HP Q4 FY05 Earnings Conference Call
Remarks by Mark Hurd and Bob Wayman
Nov. 17, 2005

[Begin Mark Hurd remarks]

Good afternoon and thank you for joining us. I'm pleased with our fourth quarter results. We delivered solid operational results, saw margin expansion in some of our key businesses, had good cost discipline, generated strong cash flow and continued to make progress on key initiatives. The employees of HP have been working hard and our efforts are paying off.

Let me give you some highlights of the quarter:

- Net revenue growth of 7 percent year-over-year, or 6 percent in local currency
- Non-GAAP EPS growth of 24 percent year-over-year;
- Continued operating margin expansion in key businesses, with Personal Systems operating margins of 2.8 percent, Enterprise Storage and Servers margins of 9.1 percent and Software margins of 8.7 percent;
- Our third consecutive quarter of solid printer hardware unit growth in Imaging and Printing, one of the leading indicators of future supplies growth;
- Cash flow from operations of $1.9 billion, bringing the year-to-date total to $8.0 billion; and
- Share repurchases of $1.4 billion, bringing the year-to-date total to $3.5 billion.

Our performance in the fourth quarter, coupled with a solid third quarter, triggered significant employee bonuses for the second half of fiscal 2005, and the fourth quarter impact of this is reflected in the segment results.

Turning quickly to the business segments, during the fourth quarter Imaging and Printing revenue grew 4 percent year-over-year to $6.8 billion, with consumer hardware revenue down 4 percent, and commercial hardware revenue and supplies revenue up 4 percent and 7 percent, respectively. Segment operating profit was $896 million, or 13.2 percent of revenue.

During the quarter, overall printer hardware unit growth was 8 percent, with consumer printer hardware unit shipments up 6 percent and commercial printer hardware unit shipments up 16 percent. Within these categories, we saw strong unit shipment growth in key initiatives, with all-in-one unit shipments up 25 percent year-over-year, color laser unit shipments up 41 percent year-over-year and enterprise multifunction printer shipments up 83 percent. We are focused on driving unit growth of high ink consumption units and we are confident that this will drive solid supplies growth.

We've also seen strong acceptance of products based on our recently introduced Scalable Print Technology, a breakthrough in the architecture and manufacturing of the inkjet print head. This allows us to deliver record print speeds in the home and office and can be scaled to a broad set of high-volume printing applications, making it one of our most significant announcements in recent years.

We're also focused on success in the high-end, with our digital press, wide-format and graphics initiatives. On Nov. 1, we closed our acquisition of Scitex, expanding our leadership in large-format printing into the industrial super-wide category. And at Print 05, we announced major advances in the digital transformation of the graphics arts industry, further consolidating our leadership position. This is a significant opportunity for HP and we're aligning significant resources behind the commercial print opportunity.

Moving now to Personal Systems, we continued to show a balanced approach to revenue growth and operating margin improvements. Revenue grew 9 percent year-over-year to $7.1 billion, with particular strength in notebooks, where revenue increased 23 percent.

Our consumer business had another excellent quarter, with revenue growth of 14 percent year-over-year and strong operating margins. Consumer notebook shipments increased 48 percent over the prior-year period, demonstrating HP's competitive strength and strong retail presence, as well as the shift to mobility. Revenue in commercial clients increased 8 percent year-over-year, with notebooks posting strong growth and profitability improvements. Our workstation business continues to post solid results – delivering share gains, strong year-over-year revenue growth and excellent profitability.

Segment operating profit was $200 million, or 2.8 percent of revenue, representing the fifth consecutive quarter of operating margin improvement in Personal Systems. The team has done an excellent job turning around the profitability of the PC business and operating margins have now increased for each of the last four years, with full year FY05 margins at 2.5 percent of revenue.

Enterprise Storage and Servers had a strong quarter, with revenue up 10 percent year-over-year to $4.5 billion and operating profit of $405 million, or 9.1 percent of revenue.

Over the past 12 months, the Enterprise Storage and Server team has focused on various operational levers to improve the momentum and profitability of the business. This quarter's results reflect their efforts in turning around the business and demonstrating the financial leverage of the model.

Within ESS, revenue in industry-standard servers increased 12 percent year-over-year, reflecting continued solid execution on a number of fronts, including discount controls, option attach rates and unit mix. We continued to see strength in server blades, where revenue increased 65 percent over the prior-year period.

Revenue in business-critical systems declined 1 percent year-over-year. We continued to see solid momentum in Integrity servers, with revenue up 70 percent year-over-year. This was offset by weakness in PA-RISC and Alpha.

Storage revenue increased 17 percent year-over-year, reflecting improved execution and solid growth in every product category and every region. We saw ongoing strength in the midrange, with EVA revenue up 44 percent year-over-year. We also had solid growth at the high-end, where XP revenue increased 32 percent over the prior-year period. We will continue to work hard on key initiatives such as sales specialist hiring and our alignment with enterprise VARs to drive sustainable momentum in storage.

Revenue in HP Services grew 6 percent year-over-year to $3.9 billion. Within HPS, technology services grew revenue 4 percent, managed services grew 9 percent and consulting and integration revenue grew 11 percent.

We're working on driving greater efficiency and leverage in the services organization via delivery model improvements and investments in lower cost locations. We are also working to leverage the R&D investments in OpenView to reduce the cost structure of services and optimize our R&D roadmap.

Segment operating profit was $322 million, or 8.3 percent of revenue. As in the third quarter, HP Services margins were pressured by the company bonus accrual given the headcount intensity of the business. If you exclude the fourth quarter bonus accrual, operating margins in managed services and consulting and integration were at their best levels in two and three years, respectively, and operating margins in technology services were at their highest levels in FY05. However, we need to deliver solid margins while absorbing company bonus payments and we will continue to work hard on the operations of the business to drive to this goal.

Turning to Software, revenue grew 11 percent to $311 million, with growth in OpenView and OpenCall of 16 percent and 3 percent, respectively. Software delivered its first-ever operating profit, with segment operating profit of $27 million, or 8.7 percent of revenue. We are pleased to be in the black and will continue to work on revenue growth and productivity initiatives as well as cost discipline.

During the quarter, we continued to strengthen our software offerings with the pending acquisition of Peregrine. The acquisition will add key asset and service management components to the HP OpenView portfolio, a distributed management software suite for business operations and IT. Peregrine's capabilities include asset tracking, expense controls, process automation, service control, service alignment, enterprise discovery, IT executive dashboard products as well as outsourcing, business continuity and consolidation management.

I'll leave my segment comments at that for now and I'd like to turn the call over to Bob.

[Begin Bob Wayman remarks]

Thank you, Mark, and good afternoon, everyone.

Let me begin with a quick review of the performance of our financial services business.

Revenue for HPFS during the quarter was $514 million, up 3 percent year-over-year and 5 percent sequentially.

Operating margin was 10.1 percent, up from 3.8 percent last year and down from 11.9 percent in Q3. The improvement in margin is largely due to the fact the Q404 results were adversely impacted by the recording of reserves for certain receivables. During the course of FY05, the risk profile of the portfolio has steadily improved and the reserve levels have been adjusted accordingly.

Financing volume decreased 1 percent year-over-year and was up 21 percent sequentially. Portfolio assets decreased 3 percent year-over-year and increased 1 percent sequentially.

Now on to the key elements of the P&L.

Non-GAAP EPS was 51 cents, up from 41 cents a year ago.

GAAP EPS for the quarter was 14 cents, which included $1.1 billion or 37 cents in after-tax adjustments that were not included in our non-GAAP results. The majority of the adjustments relate to pre-tax restructuring charges of $1.6 billion, which is a more significant charge than the $1.1 billion that we estimated when we announced our restructuring plans in July.

The increase over our initial estimates is due to the following:

- Approximately $250 million primarily associated with higher U.S. early retirement program costs versus our original estimates and incremental expense from the acceleration of vesting and extension of exercise periods on stock options;
- Approximately $200 million primarily arising from differences in the job mix of terminated employees versus original estimates;
- We now expect to include approximately 15,300 employees in our announced restructuring program, approximately 800 more than our original estimates.

While some of these additional costs will not yield additional savings, we do expect roughly $150 million in incremental annual gross savings beginning in FY07 above the $1.9 billion in gross savings that we estimated in July. Consistent with our announcement in July, we expect roughly half of these saving to fall to earnings.

Note also that although we took a significant charge in the fourth quarter, we will not begin to yield savings until employees have left the company. Approximately 4,700 employees left the company in the fourth quarter related to the July announcement. We still estimate that we will be executing on the plan throughout FY06 and savings will increase accordingly.

Revenue of $22.9 billion for the quarter was up 7 percent year-over-year and up 6 percent when adjusted for the effects of currency. On a regional basis, revenue was up 5 percent in the Americas, 8 percent in EMEA and 12 percent in Asia Pacific. When adjusted for the effects of currency, revenue was up 4 percent in the Americas, 8 percent in EMEA and 9 percent in Asia Pacific.

Gross profit was $5.4 billion for the quarter, or 23.5 percent of revenue, up from 23.4 a year ago and 23.2 percent sequentially. Year-over-year gross margin improvements in ESS, PSG and to a lesser extent HPFS and Software were partially offset by gross margin declines in IPG and HPS.

Non-GAAP operating expense totaled $3.6 billion for the quarter, or 15.9 percent of revenue, down from 16.4 percent a year ago and 17.5 percent sequentially. Adjusting for currency, expenses were up 3 percent year-over-year and 1 percent sequentially. Given that bonus accruals significantly pressured op-ex relative to the prior-year, I am pleased with the progress we have made in op-ex and we will continue to focus on expense management.

Non-GAAP operating profit was $1.7 billion, or 7.6 percent of revenue, up $245 million year-over-year and $543 million sequentially.

Non-GAAP other income and expense was income of $135 million, or roughly 4 cents per share, above the 2 cents per share we had estimated coming into the quarter. The increase reflects more favorable net interest income and currency impacts than our original estimate.

Given current interest rates, projected cash and debt levels, and currency dynamics, we estimate OI&E to be about 3 cents per share per quarter for FY06. While we may experience one-time gains or losses from this baseline, these items are difficult to predict and we will just call them out if or when they occur.

Our non-GAAP tax rate was 20.0 percent for the quarter, in line with our guidance. I expect a non-GAAP tax rate of about 20 percent for fiscal 2006.

Next, the balance sheet.

HP owned inventory came in at $6.9 billion, down $194 million year-over-year and up $233 million sequentially. Inventory days of supply stands at 35 days, down from 39 days last year and 38 days sequentially. Inventory was managed well across each of our businesses.

Regarding channel inventory, we ended the quarter in excellent shape across the board, with ESS and PSG at roughly 4 weeks and IPG a bit over 5 weeks. Further, IPG channel inventory dollars were down year-over-year, while PSG was roughly flat. ESS dollars were up from unusually low prior-year levels.

Trade receivables ended the quarter at $9.9 billion, down $323 million or 3 percent over the prior-year and up $1.1 billion or 13 percent sequentially, in line with normal seasonality. As a percentage of revenue, trade receivables were 11.4 percent – down from 12.8 percent year-over-year and up from 10.3 percent sequentially. DSO now stands at 39 days, down from 43 days last year and up sequentially from 38 days.

Next, property, plant and equipment was down $198 million year-over-year and up $21 million sequentially to $6.5 billion. Gross cap-ex was $522 million, down 29 percent year-over-year and up 57 percent sequentially. On a net basis, cap-ex was $446 million, down 30 percent year-over-year and up 114 percent sequentially primarily reflecting a lease reclassification that I mentioned last quarter. Financing assets accounted for a significant portion of cap-ex during the quarter. Net PP&E as a percent of revenue now stands at 7.4 percent of revenue, down from 8.3 percent year-over-year and 7.5 percent sequentially.

Regarding accounts payable, days payable closed the quarter at 52 days, up from 51 days both sequentially and year-over-year.

Next, some comments on cash.

Cash flow from operations was $1.9 billion for the quarter despite paying approximately $900 million in funding to the pension plans and $300 million in tax payments related to repatriation. For the full year, we generated $8 billion of cash from operations, up 58 percent year-over-year. Free cash flow, that is, operating cash flow less net cap-ex, was $6.6 billion, up 93 percent over last year. Both operating cash flow and free cash flow are the highest in the company's history. For Q1 cash flow planning purposes, do keep in mind that we expect significant cash outlays associated with our restructuring actions and company bonus payment.

During the quarter, we repurchased $1.4 billion in stock and paid $229 million in our normal dividend. For FY05 we repurchased $3.5 billion in stock and paid over $900 million in dividends.

We closed the quarter with total gross cash of $13.9 billion, down from $14.6 billion sequentially and up from $13.0 billion year-over-year.

Our weighted average shares outstanding remained flat from Q3 to Q4, in-line with the guidance we gave you last quarter. Going forward, I expect weighted average shares outstanding to remain about flat with our Q4 exit level of 2.915 billion. This expectation takes into account our continuing share repurchase activities and the current year appreciation in the stock price. There will, of course, be some variation based on our level of share repurchases and on the subsequent share price and its impact on option exercise patterns and common stock equivalents.

Now, a few full year P&L highlights.

For the full year, revenue was $86.7 billion, up 8 percent year-over-year or 6 percent when adjusted for the effects of currency.

On a full year basis, non-GAAP EPS was $1.62 up 22 percent from $1.33 last year. GAAP EPS for the year was 82 cents, which included $2.3 billion or 80 cents in after-tax adjustments that were not included in our non-GAAP results.

Now for a few comments on our outlook for Q1 and full year fiscal 2006.

On a constant currency basis, revenue typically declines by approximately 2 to 3 percent from Q4 to Q1, in line with normal business seasonality. However, given the significant currency movements over the last few months, we are faced with an additional sequential headwind of approximately 1 percent in Q1 if exchange rates stay roughly where they are today. With this in mind, we expect revenue of $22.3 billion to $22.6 billion in Q106.

The full year impact of the currency fluctuations is more difficult to predict. However, if the Euro traded in the $1.25 to $1.35 range for the majority of FY05, we expect an adverse full-year currency impact of approximately 2 to 3 percent for FY06 with our current modeling suggesting that Q206 growth may be the most adversely affected.

When looking forward to the full year and taking these currency effects into account, we estimate FY06 revenue growth of roughly 3 to 5 percent, suggesting FY06 revenue of approximately $89.5 billion to $91.0 billion. On a constant currency basis, this would reflect similar growth to the 6 percent constant currency growth we achieved in FY05.

Before addressing EPS guidance, a few comments on stock compensation. Effective Q106, we are adopting FAS123R which requires us to include expenses related to stock compensation based on their fair values. We are providing non-GAAP EPS estimates with and without option expenses for comparability purposes. However, we will include stock

compensation in our reported non-GAAP results and ask that all analysts include stock compensation expense in their officially submitted estimates.

We are adopting FAS123R prospectively and as such, we will not be restating prior period financial results. However, to assist you in analyzing trends in our stock compensation, we have provided two slides in our earnings presentation, which include stock compensation, functionalized between cost of goods sold and operating expenses for the last eight quarters. Also, for FY06 we currently intend to hold FAS123R expenses at the corporate level and not allocate them to our operating segments.

We expect Q106 non-GAAP EPS of $0.46 to $0.48, excluding stock compensation or $0.42 to $0.44 including approximately $0.03 or $0.04 from stock-based compensation.

For FY06, we expect non-GAAP EPS of $1.88 to $1.95 excluding stock compensation or $1.75 to $1.82 including approximately $0.13 from stock-based compensation.

With that, I'll turn it over to the operator and we'll begin the Q&A.

[End of Wayman remarks]

... Q&A portion of call ...

[Resume Hurd remarks]

OK, thanks for your questions. Before wrapping up, I wanted to summarize today's call by saying that I am pleased with the company's execution in the fourth quarter.

- We had solid revenue growth, we saw improved momentum and margin expansion in some of our key businesses, we had good cost discipline and we generated strong cash flow;
- We began the implementation of our restructuring program that will improve our cost structure and allow HP to become more competitive;
- We returned $1.6 billion to shareholders in the form of share repurchases and dividends; and
- We rewarded employees for their hard work by paying our first significant bonus in many years.

That said, we know we have more work to do but we're pleased with our progress to date.

We'll conclude today's earnings call with this. We do look forward to seeing you at our securities analyst meeting in New York City on Dec. 13.

Thanks again for joining us on today's call.

[End remarks]