FINAL TRANSCRIPT

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HPQ - Q3 2006 Hewlett-Packard Earnings Conference Call - Q&A Line

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third-quarter 2006 Hewlett-Packard earnings conference call. At this time, all participants are in a listen-only mode. We will conduct a question-and-answer session at the end of this conference. (OPERATOR INSTRUCTIONS). As a reminder, this call is being recorded for replay purposes.

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

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

Good afternoon, everybody, and thanks for joining us. I would like to welcome you to our third-quarter earnings conference call. Joining me today, as usual, is our CEO and President, Mark Hurd, and CFO, Bob Wayman.

Before we get started, I'd like to remind you that this call is being webcast live. The webcast and the third-quarter earnings slide presentation, including non-GAAP reconciliation tables, can be accessed on the information page of HP Investor Relations under Company Information at HP.com. A replay will also be available shortly after the conclusion of the call for approximately one year.

Next, it's my duty to inform you that the primary purpose of this call is to provide you with information regarding the third quarter. 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 annual report on Form 10-K for the fiscal year October 31, 2005, the Company's quarterly report on Form 10-Q for the fiscal quarter ended April 30, 2006, as well as other SEC reports filed after that report.

I would also like to point out that earnings, gross margins, operating expenses and similar items discussed at the 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 gains or losses. A presentation of GAAP financial information for the present quarter and fiscal year to date and reconciliation of non-GAAP amounts 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 Hurd.

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

Thanks, Brian. First, good afternoon and thank you for joining us. HP delivered a solid third quarter. We posted revenue growth and expanded margins while gaining share in key segments, and generated strong cash flow from operations.

Financial highlights of the quarter include revenue growth of 5% year over year or, in dollars, $1.1 billion to $21.9 billion. Non-GAAP gross margin of 24.8%, up 1.6 percentage points over the prior-year period. Continued year-over-year operating margin expansion in key businesses, with Personal Systems margins of 4%, Imaging and Printing margins of 14.2%, Enterprise Storage and Server margins of 7.2%, HP Services margins of 9.4% and Software margins of 4.1%. Non-GAAP operating margin of 7.6%, up from 5.7% in the prior-year period. Non-GAAP EPS of $0.52, representing growth of 44% year over year, and cash flow from operations of $2.6 billion. That brings year-to-date cash flow from operations to $8.1 billion, which represents an annual record after just nine months of the year.

I'm pleased we have been able to post another quarter of solid results. At the same time and, I think, just as importantly, we have made progress on strategic initiatives that will strengthen HP's long-term competitive positioning in the market.

On July 25, we announced that we have signed a definitive agreement to purchase Mercury Interactive. Once completed, the transaction will bring together two market-leading businesses to create one of the most powerful management software portfolios in the industry. It will improve HP's position in the Enterprise, and enable us to drive strong revenue growth and margin expansion.

We continue to drive towards a lower-cost structure by transforming our IT infrastructure, by announcing our intent to consolidate and streamline our real estate portfolio over the coming years, and by eliminating approximately 1,900 positions as part of our restructuring program. These actions reduced our cost structure, allowing us to be more competitive in the market.

As I have said before, cost and growth are one and the same, and these are fundamental to our operating model principal. You will see us spend money to lower our cost structure and save money to invest in growth. The IT transformation and real estate programs mentioned above are good examples of these.

Now, let me turn to the business segments. Imaging and Printing had a solid quarter. Revenue grew 5% year over year to $6.2 billion, fueled by year-over-year unit shipment growth of 15% off a tough compare, and a supplies revenue growth of 9%. Revenue and commercial hardware grew 3% over the prior-year period, while consumer hardware revenue declined 3%. As I said previously, we are focused on leveraging our best-in-class technology, brand preference, our strong retail presence and a lower cost structure to accelerate supplies growth, by driving shipments in areas of high ink consumption. The strategy is driving success, with third-quarter consumer inkjet hardware unit shipments up 13% year over year, led by all-in-one growth of 17%.

We're also seeing continued momentum in our digital photography initiative. In the third quarter, Snapfish acquired its 30 millionth user, and by generating approximately 5 million prints in a single day, set another daily print record.

Commercial printer hardware unit shipments grew 23% year over year, fueled by color laser shipments growth of 7%. We're confident that this unit growth will drive further market-share gains from calendar quarter Q1 2006 levels, which already represented our highest market-share position in nine quarters.

Many of our growth initiatives are in the Enterprise, and we continue to see strong momentum here as well. During the quarter, printer-based MFP unit shipment rose 196% over the prior-year period, and the HP Indigo digital press page volume grew 37%. We also continued to build out our commercial printing sales force to take advantage of growth opportunities in Enterprise Imaging and Printing. You should expect to see us continue to aggressively target these markets, driving the shift from analog to digital, and leveraging our technology leadership and broad portfolio solutions to better address Enterprise customer needs for managing digital information.

IPG segment operating profit was $884 million or 14.2% of revenue, up from 13% in the prior-year period, as supplies strength offset pricing and promotional actions taken to drive hardware placements.

Personal Systems continued to post solid results, with revenue up 8% year over year to $6.9 billion, led by notebook growth of 14% and desktop growth of 5%. Operating profit was $275 million or 4% of revenue, up from 2.6% in the prior-year period. This margin percentage represents our highest level in a number of years, and I'm particularly pleased with this performance, given that this is typically our seasonally weakest quarter.

We do remain focused on profitable growth, and continue to execute well in the sweet spots of the market, in consumer, mobility and emerging markets. At the same time, our lower cost structure and progress on reducing cost of goods sold in areas such as warranty has allowed us to better address the commercial PC market opportunity. During the quarter, revenue in consumer clients grew 17% year over year, and revenue in commercial clients grew 4%. Total unit shipments grew 14% over the prior-year period, with double-digit growth in every region, driving share gains in both desktops and notebooks.

Turning now to Enterprise Storage and Servers, where revenue grew 3% year over year to $4.1 billion, within ESS, industry standard server revenue growth accelerated to 6% with strong growth in blades, where revenue increased 37%. During the third quarter, we unveiled our new c-Class blade offerings, which offer customers significant power pooling management and virtualization advantages. These have been very well accepted by the market, and we expect continued strong blade growth momentum in the fourth quarter.

Revenue in Storage grew 5%, with ongoing strength in external arrays, where revenue in our high-end XP and midrange EVA offerings grew 19% and 17%, respectively. Business-critical systems revenue decreased 6% year over year, with Integrity server revenue growth of 76%, offset by revenue declines in PA-RISC and Alpha. We will begin to ship Montecito-based integrity servers in Q4, position us well as we end the calendar year.

Enterprise Storage and Servers posted third-quarter operating margins of $296 million or 7.2% of revenue, up from 3.7% in the prior-year period, led by margin expansion. Given typical third-quarter seasonality, I'm pleased with the operating margin performance in the quarter.

Going forward, we will continue to balance margin improvement with revenue growth. As part of this, we continue to reinvest in the business via product innovation, pricing actions and the building out of our enterprise sales force.

Revenue in HP Services grew 1% year over year to $3.9 billion, reflecting the impact of currency and a focus on profitability improvements. Excluding the effects of currency, revenue in HP Services grew 2% year over year. Within HPS and on a year-over-year dollar basis, revenue in Managed Services and Consulting Integration grew 9% and 3% respectively. Revenue in Technology Services declined 1%. HPS reported operating profit of $364 million or 9.4% of revenue, up from 6.7% in the prior-year period, reflecting solid margin expansion across all of our businesses.

Over the past few quarters, we have shown strong margin improvement in Managed Services and Consulting Integration. At the same time, we have seen strength in Technology Services margins. The margin improvement reflects efforts on reducing our cost structure via labor management and efficiency measures, as well as process standardization and automation. We will continue to focus on these levers to optimize the cost structure of the business and align for greater revenue growth in fiscal year 2007.

Revenue in Software grew 30% over the prior-year period to $318 million, with revenue in HP OpenView and HP OpenCall increasing 34% and 21%, respectively. Software reported an operating profit of $13 million or 4.1% of revenue, up from a loss of 15.1% in the prior-year period.

We're pleased to have strengthened our Software portfolio by announcing that we have signed a definitive agreement to purchase Mercury Interactive. Combining Mercury with HP Software will create an annual run rate business of more than $2 billion. We believe this combination [will provide] revenue growth of approximately 10% to 15%, and think this business can drive operating margin of approximately 20% of revenue in fiscal year 2008.

I will leave my segment comments at that, and now I would like to turn it over to Bob.

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

Thanks, Mark, and good afternoon, everyone. I will begin with a review of the performance of our Financial Services business. Revenue for HPFS during the quarter was $519 million, up 6% year over year and flat sequentially. The year-over-year increase reflects the reclassification of certain leases in Q3 2005 from operating to capital leases, which resulted in a $40 million net reduction in revenue last year. Revenue was down approximately 2% when normalized for the prior-year reclass.

Financing volume increased 10% year over year and 11% sequentially. Portfolio assets increased 4% year over year and were flat sequentially. Operating margin was 6.7%, down from 11.9% in Q3 of last year and 7.5% in Q2. We're encouraged to see growth in volumes this quarter, and are taking steps to continue volume momentum, while balancing the risk profile of the portfolio, which remains in very good shape.

Before getting into the key elements of the P&L, let me remind you that fiscal 2005 results -- including cost of sales, operating expense, operating profit, net income and EPS -- did not include the impact of FAS 123(R) stock-based compensation.

Consistent with last quarter, to assist you in comparing results versus prior periods, we have included the quarterly historical EPS trend in the financial tables accompanying the earnings release. This should allow you to view the results as though all stock-based compensation had been included in previously reported results.

Non-GAAP EPS for the quarter was $0.52, including approximately $0.03 from stock-based compensation, up from $0.36 a year ago, which, again, excluded the impact of FAS 123(R). In addition to operational factors, there were several items that impacted our results this quarter. Non-GAAP [operating income and] expense was pretax income of $221 million or roughly $0.06 per share after tax, above the guidance range of $0.03 to $0.04 per share we had estimated coming into the quarter. The excess reflects the impact of real estate gains and losses during the quarter. As we indicated last quarter, the timing of one-time items such as land and building sales are difficult to predict, and we will continue to call them out as appropriate.

Our non-GAAP tax rate was 21.5% for the quarter, above the guidance range of 20%, which negatively impacted non-GAAP EPS by approximately $0.01.

Weighted average shares outstanding declined to 2.839 billion from 2.887 billion in Q2, which benefited EPS by approximately $0.01 relative to our guidance of shares being flat from second-quarter levels.

GAAP EPS for the quarter was $0.48, which included $108 million or $0.04 of after-tax adjustments that were not included in our non-GAAP results. The majority of the adjustments relate to the amortization of purchased intangibles.

Just a quick update on restructuring. During the quarter, approximately 1,900 positions were eliminated related to the July 2005 announcement, bringing the cumulative total to about 10,000.

Now, on to the P&L. Revenue of $21.9 billion for the quarter was up 5% year over year, and up 6% when adjusted for the effects of currency. On a regional basis, revenue was up 8% in the Americas, up 2% in EMEA and up 7% in Asia-Pacific. When adjusted for the effect of currency, revenue was up 7% in the Americas, 3% in EMEA and 8% in Asia-Pacific.

Now, I know there is a lot of interest in currency movements, so I will add some perspective on the impact this quarter. In an effort to mitigate the impact of currency to the bottom line, we hedged the majority of our exposed currency on a short-term basis. Though the policy helped limit volatility of currency movements on earnings, gains or losses associated with the hedge contracts are recorded in revenue. Thus, our revenue is impacted by two elements -- market movements in currency rates and gains or losses on the hedge contracts.

The majority of printing contracts are entered into somewhat in advance of the quarter, and the timing can depend upon the nature of the business being hedged. Therefore, the currency impact in a given quarter is dependent upon a number of factors, including the nature and number of hedged contracts, natural hedges within specific businesses, the volatility of the spot market, et cetera. The net impact of currency movement on our revenue typically lags actual market movement, given the timing of our hedging contracts.

As we indicated to you last quarter, given the accounting rate used in Q3 2005 and the rate of timing of hedged contracts that we entered into hedging into Q3 2006, we did not expect a significant year-over-year currency impact in Q3. During Q3 2006, actual market currency movements positively impacted revenue growth by just under 100 basis points. However, the impact of hedging transactions negatively impacted revenue year over year by just over 100 basis points, resulting in a net negative impact of approximately 20 basis points, enough to cause constant currency growth to round up to 6%.

Now, on to gross profit, which was $5.4 billion for the quarter or 24.8% of revenue, up from 23.2% a year ago and flat sequentially. Gross margins improved year over year in each of our non-financing business segments, reflecting improved operational effectiveness in key areas, including option attach, delivery efficiency, utilization and discounting, as well as favorable mix in certain businesses.

Non-GAAP operating expense totaled $3.75 billion for the quarter or 17.2% of revenue, down from 17.5% a year ago and up from 16.8% sequentially. In dollars, operating expenses were up 3% year over year and down 1% sequentially. Adjusting for currency, expenses were up 3% year over year and down 2% sequentially. The year-over-year increase reflects volume growth, FAS 123(R) expense, investments in sales force hiring, demand generation and other go-to-market initiatives, as well as significant employee bonus accruals commensurate with the improved financial performance of the Company.

Non-GAAP operating profit was $1.7 billion or 7.6% of revenue, up $475 million year over year, despite the inclusion of approximately $130 million of stock-based compensation in the current period.

Next, the balance sheet. HP-owned inventory came in at $7.5 billion, up $820 million year over year and $696 million sequentially. Inventory days of supply stands at 41 days, up from 38 days last year and 36 days sequentially. The increase of inventory reflects strategic [buys of complements] as well as volume growth. With regard to channel inventory, ESS and PSG ended the quarter at roughly five weeks, and IPG at roughly five and a half weeks.

Trade receivables ended the quarter at $9.6 billion, up $867 million year over year and down $152 million sequentially. DSO now stands at 40 days, up from 38 days year over year and 39 days sequentially. The dollar increase in receivables was due to revenue growth, as well as exchange rate fluctuations, which was also a significant driver of the increase in DSO year over year.

[Next], property, plant and equipment was down $61 million year over year and essentially flat sequentially at $6.4 billion. Gross CapEx was $623 million, up 88% year over year and 20% sequentially. On a net basis, CapEx was $389 million, up 87% year over year and down 3% sequentially. The year-over-year increase in CapEx reflects incremental investments in IT, as well as increases in financing assets.

Net PP&E as a percentage of revenue now stands at 7.1%, down from 7.5% last year and 7.2% sequentially.

Coming into FY 2006, we expected full-year gross capital expenditures of $2.8 billion and net CapEx of $2.2 billion, which assumes capital expenditures would be heavily weighted to the second half of the year. While we continue to expect a significant amount of CapEx in Q4 2006, the full-year capital expenditures are likely to be somewhat less than our initial expectations.

Regarding accounts payable, days payable closed the quarter at 58 days, up from 51 days a year ago and 53 days sequentially.

Next, some comments on cash. Cash flow from operations and free cash flow were both strong, at $2.6 billion and $2.2 billion, respectively, for the quarter. Year-to-date cash flow from operations was excellent, at $8.1 billion, up 32% year over year. Free cash flow was $7.0 billion, up 36% year over year. Year to date, we have already generated more operating and free cash flow than we did in all of fiscal 2005, which was a record cash flow year.

During the quarter, we repurchased $2.3 billion in stock in the open market, or approximately 72 million shares. In addition, we received approximately 13 million shares under the prepaid variable share purchase program that we entered into earlier this year, so a total of 85 million shares were acquired during the quarter. Given the level of share repurchases, our Board of Directors has authorized an additional $6 billion for share repurchases. The total remaining purchase authorization is currently just above that amount.

Finally, we utilized $222 million in cash for our normal quarterly dividend. [We close the quarter with] total gross cash of $16 billion, up from $14.6 billion year over year and $14.1 billion sequentially. Net cash was $9.2 billion, up from $8.8 billion year over year and $9.0 billion sequentially. In terms of cash usage, do bear in mind that we expect the Mercury acquisition to close in the fourth calendar quarter, and this will result in a substantial cash outlay in either Q4 2006 or Q1 2007, depending upon the timing of the close.

Now, a few comments on our outlook. As you know, we normally see strong sequential revenue growth coming into Q4. Given where rates are today, we would expect a modest sequential currency benefit. At the same time, the current macroeconomic environment and competitive environments contain some uncertainties. Taking all these factors into account, we estimate Q4 2006 revenue will be approximately $24.1 billion, in line with current consensus analyst expectations.

Regarding earnings, there are a few variables to consider. We will continue to fund investments to drive long-term growth initiatives. We estimate non-GAAP OI&E to be about $0.03 to $0.04 per share in Q4, which primarily reflects baseline net interest income given projected cash and debt levels. We will call out deviations from this baseline is appropriate. We expect a non-GAAP tax rate of approximately 20% in Q4.

Given the level of share repurchases we executed in Q3, we expect weighted average shares outstanding to decline modestly in Q4. Potential increases or decreases to share count are dependent upon our continuing share repurchase activity, HP's stock price, option exercise patterns and common stock equivalents. With that in mind, we know expect Q4 2006 non-GAAP EPS of $0.61 to $0.63, which includes approximately $0.03 of stock-based compensation.

With that, we will move on to questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Bill Shope, JPMorgan.

Bill Shope - *JPMorgan - Analyst*

There's been a lot of debate in the industry over the roll that AMD has played in some of the changes we've seen in the competitive landscape. Can you give us perhaps a qualitative read, at least, on how significant you think AMD has been to your relative cost structure improvements? As is being discussed quite a bit, if Dell begins to use AMD more aggressively in their PC line, do you think there's a risk that some of these improvements could be reversed or narrowed?

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

Well, we think competition is good. I think competition drives a better market and a better overall ecosystem for the industry. So I think that it might sound strange to you, but we actually think that more adoption is actually a good thing, on a macro basis. So we would actually be encouraging that kind of thing to occur, as opposed to not looking for that kind of a thing to occur. The more industry adoption, the more competition, we think the better the market.

Operator

Laura Conigliaro, Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

On the inventory side, you indicated that you made some strategic purchases. First of all, is that consistent with your outlook for demand, or consistent with what you think the supply outlook is? Then, can you talk a little bit about the component situation as you see it now, and kind of going forward?

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

On the strategic buy side, it's mostly in the PC business. It is a reflection, certainly, of what we typically see as strong demand in Q4. But beyond that, when we say strategic, we mean that it's different than our normal purchase, which is done either because we have a particularly good cost opportunity -- that is, we're given a really good deal -- or because we have some concern for supply. In this case, this past quarter, it was mainly because we had some offers to get some good purchases.

Overall, the commodity situation has been pretty normal -- normal price declines, normal availability. The only exception to that probably is panels. Panel prices have been coming down fast. They have, now, we think, stabilized. We will see what happens going forward here. But going into the heavy consumer fourth quarter of the year, there is some concern that pricing could get a little tighter on some panels.

Operator

Katie Huberty, Morgan Stanley.

Katie Huberty - *Morgan Stanley - Analyst*

You are clearly executing well on the revenue front. But Bob, you did mention some uncertainties in the broader market. Can you just talk about what you're seeing in terms of broad demand trends, and then what linearity looked like in the quarter?

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

This is Mark. Linearity was fine in the quarter for us, so there's no story for us inside the quarter of this versus that. I'd say that was fine. [Macro development] -- we listen to the same stuff you listen to. We hear stories of all types. I'd say, when you boil it all together, what our data tells us is things are "relatively steady" -- and I'll put that term in quotes -- with stories within the story. We continue to keep our eye on US consumer, which is an important market for us. We hear the same stories you hear about where US consumer is headed. But given the data we're seeing, I would net it all together globally to say steady.

Operator

Tony Sacconaghi, Sanford Bernstein.

Tony Sacconaghi - *Sanford Bernstein - Analyst*

You had mentioned revenue growth and trying to strike a balance between profitability and revenue growth, Mark. This was the fifth quarter that you have presided over HP. It was the lowest revenue growth at constant currency since you have been at the helm, albeit modestly lower than the other quarters. Your guidance, given the currency outlook, is for year-over-year revenue growth to decline even further. If we think about how you have been doing relative to your guidance, you have been blowing out EPS -- you beat EPS by $0.05 or more every quarter since you have been CEO -- but you really haven't been beating the revenue number.

So the question is, have you been pleased with the revenue performance? Why not reinvest some of that earnings upside that you have been delivering, to deliver some revenue upside? How do you think about that trade-off? Have you been extremely pleased with EPS and comfortable with revenue growth, or have you been modestly disappointed, given the divergence in your actual performance versus guidance on those two metrics?

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

Thanks for the question. There was a lot of stuff in there, and it will probably take me a while to answer that thing as thoroughly as I could. Basically, we said we would be at a roughly 6% constant currency growth as the year started. To some degree, you have seen as actually perform better than we modeled in the first two quarters. I think that would be the way I would describe it. So I think, from that perspective, I'm clearly pleased.

But, listen, I look at the Company's performance on two axes. One is incremental improvement in performance, and the other is absolute performance. So I think, from an incremental perspective, we're pulling a lot of levers at the same time, which is what you see going on, which makes the landing of the guidance, to your point, the exercise we're going through right now, which is to line up our cost levers and our revenue levers.

We have invested, so I don't want you to misunderstand. What you see in the quarter when you look at our OpEx is a series of investments. We invested in printer market share, and we got it. We invested in going to market with different other market development activities in the PC business, and we got it. So when you look and ISS growth, I think if you look at the market and you look at share positions by market, you're actually going to find we had a pretty strong quarter.

So it's really a combination of all those levers. If you asked me in the end, from where we started to where we are, am I pleased, the answer would be yes. Let me give you either answer. If you asked me, do I think we can do better than we've done, the answer would be yes. We certainly have opportunities. It's the reason we're making investments we are in the sales organization that we are, other investments in market development and why we still have a lot of cost work to go do across the Company.

So we are a long way from done, and by no means am I coming to you today, telling you we're rolling a perfect game on every line. We have got a lot of work left to do.

Operator

Richard Farmer, Merrill Lynch.

Richard Farmer - *Merrill Lynch - Analyst*

I would like to ask a question on the restructuring progress and the margin targets, please. I think last quarter, you said you were about 53% through the restructuring. If I heard you right, Bob, you said 10,000 cumulative headcount. So if my math is right, that's about 65% now. Is that the right way to think about it, so that maybe 35% or so is left to flow through?

Then, Mark, given that you are already at your long-term -- a little above your long-term, along your long-term margin guidance, despite a seasonally weak quarter, despite the real estate savings coming, the data center savings coming, why shouldn't we have long-term margin targets going up significantly from here?

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

So let me start with the restructuring. Yes, you have interpreted the numbers right. About two-thirds of the headcount is now -- the positions are gone from the Company. Do want to remind you that another part of our savings was the pension, which all kicked in in early 2006. So you've got to play both variables separately when doing your calculations.

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

To your question, I'll have to go study those numbers closer. No, I have your view. We will, certainly, as we close Q4 and as we get towards the security analyst meeting that we have planned for December, certainly come to you with our best view of forward-looking margins. So I think that would be the timeframe, as opposed to today.

Operator

Andrew Neff, Bear Stearns.

Andrew Neff - *Bear Stearns - Analyst*

If I could just follow up on the question talking about the different initiatives that you have, can you give us an update on where you are in the IT savings initiative, sort of lay out how that will play out? Also, you have talked, Mark, a lot about the hiring efforts you are going to deploy. Can you talk about where you are in terms of the hiring efforts in bringing people onboard?

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

Sure. I won't give out numbers, but I would say we have made a material dent in getting our hiring started. I'm actually pleased with it, because I think we took on a fairly sizable task, and we did make a good dent in it in Q3, starting in Q2 and what we followed on with in Q3.

In terms of IT, we still a lot of work to do. We believe in our strategy. We have begun the work. We are a year into it, but at the same time, we still have plenty of work left to do. The work in IT will stretch out through 2008, so you've got, clearly, 2007 and 2008 to go. I wouldn't call it linear, but we do have a lot of work left to do, to get our IT to where we went to get it.

Operator

Harry Blount, Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

Back to the revenue growth side of the equation, the segment that really stands out to me is maybe being a little bit behind where maybe I would have expected to be would be on the Services side. You have kind of met your midpoint or so of your margin goal. I know you have a couple of big contracts kicking in in the back half of the year, but what do you specifically have going on there? What should we be looking for over the next two, three, four quarters?

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

I think you're right in what you say. I think that we -- I take complete accountability for this. We really wanted to get our cost structure right. It was a major driver for us, even if it meant that -- not only two things, one, that we didn't go after deals that we might have gone after before; secondly, we have actually exited a couple that -- with tremendous support from the customers -- that weren't ones that we felt we could go on with.

So those two things have caused what you have seen. Now, we have a strong pipeline, so that's good news. We're beginning to build back our pipeline, but we still won't sacrifice profitability for just taking bad deals to get revenue growth. I feel better about the pipeline. I think we're building that back up, and I think our focus on the cost structure will give us renewed ability to go win transactions, but win them the right way.

So I do expect us to see 2007 to have better growth than what you have seen in 2006. So that's probably where I will leave it today, as it relates to the Services business.

Operator

Keith Bachman, Banc of America Securities.

Keith Bachman - *Banc of America Securities - Analyst*

I wanted to talk about Software, if I could, for a second. Mark, you had pretty good growth there. If you could talk a little bit about what the organic side was? The margin was a little less than I was thinking. If you could talk about the margin expectations you have before you consolidate Merc, that would be great.

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

I think, again, let me go back really and start on the growth side. Growth was pretty similar across OpenView and OpenCall, so the organic growth was actually favorable across both of the different groups. So we got some benefit, of course, out of the Peregrine growth, but we had double-digit growth in both OpenView and OpenCall organically, so that was a good story, I think, on the top line across the board in Software.

On the bottom line, which I think is an excellent question, I think you've got multiple factors. You've got the additional cost structure we're working through with the Peregrine acquisition; that's certainly part of it. Secondly, they do get an impact from the bonus that hits across the Company. So that certainly was a -- because of the size of their business, had some materiality in the bottom line, because that business is very sensitive, with a few million dollars to the bottom line.

Then there is a slight bit of mix between the OpenCall factoring versus the OpenView factoring. So those are really the three drivers, when you net it out. I would say, if you balance those out, the business is roughly what we would have hoped for, from an operating margin perspective. It could have been a little bit better.

Long run, where am I expecting? I still believe a business of this scale has the opportunity to be in the -- whether it's 17%, 18%, 19%, 20% -- it's in that ballpark of operating performance. Again, as we've stated, I think you look at the combination of Mercury and our Software business, we have an opportunity by the time we get to 2008 to blend these businesses together and have a 20% operating margin business.

Operator

Ben Reitzes, UBS.

Ben Reitzes - *UBS - Analyst*

Mark, I'm not sure you have to apologize for anything on the revenue line, considering you're outgrowing IBM by 500 basis points and Dell by probably 2 this quarter, while you are intentionally, I might add, not growing services intentionally. But can you keep it up? Can you keep gaining share? What are you going to do to make sure you do that into next year? Maybe if you want to highlight a few key segments?

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

Thanks for the comment. I think when you look at some of our nearest competitors in dollars, we did a pretty nice job from a growth perspective when you compare those numbers. But I think it's up to us to optimize our cost structure to make sure we can invest in the right segments. I do believe we can keep up the kind of growth that we're forecasting. That's why we're making the investments we're making. It's why I think the improvement in our cost structure allows us to get more aggressive in the market, as we see things that make sense.

So to some degree, we're affected by the macro market, and we have to deal with those macro market movements. But within the context of a reasonable market, I like our opportunities to compete effectively to be in a good share position.

So I think I would net it out to say, listen, I'm optimistic that we can show good revenue growth within the context of the segments we compete. So again, the only caveat I would give to that is the macro environment.

Operator

Richard Gardner, Citigroup.

Richard Gardner - *Citigroup - Analyst*

Bob, are you still targeting completion of your 15,300 headcount reductions by the end of the October quarter?

Secondly, Mark, you mentioned that the demand environment overall was relatively steady. I think you called out US consumer as an area that you are keeping a close eye on. But could you specifically address what you're seeing in Europe, given some of the reports that we have heard from other companies regarding weakness in June, and whether you feel like that's just typical seasonal, or whether there's something else going on there? And perhaps a quick comment on federal as well?

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

First, yes, we expect to be virtually complete by the end of the Q4. There could be a few very small exceptions to that, but virtually complete.

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

As it relates to Europe, generally speaking, we had pretty balanced growth across the businesses. So if you look at it the way you asked the question, I would say that Europe was okay for us in the quarter across most of our segments.

That said, just to try to give you a little more color, there are multiple stories within Europe. So it's really not, I think, fair to go into a Europe generalized discussion. We see strong growth in most of the Eastern European countries. That's a generalization, but it's a reasonable one to make. We see less so in Western Europe, and there's even stories within Western Europe, if I took you from the UK to France to Germany to Italy.

So we don't really spend a lot of time looking at Europe in the aggregated context as we do spending time looking at the individual segments. There are stories within the story. When you net all of Europe together as an entity, it was okay in Q3 for us. But again, we have got to keep our eye on more subsegments for us to really make sure that we make sense out of it.

Operator

Louis Miscioscia, Cowen and Company.

Louis Miscioscia - *Cowen and Company - Analyst*

I question I wanted to ask was on the services area. In the past, I think you have mentioned that you were looking for acquisitions in Software and Services to fill in your product lines there. On the services side, do you think that you would be more focused on something that would add to Managed Services, being something IT infrastructure outsourcing? Or would it be something more in the Consulting and Systems Integration area? Or it would be something different, in a BPO kind of application, or something maybe to enhance offshoring in something like India's software outsourcing?

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

I look forward to working with you, first. Second, I don't comment a lot on those kinds of things, in terms of forward-looking acquisitions. I think, fair to say that we're going to look at potential acquisitions that fit the following criteria. They strategically make sense for us. Service is certainly an important strategy for us, but they have also got to financially make sense. They have got to operationally make sense for us. That means, for us, that we can run them, that we don't have to jeopardize the trajectory of the Company at the same time that we do it, et cetera, et cetera.

So we really look at those three filters, and we will continue to look at them across those three filters as we go. But I would not try to pigeonhole us into one certain area in this phone call.

Operator

Shannon Cross, Cross Research.

Shannon Cross - *Cross Research - Analyst*

Can you give us some more details on IPG? Your results are basically the opposite of what we have heard from one of your close competitors. Then also, from Canon, we heard they are expecting 23% year-over-year in second half in laser. So it sounds like things are on track, but can you just give us some more color?

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

I think, clearly, our team has done well. I think it's a combination of things. I don't think it's one thing. I think it first starts with just pure technology and the product offering itself. I think, when you look at the releases we have had, the technologies just kept coming. It has really been impressive, so that's kind of point one.

Point two, I think we've done a lot of work to try to optimize our go-to-market. There has been a lot of work done with in-store promotion. There has been a lot of work done with promotion overall, with merchandising. I think that has been a real strong move as well.

Thirdly, we continue to try to improve our ability in our go-to-market model, as it relates to even our human capital. So we're putting more people in the enterprise, et cetera.

So I think it's a confluence of technology. I think it's a confluence of our ability to improve our go-to-market. I think, when you look at some of the service statistics that are coming out about our Printer business, it's a combination of good improvement on the service side. It's no one thing, but I think the team overall has done a nice job.

Operator

Brian Alexander, Raymond James.

Brian Alexander - *Raymond James - Analyst*

Just to follow up on the question on PSG, obviously at the high end of your margin target in a seasonally weak quarter, just wondering what you saw in terms of pricing from Dell? Obviously, they have talked about getting more aggressive. Have you noticed any change in their tone? If you look at the operating margin expansion versus a year ago, obviously there's a lot of levers that cause that. But could you help us rank sort of the mix shift in consumer, mix shift in notebook attach? You talked about warranty. What were some of the primary drivers of that margin expansion?

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

Sure. My answer to your second one would mostly be yes, but let me start with the first one. I can't say that if I looked at the -- let me go into a broader comment on competition in PSG. We did not see an extraordinary competitiveness in the market. Now, I say that against the backdrop of this has always been a competitive market. So I can't say I saw a less competitive market, but we didn't see an extraordinarily more competitive market in our Q3. So that would be the way I would describe your question. That's a broader answer across multiple geographies and obviously multiple competitors.

As it relates to the levers, you're [right on] all of them. The big levers here are, first, we are working on the cost structure of the whole Company. That certainly helps PSG. Bob mentioned to you strategic buys and the ability we look at our procurement processes and our ability to improve our leverage as are it relates to cost of goods sold. Certainly, that's a lever. You already mentioned the warranty lever; that's certainly an important lever as it relates to the integration of our service go-to-market with our cost of goods sold and our product software, which is a big lever for us. Certainly, the other one for us is just attach and growth and growth of attach.

So, when you look at those levers and our ability to leverage that, certainly that last piece, with our partners, those are really the levers that we pull. I think you have seen them manifest themselves in Q3.

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

Let me just add that we have certainly seen profit improvement on the consumer side of the business, but also on the commercial side of the business. It's not just the growth on the consumer and notebook that has benefited this business. Of course, PSG, like all of our business, has benefited from the cost reduction, expense reduction efforts around the Company. So everybody shares somewhat in those reductions as well.

Operator

David Wong, A.G. Edwards.

David Wong - *A.G. Edwards - Analyst*

One detail and then a question. The detail -- when you talked about components and strategic opportunity in components, can you give us some idea of what type of components these were, and what timeframe those buys occurred?

Secondly, when you are talking about (indiscernible) trading off some profitability to get growth in specific areas in the current quarter, can you tell us which areas you are going to target for growth, going forward, where you would like to see slightly higher growth than you're getting at the moment?

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

Let me began with the first detailed question. A variety of categories of components, but the top of the list is panels. Once again, that's an area that we depend upon very heavily in our notebook business, and we have had some good opportunities -- not only this quarter, but over the past several quarters, to buy panels at the right point in time. But it includes processors, chipsets, just about everything, occasionally, that we go out and buy more than what the schedule says we should be buying. It occurred throughout the quarter.

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

One more thing. To try to give you a quick color on that, listen, we're going to go after -- we're not going to try and gain share just so we can gain share. We're going to go out and try and do things that makes sense in businesses that can bring us a long-term benefit, so places where we can get long-term margin expansion will be where you'll see us invest.

Operator

Bill Fearnley, FTN Midwest Securities.

Bill Fearnley - *FTN Midwest Securities - Analyst*

On IPG, should we be thinking about the operating margin range now in 14% to 16% versus the previous 13% to 15% guidance, with unit growth in the teens?

Then, what about the threat of third-party remanufactured ink and toner to the supplies business? Any change in your view on the supplies threat there?

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

I'd say you should not do anything other than what we have told you in the past, that this is a 13% to 15% kind of business, 4% to 6% revenue growth kind of model. I think you've seen the interrelationship between unit growth and supplies growth, and you can see by the supplies growth how feel about the supplies market and how it's performing.

So I think what you've seen is the business performed basically in the ranges we have described. It's 14.2% this time. It was 13% this time last year. You look at the unit growth rates, you can see that we had, going into this quarter, blended 8% unit growth over the last rolling, I guess, four quarters. We have now posted a 15%.

So I think you're going to see us continue to operate in those ranges. Now, the only caveat I would give to that is when we see opportunities, as we have talked about our strategy, we'll take advantage of those opportunities in high-usage segments to be appropriately focused in how we go to market. So again, I would give you no change from what we said before.

Operator

Cindy Shaw, Moors & Cabot.

Operator

Cindy Shaw, Moors & Cabot.

Cindy Shaw - *Moors & Cabot - Analyst*

I wanted to ask about the Enterprise hardware business. Blade servers -- one of your competitors doing quite well. Another competitor that used to tout its blade server growth now saying blade servers don't matter.

Also, Bob, you had talked last December about stock options. I think you said that there were two waves where a lot of options went in the money, one low 20's, one low 30's. It looks like we may have both those waves behind us. If you can comment on the outlook on how that could impact share count going forward?

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

First, I would start with we think blade servers are important. We think, when you look at the virtualization of servers, which we think is where it's headed, blades are critical to that. We feel great about our blades announcement that we did in the early part of the summer. We had another good quarter in terms of growth in blades, and we're very focused on it going forward. Our c-Class blades will really just be out in fiscal fourth quarter. So we think it's an important segment, and we feel well-positioned within it.

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

Yes, if you look at the outstanding options, there's still a bubble around the low 20's, and another bubble right around 29 to 32, in terms of number of options that are outstanding, as well as those that are vested. So we have been at or above those ranges now for a while. What is really hard to predict, of course, is own employees will behave. That's a function not only of what the stock price is, but what they think it is going to be. So we will just have to see it plays out.

Obviously, along with that, as we go quarter by quarter, there will be more vesting of some of those waves of options as well. That typically occurs in the springtime, when another prime vesting period occurs. So we will just have to see.

Operator

Dan Renouard, Robert Baird.

Dan Renouard - *Robert Baird - Analyst*

My question is on the Enterprise business. You mentioned some areas very strong, specifically blades and then the XP and EVA and storage. What areas were weak or concerns you have? Then, is it getting more competitive? Or, said another way, are there deals you're walking away from in this area as well?

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

Let me just make sure I'm clear. You're talking about specific to the Enterprise, what markets are getting more competitive? I think that's what you asked.

Dan Renouard - *Robert Baird - Analyst*

Yes, and what areas were weak? You've mentioned some areas that were very strong. What areas were weak for you, or areas that you think you can improve upon?

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

Sure. Well, you saw by our numbers, right? You saw what happened in BCS, which was a decline in revenue year over year. I think our business really reflects what we see going on in market trends. Back to Cindy's question, you see a definite change in what we think is mainframe architectures and UNIX architectures and lots of people going to virtualized servers, which does mean lots of blades. You need lots of software management around those blades technologies, and the virtualization of storage at the same time.

So that's where you see the growth. You look at the growth numbers, and they say that things are going to more industry-standard platforms. You see growth in our ISS business, you saw growth in our blades business, growth in our EVA line, our XP line. You see growth in our software business, which is really the binding fabric that brings many of those things together in the Enterprise. Things that are not growing in the Enterprise, things like tape, proprietary UNIX, what I would describe as more of the older architectures. We have a piece of that, as you can see in our portfolio.

So, as I said before, I think, in the Enterprise, we feel pretty good about where we think the Enterprise is headed. I think it reflects itself in what you see in the numbers as they show up quarter after quarter.

So let me say thanks for your questions. Before wrapping up, I would like to summarize the call by saying that I am pleased with our execution in the third quarter. We posted strong revenue growth, we expanded margins while gaining share in key segments and we generated strong cash flow from operations. We drove investments and saw success in strategic initiatives, from hardware units and commercial print offerings in Imaging and Printing to consumer and mobility in Personal Systems to blades and external arrays in the Enterprise. We continue to make progress in our cost structure. We made further progress on strategic conditions that will strengthen HP's long-term competitive positioning and increased non-GAAP EPS guidance for the fourth consecutive quarter.

All in all, it was a solid quarter for HP. I will leave my comments at that, and I will thank you again for joining us on today's call.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the presentation. You may now disconnect.