FINAL TRANSCRIPT

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HPQ - Q2 2005 Hewlett-Packard Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Hewlett-Packard second-quarter earnings conference call. At this time, all participants are in a listen-only mode. We will be facilitating a question-and-answer session during today's conference. (OPERATOR INSTRUCTIONS). As a reminder, the conference is being recorded for replay purposes.

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

Brian Humphries - *Hewlett-Packard Development Company - VP of IR*

Thank you, and good afternoon, everybody. I would like to welcome all of you to our second-quarter conference call. Joining me today is our CEO and President, Mark Hurd, and CFO, Bob Wayman.

Before we get started, I would like to remind you that this call is being webcast on HP.com. Also, the webcast and the slide deck that we will be using, along with non-GAAP reconciliation tables for the slides, can be accessed by clicking on Company Information, then Investor Relations and then View Webcast and Earnings Information. A replay will also be available shortly after the conclusion of the call through the end of May.

Next, it's my duty to inform you that the primary purpose of the call is to provide you with information regarding the quarter just ended. However, some of our comments and responses to your questions may include forward-looking statements. These forward-looking statements are based on certain assumptions and are subject to a number of risks and uncertainties, and actual future results may vary materially. I encourage you to read the risk factors described in the Company's quarterly report on Form 10-Q for the fiscal quarter ended January 31st, 2005, as well as subsequent SEC filings after our Form 10-K, for an understanding of the factors that may affect company business results.

I would like to point out that earnings, gross margins, operating expenses and similar items discussed at the company level are generally expressed on a non-GAAP basis, and therefore have been adjusted to exclude certain acquisition-related charges, in-process R&D charges, amortization of goodwill and purchased intangibles, restructuring charges and net investment losses. A presentation of GAAP financial information for the present quarter and a reconciliation of non-GAAP amounts to GAAP is included in the financial statements accompanying today's earnings release, which is also available on HP.com in the Investor Relations section.

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

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Thanks, Brian. Good afternoon and thanks for joining us. We are placed with HP's second-quarter results during the quarter. Revenue grew 7% to 21.6 billion. We posted non-GAAP operating profit of 1.3 billion or 6.1% of revenue, and we generated 2.4 billion in cash from operations. Importantly, we delivered improved financials in many of our business segments, and the pricing actions we have taken in Imaging and Printing are taking effect with solid hardware unit growth in the quarter, reversing recent trends.

In our discussion this afternoon, I would like to describe our financial performance by segment, then Bob will review the financials in more detail and I will close with some comments on my early impression of things here at HP.

Let me quickly get into the business segments. During the quarter, we saw 5% revenue growth in Imaging and Printing. Consumer hardware revenue increased 3% year over year, with shipments up 13%. Commercial hardware revenue grew 8% year over year, with units up 12%, led by color laser unit growth of 96% and MFP unit growth of 61%. Color in the office and capturing more enterprise print pages are two of our key growth initiatives, and we are pleased to see continued strong momentum.

Our strategy is to align hardware pricing to stimulate unit growth and in turn, drive higher-margin supplies. Although our accelerated pricing has a margin impact in the short term, it is the right thing to do for the long-term health of the business. Our overall hardware unit growth of 12% year over year in the second quarter is a significant improvement over first-quarter results, and represents our highest year-over-year unit growth since Q4 of '03. We expect to see share gains in the quarter.

Supplies revenue grew 4% over the prior-year period, reflecting unit shipment weakness in recent quarters and the tough year-over-year compare. It will take a number of quarters for supplies to feel the benefit of a renewed push in hardware unit sales, but Q2 hardware shipments gets us off to a good start.

For the quarter, operating profit was 814 million or 12.7% of revenue. During the quarter, we introduced a voluntary severance program, which was taken by roughly 1,900 employees and resulted in a charge of 71 million in the quarter. Without this, operating margins would have been 13.8%, still best in class but yet down year over year, reflecting workforce reduction costs, hardware pricing actions, hardware growth and mix shifts within supplies.

We continue to make good progress in Personal Systems. Revenue grew 6% year over year, with consumer up 10% and commercial clients up 3%. Average selling prices declined 6% year over year, with the greatest decline in consumer. We saw revenue growth in every region and had excellent performance in Asia-Pacific, where shipments increased 29% year over year. The segment posted operating profit of 147 million or 2.3% of revenue, our highest level since the merger. After the first half of the fiscal year, we have now delivered almost 300 million in operating profit to position us well for a fourth consecutive year of improving operating margins in Personal Systems. We have more work to do, but with the right cost structure I'm confident we can continue to show improvement.

Turning to the Enterprise, we saw 6% revenue growth in Enterprise Storage and Servers. during the quarter, we saw the benefit of solid topline performance and the other cost and margin issues we have been working on. Segment operating profit was 184 million or 4.4%, our highest profitability in the business since the merger. During the quarter, we also incurred 24 million in workforce reduction charges, without which segment operating margin would have been 5%.

Within the business, we had good performance in our server divisions, with revenue in industry standard servers up 12% over the prior-year period. Blade revenue increased 56%, reflecting continued strong customer acceptance in HP's Blade system offering. Revenue in business-critical servers grew 2% year over year, reflecting strength in Integrity, where revenue grew 37%, and HP-UX revenue growth of 9%. Integrity now represents 21% of BCS revenue.

We continue to post weak results in Storage, with revenue down 6% year over year. We have a lot of work to do in Storage to get this business back on track. The good news is that our product offerings are competitive, and yesterday we introduced a wide range of new storage products and services, including our next-generation EVA. The bad news is that we have not made enough progress in building out our specialist sales force, and we're not closing enough deals in the field. And you can expect to see a lot of focus on this business in the coming quarters. We are aware of what needs to be done, and we are intent on applying the appropriate level of rigor to do just that.

Now, I want to turn to HP Services, where revenue grew 14% year over year, or 8% if you exclude the effect of acquisitions. Technology Services grew revenue 11% over the prior-year period. This is a strong profit cash generator and provides us with good stability, given the annuity nature of the business. Managed Services continued to outgrow the market, with revenue up 27% year over year. Consulting and Integration revenue grew 10% over the prior-year period. Segment operating profit was 292 million or 7.3% of revenue, reflecting margin deterioration in our technology services from secular shifts away, from proprietary hardware and pricing pressure, the absorption of $74 million in costs associated with workforce reductions and the impact of recent acquisitions. Without the workforce reduction charge, operating profit would have been 9.2%. Operating margins improved year over year in both Managed Services and Consulting and Integration, but we have got a lot more work to do in the coming quarters to get these businesses where they need to be.

Let me now address performance of Software, where revenue of 277 million was up 23% year over year. OpenView revenue grew 36% year over year, and OpenCall was up 4%. Software lost $6 million on an operating basis, which is our best performance in recent time, reflecting topline strength and mix. We still have work to do to get the Software business where we need it to be. The good news is that the business is growing rapidly, demonstrating that customers like our offerings and see value in them. The bad news is we have got a Software business with an annual revenue run rate in excess of $1 billion that is losing money. While a sequential revenue increase of $37 million delivered an acceptable level of operating margin flow-through, it

is clear that the profitability of the business needs to be improved. We expect to be profitable in the fourth quarter, but you'll see us really work hard on the cost structure of the business to ensure we deliver acceptable levels of profitability.

Finally, a quick update on HP Financial Services, which had a solid quarter. On a year-over-year basis, revenue increased 16%, financing volume grew 4% and net portfolio assets increased 2% to 7.1 billion. Operating profit was 58 million or 10.7%. Operating profit was aided by the reversal of approximately 16 million of reserves relating to certain aged receivables that have since been collected. Without this, operating margins were 7.7% of revenue.

I will leave my segment comments at that. As you can see, excluding the effects of workforce reduction items, we had a reasonable quarter in each of our segments, and importantly, the pricing actions we have taken in Imaging and Printing are generating good hardware unit growth.

With that, I would like to turn it over to Bob, and I will be back with some additional comments later in the call.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Thanks, Mark, and good afternoon, everyone. Mark has covered the segments and non-GAAP results. GAAP EPS for the quarter was $0.33, which included 152 million in pretax charges that were not included in our non-GAAP results, the bulk of which is amortization of purchased intangibles.

There were a number of offsetting items that impacted our results, which on a net basis had minimal impact on EPS during the quarter. We recorded 101 million within our other income and expense and expenses associated with the resolution of pre-merger Compaq sales and use taxes for the years 1998 through 2002. These expenses were not included in our guidance for the quarter, and negatively impacted EPS by roughly $0.03.

Previously, I told you that we would absorb roughly 200 million in workforce reduction costs in the first half, of which 140 million would be in Q2. The actual impact in Q2 was 177 million, so about 37 million more than we had expected, which impacted EPS by $0.01. The excess (ph) reductions related primarily to the voluntary severance program within IPG, as more employees accepted the severance in Q2 than we had anticipated.

Offsetting this, we had a non-GAAP tax rate of 12.8%, lower than our previously guided 20%, which benefits EPS by about $0.03 in the quarter. The lower rate primarily reflects favorable adjustments to deferred taxes. Going forward, I expect a non-GAAP rate of about 20% for the second half of the year.

We also released about 47 million in reserves related to certain aged receivables associated with our financing business. The release comes from the additional reserves that we recorded in Q4 of last year. The majority of the adjustment was recorded within the product groups, with the smaller portion within HPFS. This release had a positive impact of about $0.01 on EPS.

Now, on to the P&L -- revenue of 21.6 million for the quarter, up 7% year over year, up 4% when adjusted for the effects of currency. On a regional basis, revenue was up 4% in the Americas, 10% in EMEA and 9% in Asia-Pacific. When adjusted for the effects of currency, revenue was up 4% in the Americas, 4% in EMEA and 6% in Asia-Pacific. Gross profit was 5.1 billion for the quarter or 23.8% of revenue, up sequentially from 22.9 but down from 24.5% in the prior-year period, primarily reflecting margin declines in IPG and HPS and, to a lesser extent, ESS. Within IPG, hardware growth and the hardware pricing actions that we took throughout the quarter, coupled with higher growth in laser toner relative to inkjet supplies, pressured margins. ESS and HPS margins continued to be pressured by the shift towards lower-margin, industry-standard hardware, while HPS margins were additionally impacted by the growing mix of Managed Services business. Offsetting these pressures was a solid gross margin improvement in PSG, due primarily to product introductions in our notebook portfolio and the continued focus on supply chain costs. Software and HPFS also had significant margin improvements year over year.

Non-GAAP operating expense totaled 3.8 million for the quarter or 17.7% of revenue. Although this is down slightly from the 17.8% in the prior-year period, it is up from 16.7% sequentially. Adjusting for currency, expenses were up 5% year over year and 7% sequentially. Workforce reduction costs accounted for 2% of the year over year and 1% of the sequential increase.

Though we have made some progress in reducing our OpEx ratio, we clearly have more work to do to improve our expense structures. Non-GAAP operating profit was 1.3 billion or 6.1% of revenue, down 24 million year over year, reflecting the gross margin erosion, as well as the 177 million in workforce reduction costs.

Other income and expense was an expense of 87 million in the second quarter, as compared to a $2 million benefit last year. This reflects the resolution of the sales and use tax audits that I mentioned earlier.

Next, to the balance sheet. HP-owned inventory came in at $6.5 billion, down 656 million sequentially and up 191 million year over year. Inventory days of supplies stands at 35 days, its lowest level in three years, and down from 39 days sequentially and 37 days in the prior-year period. IPG inventory is down almost $500 million sequentially, as intended, and up roughly 270 million year over year, in line with the growth of the business. All in all, I am pleased with where our owned inventory closed for the quarter.

Regarding channel inventory, we ended the quarter in good shape across the board, with PSG and ESS inventory at just over four weeks and IPG at five weeks. IPG and PSG channel weeks are essentially flat, both sequentially and year over year, while ESS is flat sequentially and down slightly year over year. Further, PSG channel inventory dollars are down, both sequentially and year over year.

Trade receivables ended the quarter at 9.3 billion, up 601 million or 7% sequentially and up 736 million or 9% over the prior-year period. As a percentage of revenue, trade receivables is at 11.1%, up from 10.6% sequentially and in line year over year. DSO now stands at 39 days, up from 36 in the first quarter and 38 in the prior-year quarter.

Next, property, plant and equipment was roughly flat quarter to quarter and up 287 million year over year to 6.7 billion. Gross capital expenditures was 566 million, down 2% sequentially and up 14% year over year. On a net basis, CapEx was 308 million, down 9% sequentially and essentially flat year over year. The majority of the current quarter investment was for financing assets, which are now at 7.1 billion. Net PP&E as a percent of revenue now stands at 8.0% of revenue, down from 8.2 sequentially and 8.3 in the prior-year period. Regarding Accounts Payable, days payable closed the quarter at 47 days, up 2 days sequentially and down 2 days year over year.

Next, a few comments on cash management. Cash flow from operations was 2.4 billion for the quarter, down from 2.6 billion in Q2 last year. On a year-to-date basis, we have generated a very strong 3.9 billion (ph) of cash from operations, up 40% year over year. Free cash flow -- that is, operating cash flow less net CapEx -- totaled 3.1 billion through the first half of year, up over $1 billion from the first half of last year.

We closed the quarter with total gross cash of $14.5 billion, up 883 million sequentially and down 600 million year over year. Major uses of cash in the quarter included 618 million in stock repurchases, 325 million for acquisitions and 233 million for dividends.

On a topic related to cash management, the American Jobs Creation Act, we are still finalizing certain elements and have not yet concluded our analysis. However, we expect to make an announcement in the third quarter about the amount of cash to be repatriated, if any.

Let me now turn your attention to our outlook for the third quarter. We expect third-quarter revenue in the range of 20.3 billion to 20.7 billion and non-GAAP EPS of $0.29 to $0.31 per share. As we noted in the press release, this excludes the cost of approximately $0.03 per share from amortization of purchased intangible assets and of approximately $100 million or $0.03 per share in workforce reduction expenses.

While we have been absorbing workforce reduction costs in our segment results recently, we are currently evaluating ways to optimize our cost structure, and are preparing to take the actions necessary to do so. During this time, we feel that it is most appropriate to provide greater transparency into the resulting costs from the actions we may take. Beginning with the third quarter, we will exclude the costs of workforce reductions from our segment operating results and treat them as a GAAP-to-non-GAAP adjustment. We will continue to do so until such time as the majority of the actions are behind us -- this to provide better clarity into our fundamental operating performance.

One last item of note -- effective May 1, we excepted a companywide wage review for the first time in two years. The resulting increase in expenses was not phased in over time, and as such, will have approximately a $0.03 step function impact on our earnings for Q3.

With that, let me turn it back to Mark.

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Thanks, Bob. Before we take your questions, I want to take a couple minutes to share some of my early impressions with you. Over the past month, I have spent the majority of my time getting beneath the strategy, operations and financials of the business segments and corporate functions. I've met the management team, conducted face-to-face meetings with thousands of employees and spent time with many of our largest customers. Every day, I get a better sense of how the Company runs, how we deploy human and capital resources and what people are focused on. At this stage, I have more work to do to get further beneath the operations of the Company, and it would therefore be premature of me to discuss any changes to operational plans in detail.

However, what is clear to me already, even at this early stage, is that hard work lies ahead of us if we are to get HP's overall financial performance where it needs to be. The good news is that many of the fundamentals for success are in place. We have a loyal customer base that values our products and services. We have an employee base that wants to be part of a winning team. We are one of the few remaining hardware companies that bring to the market innovation that customers value. We have a strong brand. We enjoy a strong market position in each business and region. We continue to post solid topline growth. We have a very strong balance sheet and a healthy cash position, and we generate billions of cash from operations each year.

The reality is there is no quick fix to achieving the kind of performance that I think this company is capable of. HP is a matrix company with large shared service organizations and a cost structure that is off benchmark in many areas. The way I look at it, behind each of these is a great opportunity for improvement, and you can expect to see us move quickly on some of these things.

Right now, we're in the process of reviewing every element of operations and cost structures, and nothing will be taken for granted. We are stacking up the cost structures of each business, the corporate function, against best in class. We are reviewing the organization structure and determining how we can simplify it and take out complexity, and we will take necessary steps to drive a performance-oriented culture across our company. You should expect to see an operational plan behind these comments in the next several months, and we will be focused on cost structure reductions, capital allocation strategy, driving Imaging and Printing forward, driving the breakeven point of Enterprise Storage and Servers, addressing the weakness of our Storage business and driving profitability in Managed Services, Consulting and Integration and Software.

I will reserve further comment on these initiatives for now. At this stage, I thought it was appropriate to continue the run rate workforce reduction activities Bob referred to, rather than putting them on hold until I am able to finalize our plan. We will be able to give you more information on these initiatives as soon as our work is finalized.

Let me conclude by saying that I believe much of our success lies within our own hands. Our market position, our strong product and services portfolio, our loyal employee and customer base and our ability to push through the initiatives mentioned above gives me great confidence for our future.

With that, we will be glad to take any questions you might have.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Toni Sacconaghi, Sanford Bernstein.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

I have a couple questions, please, Mark and Bob. Firstly, on your guidance for next quarter, effectively, this quarter you took about $0.05 in workforce reductions that was built into your earnings. So, adjusting for that, you effectively delivered earnings of $0.42 this quarter. You are guiding for earnings of $0.29 to $0.31 next quarter on a relatively modest sequential revenue decline of about 4% -- implicitly, so about a 25 to 30% reduction in earnings on a relatively modest workforce reduction.

I do understand that costs will be stepped up because of the pay increases that you alluded to. But can you help us bridge what appears to be a pretty material step-down in earnings guidance? Are you simply being conservative? Do you expect some of the profitability improvements that we saw in some businesses this quarter to relapse? Are you going to be more aggressive in printing? Can you help us understand where the EPS guidance comes from? And then I would like to follow up with another question, please.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

That was one question, Toni? Let me just say a few words about the typical seasonality of HP. Q3, as you know, is always a tough quarter for us, and there are some good reasons for that. We are very heavily represented in our revenue base from Europe, and Europe is always a weak quarter in Q3. We have consumer in our mix; that is also a weak spot in the consumer seasonality. But just to reflect back on not only the last couple of years but even the longer-term history of HP, Q3 is just a difficult quarter.

So you add to that things like this $0.03 step function impact in compensation expense -- it's a real challenge. And you are right; we did have some workforce reduction in the prior quarter of about $0.05, and we now not have that in there. But when you look at all the macrodynamics, the typical seasonality, we think this is appropriate.

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

And I think, Toni, just to add some color to it, I think there are pluses and minuses in the Q2 performance that we have driven, which I think you can rationalize north, as you have done in your model. But I'd also say there are some offsetting things that won't re-occur as we go into Q3. We have the sales tax issue, but we also have the tax credit that has some offsetting effects on EPS in the quarter.

I think, to your point, you hit many of the points very well. We've got a revenue decline sequentially factored into the guidance, in addition to the fact that we've got the salary increase at the same time as we are trying to align our printing equation for the right long-term answer. So when you net it out, it gets us to roughly the range that we described, and we think that's roughly the range that we will fall into.

Toni Sacconaghi - *Sanford Bernstein - Analyst*

Just to follow up, which is my second question, you had mentioned the printing equation in response to my question. Are you suggesting that printing profitability can be further traded off next quarter -- i.e., can be lower -- to try and continue to sustain or drive further volumes in printing?

And you guys have always talked about 13 to 15% as a profitability range for printing. I guess, ex workforce, it was 13.8 this quarter. But should we be expecting in the short term that profitability could in fact be below that range, and we should be expecting that in your effort to drive units?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Well, I think there are a couple points to it. First, you have got some IPG seasonality that also occurs, as you think about Q3, that I think needs to be factored in. Going back over the past several years of IPG performance, there is a seasonality effect in Q3 -- point one. Point two -- I do believe, long term, your 13 to 15% operating performance model is right. So I believe that to be the place that we see the business being.

We are trying to optimize the equation, though, because, as you know, the business is very much annuity-like in behavior, and the hardware units drive supplies, and that is the model, how it works. So we are trying to optimize that answer, and I think you should expect us to continue to push on that. And that's where I think we will end.

Operator

Richard Chu, SG Cowen.

Richard Chu - *SG Cowen - Analyst*

I wonder if I could just follow up on the term that you just used -- optimization of the model. I would like to understand the context in which you are trying to optimize. Is it to optimize two- or three-year installed base growth, a particular blend of supplies growth and consumption? And what are the boundary conditions that you believe you are working with in that optimization? And I'd like to follow up.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Richard, we're not going to give any new segment guidance here today. I'm not sure exactly where you are going with it. I think you are on the right track. What we are saying is that we will make trade-offs of the type we began making in this quarter -- that is, Q2 -- to align pricing of our hardware to give the best lifetime returns to our shareholders from those actions. And I think that's what we mean when we say optimizing. But we are not going to put any new limits on the top or bottom and the profitability in this business. We'll just have to see. And of course, competitive environment changes. Do keep in mind that last year, for example, IPG profitability dropped by about a point in Q3 over Q2, so it is not unusual to see some downward movement.

Richard Chu - *SG Cowen - Analyst*

If I can seek a clarification on the 100 million charge that you plan to segregate in the third quarter, is that entirely from previously identified initiatives that you discussed, the 200 million residual value (ph)?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Well, it's the same kinds of initiatives. It's entirely actions that were already underway, frankly, before Mark arrived. We had only given you guidance earlier for the first half, so this 100 million is what would have happened as a result of some of the strategies that were already underway, including some of the VSI actions -- voluntary severance actions in IPG, which did not all get done and booked in Q2, included some of the workforce efforts that have been underway for a number of quarters in HP Services.

Richard Chu - *SG Cowen - Analyst*

So can we assume from that that pending Mark's complete assessment that there will be no further incremental charges beyond that 100 million in this current quarter?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

No, you cannot assume that.

Operator

Steve Milunovich, Merrill Lynch.

Steve Milunovich - *Merrill Lynch - Analyst*

Mark, could you talk about the computer business a little bit? What does the demand environment feel like? And on the PC side, you continue to make progress. Where do you think that margin can go to, and what kind of trade-offs do you feel you need to make in that business, similar to what you're making in printers, in terms of share versus profits? And on the enterprise side, you are making some progress. So, without necessarily giving us targets, I guess, what opportunities do you see in the enterprise business for margin improvement over the next couple of years?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Steve, I was writing as fast as you were talking, and I didn't get them all down. So let me try to give you a weather report on the Enterprise business. First, you talked about demand. While there are nuances by region and a little bit by segment, demand has been pretty steady. So I think we talked about in my comments a little bit how it worked out by product line. I think, again, profitability is a big issue for us and part of our Enterprise business. So, when you look at what we have done, we have got kind of mixed results -- strong results in Servers; we have got issues in Storage. We talked yesterday about -- or talked about the release we made yesterday of a long new line of storage products, and we certainly have to improve our profitability in the Storage business as we move forward.

As it relates to what our goals are going forward in that business, clearly we have got a couple parts of our Service business that I would argue is part of our Enterprise business that's certainly related, that we need to show improved profitability as part of what we do. We have got strong revenue growth in virtually every piece of our Enterprise segment, and we need to be able to translate that revenue growth into profitability.

I'm not going to give you a segment profitability map on Personal Systems today, although, to your point, I am pleased to see the progress that has been made. Progress has been steady, it has been consistent. And I would argue, over the past two quarters, it has been pretty positive.

Steve Milunovich - *Merrill Lynch - Analyst*

Is Personal Systems high on your worry list, in terms of, hey, what do we do with this business long term? Or do you think it's just an execution issue, and HP is in a basically strong position here, even with Dell taking share over time?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Well, share is always one metric to look at, but it's not the only metric you look at when you try and run a business. We're interested in driving revenue growth, of course, which we are doing, which is positive. It's got to turn into profitability for us. So profitability is a driver of eventually driving shareholder value. So profitability is an important metric for us overall. I would not say Personal Systems is the number-one thing on my list of concerns across the Company right now.

Operator

Ben Reitzes, UBS.

Ben Reitzes - *UBS - Analyst*

I wanted to ask, with regard to just -- I guess, going forward, you're going to exclude the restructuring costs from your reporting, at least on non-GAAP, and segment it out for us. Should we think philosophically that would mean that you think those will come in the form of savings in the future, and that these will stop, and that we could see commensurate margin improvement in the future from these types of hits that we are getting now, that are actually turning the margin accretion in the future? If you are pulling it out so we get a better idea of what the real business looks like, then should we assume that we get this kind of improvement later on?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

That would absolutely be the theory, yes.

Ben Reitzes - *UBS - Analyst*

But of this kind of order of magnitude, or is it tough to say?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

When you said what kind -- I'm sorry; I missed --

Ben Reitzes - *UBS - Analyst*

Of some kind of fraction of the charges that we're taking -- we get some kind of (multiple speakers).

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Oh, yes, we try to lay that out for you, certainly.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

And if the numbers get larger, which they probably will, we'll give you a little more insight into how we think that will play out over time. But absolutely, we expect savings from these charges. It depends upon what kind of action it is, what kind of job category, wage level, et cetera. But overall, that's the purpose -- to reduce the cost structure and improve the bottom line.

Ben Reitzes - *UBS - Analyst*

But I guess, into FY '06, I guess I would assume that these would kind of dwindle, and we'd start to see these benefits, I guess, is what you guys are trying to say?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Well, I don't think we gave you that discrete a timeframe. I think the way you should think about what we are doing, though, is in the context that we are working as quickly as we can. And think of it -- I like to describe to people here we are in a sprint to get the Company in shape to go run a marathon. So we are working hard to do prudent things as quickly as we can. We are not in a race just to do things. We need to do things that create a sustainable structure going forward that makes the Company competitive.

So I don't want to commit to this discrete timeframe where this begins, ends, et cetera. But I would tell you that we are working as fast as we can. And clearly, the theory and the architecture you're describing is right. We would be looking to deal with costs, and certainly put costs in a position to make the Company more competitive, so that we can eventually turn that also into a good competitive structure that we can grow from.

Ben Reitzes - *UBS - Analyst*

One last thing is your UNIX business was better than I expected. Could you just tell us what happened there, and any detail on whether it's sustainable?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

From a region perspective, the color I can give you is we had a very strong showing in the Americas in UNIX. So from a region perspective, that is where we saw the biggest growth.

Operator

Keith Bachman, Banc of America Securities.

Keith Bachman - *Banc of America Securities - Analyst*

When a previous quested was asked, you indicated that PCs was not your number-one worry. I have to follow that up on what is your number-one worry?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

I think, if you look at the Company overall, it starts with the fact that we are trying to make sure that we get our operating model right. We've got some things, I think, in the Company that we can make simpler. And simplifying the Company is clearly my

number-one priority, getting our operating model lined up so that we can go take advantage of the opportunities we have got, driving the kind of a bipolar thought process in management that we have got to learn how to get costs out. We've talked a lot about costs in the past two or three questions, but frankly, we have got to be bipolar in looking at growth at the same time as we look at costs. And we are trying to get a balanced view of -- we got great opportunities to grow revenue. We're in great markets with revenue growth, and we have got to go seize that revenue growth. But at the same time, we have got to be taking costs out. So we have got to get good at both things. And I would say, getting that ingrained into our management philosophy is key.

Certainly, at the same time, we have got issues to go to make sure that we get more competitive because I do believe, in the end, costs and growth are directly related. Getting costs out will drive more growth on the top line, so the two are interconnected at the hip.

Keith Bachman - *Banc of America Securities - Analyst*

And so, Mark, is the thought there, as you're getting costs out to drive top line, you keep margins -- try to hold margins the same so that that falls to the bottom line? Or are you thinking that, as we move forward, that you will be able to improve operating margins?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

It will do both. You'll give some costs back to the marketplace to stay competitive. And the job of management is to get more costs out than we have to give back to the marketplace, so that we actually get more competitive on the bottom line at the same time as we get more competitive in the market.

Keith Bachman - *Banc of America Securities - Analyst*

Just one follow-up on printers. I just wanted to clarify one thing. The $71 million hit included a number of things, as I read the statement in the press release. Could you just characterize how much of it, or roughly how much of it was workforce reduction versus the other things that were mentioned, which are hardware pricing actions, hardware growth and mix shifts within supplies?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Keith, I believe the 71 is all workforce reduction.

Operator

Rebecca Runkle, Morgan Stanley.

Rebecca Runkle - *Morgan Stanley - Analyst*

Just two questions -- one as it relates to some of the discussions already, in terms of what is going to be included versus not included in the non-GAAP numbers going forward. Can you just talk how you think about it more structurally in terms of, I guess, given the industry and how dynamic it is? Clearly, there seems to be an ongoing need to do some sort of workforce rebalancing. How do you think about what is one-time in nature versus just more recurring ongoing costs of doing business?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Rebecca, I generally agree with the thesis behind your question, and that is, of course, why over the past number of quarters we had just included some nominal level of restructuring in our normal results and our segment results, because that is part of staying competitive in this environment. The feeling here is that, with Mark coming in as a new CEO and an additional emphasis on getting the entire structure of the Company in line, that the magnitude of the numbers will be larger and they may be lumpier. And therefore, it's best to give it to you both ways -- that is, you have your GAAP results, which will include all of the workforce reduction charges, and the non-GAAP, which won't, and a clear reconciliation of the difference between them. So you can both see what we are spending to take these actions and, importantly as well, track the underlying progress of the businesses.

Rebecca Runkle - *Morgan Stanley - Analyst*

And would you consider the run rate of reductions that we have seen over the last couple of quarters and what you have talked about in the third quarter as being more reflective of the nominal ongoing?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Yes.

Rebecca Runkle - *Morgan Stanley - Analyst*

And then, secondly, just shifting back to IPG for a second, can you just again talk to me about how you think about this business strategically on two fronts? One, it seems as though the market isn't all that terribly elastic, from a hardware standpoint -- i.e., you can cut prices; you are not going to sell that much more hardware. Do you agree or disagree with that? And then, related to that, how are you thinking about competitors' reactions here? Again, it seems to me that this is a market where competitors are willing to cut price and match just to get the hardware out the door. So do you really think that the marketshare gains that your alluded to are all that sustainable, within the context of competitors coming down and matching your price? Or do you believe you're not going to see that, and haven't seen it to date?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Well, we can both comment on it, Rebecca. I think that at the end of the day, still, this was the highest unit growth that the Company has had in Printing since Q4 of '03, 12% year on year in terms of unit growth. So I think that's strong.

I think, at the same, to your point, just cutting pricing relentlessly is no long-term strategy for any kind of industry. So we are trying to run, as I mentioned, a profitable business; we are not looking to tank the industry in terms of pricing. We're looking to optimize our ultimate position in the business, and there are segments that we have positions that we want to take advantage of. So I don't think you should think of this as a relentless price-cutting model and an attempt to get one more point of share next week so we can optimize supplies businesses in Q1 of '06. That's not what we're after here. At the same time, we're after ensuring that we take advantage of the opportunities that we have got in the market, and that is what we're doing.

Rebecca Runkle - *Morgan Stanley - Analyst*

But are you suggesting that the growth that you saw was largely, if not entirely, impacted by the pricing, as opposed to secular shifts in the demand environment -- say, enterprise and the shift to laser?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Rebecca, let me jump in here and remind everyone what we said in Q1. In Q1, we said that we had mis-positioned, from a pricing point of view as well as a marketing and promotion point of view, some of our consumer products. And I think you have now seen us correct that and regain a bit of -- we think a bit of market share, but certainly regained a unit growth rate that is much healthier than what we saw in the first quarter. What this means about long-term competitiveness and what individual competitors will accept on the bottom line, in returns for their shareholders -- we are not going to comment on that today. What we did, I think, is now get more back in line to correct a mis-positioning in the marketplace that occurred six months or so ago.

Operator

Bill Shope, JPMorgan.

Bill Shope - *JPMorgan - Analyst*

Could you give us a bit more color on the demand patterns during the quarter? It looks like most of the industry saw a positive inflection point in April. Did you see this, and if so, which segments were the most pronounced?

And then a question on the Printing side, as well. Should we expect any material cost relief in the Printing segment with your next major product launch?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

In terms of your first question, it was pretty steady throughout the quarter. I can't say that we saw any inflection point by region, by segment, that would be worthy of any kind of dialogue here. So we saw fairly steady demand across segment, across region. I could take you down a bunch of little nuances, but I don't think they would be worth the time.

One more time on the second question, Bill?

Bill Shope - *JPMorgan - Analyst*

Should we expect any material cost relief in the Printing division for your next round of product launches there?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

I think you'll see a little bit, as you always do with new products. But if you're asking in the context of, you know, big bang run (ph), repositioning of the fundamental cost structure -- no, that's not part of the program.

Bill Shope - *JPMorgan - Analyst*

And then, one last question on PCs. How much did component prices help you during the quarter, in terms of operating profits, and should we expect this to continue in the next quarter?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Q2 saw continued, normal declines of most components, is the way I would describe it. I don't think it was an abnormally light quarter or heavy quarter. And therefore, I would argue there was no particular help. It's just the way it is right now. Actually,

since -- toward the end of the quarter, we saw a couple of the components level out a bit, so we will see what happens here. But no particular impact, from my point of view, of the commodity (multiple speakers).

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

I think, very small. There were a few components we wish we had a few more of.

Operator

Laura Conigliaro, Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

Just a couple of quick figures, please. First of all, you referred to hardware unit growth in printers, that the increases will take a number of quarters before seeing the effect. How long before you'd actually expect to see a positive impact from this quarter?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Six to nine months, roughly.

Laura Conigliaro - *Goldman Sachs - Analyst*

Also, your corporate and unallocated costs and eliminations spiked a bit to 120 million this quarter, which was really more than double last quarter and significantly more than last year same quarter. So it's certainly boosted segment operating margins. Can you help us understand what is in there?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

To some degree. We're not going to go down too far in this, but there were, as you might imagine, a few executive compensation expenses associated with the transition of CEOs. There were a few long-term bonus impacts when compared to some other quarters. Those are the key items that come to mind.

Laura Conigliaro - *Goldman Sachs - Analyst*

So it will go back to more normal levels next quarter?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

Some of that should normalize, yes.

Operator

Richard Gardner, Smith Barney.

Richard Gardner - *Smith Barney - Analyst*

Just two quick questions, please. I was hoping you could talk about the health of the Managed Services portfolio, and I know that business continues to be modestly unprofitable. But I believe they are working on getting it profitable by the end of the year. Can you talk about whether deals are maturing in terms of profitability, as you had expected, particularly some of the large deals that you pursued 12 to 18 months ago?

And then, secondly, I guess I'm still unclear within IPG on whether we should be expecting operating margins to decline further near term, as you reinvest in getting the business back into price position before a lagging increase in supplies revenue takes us back up into the 13 to 15% range.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

I'll start with the second one. As I said earlier, Q3 is a weak quarter in virtually all of our businesses. IPG revenue normally declines and IPG margin normally declines. So, barring any unforeseen effects, yes, it's reasonable to expect a little decline in IPG in Q3.

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

To your Managed Services question, obviously, there's good growth. 27% growth year on year is a strong performance. There is a strong funnel; there are a number of deals that are active today. I do not believe, to your point, that there is a volume issue, as much as this is we have got to take deals that we can execute and we can make money on. So we are very focused on ensuring that that business grows, but grows with profitable deals that we can manage. And it clearly is right on the bullseye, in terms of us getting that business profitable for the Company.

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

A couple of questions, if I might. First, on the revenue side of the equation, Mark, you did focus primarily on profitability and touched on a few things on the revenue growth side. Can you maybe highlight a couple areas where you think there is revenue growth opportunities? And associated with that, any comments here on acquisitions? You have in the Software business a business that is arguably subscale, and you have got to make a determination there. And then I have one follow-up.

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

Well, you almost started fighting words with me there on the Software business being subscale. I don't believe that, first of all. I think software businesses that run $1 billion plus in revenue can, should and in my opinion, for HP, will be profitable. When you run a software business, you are really trying to drive licensees into the marketplace with alignment with your S in the SG&A model, and you are making a profit off software maintenance minus R&D -- it drives your profit model. We have got plenty of scale to drive that in this business. And the great thing is that also, we have got a very competitive product line that is driving growth, that is driving more revenue, which in the end puts more software maintenence into your portfolio. So this is a very strong, powerful model. We just have to harness it in a way that it drives profits. So I don't subscribe to the subscale thing.

I'm not going to comment on acquisitions. We would obviously look at acquisitions as they make sense and align to the portfolio. We're not against them; we have done them in the past. To the degree that we see them making sense to enter the portfolio, we will pursue them.

But, while I'm pleased, again -- one more time, on the Software business. I am pleased with the sequential performance of the business. When you look at its growth and you look at the profit drop from the growth, it was exactly what you would expect to happen in a software model. Our issue is the absolute profitability of the business, from its current point today, isn't where we would like to be, and we're going to go drive hard to get it there, and we are focused on it.

In terms of growth across the portfolio, to some degree, some of the results we have here speak for themselves -- strong growth against Managed Services, strong growth in the Software business. You have got a UNIX market that has some consolidation around it. We have got strong opportunity with our Integrity server. So I think we have a pretty strong opportunity to grow industry-standard servers again strong in the quarter. So I think these are markets that all have growth, and I do believe Enterprise Printing -- we talked a lot about IPG here today. The Enterprise Printing segment is one that's going to scale.

So I like our hand in terms of growth. I think our trick is to be able to turn that growth into money that sticks to our fingers.

Harry Blount - *Lehman Brothers - Analyst*

Then the follow-up and the clarification would be -- clarification is on acquisitions. I think the concern is that you guys have made a number of smaller acquisitions, post Compaq. I think the concern would be a large acquisition, and what you might do there. But the follow-up question I had would be on incentives -- your incentive package is obviously in the public filings market. Is there any other benchmarks or incentives that you have to hit -- either profitability or return type goals -- in order to maximize the maximum payout?

Mark Hurd - *Hewlett-Packard Development Company - CEO, President*

I'll be honest with you; whether I get paid on it or not -- trust me, I am ultra-focused on getting this business to perform the best that it can perform. And that is the number-one incentive I have.

Brian Humphries - *Hewlett-Packard Development Company - VP of IR*

We will take two more questions, please, operator.

Operator

Andy McCullough, Credit Suisse First Boston.

Andy McCullough - *Credit Suisse First Boston - Analyst*

I wanted to follow up on hardware profitability, specifically in ESS. Bob, can you just walk us through the drivers of the sequential increase in operating profitability? And particularly, I think you said gross margins were down in the segment. And then, how sustainable do you see these gains in the Enterprise business, just from and operating profitability perspective?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

I'll start with a broken record. Q3 is always a tough quarter in this business, particularly in ESS, because it is a higher-leveraged profit business -- that is, as revenue grows, profit tends to improve, and as revenue declines, which is normal in Q3, in this business, we see a profit decline. So that's just a Q3 commentary.

We made some progress in ESS in some of the segments of the business, with regard to profitability. We did take expenses down slightly, and of course we saw some sequential revenue growth. All of the three subsegments that we talk about -- that is, ISS, BCS and Storage -- were profitable; none of them as profitable as we think they should be, but very decent -- the biggest dynamic of profitability in ESS this quarter, either a year over year or sequential basis, was in BCS.

Operator

Rob Cihra, Fulcrum Global Partners.

Rob Cihra - *Fulcrum Global Partners - Analyst*

A couple within PCs, if that's okay. And one of them is, over the last few quarters your consumer revenue growth has been slowing with the overall PC market, but this actually looks as though you have flipped back to consumer growing faster than commercial this quarter. I just wonder if you think that's maybe reflecting a consumer market that is turning around at all, or is that more of an HP-specific thing?

And then, secondly, if I could, you also highlighted notebook revenue growth -- 10% obviously being better than desktops. But I actually would think that would still be actually a little less than the market for second quarter in a row, at least now, for notebooks. So I don't know if it's a matter of maybe giving, if you could, notebook unit growth numbers or talking about whether you think you're gaining share or losing share, or where you are there on the notebook side.

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

We have seen some improvement in notebook growth, as you noted. We did acknowledge a couple of quarters ago that we really didn't have the right notebook products in place. And we now have them; that has helped both our growth and our profitability. But it is correct that we have not achieved the kind of overall notebook growth that we need to. That is a change from a year or so ago, where our notebook growth was doing exceptionally well. We did have a few component issues and shortages in commercial notebooks that impacted our results -- not materially, but it shows up. As in most quarters, there's a few things that don't work quite perfectly.

Rob Cihra - *Fulcrum Global Partners - Analyst*

And in consumer versus commercial? Any (technical difficulty) can give you things (ph) for the consumer, because they think consumer is getting better? Or is that just an HP-specific thing, where consumer is back to being better than commercial?

Bob Wayman - *Hewlett-Packard Development Company - EVP, CFO*

I, at this point, would just have to view it as an HP-specific thing, but I can't comment on the overall marketplace.

Brian Humphries - *Hewlett-Packard Development Company - VP of IR*

That concludes today's second-quarter earnings call. Thank you so much for your participation, and we look forward to speaking with you on our callbacks (ph).

Operator

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