

# FINAL TRANSCRIPT

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## **HPQ - Q1 2006 Hewlett-Packard Earnings Conference Call**

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## PRESENTATION

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**Operator**

Welcome to the Hewlett-Packard first quarter 2006 earnings conference call. [OPERATOR INSTRUCTIONS] I would now like the turn the presentation over to Mr. Brian Humphries, Vice President of Investor Relations. Please proceed, sir.

**Brian Humphries - Hewlett-Packard - VP, IR**

Thank you, Jennifer. Good afternoon, everyone. I would like to welcome you to our first quarter earnings 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 this call is being Web cast live. The Web cast and the first quarter earnings slide presentation, including non-GAAP reconciliation tables, can be accessed on the HP Investor Relations page under Company Information at HP.com. A replay also will be available shortly after the conclusion of the call for approximately one year.

Next, it is my duty to inform you that the primary purpose of the call is provide you with information regarding the first quarter. However, some of our statements 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 risk and is uncertainties and actual future results may vary materially. I encourage you to read the risk factors described in the Company's annual report on form 10-K for the fiscal year ended October 31, 2005, as well as subsequent SEC filings after our form 10-K for an understanding of the factors that may affect the Company's businesses and results.

I would also like to point out that earnings, growth margins, operating expenses and similar items discussed at a company level are sometimes expressed on a non-GAAP basis and therefore have been adjusted to exclude certain items including in process R&D, amortization of goodwill and purchased intangibles, restructuring charges and net investment losses. A presentation of GAAP financial information for the present quarter and reconciliation of non-GAAP to GAAP are included in the financial statements accompanying today's earnings release which is also available on the HP Investor Relations page under Company Information at HP.com. Finally, and with a view to allowing time for questions from multiple firms, please refrain from asking multi-part questions or clarifications. With that, I will turn the call over to Mark.

**Mark Hurd - Hewlett-Packard - President/ CEO**

Good afternoon and thank you for joining us. I am pleased with our first quarter results. We delivered solid revenue growth with some of our key businesses coming ahead of plan, and we controlled costs and expenses and posted strong cash flow from operations. We're on track with our plan to strengthen our management team, implement our restructuring plan and reduce our cost structure. We're refining our sales model and hiring in key areas to take advantage of the opportunities in the market.

Financial highlights of the first quarter included revenue growth at 6% year-over-year or 8% in constant currency. Operating margin expansion in key businesses with Personal Systems margins up 3.9%. Imaging and printing margins up 14.9% Enterprise Storage and Servers margins of 7.7% and HP services margins at 7.8% as well as total company margins. Non-GAAP operating profit of 7.5% up from 6.2% in the prior-year period. Non-GAAP EPS growth of 30% year-over-year and cash flow from operations of 1.8 billion.

We also made progress on key initiatives including the further strengthening of our management team with key hires in sales, services and software. The extension of our imaging software and storage offerings with closure of Scitex and Paragon acquisitions. And the announcement of a definitive claim to acquire Outer Bay a leading provider of archiving software and enterprise applications and databases, and the elimination of a further 1,800 positions as part of our restructuring program as well as the change to our U.S. pension and post retirement plans. We're pleased that our initiatives are on track and results are showing up in both the top line and inner margins. However, we know we have more work to do. We know we can do better. We have growth opportunities to pursue and to fund. We need to remain disciplined in terms of our costs.

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Turning to the business segments. Imaging and print had a solid quarter with revenue growth of 8% year-over-year, and segment operating profit of 973 million or 14.9% of revenue. Over the past few quarters we've taken steps to strengthen IPG's position in the market with cost actions aimed at reducing our cost structure to allow us to be more competitive in the market, targeted pricing actions to drive market share gains in areas of high supplies consumptions, new product innovations in our scalable print technology and targeted acquisitions that extend our leadership in adjacent growth market. These actions have begun to pay off with supplies growth of 11% in the first quarter and strong IPG profitability. We also continued to see strong momentum in the market with total shipments of 13 million printers in the quarter, growth of 12% over the prior-year period. Consumer hardware revenue grew 1% in the quarter with printer unit shipments up 10% led by 20% growth in all and one shipments and strong acceptance of HP's scalable printing technology.

Commercial Hardware revenue increased 6% year-over-year with printer unit shipments up 18% led by color laser shipment growth at 36% and printer based MFP unit shipment growth of 40%. HP Indigo digital press volume grew 43% year-over-year.

You should expect us to continue to focus on balancing growth and profitability going forward, delivering profitability in the 13% to 15% range and investing in stall based growth and hardware and supplies innovation. You will also see us continue to target investments at the adjacent growth areas such as managed print services and commercial printing, and new and emerging business opportunities as well. We're in the process of building out our sales force to take advantage of these opportunities.

Moving out of Personal Systems we continue to show a balanced approach to revenue growth and margin improvement. First quarter revenue grew 8% year-over-year to a record 7.4 billion with solid growth across all regions. During the quarter shipments grew 16% year-over-year with double digit unit growth in every region, and particular strength in both consumer and commercial notebooks as well as workstations. Over the past few quarters growth in the market has been fueled by the shift to mobility, strength in emerging markets and consumer.

We're pleased to be well position to do take advantage of this with a strong lineup of consumer and commercial notebooks, a significant exposure in strong competitive position in emerging markets, and a solid relationship with the retail and commercial channel which is essential for both emerging markets and the consumer business. In the first quarter and on the year-over-year basis revenue grew 26% in notebooks and 18% in consumer clients. We also continued to post strong growth in emerging markets with unit shipment growth of 68% in India, 62% in Brazil, and 49% in Russia.

Segment operating profit was 293 million or 3.9% of revenue representing our highest operating margins in many years. Margins continue to benefit from top line strength, strong momentum in consumer and improved execution against various operational efforts. We're pleased with the ongoing improvements we're seeing at PSG and will continue to focus on executing well against the operational levers as well as continuing to reduce the cost structure of the business. However, top line will be seasonally weaker in the second and third quarters given consumer mix and the traditional European holiday season so you should expect this to be reflected in PSG margins.

Enterprise Storage and Servers had a solid quarter with revenue up 5% year-over-year to 4.2 billion and operating profit of 326 million or 7.7% of revenue. Within ESS industry standard server revenue grew 6% over the prior year period and continued strength in server blades where revenue grew 58%. Revenue in Storage grew 4% with ongoing strength in external raise where revenue in our high-end XP and midrange grew 14% and 28% respectively. Business critical systems revenue increased 1% with Integrity server revenue up 94% offset by declines in PA-RISC and Alpha.

We did close the quarter with approximately 7,000 ISB applications imported to HP Integrity, double the number over the prior year period and we are investing funds and resources to expand this in the year ahead. Over the past few months we've extended our storage and server offerings with the acquisitions of ApplQ, RLX and most recently the announcement that we signed a tentative agreement to acquire Outer Bay. We are determined to drive greater success in the enterprise through ongoing execution and cost discipline as well as targeted R&D and acquisitions. We're also hiring in key areas and refining our enterprise sales model to ensure we have the right skills in place to take advantage of these market growth opportunities.

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Revenue in HP Services declined 2% year-over-year to 3.8 billion reflecting the impact of currency and a focus on profitability improvement. HPS reported operating profit of 293 million or 7.8% of revenue. Within HPS revenue declined 2% in technology services, 1% in consulting and integration and managed services as well. Excluding the effects of currency HPS grew 3% year-over-year. We remain focused on lower our cost of service delivery to allow us to compete more aggressively in the market. Until then you should expect to see us remain disciplined in terms of deal times. This and the impact of currency will challenge HPS top line growth in fiscal year '06.

Turning to software, revenue grew 29% to 304 million led by growth in OpenView and OpenCall, up 34% and 19% respectively. During the quarter we strengthened our software offerings with the acquisition of Peregrine which adds key asset service management components to the HP OpenView portfolio. Software reported an operating profit of 9 million or 3% of revenue representing a second consecutive quarter of profitability. Given the model improvements we're making and the cost actions we have in place to further reduce the break even point of the business, we should begin to see further improvements in software margins in the coming quarters. I am going to leave my segment comments at that and turn it over to Bob for more on the financials. Bob?

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

Thanks, Mark and good afternoon, everyone. Before I get into the numbers, I want to briefly touch on a financial reporting item. Each year as part of our first quarter annual financial review, we make minor changes between the reported statements on cyclical results that reflect organizational shifts between the businesses. Under accounting rules we're required to report our cyclical results consistent with our internal reporting. As such any changes that we make to prior period results internally must be reflected in our external results as well. This year the changes are immaterial in size and primarily reflect revenue shifts at the GPU level beneath the segments. At the segment level only ESS and software are impacted with quarterly revenue and operating profit fluctuations of no more than \$5 million.

However, in the interest of complete disclosure we thought it was appropriate to mention them at the start of this call. A detailed bridge on these changes including historical data is available on our Investor Relations website as well as furnished on a Form 8-K filed with the SEC. I want to be very clear the changes do not impact each piece previously reported to consolidated net revenue, earnings from operations, net earnings or EPS. So view this as an annual fine tuning of our financial reporting structure to better align it with business changes.

With that, a quick review of the performance of our financial services business. Revenue for HPFS during the quarter was \$496 million down 11% year-over-year and 4% sequentially. The revenue decrease reflects lower used equipment sales and declining financing volume which decreased 10% year-over-year. The volume declines were primarily driven by softness in Asia Pacific and select European countries. Portfolio assets decreased 2% year-over-year and increased 2% sequentially. Operating margin was 7.7% down from 8.1% in Q1 of last year and 10.1% in Q4. However, within our guided range of 6% to 8% margin for the business.

The risk profile of the existing portfolio and the trend for delinquency rates are in good shape. Going forward, we'll focus on returning the business to appropriate levels of volume and revenue growth while continue to manage the portfolio for acceptable levels of risk. In order to give you better visibility into HPFS financials we have provided a supplemental slide in the earnings presentation which includes depreciation, change in financing and receivables, and the net capital expenditures for HPFS.

Before getting into the key elements of the P&L let me remind you fiscal Q1 '06 results including cost of sales, operating expenses, operating profit, net income and EPS reflect the inclusion of FAS123-R stock based compensation while prior period results do not. Also, stock based compensation is held at the corporate level and not included in segment results. To assist you in comparing results versus prior periods we have included quarterly historical EPS trends in the financial tables accompanying earnings release. This should allow to you review the results as though all stock based compensation had been included in previously reported results.

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Non-GAAP EPS was \$0.48 including approximately \$0.03 from stock based compensation, up from \$0.37 a year ago which again excluded stock based compensation. GAAP EPS for the quarter was \$0.42 which included 166 million or \$0.06 in after tax adjustments that were not included and in our non-GAAP results. The majority of the adjustments relates to the amortization of purchased intangibles. Quick update on restructuring. During the quarter approximately 1,800 positions were eliminated related to the July and announcement bringing the cumulative total to 6500.

Now to the P&L. Revenue of 22.7 billion for the quarter was up 6% year-over-year and up 8% when adjusted for the effects of currency. On a regional basis revenue was up 10% in the Americas, 1% in EMEA, and 6% in Asia/Pacific when adjusted for the effects of currency revenue was up 9% in the Americas, 8% in EMEA and 9% in Asia/Pacific. Gross profit was 5.3 billion for the quarter or 23.2% of revenue, up from 22.9 a year ago, and down from 23.5% sequentially. Year-over-year gross margin improvements in EES, PSG 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 15.7% of revenue down from 16.7% a year ago and 15.9% sequentially. Adjusting for currency effects expenses were up 2% year-over-year and down 2% sequentially. We will continue to focus on further operating expense improvements while investing in areas to drive future growth. When looking forward bear in mind that historically operating expenses increase approximately 4 to 5% in constant currency sequentially from Q1 to Q2.

In addition, we implemented our annual salary adjustment effective February 1st which will negatively impact operating expenses and gross margin on a sequential basis. In FY '05 similar salary adjustments were implemented effective May 1st. The change and timing this year was made to more closely align merit based salary increases with the end of our fiscal year. Non-GAAP operating profit was 1.7 billion or 7.5% of revenue up 369 million year-over-year, and down slightly sequentially despite the inclusion of approximately 140 million of stock based compensation in the current period. Non-GAAP OI&E was pre-tax income of 38 million or roughly \$0.01 per share after tax below the \$0.03 a share we had estimated coming into the quarter. The decrease reflects currency losses during the quarter following significant currency gains in each of the last two quarters and losses on non operational property sales.

As I indicated last quarter, currency dynamics within OI&E and one-time items such as land and building sales are difficult to predict. However, given projected cash and debt levels and our expectations for currency we are reducing our estimate for OI&E to about \$0.02 per share per quarter for the remainder of FY '06. We will call out deviations to this baseline if and when they occur. Our non-GAAP metric 20% for the quarter, in line with guidance.

Next, the balance sheet. HP owned inventory came in at \$6.7 billion down 389 million year-over-year and 146 million sequentially. Inventory days of supply stands at 35 days, down from 39 days last year and flat sequentially. Overall we continued to make good progress in inventory management across each of the businesses. With regard to the channel inventory, we ended the quarter in good shape across the board with ESS and IPG at roughly five weeks and PSG at four weeks. Further, IPG sale inventory dollars were down year-over-year and ESS dollars were flat. PSG dollars were up slightly reflecting increased revenue and PSG channel inventory weeks were down both sequentially and year-over-year.

Trade receivables ended the quarter at 8.7 billion flat year-over-year and down 1.2 billion sequentially in line with normal seasonality. As a percentage of revenue trade receivables were 9.9% down from 10.6% year-over-year and from 11.4% sequentially. DSO stands at 34 days down from 36 days last year and 39 days sequentially. Trade receivables are in good shape particularly given revenue performance for the quarter.

Next, property plant equipment was down \$344 million year-over-year and 105 million sequentially to 6.3 billion. Growth, CapEx was 427 million down 26% year-over-year and 18% sequentially. On a net basis CapEx was 322 million, down 23% year-over-year and 28% sequentially. Financing assets accounted for a significant portion of CapEx during the quarter. Net as a percentage of revenue now stands at 7.2% down from 8.2% year-over-year and 7.4% sequentially. Despite the low level of CapEx in Q1, our full year capital expenditure guidance remains unchanged and we expect total CapEx of 2.8 billion and net CapEx of 2.2 billion

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in FY '06. Regarding accounts payable, days payable closed the quarter at 46 days up from 45 days year-over-year and down from 52 days sequentially.

Next, some comments on cash. Cash flow from operations was 1.8 billion for the quarter, despite significant bonus payments and approximately 152 million in payments related to our restructuring activities. Free cash flow, that is operating cash flow less net CapEx, was 1.5 billion up 34% over last year. During the quarter we repurchased \$1.4 billion in stock and paid 227 million for our normal quarterly dividend. In addition to our normal open market share repurchases, we entered into a prepaid variable share repurchase program with an investment bank during the quarter.

Under the terms of the program, we prepaid 1.7 billion in exchange for the right to receive a variable number of shares of our common stock over an approximate one year term of the transaction. The price at which we purchased the shares are subject to a minimum and a maximum as determined under the terms of the agreement thereby effectively hedging our purchase price. For modeling purposes it is important to understand the actual number of shares purchased will be determined over the course of the program and that the shares will only come out of our share count periodically over the life of the agreement as our purchase transactions are settled. Given the level of share repurchases and the prepayment transaction entered into during the quarter our Board of Directors authorized an additional 4.0 billion for share repurchases and total remaining authorization is just over that amount.

We closed the quarter with total gross cash of 12.0 billion down from 13.6 billion year-over-year and 13.9 billion sequential. The decrease in cash balance primarily reflects the prepayment and repurchases of common stock as well as 653 million in net cash payments for acquisitions, bonus payments and restructuring payments. Our weighted average shares outstanding declined slightly from Q4 to 2.893 billion. Going forward I expect weighted average shares outstanding to remain at approximately 2.9 billion with the potential for some variation quarter to quarter. This expectation takes into account our continuing share repurchase activities, HP stock price and our current expectations for option exercise pattern and common stock equivalents.

Now a few comments on our outlook. On a constant currency basis revenue typically decreases up to 1% from Q1 to Q2. Now, in recent years we have benefited from currency movement sequentially from Q1 to Q2 which more than offset typical constant currency decreases. Assuming exchange rates stay roughly where they are today we expect revenue to decline for normal seasonal patterns. As such we expect revenue of 22.4 to 22.6 billion in Q2 '06 or year-over-year constant currency growth of 6 to 8%. For the full year FY '06 we continue to expect an adverse currency impact of approximately 2 to 3% and now expect revenue of 90 billion to 91 billion.

Regarding earnings there are several factors to consider. Our results this quarter reflected balanced performance across our portfolio and we are ahead of plan in certain businesses. In addition, we will continue to execute on our restructuring plan throughout FY '06. Offsetting these factors as previously mentioned operating expenses typically increase sequentially and we will see the impact of the annual salary adjustment in Q2.

Mark noted that we will continue to fund investments to drive long-term growth initiatives. Further, we are now expecting roughly \$0.02 per share in OI&E versus previous guidance of \$0.03 per quarter. With that in mind, we now expect Q2 '06 non-GAAP EPS of \$0.47 to \$0.49 which includes approximately \$0.03 to \$0.04 of stock based compensation. For FY '06 we expect non-GAAP EPS of \$1.90 to \$1.95 which includes approximately \$0.13 of stock based compensation. While we're not going to give Q3 and Q4 guidance today, let me remind you that Q3, as you know, is always a tough quarter for us. Our mix includes a significant portion of revenue from Europe as well as consumer. Both of which are seasonally weak in the third quarter. As you build your models for the rest of the year, keep many mind this seasonality adversely impacts both revenue and earnings in Q3. With that, we'll move onto your questions.

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## QUESTIONS AND ANSWERS

### Operator

Thank you, sir. [OPERATOR INSTRUCTIONS] Your first question comes from the line of Harry Blount with Lehman Brothers.

### Harry Blount - Lehman Brothers - Analyst

Thanks, guys. Mark, the principle question I get from investors is typically focused on how HP is going to continue to drive the margin improvement excluding the cost cutting that's going on there, and I know you have a number of initiatives underway, so I was hoping you could maybe talk about some of the progress you're making and where you feel real good about the prospects going forward.

### Mark Hurd - Hewlett-Packard - President/ CEO

Well, I think for us a lot of it is about mix, Harry. For us how we deal with mix both across the Company as well as within the product lines and the attached themselves are really big deals to us, Harry, as you know, so we're putting a lot of energy in the places that we think have significant margin opportunity for us across the Company, but also within the context of businesses like PSG and ISS where we can bring with that other things that attract more margin either in the attach of options or other opportunities that bring more services and other products with them.

Secondly, there is also a significant number of other operational levers that we can pull as it relates to our supply chains, it relates to warranty, it relates to revenue also a big part of our portfolio and how we incent and align our channel partners and how those relate to the various factors I just described, so it is mix within the Company. Software and services obviously play a key mix in that. Mix within the product line, aligning to attach. Supply chain levers like what I described. All around cost of goods sold, warranty, etc.. It's mix within contra, et cetera. There are a fair amount to go on but, Harry, I would also caution that we're we've got a lot of work to do here. Both in the context of there is a lot of opportunity, but there also is a lot of work for us to do at the same time.

### Brian Humphries - Hewlett-Packard - VP, IR

Thanks, Harry. Next question, please, operator.

### Operator

Your next question is from Richard Farmer with Merrill Lynch.

### Richard Farmer - Merrill Lynch - Analyst

Thanks. Mark, I think, or maybe Bob had mentioned you're a little bit ahead of plan in the segments of restructuring, and we've seen operating margins already at the high-end of the long-term target range in IPG, PSG and DSS. Can you help us quantify how far you are along in capturing the restructuring savings into the P&L and how much there is left going forward to be realized?

### Mark Hurd - Hewlett-Packard - President/ CEO

No more than what we said. I think, Richard, you were really faint in your question, but I think I got the spirit of it. I would say we're roughly on track with our restructuring activities. As we said before, it would be a six quarter kind of process, that certainly



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takes into consideration we have some regions and some geographies that are frankly a little bit more difficult to get through. I would also add to you we have chosen to tackle those as opposed to not tackle them. We knew going in they would be hard work, and they've proven to be all of that. We're going to go get it done, and it is going to take us time to get all of that accomplished, but within the context of what we had originally described and I think the schedule we gave you earlier is roughly the right schedule. In terms of us coming out with new operating margin parameters for '07, that's not where we are today, where we are is in the the ranging that we described and I think the answer to your question on restructuring is on track.

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

Richard, just to clarify, my comments about a couple of businesses being ahead of plan was not specifically related to restructuring. It was just in the quarter. They performed a little better than we had assumed going into the quarter.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thanks, Richard. Next question, please.

**Operator**

Your next question comes from Tony Sacconaghi with Sanford Bernstein.

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

Yes. Thank you. I just have a question about currency and how you're factoring that into your guidance. I think the center point of your revenue guidance year-over-year is 4.3% revenue growth. Bob, you said 6% to 8% growth at constant currencies. Are you expecting a minus 2% to minus 4% hit year-over-year in currency in Q2 and then related to that, what was your expectation for year-over-year currency impact for Q1? We know it came in at minus 2%. Can you tell us what your expectation was at the beginning of the quarter?

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

Hang on just a moment, Tony. I think the 6% to 8% you're referring to was a Q2 number. I am sure it was. So the full year, yes, we still believe 2% to 3%. You may recall in December when we talked to you we were talking about a couple of percent full year currency impact. Yes, Brian is just confirming here the 6% to 8% was indeed a Q2 number.

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

Right. The mid-point of your Q2 guidance as reported is for 4.3% revenue growth, so the implication is for Q2 you're expecting a negative year-over-year currency hit of minus 2% to minus 4%? I just want to confirm that.

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

That is correct.

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

What was your expected currency impact for Q1 because if anything year-over-year Q1 looks about as hard as any other quarter, and you're expecting 2% to 3% for the year, what was your expectation for Q1 at the beginning of the quarter?

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

It was in the 2 % to 3% range.

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

Thank you.

**Brian Humphries** - Hewlett-Packard - VP, IR

Thanks, Tony. Next question, please. Your next question is from Laura Conigliaro from Goldman Sachs.

**Laura Conigliaro** - Goldman Sachs - Analyst

Yes, thank you. This is a continuation of a couple of questions that were already asked, but it really is getting more specific on it. Can you give us a sense maybe a percentage terms or otherwise how much of the just reported quarter earnings actually came from restructuring and also how much of your targeted FY '06 earnings you actually look to come from restructuring and then maybe a somewhat better explanation if you could on what happened as far as the Enterprise group, that is despite an easy compare you had weak stores revenue growth and also decelerated ISS revenue growth.

**Mark Hurd** - Hewlett-Packard - President/ CEO

Okay. Laura, lots of questions. Let me try to tackle a few of them. I will let Bob grab a couple of them. On storage I think there is a mixed story within storage. We want to keep in mind that we had pretty strong growth as it related to EVA and the XP. When you look at EVA growth in the quarter of 28% and when you looked at growth of 14% many XP, I think if you look at that against the you're going find those are pretty strong growth rates overall, so I think that's encouraging part of the story. I think in the tape part of our business we've had flattish kind of performance overall.

Now, that's really a mixed story within storage. I would say our storage growth on the non-tape products was very strong in the quarter and we're encouraged by that. On the ISS side, it is depends which way you want to look at the story. Clearly 6% growth you have got to look at it also in the context of the overall performance of the business. You see it at the ESS level and I would tell you the business has been very strong in terms of its ability to attract attach and its ability to improve on the margin line, so when you look at it overall, I would say it is a fairly balanced story across ISS.

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

Let me try on restructuring. As I indicated 6,500 people have left on the restructuring program, so that's 30% to 40ish percent of the total we expect. There is still more labor cost reductions we will expect going forward. Another big part of our announcement back in July was the changes to the U.S. retirement and retiring medical plans and that is largely reflected in Q1. That is almost 100% already reflected in Q1 and will be fully reflected in Q2 and beyond. That part of it we've captured already.

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**Laura Conigliaro** - *Goldman Sachs - Analyst*

Thank you.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Question, please, operator.

**Operator**

Your next question is from Richard Chu with SG Cowen & Co.

**Richard Chu** - *SG Cowen & Co. - Analyst*

Thank you, very much. I note your supply revenue growth in IPG was 11% easily the best in any quarter's. I wonder if you could give us some sense of how that was achieved. How transient, how sustainable that level of ascension is, and any difference you can describe between the consumer and commercial businesses or Inkjet and LaserJet businesses? Thank you.

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Well, I think again there isn't a lot of-- the best way I can describe it is we tried to let the printer business and the IPG organization go out to the marketplace and make some moves that we think are appropriate relative to our opportunity to go scale the business, so I think when you go look at our unit growth, it is a fairly clear story. We're sitting here in Q2 of 12% growth.

We had kind of 9% to 10% unit growth in Q3, and then we followed that up with 8% in Q4 and 12% here, and what we tried to do is really target our actions at high consumption segments that we think relate to your point, a supplies growth opportunity in the future, and I think that's really what happened. I think your point is it sustainable, we will have to continue to do the work we've been doing, so I think that's one dimension of it because I think if you can see by previous quarters back if you go a couple years back, there is a fairly strong inter-relationship between what happens on units and the segments that the unit growth comes out from and what happens with supplies growth going forward. So I think that's one dimension of it, Richard.

I think in addition to it you are going to see us make some investments particularly in our demand creation model to put more effort into creating demand particularly in the commercial printing space and in the Enterprise where we think we've got a very strong technology position but we have to go make some level of investment to be able to go pursue the opportunity, so I tried to answer as many of your questions as I could.

I tried to answer as many of your questions as I could. I think we feel good about the improvement of the business. I still think you should model a 4% 4% to 6% revenue growth for the business that will behave within the range of 13% to 15% operating performance and we think those are appropriate ranges to be modeling as we go forward and I do mean 13% to 15% in the model that we're describing.

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

Richard, just on supplies itself, we saw improved growth rate on both Inkjet and Laser supplies. It is not just one, and as you see in the information packet we put out there, we're seeing good unit growth in both commercial and consumer space.

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**Richard Farmer** - *Merrill Lynch - Analyst*

Thanks very much.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Question, please.

**Operator**

Your next question comes from Ben Reitzes with UBS.

**Ben Reitzes** - *UBS Warburg - Analyst*

Hi, yes. Good afternoon. Thanks. Mark, you have -- --Hello?

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Yes, Ben. Go ahead, please.

**Ben Reitzes** - *UBS Warburg - Analyst*

Mark, you have an interesting problem that you're already at the lower end of your 2007 operating margin target at 7.5%. With only -- I am going to take another crack at this -- but with only 40% of restructuring done, how can we not assume that that 7.5% to 8% for '07 is a very conservative forecast. Sorry to push on this. But it seems like the key question.

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Ben, it is fine to push on it. I understand the math and appreciate it. I think for us we've got a number of things to go do at the same time. We clearly are adjusting our cost trajectory to your point and we have more work to do to get that trajectory to where we want to go, to Bob's point to how much work is left in our restructuring. At the same time I would like to emphasize we are trying to adjust our demand creation model which means for us that there are some targeted areas where we will spend more money.

I go by the theory you don't go spend a lot of money to create a product to purposely under distribute it, so we actually have a theory that we would like to get into the marketplace and participate in a bigger part of the market which causes us to make some investments. I think when you go look overall for us, we will be taking more cost out to your point. We will take some portion of that as we described way back in the restructuring. I think you have to deal with some of the timing of this as we optimized the mix going forward, and I certainly think long run this is very much in the best interests of HP, but we do have some investments to make as we do take some of this cost out. As it relates to some of the short term issues, I think you have to deal with some of the seasonality benefits in certain businesses that exist in Q1. We had some mix shifts that are going to go on within the businesses and demand generation that I described.

I think there are a number of stories here. Don't take any of that away from HP, Ben. I am pleased with the performance of the Company in Q1. I don't want to come off in any way to put a cloud on this, but we just still have a lot of work to do to get the place optimized and we know we can long run do better than we're doing.

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**Ben Reitzes** - UBS Warburg - Analyst

Thanks a lot, Mark.

**Brian Humphries** - Hewlett-Packard - VP, IR

Thank you, Ben. Next question, please.

**Operator**

Your next question is from Richard Gardner with Citigroup.

**Richard Gardner** - Smith Barney Citigroup - Analyst

Thank you. Well, nobody asked the demand question yet. Maybe Mark you can give us your qualitative assessment of demand for each of the various regions you're operating in and in particular address comments from some of the distributors here that January was a little quiet in terms of demand and whether that is something that's concerning to you or something that HP even saw out in the marketplace? Thank you.

**Mark Hurd** - Hewlett-Packard - President/ CEO

Everything concerns me, to be frank with you. When I look across our macro demand picture without getting into every geography in the sake of time, Richard, I would call it roughly steady. I can tell you, I could tell you stories by country. I could tell you Western Europe is a little less exciting than Eastern Europe. I could tell you that we saw very strong growth in the emerging markets. China and India were exceptionally strong and now we're starting to compare against very large comparisons in markets of China. It is no longer emerging. It is emerged and we still have very strong growth rates there.

I think steady would be how I would describe it. We certainly saw some stories within the story. Now, on the channel side, we finished with as about macro basis across HP about a strong a channel inventory position as we have. When I look at the comparisons across product and regions, it is a very strong story, so for us we feel good about that piece of it. Inventory overall, very strong for the Company. So we continue to monitor, Richard, as things go, but I would say when I net all of that out about emerging countries, this geography, this product segment, this channel inventory being strong for us against the Company, the best answer I can give you with the data I have is pretty steady overall from a demand picture.

**Richard Gardner** - Smith Barney Citigroup - Analyst

Mark, if I could, any comment on the linearity of this of demand in the quarter, specifically this idea of some down tick in January?

**Mark Hurd** - Hewlett-Packard - President/ CEO

Nothing that I can really drive to you on. Clearly within the quarter you had the holiday season and some other factors, but I wouldn't say anything in the quarter that I can -- may be Bob can comment, nothing I would say would give necessity dramatic pause to tell you there was something in this week or that week or this month that I would point to, no.

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

Pretty normal seasonality within the quarter.

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**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thanks, Richard.

**Richard Gardner** - *Smith Barney Citigroup - Analyst*

Thank you.

**Operator**

Your next question comes from Andy McCullough with Credit Suisse.

**Andy McCullough** - *Credit Suisse First Boston - Analyst*

Thanks. Mark, question on the software side. The acquisition strategy here recently has been geared to the smaller type company. What's your appetite for doing something a little bigger on the software side and where are you with respect to hiring a new head of software?

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Okay. We did hire a new head of software. We announced that a couple of weeks back. He actually starts next week. It will be his first day on the job. So, we have hired the new head of software. His name is Tom Hogan. We think he is a great addition to HP's management team, and we're really encouraged by that. In terms of acquisitions, I think if you see what we've done, what we've done is really to acquire companies that had very strong technology that would further enhance our portfolio that we also thought were manageable operationally and things that could work within the context of improving our business, so that's what we've done, and I think that's the right strategy for HP.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thanks, Andy. Next question, please.

**Operator**

Your next question is from Keith Bachman with Banc of America Securities.

**Keith Bachman** - *Banc of America Securities - Analyst*

Hey, guys. On the Services side, obviously, Mark, a little degradation there in the growth rate. You eluded to the fact that growth would -- I can't remember the word, but would be compressed or something going forward. Can you talk about what you're doing there that would detract from the growth rate and given the growth rate I was also a little surprised that margins weren't bumped up a little bit more. Can you talk about the tension between what you hope to accomplish by compressing the growth rate and the implications to margins, please?

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**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Yes, I think that there is a couple stories within there, Keith, to be very blunt with you. First, we knew going in we were going to compress the growth rate. That was purposeful. There clearly are deals in the marketplace. But we have got to make sure our discipline in right in terms of the deals we go after and that we go after deals that not only we can make money on but that we can deliver appropriately to the customer. We're doing that.

It is a very big hallmark of HP that we execute on deals but we have to make sure we execute for the customer at the same time we have a transaction that we can make money from. We put a lot of pressure on the way we look at deals and the discipline the way we look at deals, the way we look at costs, et cetera, et cetera and we have actually walked away from deals to be very blunt with you that says we're going to get out of a deal we're already in provided we can do that within the context of a great relationship with the customer going forward and make sure we don't bid on things that don't make sense for us long run.

Secondly we are working hard on costs and we have been successful and I expect us to continue to be successful in changing the cost trajectory many HP Services as well. I would remind you that we are having to add into HP Services the bonuses that we pay and the reason we do that is because it is an appropriate part of the cost structure that exists in that as business as well. There actually is cost coming out as we do it, so I think you should expect for the short term that trajectory to continue with our belief that in the long-term the better cost position that we have and the better discipline and the better alignment we have in terms of our service delivery methodology which we're investing in standardizing in positions us very well to grow the business long run. We still think when you net it out overall 4% to 6% revenue growth rates, the ability to drive operating margins in the 8 % to 10% range is the appropriate destination for the business.

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**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thank you, Keith. Next question, please.

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**Operator**

Your next question is from Bill Shope with J.P. Morgan.

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

Okay. Great. Thanks. Can you give us some commentary on the pricing environment in the Enterprise segment? We've seen some evidence of unusually aggressive pricing in servers, particularly in January. Did you see that and overall looking at the Enterprise Hardware segment are you having to walk away from some of the big deals to put up this very strong profitability you've been putting in?

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**Mark Hurd** - *Hewlett-Packard - President/ CEO*

I get a kick out of when Bill says, "unusually aggressive". I can't remember when it wasn't unusually aggressive. I mean, it is just a competitive marketplace. I can't say I saw anything in January or December or any time during the quarter that I would describe as different from what we've normally seen. If I had a data point, if I had enough data to tell you that, I would. I just haven't seen it. I do think the pricing in the marketplace is aggressive, and I would expect it to continue to be aggressive and that speaks to the fact that we've got to make sure we're doing our job in terms of cost and so forth, but nothing that I can point to.

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**Brian Humphries** - *Hewlett-Packard - VP, IR*

Next question, please.

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**Operator**

Your next question comes from Shannon Cross with Cross Research.

**Shannon Cross** - *Cross Research/Soleil - Analyst*

Good afternoon. Just a question in terms of the commodity environment, what are you seeing in terms of component pricing, anything specific we should be watching for?

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Yes, I will give you a little color. The ramp prices were up a bit in Q 1. We expect some stabilization through Q2 and hopefully that will balance out as we look at the back half of the year. Processors, supply is now finally normalized, so I know we we had some issues as we went going into Q4 we were concerned about, but supply has normalized . That has helped. Prices on panels have dropped a bit post holiday. We expect them to be stable to declining. Hard drives supplies is meeting demand, so pricing declines have been a little less than what we've normally seen. That would be my quick top of trees view, Shannon.

**Shannon Cross** - *Cross Research/Soleil - Analyst*

Okay. Great. Thank you.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Next question, please, operator.

**Operator**

Your next question is from Brian Alexander with Raymond James.

**Brian Alexander** - *Raymond James & Associates - Analyst*

Thanks. Mark, you mentioned a couple times on the call contra revenue items can you give us a sense what you are referring to there and any way you can break out how much the reduction of that is having an impact on top line growth?

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

It is not just reduction. It really is how we deploy it because what it is basically is our alignment of discounts, market development funds, promotion dollars, to, in most cases, to the channel and the partners, and the real crux of it is how you align those channel compensation dollars to the performance of the channels. For example, when you go to the channel and say I am going to give you as my partner \$1 to create some demand or a revenue goal, the question is maybe I should say instead of giving you \$1 for getting this revenue goal, I am going to give you \$0.25 for the revenue goal and \$0.25 for the mix that you deliver within the revenue, 25% for this and 25% for that and incent a different kind of behavior from you and that's what I mean by the alignment of the contra revenue.

We have cases where we have partners that do that. We wish they wouldn't, but in the end of the day, that's not the bulk of it in terms of saving dollars. Bulk is really how we deploy it, how we align it so we expect the appropriate behavior in the marketplace



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and the numbers are significant for us in terms of dollars and being able to align that to partners and I think I said before but I will say it one more time. We actually have partners that take our brand which is one of the 12, 13 leading brands in the world, lead with our brand and hollow out our product and put in other products and components. That's not nearly as interesting to us as somebody that really puts a full Hewlett-Packard solution together provided that fits for the customer. We want to incent more of the latter as opposed to the former and that's what we mean by the realignment of contra within the business. I hope that helps.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thanks, Brian. Next question, please.

**Operator**

Your next question is from Steven Fortuna with Prudential Equity Group.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Steve, are you there?

**Operator**

Mr. Fortuna your line is open. Please proceed.

**Steve Fortuna** - *Prudential Equity Group - Analyst*

Yes, okay. Can you hear me now.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Yes.

**Steve Fortuna** - *Prudential Equity Group - Analyst*

Quick question where do you guys stand relative to your efforts to reduce number of channel partners in Europe?

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Boy, Steve, I can't give you a count. I can tell you that we've been on our new program really since the end of October which really focuses more on the alignment of contra and a partner what we call a partner plus program which really doesn't have a specific objective, Steve, to reduce partners but to really align the behavior into this new model that I just described, so we don't really keep a metric around reducing the partners, more around how we're incenting partners. So sorry I can't give you more data there.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

Next question, please, operator.

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**Operator**

Your next question is from Joel Wagonfeld with First Albany.

**Joel Wagonfeld** - *First Albany - Analyst*

Thanks. Follow up to the last two questions. Wondering when we should expect to see real tangible changes in your vice channel strategy in the U.S. in terms of your relationships with your partners and whether you can quantify for that that for us either in dollars or volume or productivity metrics the types of benefits your expecting and over what time frame? And then related to that if you had any that's on demand based on Ingram's calls is sounds like Banoba is likely to expand beyond the the ThinkPad real soon, and only a matter of time for Acorp as well? Any thoughts now you might deal with that? Thanks.

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

In terms of the dollars and metrics, Joel, I am not going to go there. Our work in the U.S. is ongoing. You should -- we started this year with work in the U.S., and you should expect us to continue that work, and I believe overall it is going well. Like any time you change things, though, you have different issues that you have to deal with. I won't go into metrics around it. It really is again back to one of the earlier questions about within our margin mix, getting our alignment with our partners and getting our incentives lined up is a big piece of our opportunity to improve the Company.

**Brian Humphries** - *Hewlett-Packard - VP, IR*

We'll take two more questions, please, operator.

**Operator**

Your next question comes from Andrew Neff with Bear, Stearns.

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

Sure. Two things if I could. You were quoted on the tape saying something about considering some acquisitions in storage. I wonder if you can clarify what you mean there and secondly if you talk about -- you've done a number of hires over the course of the past year. How are you meshing them into the HP culture and what are they bringing to the HP that you couldn't get internally?

**Mark Hurd** - *Hewlett-Packard - President/ CEO*

Yes, thanks, Andy. First I think in terms of storage I don't want to predict any future acquisitions. What I really was trying to do was describe what we've done, and I think in areas like storage and servers and management software, these are really key areas for us, Andy in terms of filling out our technology capability, and most importantly for us in the intellectual property piece of that area, so that's what we've been doing, and why it is important to us to build out our IP capability. At the same time we want to be dealing with companies that we can integrate into HP appropriately and operationally deal with as we do it. Those are really the principles. We've got great technology, things that add to our stack, bring us more intellectual property and things we can operationally integrate as we do it and I think that's what you've seen us do.

In terms of the management, it has been important for us to bring capability into the Company and when I look at management teams, I typically try to map first the skills we need long run to execute the strategy of the Company, and then you want to do

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an inventory what you what you currently have and from there you do a gap analysis. You look at what you can develop from what you got and what you have to supplement. We've done the supplemental; work that we need to do and we'll never be the point we don't have to hire outside, but when we mesh as a group we're meshing around our plan, and frankly we're I think we're doing a good job of bringing the team together as a united team behind the achievement of our strategy and the financial plans underneath it.

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**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thank you very much, Andy.

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**Operator**

Your last question comes from Cindy Shaw with Moors and Cabot.

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**Cindy Shaw** - *Moors & Cabot, Inc. - Analyst*

Thanks very much. I am hearing from the channel that their win rate versus Dell is the best it has been in years and it has improved a great deal. I wonder if you can comment on how much you think Hewlett-Packard might be benefiting from that.

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**Mark Hurd** - *Hewlett-Packard - President/ CEO*

I think, Cindy, for us it is really important to support these folks. I think that our channel partners are real core ones, are putting out a lot of effort and we're trying to put renewed energy behind them and I am pleased to hear about their success, so we're going to put more energy behind these core partners and we hope that in the end that that provides opportunity for them as well as us. Certainly, it is important for us in Consumer as it relates to Retail which we think is a key advantage for us to be able to leverage their capability, skill, and their reach. At the same time as an emerging markets we get a real opportunity to get after the commercial marketplace through those partners and we really want to leverage them in that respect as well.

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**Cindy Shaw** - *Moors & Cabot, Inc. - Analyst*

Can you comment if you think that helped the revenue growth in the quarter here?

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**Mark Hurd** - *Hewlett-Packard - President/ CEO*

You know, I probably would tell you that I think that as in terms of helping our revenue growth I think it helps our overall performance. The fact that we can leverage the hybrid model gives us reach in a position that we otherwise, I don't know how we get, Cindy. Because they get us to a series of buyers we can't get to directly. We think there is a real benefit to being able to serve some segments directly and some segments through partners because the reach and the extension they have in some of these emerging markets and some of these channels we just can't replicate with our direct resource. We think it is a key strategic advantage.

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**Brian Humphries** - *Hewlett-Packard - VP, IR*

Thanks, Cindy.

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**Mark Hurd** - Hewlett-Packard - President/ CEO

Okay. Let me stop there and before wrapping up I did want to summarize today's call by saying that overall I am pleased with our execution in the first quarter. We delivered solid revenue growth. We did grow margins. We reduced our expenses and we generated solid cash flow from operations. We extended our imaging software and storage offerings with key acquisitions. We did executed against our restructuring program freeing up capital and resources for targeted investments and growth, and we further strengthened our management team with key hires.

We know we have more work to do. We're encouraged by our progress to date as evidenced by our second consecutive quarter of raising EPS estimates. While I am confident in our ability to meet these targets we have a lot of work ahead. I will leave my comments at that and I want to thank you again for joining us on today's call.

**Operator**

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

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