FINAL TRANSCRIPT

HPQ - Hewlett-Packard Conference Call - Q&A line

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CORPORATE PARTICIPANTS

Brian Humphries
Hewlett-Packard - VP, IR

Mark Hurd
Hewlett-Packard - CEO, President

Tom Hogan
Hewlett-Packard - SVP, HP Software

Bob Wayman
Hewlett-Packard - EVP, CFO

CONFERENCE CALL PARTICIPANTS

Laura Conigliaro
Goldman Sachs - Analyst

Cindy Shaw
Moors Cabot - Analyst

Shannon Cross
Cross Research - Analyst

David Wong
A.G. Edwards - Analyst

Ben Reitzes
UBS - Analyst

Dan Renouard
Robert W. Baird - Analyst

Bill Shope
JP Morgan - Analyst

PRESENTATION

Operator

Welcome to the HP Corporate conference call. [OPERATOR INSTRUCTIONS] I would now like the turn the presentation over to your host for today's conference, Mr. Brian Humphries, Vice President of Investor Relations. Please proceed, sir.

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

Thanks. Good afternoon, everyone. I would like to welcome you to our conference call. Joining me today is our CEO and President, Mark Hurd; our CFO Bob Wayman; Executive Vice President, Ann Livermore; and Senior Vice President for HP Software,Tom Hogan, Before we get started I would like to remind you that this call is being webcast live. The webcast can be assessed on HP Investor Relations page under company information at www.hp.com. The 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 about our agreement to acquire Mercury Interactive that was announced earlier this afternoon. We do not intend to address expected third quarter results or any associated market trends such as macro demand, competitive dynamics, or the pricing environment. Some of our comments and responses to your questions about our agreement to acquire Mercury may include forward-looking statements. These forward-looking statements are based on certain assumptions and are subject to a number of risks and uncertainties including the possibility that expected benefits of the acquisition may not materialize and risks related to the timing or ultimate completion of the transaction.

I encourage you to read the risk factors described in HP's annual reports on Form 10-K for the fiscal year ended 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 and other documents filed or to be filed after that Form 10-K. Finally, and with a view to allowing time for questions from multiple firms, please refrain from asking multi-part questions for clarifications. With that I will turn the call over to Mark Hurd.

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

Thanks, Brian. Good afternoon, everybody. Thanks for joining us on short notice. I will keep my prepared comments brief and allow time to answer as many questions as we can get to in the time we've got allotted. As you see by now we announced earlier today that we signed a definitive agreement to purchase Mercury Interactive. The transaction does bring together two market leading businesses to create one of the most powerful management software portfolios in the industry.

The combination of HP OpenView strength and systems network and IT service management software together with Mercury's strength in application management, application delivery, and IT governance is compelling. It enables us to be an end-to-end leader in enterprise IT management for the entire IT life cycle, from planning to testing to operations to maintenance, repair, and retirement. The portfolio of capabilities will allow CIO's and customers to reduce IT costs and make better IT decisions by helping them prioritize IT spend and to automate to measure IT program effectiveness. Said another way it allows customers to use IT as a business enabler rather than it serving as an obstacle.

Over the past year or so we have been focused on aligning HP's cost structure to free up capital to deploy back into the business for growth. We will continue with that focus. While we remain focused on driving continued organic revenue growth our strong free cash flow and cash balance provides us with the opportunity to make strategic acquisitions.

Mercury is the first transaction of this size we've made in a number of years. As part of this we spent considerable time and effort reviewing various revenue growth, cost structure and synergy assumptions. We know we can make further progress on the cost structure of our combined software business, and even under various growth scenarios we are confident that we can drive margin expansion. Combining Mercury with HP software creates a run rate business of more than 2 billion. We believe this combination can drive revenue growth of approximately 10 to 15% and that this business can drive operating margins of approximately 20% of revenue in fiscal year '08. In terms of process the acquisition will be conducted by means of a tender offer for all the outstanding shares of Mercury followed by a merger of Mercury with an HP subsidiary.

The terms include a cash tender offer of $52 a share, premium of roughly 33% over the closing price of Mercury at today's market close. The deal has an enterprise value of approximately 4.5 billion net of existing cash and debt. The deal is subject to closing conditions and regulatory approvals, HP expects to commence the tender offer promptly and the merger is expected to close in the fourth quarter of calendar year 2006. Upon closure Mercury will become part of the HP software business that will now roughly double in size reporting to Tom Hogan. Mercury products and solutions will be available from HP through standard HP sales and HP service channels both company sales forces will immediately join forces to begin reference selling each other's products. Of course following the closing we'll be focused on quickly addressing any integration challenges from salesforce compensation to culture.

In the shorter term the transaction is expected to be $0.04 dilutive to non-GAAP earnings per share in fiscal year 2007 and $0.02 accretive to non-GAAP earnings per share in fiscal year 2008. This includes purchase accounting adjustments related to deferred revenue write downs and preferred compensation expense of approximately $141 million or $0.05 earnings per share in fiscal year 2007 and approximately 43 million or $0.01 earnings per share in fiscal year 2008 as well as expected synergies.

I will leave my prepared remarks at that. Before taking your questions, I will summarize today's news by saying we're excited to bring together HP's OpenView strength and systems, network and IT service management software. With Mercury's strength and application management, application delivery, and IT governance. We believe this combination will enable HP software to be an end-to-end leader in enterprise IT management for the entire IT life cycle. We believe it positions us well to help CIO's reduce IT costs at the same time we increase IT spend effectiveness, and we believe it positions HP to take advantage of strong revenue growth and margin expansion opportunities. With that, Bob, Tom, and I, and Ann will be open to take any questions that you got.

QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS] Sir, our first question is from the line of Laura Conigliaro with Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

A few things. First of all, can you provide a little more color on the overlap between Mercury product and HP software? And also why did you feel like you had to do the deal now? Was it a competitive situation?

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

Sure. Laura, let me have -- this is Mark. I am going to let Tom talk about the product overlap, and then I will come back and talk to you about the timing.

Tom Hogan - *Hewlett-Packard - SVP, HP Software*

I will be brief and simple because I think this is a pretty straight forward answer. Any time you contemplate acquisitions and technology one of the main considerations or obstacles of success is the level of overlap, and that we think makes this so compelling not just from a value perspective, but from the marketplace and the customer's perspective our two portfolios could not be more complementary, and you could not envision two companies this size coming together with such minimal overlap, and the way we think about it is it is almost like we sat down five years ago and said you go do this and build market leading assets and solutions in these categories. We'll do the same on our end and five years from now we'll come together and deliver what we think is clearly the solution of choice for managing and optimizing business outcomes around technology. It is very little. Very little overlap.

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

And on the timing issue, Laura, we've been thinking about this for awhile. This isn't like something that came up last week. I think the really only timing issue I'd say, was going through the appropriate steps of due diligence, the fact it is important to us to have a strategic fit. Tom really referenced this, we think we got a chance to have the ERP of the management software world with this combined offering. So that's strategic offering number one and it is really at the core of what we're trying to do in the IT overall data center world.

Secondly, it has got to make financial sense for us, and we really wanted to go do the homework to say that we have got to not only grow this business 10 to 15%, but we have got to be able to make industry expected if not better profitability numbers. We have got to make sure we can get that done. And then we had to make sure we could run it, that we had the right kind of people lined up to get together and get this thing done right. That is the only thing that the timing was to make sure we could nail it. We didn't do this lightly, Laura. We did this clearly understanding we need to show up and make this thing valuable for shareholders as well as put ourselves in the kind of strategic position that we like to be.

Laura Conigliaro - *Goldman Sachs - Analyst*

Thank you.

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

Next question, please.

Operator

Our next question is from the line of Cindy Shaw with Moors Cabot.

Cindy Shaw - *Moors Cabot - Analyst*

Mercury has got both a managed services and a consulting services business. I am not quite sure how big it is. But I am wondering how that's going to affect the HP services unit?

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

Neither business would be material in the context of HP services and its overall business, but they do have both that you described, so both are kind of a valuable piece of the integrated portfolio that's brought to market, but, Cindy, I would not call it having a material effect. But it does again, give us more leverage in the marketplace because they bring some incredibly talented people and extend our offer set in the market. I think financially in terms of revenue scale, this really aligns to our software business, so the real answer here is you have got an effective doubling of the HP software business going forward.

Cindy Shaw - *Moors Cabot - Analyst*

Thank you.

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

Thanks.

Operator

Our next question is from the line of Bill Shope with JP Morgan.

Bill Shope - *JP Morgan - Analyst*

Thanks. A few questions. First of all, could you give us your plans for integrating the two sales forces, are you going to keep them as separate entities or are you going to combine them into common functions and then also can you help us to understand some of the cost synergies I think you've been clear on the strategic synergies, but some of the cost synergies that may be available here and then finally the logic behind the premium? I am assuming this was a competitive bidding process?

Tom Hogan - *Hewlett-Packard - SVP, HP Software*

This is Tom. Let me take your first question on the go-to-market. First thing independent of the close date, between the time we closed and the calendar year end, which is their fiscal fourth quarter and given the linearity and seasonality of the software business, they have a large opportunity in the fourth quarter and our expectation is we want them to maintain the trajectory they're on and go execute and go deliver that quarter. Point number one is post close we're going to leave their organization and operation intact to minimize the discontinuity or disruption to the business. Between now and that point in time the two integration teams are going to do a bunch of work to determine what the right go-to-market is that optimizes the opportunity for our customers and our shareholders going forward.

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

A couple things, Bill, we know how to go deal with the cost issues, and obviously while there are a lot of complementary things in R&D and certainly as Tom's referenced a lot of leverage to be gained out of the salesforce, there always are things that, from a functional perspective do overlap and we will go deal with those, and we factored those into our model. In terms of the price you are going to pay, I won't get into a lot of details other than saying we have done a lot of work to know what the property was worth and what our operational plans and operational models said relative to its value. That's how we've executed, and we're quite comfortable with the value relative to what we can drive in the business to drive shareholder value long run.

Tom Hogan - *Hewlett-Packard - SVP, HP Software*

I would just add that Mercury has a reputation in the industry for being a high performance sales and marketing environment and culture, so this is more than just technology for us. We're excited about adding their people and part of our integration focus will be to protect that channel and use it to complement the people and the channels that HP OpenView has today.

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

I would like to make one general comment, Bill, and you just happened to answers a question that was a platform for it. I wanted to make sure there is no confusion. The absolute riveted focus we have on cost in this company will not stop. This fact that at the same time we're trying to grow the Company and deal with our costs, and this is really the fact that we have to do two things at the same time. We found a strategic opportunity that we think just makes tremendous sense for us in terms of our ability to grow the business, and we will continue to focus on the overall HP cost issues that we've described as well as the opportunities that sit within the combined and I say it that way, the combined software businesses as opposed to just one or the other, because with the two entities together we think there are leverage points that we can take advantage of.

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

Thank you, Bill. Next question, please.

Operator

Sir, our next question is from the line of Shannon Cross with Cross Research.

Shannon Cross - *Cross Research - Analyst*

Hi. Good afternoon. I guess I have to ask the question because I am staring at Mercury's amended 10-K with lists and lists of all the litigation that they have pending. How have you guys protected yourself from a liability standpoint?

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

This is Bob Wayman. We frankly cannot fully protect against some potential liabilities, but we have done a lot of work evaluating the potential magnitude of the liabilities. We think we have our arms around them. We of course have used outside counsel to give us their judgment on what some of the issues might be. We think they're very manageable, and all of our analysis here have put some level of litigation liabilities into our model. That's still part of our decision making.

Shannon Cross - *Cross Research - Analyst*

Okay. Are you taking reserve within the purchase price or?

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

Can't comment much about that at this point in time. There will be an opportunity I think to take some reserves in purchase accounting, but that will await more information.

Shannon Cross - *Cross Research - Analyst*

Okay. And just a data comment. Can you give us an idea of how many sales people Mercury has? I don't know, customers, locations, any data points you can give us to give us an idea of the size of what you're bringing on?

Tom Hogan - *Hewlett-Packard - SVP, HP Software*

They have roughly 3,000 employees and roughly a third of that organization is associated with sales which is very similar to the OpenView portfolio and our head count mix. They have hundreds and hundreds of customers, so it is a very broad customer base.

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

To be specific, they talk about 14,000. We talk about 15, so you're talking about a broad market reach and penetration. A lot of those are joint customers which is good news. A lot of them are separate which creates opportunity and good news.

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

Shannon, one-way you think about it is both of the product sets and offerings show up in almost the same customers. The fact is they're complementary in nature, so obviously to that point you can already understand there is a lot of leverage between the two in terms of support and in terms of the go to market model. It is a very complementary acquisition, and certainly gives us a much deeper presence in the enterprise.

Shannon Cross - *Cross Research - Analyst*

Thank you.

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

Thanks, Shannon. Next question, please, operator.

Operator

Our next question is from the line of David Wong with A.G. Edwards.

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

Thank you very much. Can you give us some idea of what might create a total head count is, what the engineering software development head count is? And will there be any new to rationalize the engineering department or is it only in sales that there are synergies that you could cost cut?

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

Listen, without getting into every number of every function, as Tom has already referenced, there are roughly 3,000 employees associated with Mercury that work for Mercury today. There is about a third of them that are tied up in a go-to-market exercise, whether that be a technical resource or a sales resource of some type. Without getting into details by function and so forth, we're going to synergize everything that makes sense. I will assure you there will be no stone unturned looking to rationalize costs at the same time as we look to expand and grow at the same time.

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

Thank you.

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

Thanks, David. Next question, please, operator.

Operator

Sir, our next question is is from the line of Ben Reitzes with UBS.

Ben Reitzes - *UBS - Analyst*

Mark, I understand why you're doing the deal so I'm going to ask a question that's not going to win me any fans in the room. Last month another hardware company announced a deal for a hefty premium and preannounced right afterwards. We are battle tested in this group right now. Do you see anything that is shaking your confidence right now to do a deal or anything in what you've built with HP and do you have confidence in the current outlook you set for the Company?

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

Ben, this is really a great question. First of all, I appreciate all your comments and the fact you know why we're doing the deal. Listen we're going to talk about Q3. What dates?

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

August 16.

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

August 16, I will be loaded up and ready to talk about Q3.

Ben Reitzes - *UBS - Analyst*

We all know why you're doing the deal. This is what's on everybody's mind, so save us some of the trouble that the last company did.

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

Sure, sure, sure. I understand the context of what you're describing. August 16, will be the time, the place, and I know you will be there.

Ben Reitzes - *UBS - Analyst*

I sure will be. Thanks a lot.

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

All right, Ben. Thank you.

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

Thanks, Ben. We'll take one last question, please.

Operator

Sir, that question will be from the line of Dan Renouard with Robert W Baird.

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

Dan, we can hear you.

Dan Renouard - *Robert W. Baird - Analyst*

I am getting an operator signal. Can you just strategically talk about, is this kind of it in terms of the software group or should we be expecting more -- are there more holes you feel you need or is that something you might evaluate once you've integrated this to some extent? Thanks.

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

We're going to be really focused on integrating this. It is a big deal for us, and we take it very seriously that we deliver on the expectations that we've described both in terms of the integration, the revenue growth targets, and the operating performance we've described. We also think it is a great strategic opportunity for us. We're not -- I want to make sure we're clear here. This really represents strategically what we said we would go do, focus on scale and services, scale and software, which are key areas for us. You have seen us do a significant software deal here. I would not expect these by any means every day in any way, shape, or form and to be as riveted on executing what we described to you. That's what we'll be. That's what we'll be doing, and I don't want to leave any misimpression that anything at HP has changed from a focus perspective.

We are very focused on improving our performance. We are very focused on making sure our cost is aligned, that our cost is right, and that we maximize our revenue growth opportunities inside the context of our strategy which is what we're doing, and I would tell you no change in cadence from that perspective at Hewlett-Packard. At the same time we're excited to be able to do this. We think this is a big opportunity for us, and we think we have a chance for software to be truly one of the crown jewels of Hewlett-Packard and we'll be very focused on getting that done.

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

Okay, everybody, that concludes today's call. Thanks for your time.

Operator

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