathie hit on which I think is great. We were pretty prudent with the way we looked at inventory. And while you see the ESS number in total, within it the ISS channel inventory was pretty strong, pretty strong being defined as we have less inventory in the channel at the same time as we're going up against that compare. So that's really the ISS story.

Richard Gardner - Citigroup - Analyst

Okay. I know Jim's going to kill me for asking a three-part question, but do you feel like virtualization is having any impact on your x86 business at this point, with customers virtualizing with VMware on existing hardware as opposed to buying new hardware?

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

Certainly not materially in the quarter. As you look at the \$60 billion server market and the opportunity to replatform from nonindustry-standard platforms to industry-standard platforms, the industry-standard server platform is really the beneficiary of that transformation. So depending on which way you look at the virtualization question, virtualization actually can be, in many ways, a driver for industry-standard server growth. So I think my answer to you would be certainly intra-quarter within that note.

Operator

Ben Reitzes, Lehman Brothers.

Ben Reitzes - Lehman Brothers - Analyst

Mark, could you talk a little bit about Europe? There are some worries in the marketplace about Europe and what the momentum of business is going into your July quarter. And then if I can also just sneak in similar questions around PCs, it actually seems maybe that units picked up in April. I was just wondering if you could characterize the PC market and competition, given what's going on there.

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

Well, I tell you, we're having a tough time with discipline on the multipart questions. But Ben, I'll go take them. Europe was strong for us, obviously -- 16% growth year on year. It's up to 43% of the Company. The performance across Europe was strong, it was broad across all of our divisions, very strong. I would tell you that within linearity, and I won't answer it specifically into PCs, but within the quarter we had a pretty normal quarter in terms of linearity. If anything, and I say this cautiously, but we were probably a little stronger in April than traditional linearity. I only say that cautiously because I don't want somebody to run too far with it, but the quarter behaved roughly as we would have expected. Perhaps as you saw, we obviously beat our guidance from a revenue perspective, and April was a healthy month for us.

Ben Reitzes - *Lehman Brothers - Analyst*

Okay. And competitively, in PCs, you were able to have that even with a competitor filling the channel? I was just wondering --

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

Yes, we felt very good about the PSG quarter. Obviously, we are going up against a -- talk about tough compares; I mean, this was a huge quarter for us last year from a growth rate perspective in PCs. And dialing in the 16% growth number here was, again, probably, to be very blunt, a little stronger than we had expected and that we had modeled. So PSG had a very, very strong quarter.

Operator

Toni Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

Mark, I was wondering if you could talk at all about the economic environment. The thing that struck the most was the U.S. growth rate actually looked like it was slightly negative in the quarter, and that's down from 6%, 7% and 12% growth in the last three quarters.

Additionally, if I look at your guidance and run my little currency model, it looks like you are guiding for about 2.5% growth at constant currency year over year in Q3 and 2.7% in Q4. Now, again, very tough comparisons -- completely understand that. But is there something here, particularly in the U.S., that caused that pretty notable deceleration in the second quarter in your business and then something around the overall economy, maybe U.S.-centric, that has you forecasting a revenue growth rate that was ultimately below your target model, and I think would certainly be the lowest reported growth rates at constant currency that you've had since you've joined HP?

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

By the way, if you'll send me that little currency model, I'll review it for you and give you some thoughts. But listen, back to the overall situation, the fact that we could have a flattish performance in the U.S. and grow the Company 11% I think is indicative of the position of the Company. To be very blunt, Toni, we pick our spots. We look around where we see the opportunity, and we try to be nimble enough to take advantage of those opportunities as we see it. And that's, for us, obviously, as you know, we have to position inventories, we have to position -- to align our demand to where we see the opportunity. I think, to be very blunt with our businesses, we did a pretty darn good job in the quarter trying to line up to fulfill the opportunities that we saw.

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U.S., to be specific, was just spotty. We had some very good numbers in the U.S. Cathie talked about storage, she talked about business-critical systems. IPG had positions of strength. So there's some very -- I could go on. There were some positions that were very positive. And to your point, we are going up against tough compares.

So I hate to give you so much data. I usually try to make it a little bit more concise, but the U.S. is a tale of many stories, and spotty would be the best way to describe it. I wouldn't describe it all bad, but I wouldn't describe it all good, either. And then within that, we frankly spun the dials to the opportunities that we saw to take advantage of what we saw in the market, and we really -- while we look at countries, we look at optimizing the entire business as we go, and that's what we did, Toni.

Toni Sacconaghi - Sanford Bernstein - Analyst

But is the choice around where you chose to play, Mark, are you effectively saying there are parts of the U.S. market, because of the growth or because of the pricing that's required, that you chose not to play in?

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

I wouldn't go to elasticity so much, Toni. I think it really is the alignment of demand. I don't think, in the U.S., that I would go drive right down to pricing, although it's an element of what we look at. We try to line up where the demand is. And again, I think the best thing I can tell you about the U.S., and it's probably where I'll leave it, it's just right now a very spotty market and one that we try to maintain caution around.

Operator

Shannon Cross, Cross Research.

Shannon Cross - Cross Research - Analyst

Just a question on cash flow because, obviously, at \$4.8 billion, it was quite strong in the quarter. Can you, Cathie, provide us with any sort of puts and takes, things to keep in mind as we look for the full year, since obviously you did as much cash in the first two quarters as you did in -- I think it's all of 2005?

Cathie Lesjak - Hewlett-Packard - EVP and CFO

So we laid out some guidance around cash flow from operations at the security analyst meeting in December, and we said we thought we'd be about \$11 billion. Basically, having done \$8 billion so far this year with only half completed, we clearly expect to do a bit better than that. We are ahead of plan. Part of that is due to earnings, and frankly, part of that is due to some improvement in the working capital space. We've really focused on getting inventory in better order and making good progress there, and we're focusing on accounts payable as well. So definitely some upside to cash flow for ops this year.

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

I think, Shannon, there's clearly some inter-quarter movement across the cash flow, so I wouldn't make it all additive, and I wouldn't double \$8 billion to \$16 billion. But we'll clearly do better than our forecast. We'll have to see how it eventually lands in, but clearly this has been a very strong performance for us. And it's no one thing; it's a multitude of things that have occurred. So, to Cathie's point, we will clearly beat this forecast.

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Shannon Cross - Cross Research - Analyst

Can you talk anything about your share repurchase strategy with the acquisition of EDS? And then that's my last question.

Cathie Lesjak - Hewlett-Packard - EVP and CFO

So with the kind of cash flow that we're generating, we fully expect to be active in our shares, even post the EDS acquisition, probably not too dissimilar from the programs that we run today.

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

We like our shares pretty well, Shannon.

Shannon Cross - Cross Research - Analyst

Good. Thanks.

Operator

Keith Bachman, Bank of Montreal.

Keith Bachman - Bank of Montreal - Analyst

I had a question on the IPG group. Cathie's clarification, though -- consumer printer hardware units in the slide deck says up 4%. I thought you said it was up plus 2%, net of some consumer units. I just wanted you to clarify.

But then, Mark, on a broader scale, I was just hoping you could speak about how we should think about the inkjet side of the business in terms of unit potential as well as on, if you can disseminate a little bit on the supplier side of inkjets and how we should be thinking about that market evolving.

Cathie Lesjak - Hewlett-Packard - EVP and CFO

Keith, let me just orient you on the first question, because -- one is units, so we're up in units 4% in revenue, and if you adjust for cameras, we were up 2%.

Keith Bachman - Bank of Montreal - Analyst

Okay, but Cathie, can you adjust for cameras on units, please?

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

We could try. We'll try to get somebody to get back to you on it.

Jim Burns - Hewlett-Packard - VP of IR

We don't count cameras as printer units.

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

Yes, that's really not in the unit count anyway, Keith. So it really hits the revenue number, but not the unit number, as we calculate it.

But let's go back to the inkjet thing. Inkjets actually looked pretty strong. Within the roundings of the inventory, too, we've done a good job on our channel inventory. Demand looked better, so overall good sort of ecosystem result would be the way I would describe it, Keith, in the context of both unit placements and the supply attach associated with it.

Keith Bachman - *Bank of Montreal - Analyst*

And so, Mark, just a broader question is, when we talk about a slowdown in the U.S. or the economy, are you seeing or have differences in terms of what's happening in the inkjet? Because this quarter was, frankly, a little bit easier compare than the last couple quarters. Are you seeing some reaction due to the consumer slowdown here in the U.S. or otherwise on that particular business unit?

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

I would say that we saw no material change in inkjet in the U.S., if anything -- and again, I say this on the margin -- if anything, perhaps a little bit better. It's back to my earlier answer to Toni; it's just the U.S. -- I would not want you to walk away from the call with HP said the U.S. is all bad. That's certainly not what we're seeing. Were seeing spotty results in the U.S. It's a little different by industry, it's even a little different by geography, and it's a little different by business unit.

And within that, I could tell you a storage story. I could tell you a business-critical systems story, an inkjet story. And it's just a mixed bag. So what I've tried to do today was not go into all of that detail, because I think it would take a long time to go through. But there's good numbers in there, Keith, and there's some numbers that we wished were better. But we think it's a factor in the market. We also feel very good about our share position within the context of all that. So long answer, but that's what we are seeing, Keith.

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

The other overlay to that is the fact that we had said last quarter that we didn't execute as well as we would have liked. We would say that we executed better this quarter.

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

This is an IPG comment that Cathie is making. I think last quarter, we left some units on the table, and we didn't feel as good about the execution. This was a better execution from IPG's perspective this quarter.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James - Analyst*

Mark, on the PSG side, this is the first quarter where I think commercial revenue grew faster than consumer since January of '05, albeit the delta was small. It also represents a slight deceleration in the contribution margin for PSG, but still strong, 9%. I'm not

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sure if I should be connecting those two factors, but the questions would be, do you expect the mix shift to continue toward commercial? And two, is there still a sizable gap in operating margins between consumer and commercial, such that this creates an additional headwind going forward?

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

Listen, I appreciate your analytics. I think you've done a nice job with that. You're connecting dots I wouldn't connect. Don't connect commercial and consumer. Don't connect the mix. There's also loads that go in which are not unique to each business in terms of costing loads. So I would not connect those dots; I would not connect the dots of a shift in mix. I would not connect the dots of different contribution margins based on those shifts as anything material to the business.

I would say that PSG saw opportunities in the commercial segment, took advantage of them, had some very, very strong wins in the quarter that we were pretty pleased with. Their operating margins are on the margin, if that makes any sense. But the difference is on the margin. And again, I'd say PSG, as we went into the quarter, because we're trying to pick our spots prudently as we look at the market, PSG performed in line with our expectations, if not a little bit stronger than what we thought. So we felt very good about the PSG quarter and their position.

Operator

David Bailey, Goldman Sachs.

David Bailey - *Goldman Sachs - Analyst*

The slowing growth in the U.S., I guess, was not a big surprise, given what's going on in the economy. But your year-over-year growth in APAC, the constant currency dropped a fair amount this quarter. Can you comment on how much of that is macro-driven and, more broadly, what you're seeing from a demand perspective in Asia?

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

We felt pretty good about Asia. We grew, obviously, 16%. And you've got to look at currency on a year-over-year and sequential basis. One thing about currency just to be a little bit cautious about is, when you look at the cycle times of our business, not all that currency -- I don't want to get into a big currency dialogue, because this could take up longer than we have left for the call. But when you look at the cycle times of some of these businesses, the currency doesn't all stick to your fingers, so to speak, because of the speed by which these move across. It's a little different in each business.

So I wouldn't read as much into, as I think many people do, into those things. I still think this is the right way for us to report it. But we felt good about Asia. We felt good about the demand and the position in Asia, our share position in Asia. So we came out of the quarter in Asia pretty encouraged, David.

Operator

Jeff Fidacaro, Merrill Lynch.

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Jeff Fidacaro - Merrill Lynch - Analyst

Mark, I was wondering if you could just give a quick update on some of the operational savings as far as the data centers and where they stand as far as percent completion of closings, as well as the applications. I know you've been working them down from 6000, getting towards your targeted 1500. Just if you can give us a quick update on where that stands?

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

Sure, I'll give you some rough numbers. We closed the quarter with 2500 applications running Hewlett-Packard. We've got about 65% of our data centers now closed, that we will close. We believe by the end of Q3 we will be about 90% to 95% of the way through and finish by the fiscal year.

So a couple of points on this, Jeff, that I think we're in position to get the full run rate savings in '09, as we've talked about. I think we will be somewhere a little higher than 1500, but 1700, 1800 applications by the end of the year. It's, I think, 1780 is the destination point.

This puts us in a position to do a couple things -- one, obviously, finish off our transformation, but to do two things -- one, to integrate any other acquisitions that we do or at least the one that we talked about last week, which is a big issue for us, to be in a position to have that kind of capacity and capability to integrate. That's significant for us.

Secondly, we've got opportunity now to start working on our applications and the productivity that comes from the applications now being integrated. We've given examples before that we had 18 planning applications in the Company. So I don't know how many different ways you can plan, but we found 18 different ways to do it. We now plan one way. I could go down this area by area -- consumer apps, where we had 75 and now have one. So the fact that we now have global application sets allow us to now accelerate our productivity process by process as we go across the Company.

One last one I'll give you free of charge is we used to deal with our channel partners, where any time a channel partner wanted to give us information, we accepted the format that the channel partner gave us. So we had however many channel partners, that's how many different ways that we accepted data, which isn't necessarily an application; it's different processes. Getting those all collapsed into one global way to do it gives us an opportunity now to increase our productivity.

So darn near completed, very good job, I think, by our IT, now capable of, with capacity to be able to integrate an acquisition like we've talked about, in addition to the fact that we now have a productivity model that allows us to enhance our global applications, because we now have a simpler environment. So maybe more data than you wanted, Jeff, but that's where we are.

Jeff Fidacaro - Merrill Lynch - Analyst

And just one quick follow-up. As you look at your data centers and you get closer to completion, what sort of utilization levels do you have available for, say, like an EDS type integration? Is there a lot of room to move them to your data centers and/or automate their processes?

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

Yes. We could completely house them in our existing capacity. And yes, we have an idea about the applications. And yes, we have an idea about how to globalize those applications and those processes. So it's a very, to your point, I think very insightful. It's a very important piece of what we do. And Jeff, we think we've built a competency now in this capability. I can tell you, if you look over three years and the total report card and you look holistically over where we started and where we've come to, that capability and that asset for Hewlett-Packard is now a big opportunity, big advantage for us.

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Operator

Bill Fearnley, FTN Midwest.

Bill Fearnley - FTN Midwest - Analyst

I'd like to switch gears, if I could, to storage. Mark, how do you rate your performance in relation to competitors, especially in storage? Have you turned a corner here, and are you gaining new customers or selling more to the existing base?

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

So, Bill, good question. I think it's a lot better. So I'm happier, so I just give you an incremental metric. On an absolute basis, listen, we can just do better than this. We've got new product we've announced into the market during the quarter, in the storage space, that we're excited about. We've begun to bring together some of the acquisitions we've done and align some of our storage essential software with our platforms. We're doing more work in the channel, and it turned into good growth. For us to get mid-double-digit growth or 14% growth in the quarter is better than we've seen.

What I'd tell you, that if there's anybody taking a lap around the building, I sure haven't seen them, because we've got a lot more work to do to be a participant in the way that HP ought to be a participant in the storage market. So I think it's good, and the good news is we're getting it done with good old-fashioned blocking and tackling. There are net new customers in addition to us being able to upsell and cross-sell into our base. We've really got to, Bill, do a better job integrating our channel partners' go-to-market, because we obviously, as you know, we've got a tremendous server channel support. Getting that same support on the storage side in many of the same partners is important for us.

Bill Fearnley - FTN Midwest - Analyst

Are you increasing incentives to get them to do that, or do you think they are making the proper progress at this point?

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

I wouldn't say we've increased incentives as much as we've focused those incentives. We've done some things to say, listen, again, back to our previous discussions in calls about sometimes for us it's the way we spend our channel money in our incentives as opposed to how much. Do we incent on pure volume or pure units, or do we incent on attach? So if you just went down a metric of storage attached to our servers, you would get a big growth in storage volume.

The question is, why hasn't that occurred? Well, some of that is the way we incent the channel. It isn't an amount of dollars, but it's the way we package those dollars. So it's more about that than it is increasing the amount, but getting focus and being very clear to our partners, this is what we value, so therefore this is how we incent. Some of that has occurred in 2008, and that's at least a reason why you're seeing some of the improvement that you are seeing.

Cathie Lesjak - Hewlett-Packard - EVP and CFO

It's also how we've segmented our channel partners, in some cases, because we didn't have as good a storage relationship in some of our ProLiant channel partners. So we've really expanded that. We've also added what we call road warriors to basically help sell the storage through the channel. That is also showing some early good returns.

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

Cathie's point is exactly right. The ProLiant franchise and what it's driven in aligning that with the storage group is a very important thing that's going on here. So we want more; we're expecting more good things, Bill, there. I don't want you to for one minute think we're satisfied with it.

Bill Fearnley - *FTN Midwest - Analyst*

Thanks for the detail. I appreciate it.

Operator

Lou Miscioscia, Cowen & Co.

Lou Miscioscia - *Cowen & Co. - Analyst*

Going back to EDS, I have a couple quick questions here. I guess your comment that you could completely house EDS's operation in your existing capacity -- they've spent a ton of money throughout the years on their on IT infrastructure. What were they inherently doing that I guess was less efficient that you could bring to the table? Was it decentralization of their data centers?

And then the second question would be if you could give us a little bit more of a comment on just India, in the sense of EDS obviously has Best Shore, but they've stumbled a little bit, but do have a footprint in India. Can you actually do a lot with that in expanding it?

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

I think your comment, Lou, was about EDS and their utilization levels of IT and how they've dealt with their IT expenses. That was the question, right, the first one? And then the second one is India?

Lou Miscioscia - *Cowen & Co. - Analyst*

Yes.

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

Great. Let me try to nail it. First, the data center consolidation we talked about for EDS -- I want to make sure it was clear -- was internal IT, not trade. So just to make sure there's no confusion, we separate trade and internal IT. And what I was talking about was internal IT, and I think you are, too, Lou. So I certainly can't explain to you any historical issues other than what we see and the opportunity we see, which we think is significant to leverage that capability with our capability. So we feel good about it. We've done a lot of due diligence on it. We think it's a pretty significant opportunity that puts us in a better position.

In terms of India, obviously both companies have a footprint there. But we are less these days, and I've tried to mention this several times -- we feel very good about India. We think India is an important country. But at the same time, we look to optimize in many locations. So India is important, but it isn't the only country where we have significant operations that we leverage.

So we are still bullish on India. Obviously, EDS has been bullish on India. They've got some 40,000 employees there, remembering, too, that of their 130,000 employees, 30,000 of those employees are government employees that work right next to the

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government because of contracts. So, of the their 100,000 remaining employees, they have a very significant presence in India. But we continue to optimize to Best Shore locations as we think that makes sense.

Lou Miscioscia - *Cowen & Co. - Analyst*

Okay, great. And just a quick follow-up. How about what both you and they are doing from an IT infrastructure outsourcing? Obviously, it seems like you plan on merging that, too. Do you think you can get some efficiencies there, too?

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

We think about efficiencies all over the place, Lou. So we think it's material in both process and in what we do, yes.

Operator

Katie Huberty, Morgan Stanley.

Katie Huberty - *Morgan Stanley - Analyst*

Cathie, in light of the currency hedge losses that hit the P&L this quarter, what was the net impacts of the weaker dollar on the bottom line? And how should we think about that over the next couple quarters?

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

I'm afraid I'm going to go down an accounting road here that I'm going to lose some of you on. But the currency losses that I was actually referencing are from hedging our balance sheet outside the United States. That currency loss is -- a big chunk of that is really just the fact that interest rate differentials have flipped around on us, and we are now paying away points when we hedge our balance sheet as opposed to earning points. So it's really not related to the revenue hedging that we do because the revenue hedging is all completely in from the revenue line all the way to operating profit.

So we don't actually -- it's very difficult for us to completely capture the total currency impact on the P&L. I can tell you what it is from a balance sheet perspective easily, because it shows up in OI&E, but the rest of it is buried in basically every line.

Operator

Clay Sumner, FBR.

Clay Sumner - *FBR - Analyst*

Just wanted to revisit the IPG business. Revenue was up 6% or so, supplies were up 8%, yet operating income, I think, was flat in dollars year over year. I assume that it essentially reflects a shift in the overall portfolio to laser. Might we expect that wide-format mix in Edgeline to hold that shift to laser, and if so, when?

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

Clay, this is Mark here. Listen, 16.2 is a pretty good number for us. We usually -- I remember the days when I got here. We never thought we could make more than 15 in the business. So 16 is a good number for us, overall.

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We have invested in the salespeople in enterprise. We have invested in salespeople in the graphics. Graphics had another good, strong quarter where we're investing some salespeople into that mix. There is shift from laser, as you described, that I would say adds to that portfolio shift. But overall, pretty healthy IPG performance all the way around. And the fact that we could deliver 16.2, deliver 6% unit growth, turn in 8% supplier growth and yet also invest into demand creation for the future in the enterprise and into graphics.

I think as Cathie referenced a little bit earlier in her talk, graphics is now quickly becoming a material piece of the business. It's got a very attractive growth rate and delivers a very positive operating performance for the business. So we are investing into graphics as we invest into enterprise. It's really the mix of those factors that gets to the answer that we did not just laser alone. But I would tell you, as I've said about Q1 and I'll say this about Q2, IPG had a strong quarter in Q2.

Cathie Lesjak - Hewlett-Packard - EVP and CFO

I think you also need to take into consideration -- we've talked a lot about this, whether it's in IPG or other segments, is that we are investing to grow, to Mark's point. But we are also investing to save, to basically set ourselves up with the right cost structure in the longer term. And you certainly saw some of that in the IPG P&L this quarter as well.

Clay Sumner - FBR - Analyst

So just to clarify, you are suggesting maybe that gross margins were more positive than operating margins because of the investments?

Cathie Lesjak - Hewlett-Packard - EVP and CFO

There are investments in both the cost-of-sales line as well as in OpEx.

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

I'd say generally your point is right, yes, and that there is some cost for investing to save, as Cathie described. And there is some investment to grow, as Cathie described. And it's the combination of those two factors that we think is prudent to be able to invest to grow and also to invest to take structural costs out of IPG for the long run, and both of those are in the Q2 numbers, and again, I'll say one more time, and yet deliver 16.2, as we did it. So we feel good about that.

Operator

Scott Craig, Banc of America.

Scott Craig - Banc of America - Analyst

Mark, with regards to Europe specifically, I know you guys have a number of different channels that you're getting hardware product out to. But can you contrast what some of your larger distributors are saying, like the Ingram Micros and the Tech Datas of the world, where they are seeing weakness in Europe? Typically, my understanding was that's a larger channel for you in Europe than it is elsewhere. And then maybe what you're seeing in the direct business or the retail business over there, because there seems to be some sort of disconnect from the solid trends you guys are seeing in Europe versus some of your partners.

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

I very much don't like talking for them. So I don't want to have any effect on them or their commentary. We just saw a strong Europe. And, to your point, we are very diversified in Europe. There is also a very large reseller base in Europe. So if you just looked at sheer number of partners, the way the channel works in Europe is a bit more dispersed than what you would see in the U.S.

In addition, Europe is now a very diverse economy between Russia, Central Europe, Eastern Europe, Middle East. And so when you talk about Europe, we combine it into this thing call EMEA. But inside EMEA, you've got a whole series of things that go on between more mature Euro markets and markets that are actually much more like an emerging market in the context of some of the markets I've already described.

So it's really hard to generalize about a conclusion there, and I would not take a result from one of those distributors you described and then try to extrapolate Hewlett-Packard's results across Europe for a quarter. I think it's a very dangerous thing to do because of the disparate nature of Europe today and the different sets of types of partners that are out there.

So again, one more time, Scott, I think to your question, Europe was strong for us in the quarter across, really, everything that we touch. So it was strong across most every segment that we have.

I think we will leave it there today. I guess, just at the end of the day, to summarize the quarter for us, we had strong growth in the quarter at 11%. We felt it was balanced, and we picked our spots where to participate, and we felt like we got good results from that. We had margin expansion. The Company executed, from an expense perspective, with discipline. Cathie gave you those numbers, and we feel good about the fact that when you look at ex currency, our spending was in line. This is the best cash flow performance we've had in the Company's history. We feel good about that, and we were active in the market in terms of share buybacks.

So I think at the end of the day, when you think about the second half for us, we go in with a diverse marketplace, diversity of customers, geography and businesses. At the same time, as we see that from a revenue opportunity, we're going to continue to be very focused on driving efficiency, and there is more leverage in our operating model to gain out of the cost actions that we're taking.

We'll leave it at that today. Thanks for joining us, and we'll talk to you again soon.

Operator

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

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