

FINAL TRANSCRIPT

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PRESENTATION

Operator

Good day, ladies and gentlemen, thank you for standing by and welcome to the Hewlett-Packard Q3 2005 earnings conference call. My name is Carlo and I will be your coordinator for today's presentation.

At this time all participants are in a listen-only mode and we'll be facilitating a question-and-answer session during today's conference. If at any time during this call you require audio assistance, feel free to press star zero on your touch-tone telephone and a coordinator will be happy to assist you.

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

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thank you, Carlo, and good afternoon, everyone.

I'd like to welcome you to our third quarter earnings conference call. Joining me today is our CEO and President, Mark Hurd, and CFO, Bob Wayman.

Before we get started, I'd like to remind that you this call is being webcast on hp.com. Also the webcast and the slide deck that we'll be using along with non-GAAP reconciliation tables for the slides can be accessed by clicking on Company Information, then Investor Relations, and then the link "View Webcast and Earnings Information". 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 with you information regarding the third quarter. However, some of the comments and responses to your questions may include forward-looking statements. These forward-looking statements are based on certain assumptions and are subject to a number of risks and uncertainties and actual future results may vary materially.

I encourage you to read the risk factors described in the Company's quarterly report on Form 10-Q for the fiscal quarter ended April 30, 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'd also like to point out that earnings, gross margin, operating expenses and similar items discussed at the Company level are generally expressed on a non-GAAP basis, and therefore have been adjusted to exclude certain acquisition-related charges, in process R&D charges, amortization of goodwill and purchase intangibles, restructuring charges and net investment losses. The presentation of GAAP financial information for the present quarter and reconciliation of non-GAAP amounts to GAAP are included in the financial statements accompanying today's earnings release, which is also available on hp.com in the Investor Relations segment.

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

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

Thanks, Brian. Good afternoon and thank you for joining us.

I'm pleased with our third quarter results. Over the past few months, we've been very focused on the customer and executing well in the field.

We've also been busy reviewing every element of operations including our operational model, our cost structure, and our growth initiatives. Thanks to the hard work and the focus of our employees, we delivered against our short-term goals and made good progress on other initiatives.

Highlights of the quarter included net revenue growth of 10% year-over-year, non-GAAP EPS growth of 50% year-over-year, Personal Systems operating margin of 2.6%, strong year-over-year growth in Enterprise Storage and Servers with operating margin of 3.8%.

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Our second consecutive quarter of double-digit year-over-year hardware unit growth in Imaging and Printing. Cash flow from operations of 2.2 billion bringing the year-to-date total to 6.1 billion, and share repurchases of 860 million bring the year-to-date total of \$2.1 billion.

During the quarter, we also announced a restructuring program that will improve our cost structure and allow us to become more competitive. Move the commercial sales function in the individual business segments providing each business segment with a tighter link to the customer, greater line of sight into operations, and greater control over its P&L, and strengthened our management bench with key new hires.

It's important to note that this quarter's improved operational performance triggered a bonus accrual for a possible second half fiscal 2005 payout and the impact of this is reflected in the segment results. The Company bonus plans are linked to the achievement of certain revenue, profit and customer experience goals and are an appropriate part of the cost equation when operating performance meets targets.

Turning quickly to the business segments during the third quarter, revenue in Imaging and Printing grew 5% year-over-year to 5.9 billion, with consumer hardware revenue up 1%, commercial hardware revenue up 5%, and revenue and supplies up 6%.

During the quarter, our overall hardware unit growth was 10%, led by unit growth of 8% in consumer hardware, and 12% in commercial hardware. This is the second consecutive quarter of double-digit year-over-year unit growth and our strategy of accelerating supplies growth by driving unit growth of high end consumption units remains unchanged.

We continue to see momentum in our color in the office initiative with color laser units up 31% year-over-year. In commercial printing we saw 67% growth in multi-function printers. We closed the first calendar quarter with 13% market share in the S4 market, up 2% in the prior period demonstrating the success of our 4345 laser-based MFP printer.

HP Indigo digital press saw printed page volume grow 40% year-over-year fueled by successful launch of the HP Indigo Press 5000, and last week we announced that we have signed an agreement to acquire substantially all the assets of Scitex Vision expanding our leadership in large-format printing the industrial super-wide category.

We've also seen good momentum in our digital photography initiative with unit shipments of the HP Photosmart appliance up 20% year-over-year, and HP Photo Cut Sheet Media revenue up 11%. We're also pleased with the market acceptance of HP Snapfish service where we've seen the rate of customer acquisition and the average customer order size increase since our acquisition in May.

During the quarter, we also unveiled a breakthrough in the architecture and manufacturing of the ink jet printhead.

A new platform called Scalable Print Technology is the result of a \$1.4 billion strategic investment over the last five years. It allows us to deliver record print speeds in the home and office and can be scaled to a broad set of high-volume printing applications, making it one of our most significant announcements.

The announcement further underscores our commitment to win in the market by offering compelling technology at competitive prices. For the quarter, segment operating profit was 771 million, or 13% of revenue, reflecting seasonality and the short-term impact of the actions we're taking to improve supplies growth.

Moving now to Personal Systems, we continue to show a balanced approach to revenue growth and operating margin improvements. Revenue grew 8% year-over-year to 6.4 billion with revenue and commercial clients up 6% and consumer revenue up 8%.

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We saw particularly strong growth in notebooks where revenue increased 21% over the prior year period, offsetting a slight decline in desktop revenues. Average selling prices declined 6% over the prior year period with the greatest decline in notebooks given recent product introductions.

The segment posted operating profit of 163 million, or 2.6% of revenue our highest level in recent years, despite the fact that this is our seasonally weakest quarter. I'm pleased with the progress we've made to date, and I'm confident that with the right cost structure we can continue to balance revenue and margin improvements.

Enterprise Storage and Servers revenue grew 20% year-over-year, reflecting improved execution, traction on our key margin expansion initiatives, and easy compare given the challenge in this business in the prior year period. Operating margin was \$150 million, or 3.8% of revenue despite this being our seasonally weakest quarter.

We're pleased with the third quarter results and we'll continue to focus on driving this business forward. Revenue in industry standard servers increased 28% year-over-year, reflecting solid execution on a number of fronts, including discount controls, option attach rates, and unit mix.

We continue to see strength in server blades where revenue increased 53% over the prior year period. Revenue in business-critical systems grew 7% year-over-year with HP-UX revenue up 8% and continued strength in Integrity where revenue more than doubled over the prior year period.

Integrity now represents 24% of business critical server revenue and during the quarter we crossed the 5,000 mark in terms of ISP application support, well ahead of our earlier expectation of 4500 by the end of the calendar year.

We saw return to growth in storage with revenue up 15% year-over-year, reflecting improved execution and solid growth in every product category. We saw particular strength in mid-range with the recent introduction of the next generation EVA, fueling revenue growth of 44% over the prior year period.

Over the last few quarters, we've been working hard on key initiatives in storage including product refreshes, the hiring of sales specialists, and improving our alignment with enterprise VARs. We'll continue to work on these programs and remain focused on driving sustainable momentum in storage.

Now I want to turn to HP Services where revenue grew 10% year-over-year.

Within HPS, Technology Services grew 7%, Managed Services grew 21%, and Consulting and Integration revenue grew 12%. Segment operating profit fell to 256 million, or 6.7% revenue.

The operating margin reduction reflects primarily the more normalized Company bonus accrual, which heavily impacts HP's Services margins given the headcount intensity of the business. Bonuses are a part of the normalized cost equation and we need to get HP Services in a position to deliver competitive margins in section environment.

However, to help new terms of your analysis of operational performance, if you were to exclude the bonus accrual, operating margins in HP Services improved year-over-year. We have a lot of work to do to get Services margins to appropriate levels and we're spending a lot of time reviewing the operations to ensure the business delivers competitive margins.

In terms of the businesses below HP Services during the quarter, we saw good operating profit improvements from year-to-year revenue growth in both Managed Services and Consulting and Integration, with operating margins now at their best levels in the last couple of years in both these businesses.

Let me now address performance in software where revenue was \$249 million, up 11% year-over-year. OpenView revenue grew 13% year-over-year and OpenCall was up 5%. Software lost \$40 million on an operating basis.

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As I mentioned on the second quarter earnings call, it's clear that the profitability of the Software business needs to be improved, and we have a lot of work to do. We expect to be profitable in the fourth quarter as revenue growth should drive us past the breakeven point of the business, however, you'll see us work really hard on the cost structure of the business and productivity metrics to ensure we deliver acceptable levels of profitability.

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

Bob Wayman - *Hewlett-Packard - CFO*

Thanks, Mark. And good afternoon, everyone.

Let me begin with a quick review of the performance our Financial Services business.

Revenue for HPFS during the quarter was 489 million, essentially flat year-over-year and down 10% sequentially. During the quarter, we reclassified certain leases from operating leases to capital leases, resulting in a \$40 million net reduction in revenue.

This reclassification was the result of a review of our leasing portfolio for appropriate classification of leasing assets. While revenue was negatively impacted, the impact on operating margin was not material.

Operating margin was 11.9% up from 8.6% last year and 10.7% sequentially. Also, operating profit dollars were up 38% year-over-year and were flat sequentially.

Financing volume increased 4% year-over-year and was down 13% sequentially in line with normal seasonality. In addition, portfolio assets increased 1% year-over-year and were down 3% sequentially.

Now to the key elements of the P&L.

Non-GAAP EPS was \$0.36 up from \$0.24 a year ago. GAAP EPS for the quarter was \$0.03 which included \$988 million or \$0.33 in after-tax adjustments that were not included in our non-GAAP results.

The majority of the adjustments relate to a one-time \$788 million tax charge associated with the repatriation of \$14.5 billion of cash that I will discuss furtherer in a moment. The remainder of the adjustments were composed primarily of amortization of intangible assets and restructuring charges.

Revenue of 20.8 billion for the quarter was up 10% year-over-year, up 7% when adjusted for the effects of currency.

On a regional basis, revenue was up 8% in the Americas, 10% in EMEA, and 15% in Asia Pacific. When adjusted for the affects of currency, revenue was up 6% in the Americas, 6% in EMEA and 11% in Asia Pacific.

Gross profit was \$4.8 billion for the quarter, or 23.2% of revenue up from 23.0 in the prior year period and down from 23.8 sequentially. The year-over-year increase reflects gross margin improvements in ESS and PST, offset by margin declines in IPG and HPS.

Within IPG, our strategy to drive hardware unit growth, which we believe is the right thing to do for the long-term health of the business, pressured margins this quarter. And while all segments were impacted by the bonus accruals that Mark referred to earlier, margins in HPS were pressured more than any other segment given their headcount intensity.

Non-GAAP operating expenses totaled \$3.6 billion for the quarter or 17.5% of revenue, down from 18.5% a year ago and 17.7% sequentially. Adjusting for currency effects, expenses were up 2% year-over-year and down 4% sequentially.

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Overall, I'm pleased with our progress in op ex for the quarter, particularly given that bonus accruals significantly pressured op ex relative to prior periods. However, we still have more work to do and will continue to focus on op ex management.

Non-GAAP operating profit was 1.2 billion, or 5.7% of revenue up 347 million year-over-year and down 125 million sequentially. Non-GAAP, other interest and expense was income of 126 million, or roughly \$0.03 per share as compared to 20 million a year ago.

The increase relates primarily to favorable impacts from currency on various balance sheet items, higher net interest income over the prior year, and a gain on the sale of land in the current quarter.

As you know, OI&E is volatile and difficult to predict. Our best estimate for Q4 is income of about \$0.02 per share. This reflects higher interest income on our cash balance due to increased interest rates and lower interest expense from a reduced overall debt balance.

Our non-GAAP tax rate was 19.6% for the quarter, basically in line with our guided rate of 20%. I expect a non-GAAP tax rate of about 20% in the fourth quarter.

Next, the balance sheet.

HP-owned inventory came in at \$6.6 billion, down 101 million year-over-year and up 180 sequentially.

Inventory days of supply stands at 38 days, down from 42 days last year, and up from 35 days sequentially in line with normal seasonality. Inventory was managed well across each of the businesses and overall, I'm pleased with where our own inventory closed the quarter.

With regard to channel inventory, we ended the quarter in good shape across the board with ESS at about four weeks, PSG at 4.5 weeks, and IPG a bit over five weeks in line with normal seasonality.

Now I know there's a lot of interest in channel inventory so I'll add some perspective on channel inventory dollars. ESS and IPG channel inventory dollars were down sequentially while PSG channel inventory dollars were up slight sequentially in line with our expectations heading into the fourth quarter.

Trade receivables ended the quarter at 8.8 billion up 299 million, or 4% over the prior year, in bound 502 million or 5% sequentially. As a percentage of revenue trade receivables were 10.3%, down from 10.8% year-over-year and 11.1% sequentially.

DSO now stands at 38 days, down from 40 days last year and down sequentially from 39 days.

Next, property, plant and equipment was up 185 million year-over-year and down 239 million sequentially to 6.4 billion. Gross Cap Ex was 332 million, down 28% year-over-year and 41% sequentially.

All of the year-over-year decrease and the majority of the sequential decrease is attributable to the reclassification of leases within the financing business.

On a net basis, Cap Ex was 208 million, down over 40% both sequentially and year-over-year. Financing assets accounted for a significant portion of Cap Ex during the quarter.

Net PP&E as a percentage of revenue now stands at 7.5% down from 8.0% year-over-year and sequentially. Regarding accounts payable, days payable closed the quarter at 51 days down from 53 days year-over-year and up four days sequentially.

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One additional item of note on the balance sheet, total debt decreased by approximately 1.4 billion sequentially to 5.8 billion, all of which relates to our financing business. We continue to manage the financing business at an appropriate debt-to-equity ratio.

Next, some comments on cash.

Cash flow from operations was 2.2 billion for the quarter, up from 319 million in Q3 of last year. On a year-to-date basis we have generated 6.1 billion of cash from operations, up 98% year-over-year.

Through three quarters our cash flow from operation has already exceeded the highest full fiscal year operating cash flow in the Company's history. For Q4 cash flow, do bear in mind we expect to make a portion of the tax payment related to repatriation and will begin cash outlays associated with our restructuring actions.

Free cash flow, that is operating cash flow less net Cap Ex totaled 5.1 billion year-to-date up over 3 billion or 150% year-over-year. This cash generation reflects improving fundamentals of our businesses and a focus on cash and working capital management.

I'm very pleased with our cash performance but we will continue to focus on driving our cash management initiatives. We close the quarter with total gross cash of 14.6 billion, up slightly both sequentially and year-over-year despite the net repayment of 1.3 billion in debt.

In addition, we've repurchased 860 million in stock during the quarter and have repurchased 2.1 billion in stock year-to-date. Our stock repurchase activities have contributed to a decline in weighted average shares outstanding for six consecutive quarters.

Going forward, I expect weighted average shares outstanding to remain about flat with our Q3 exit level of 2.915 billion shares. There will of course be some variation based on options that become in the money, option exercise patterns, and our level of share repurchases.

During the quarter, our CEO and Board of Directors approved repatriation of 14.5 billion in cash associated with foreign earnings under terms of the American Jobs Creation Act. We began repatriating cash in the third quarter and recorded 788 million in one-time tax charges, or \$0.27 per share.

As noted we expect to pay the portion of the taxes associated with the repatriation in Q4 '05.

Now a few comments on fourth quarter outlook.

As Mark noted, we are pleased with our performance in the third quarter. We are entering our seasonally strongest quarter.

When considering our Q4 outlook, keep in mind that currency movements may negatively impact revenue on a sequential basis. As for the outlook itself, we expect fourth quarter revenue of between 22.4 and \$22.8 billion and non-GAAP EPS of 44 to \$0.47.

As we noted in the press release, this excludes approximately \$0.03 per share from amortization of purchased intangible assets, and approximately 900 million, or \$0.22 per share in workforce reduction cost. It also excludes a one-time credit of approximately 200 million, or \$0.05 per share related to benefit plan changes.

That concludes my comments, and we will now take your questions.

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QUESTIONS AND ANSWERS

Operator

Thank you, sir. [OPERATOR INSTRUCTIONS] Sir, our first question is from the line of Steve Milunovich with Merrill Lynch.

Steve Milunovich - Merrill Lynch - Analyst

Thank you. First of all, do you have dollar amounts for the bonus accrual and on the gain on the sale of land during the quarter?

And then Mark, you know, kind of, what's changed? I mean the environment doesn't seem to be generally much better and yet HP's operating improvement seemed to have improved a fair amount and you haven't had that much time to implement some of your changes. What's your view in terms of what is going on operationally particularly in the sales force?

Mark Hurd - Hewlett-Packard - CEO, President

Steve, let me let Bob go first on your first questions and then I'll take the follow-ups.

Bob Wayman - Hewlett-Packard - CFO

Yeah, of course, we have a dollar amount, Steve, but we are not going to disclose it. We just don't want to set a precedent of getting into that each and every quarter. We've tried to give you a sense that it was a noticeable change and one that, you know, did put some upward pressure on op ex and cost of sales compared to prior year periods.

Real estate gain, all I'll say is less than a cent per share impact.

Steve Milunovich - Merrill Lynch - Analyst

Is the bonus accrual something that comes up every couple quarters or--

Bob Wayman - Hewlett-Packard - CFO

Every quarter.

Steve Milunovich - Merrill Lynch - Analyst

So it could be every quarter?

Bob Wayman - Hewlett-Packard - CFO

Yes. But I will say that first half, we accrued no bonus. So it went from a small number to something that's noticeable.

Mark Hurd - Hewlett-Packard - CEO, President

I think again, though, Steve, that we'll need to, we know about this. This needs to become part of our cost structure, so it's something that we need to build into our operating models, and we have as we've thought about some of the actions that

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we've already told you about. So this is just a part of the process, and, you know, one that we need to get into the operating models and is in the guidance that we're giving you as will give you as we go forward in the future.

In terms of what's changed, I'm not sure that anything, quote unquote, has changed other than I think that the people of HP have been really focused. I'll say again that I think we attempted to do two things during Q3 that, you know, frankly aren't always the easiest to do and that's to focus on the long-term health of the Company and take the actions that we articulated on July 19.

At the same time as we stay focused on delivering our short-term commitments to find as our Q3 guidance, and, you know, frankly, we'll go at it again in Q4, and our job is to get both done and that's what we're focused on and I just think it's a credit to the team of people here and the people of HP for getting both done. We'll keep at it, though, and believe me, we're not confused that we've got more work ahead of us.

Steve Milunovich - *Merrill Lynch - Analyst*

What has been the response internally since you announced the restructuring and could you give us an update on people leaving and what you expect there?

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

I don't know about, I mean in terms response, I think it's everything you'd expect that would happen in an announcement like that. I think there's a piece of optimism that exists in the Company about us getting about the job of some of the things that we need to do and the opportunity that we have in the future to be competitive and to be a force in the industry.

At the same time is we have to get through the process, and, you know, that's work to do at the same time. So I think, Steve, it's like anything you'd find, it's got a bit of both.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Steve.

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

Next question, please.

Operator

Sir, our next question is from the line of Richard Chu with SG Cowan.

Richard Chu - *SG Cowen Securities - Analyst*

Yes, thank you. I wondered whether you could talk a little bit about the Personal Systems business? As you pointed out in a weak quarter you delivered your best margins in recent history. What really contributed to that?

Can you talk about the differences between fixed costs, variable costs, gross margin spreads, model changes, [inaudible] promotions, et cetera? Can you tell us more?

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

I'll start. I think that, first of all, I think it should be noted that this is not a one-time thing. I mean, if you start looking over quarters, and even stretch back over fiscal years, this business has been on a steady incline and a steady improvement, and I will tell you that when I look at it, it's been a fairly steady improvement and steady incline, and I think at one point in time, all of the factors you've described has had a role to play in the improvement in the business.

So I think it's back again strategically looking at what is your objective. Is your objective to drive pure share. Is your objective is to drive pure share balance by profitability? And I think what you've got is a group that's executing very well against the latter.

I'll let Bob give you some more incremental color.

Bob Wayman - *Hewlett-Packard - CFO*

Two particular elements of the product line did very well. Our workstation business, which is not large, but it's noticeable enough to make a difference, and there we had some great new products, very good financial results.

Consumer notebook did particularly well. As you know we refreshed our consumer line heavily about 6 to 9 months ago, it really put us on a good trajectory, seemed to have the right products for the marketplace and you saw, you heard from Mark, the numbers there in terms of how we did in the marketplace.

This quarter consumer notebook revenue actually exceeded consumer desktop revenue for us for the first time. So some really good things going on there.

We had European strength in consumer and commercial. The U.S. was relatively stable, balanced between both consumer and commercial.

Richard Chu - *SG Cowen Securities - Analyst*

Bob, was there anything unusual with respect to European channel inventories in either the PC business or the printer business?

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

No.

Bob Wayman - *Hewlett-Packard - CFO*

No, there wasn't. As I indicated, everything on an overall basis was in line with our expectations. There's always a few ups and downs but if you look at the entire package we feel very good about channel inventory.

Richard Chu - *SG Cowen Securities - Analyst*

Thank you.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Next question, please.

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Operator

Sir, our next question is from the line of Rebecca Runkle with Morgan Stanley.

Rebecca Runkle - Morgan Stanley - Analyst

Good afternoon. Thanks so much. Just a couple of follow-up questions on the accrual. Bob, can you just provide some perspective in terms of when the last time HP did accrue for bonuses, and then going forward, is this something that you expect to talk about at least qualitatively when you do accrue for a bonus in any given quarter?

Bob Wayman - Hewlett-Packard - CFO

Well, we hope to accrue for a bonus every quarter, that's the plan. There's a certain targeted amount of our pay to be competitive that we intend to deliver by the way of bonuses or pay at risk.

The last time we accrued a bonus was in the fourth quarter of last year. And we will talk about it when we think it is big enough of a change that it will be necessary to help you understand the real dynamics underlying the business.

I mentioned it, for example, when talking about operating expenses this quarter because without that you might think we weren't doing as good a job of controlling the underlying op ex as I think we actually have done. So we've controlled the base spending level, we've made some good results on the bottom line, and fortunately are sharing some of that with employees.

Rebecca Runkle - Morgan Stanley - Analyst

And then just a follow-up, Mark, to some of your comments on Services earlier. You talked about wanting to get to competitive margins over time. Can you just talk to what you view are competitive margins in the Services business and provide some context in terms of how you are thinking about getting there in the type of time frame that you're looking at these days?

Mark Hurd - Hewlett-Packard - CEO, President

Yeah. We'll probably do more of that when we get together at the end of the year in December at our analyst meeting. But suffice to say, Rebecca, for now we have opportunities to improve and that's what we're going to get done.

Brian Humphries - Hewlett-Packard - VP Investor Relations

Thanks, Rebecca. Next question, please.

Operator

Sir, our next question from the line of Toni Sacconaghi with Sanford Bernstein.

Toni Sacconaghi - Sanford C. Bernstein & Company - Analyst

Yes, thank you. A couple of questions please.

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Firstly, with regard to both PCs and Printing, are you satisfied with your current revenue or unit growth rates, because it is a balance that you're trying to strike in each between I think unit growth and profitability. So can you be as specific as you can in terms of whether you're happy with the revenue growth rate in PCs and with the unit growth rate in Printing and whether we should expect you to be more or less aggressive in pricing going forward given your satisfaction level with the volumes in those businesses?

And then secondly, can you provide us with any kind of update on the restructuring. I think when you provided the plan in July, you were fairly light on details, saying that you were still finalizing the numbers and that you would hope to have some update on this earnings call.

Can you confirm that 14,500 is still what you're targeting or whether that number is lower or higher and whether you're getting a sense of how much might be voluntary versus involuntary and how is that versus your initial expectations?

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

Okay, Toni, I'm going to take those dozen questions and I'm going to get at them as fast as I can.

First in the Printing and PC description that you described, I would say that what's occurred is roughly to our expectations in terms of the unit growth and how that balances out. So I think you should expect us to try to continue on the strategy that we've described, and that's the verbiage that I tried to give earlier.

Secondly, of course, to your point, there's a tail on supplies revenue impact as a result of the unit growth, and, again, we'll continue to try to optimize that equation as we previously described.

Secondly, on restructuring, yes, our target is the same. Let me try to give you a little bit more color on timing here.

We, as we announced in the July 19th restructuring, we were going to implement an early retirement program. That early retirement program is a voluntary program for the U.S., and that program is just now coming to a conclusion of people that will enroll in that program. So that is imminent, the conclusion of that.

Once that is done, that gets through the voluntary piece, Toni, that you referenced then creates the gap that we'll have to look at by function, by segment and we begin the work. So we are advancing the work. It is on schedule. It is on the targets we aligned to the 19th and we'll continue to drive on it.

Toni Sacconaghi - *Sanford C. Bernstein & Company - Analyst*

If I may, two quick follow-ups. One, can we have a more detailed readout on the split in the restructuring and where the gap will be made up?

And then secondly, specifically on Printing, I think your Printing pricing strategy was probably more aggressive in Q1 than it was in Q2. You said "we will stay the course" in terms of Printing. The course has been, I think, a little less aggressive in Q2 than Q1, excuse me, Q3 versus Q2. How should we be thinking about the next couple of quarters going forward?

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

Okay. Let me go back at those again. I think there should be no gap to, let me just make sure I'm specific to the 14,500, there should not be expected to be a gap so we will continue to execute against that plan. If we were to ever deviate from that plan we would clearly tell you about that.

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So when I refer to any gap, I was meaning specifically from the voluntary program to any segment that would be different. For example, a voluntary program it is a broad program, Toni, that could have people in other parts of HP that weren't targeted for an action. As you said this is a very precise action in specific groups. So that could create a bit of an outage, but we will close that and we will deliver on the commitments that we described.

To your points on Q2 and Q3, I think the words you used would be the ones I would describe of "staying the course" that we're trying to optimize our answer that again in the end drives supplies growth and we've been operating to what we've expected and I think you should continue to expect us to do that.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Toni. Next question, please.

Operator

Sir, our next question from the line of Harry Blount with Lehman Brothers.

Harry Blount - *Lehman Brothers - Analyst*

Good afternoon. Several questioners. First of all, as it relates to guidance, as I look at the guidance you've provided on the revenue line, you're looking at about an 8 to 10% sequential if I did my math correctly, and your historical's more like 12% for this particular quarter. I was wondering if you could provide a little bit of color on that?

Secondly, Bob, just to clarify that the EPS guidance includes the \$0.02 interest income benefit that you talked about.

And third and finally, I was looking to see if I could get a little bit more color on the ESS. Mark, last quarter you said that storage was a critical focus for you. It does look like across the board on ESS you guys performed a bit better than expectations.

Bob Wayman - *Hewlett-Packard - CFO*

So let me start. The 12% number I think is not really typical. Last year it was a greater sequential growth from Q3 to Q4 because we had such a disappointment in both revenue and profit in Q3.

I think if you look, you know, at a longer period of time that's a high number. You know, my analysis of it, if you exclude last year's numbers, more like 9 to 10. And we're plus or minus right in that range.

Second question, yes, the \$0.02 other income and expense expectation statement is of course incorporated in the overall guidance.

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

Harry, to your question on storage I think that it is again what we expected. We expected some improvement in performance. I do think though that we have a longer run here before we're going to be pleased with the performance of the business.

So I think we've had a good start. It's roughly on the expectation that we had, but we have, you know, we have more work to do to get to a sustained position that we feel good about.

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Harry Blount - *Lehman Brothers - Analyst*

And just on the 9 to 10%, Bob, that you were talking about as kind of your analysis, is there any other, could you maybe provide a little bit more color on the factors that you took into account in providing this guidance specifically around things like currency and disruption maybe perhaps related to the restructuring actions?

Bob Wayman - *Hewlett-Packard - CFO*

Yeah, we are not building into our model explicitly any disruption or distraction based upon restructuring. We're doing everything we can to manage it without that byproduct.

The factors includes currency changes, again if the dollar stays where it is that's going to put up a little extra headwind sequentially compared to a currency neutral situation. You've seen some of the announcements around us with regard to revenue disappointments, those kinds of things make you wonder what exactly is going on out there in the marketplace. We think it's appropriate to give the kind of guidance that we have just put forth.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Harry. Next question, please.

Operator

Sir, our next question is from the line of Rob Cihra with Fulcrum Global Partners.

Rob Cihra - *Fulcrum Global Partners - Analyst*

Hi. Thank you very much. Within the IPG you mentioned now you've have two quarters of double-digit unit growth and a lot of that driven, I guess by aggressive pricing two quarters ago now. Can you maybe explain why you think given that you guys are the dominant printing company, why do you feel as though you can price more aggressively, drive share back up, yet not sort of see competitors be maybe forced to follow and start, maybe not a price war, but at least something that's a little more price war-like than you'd like?

Bob Wayman - *Hewlett-Packard - CFO*

So let me start by backing up a little bit to before when Mark was here. You know, our pricing three or four quarters ago in inkjet fell a little behind. So our aggressiveness is getting back to the kind of position that we had wanted to have, but back in Q4, early Q1 we introduced some products, put them at price points that were not where we, in hindsight wanted them to be.

So don't read into this as trying to lead the market to some kind of a new pricing strategy. That is not our approach at all. It's really a matter of appropriately restoring what we think is the right position for HP, which includes some well-targeted price actions.

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

I think if you go, also go look at the, by model, you're going to find that you get very different answers by model. To Bob's point about being targeted, in many cases we're actually closing on the premium as opposed to leading the market from a price perspective. So we're not typically viewed as the quote unquote price leader.

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It really gets down to the differentiation of our technology, the differentiation of our serviceability by targeted model and what that premium should be. So in many cases to Bob's point, we've been optimizing the model to make sure we've got the premium right and these are in very targeted arenas as opposed to broad-based actions.

So again, I think it's back to the earlier question of what we're trying to do is optimize the model as opposed to some broad-based kind of cost or price cut. That's not what we're after here. We're really working on making sure that we've got the entire equation right.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Rob.

Rob Cihra - *Fulcrum Global Partners - Analyst*

Okay. Thank you.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

We'll take the next question, please.

Operator

Sir, our next question is from the line of Laura Conigliaro with Goldman Sachs.

Laura Conigliaro - *Goldman Sachs - Analyst*

Yes, thank you. A couple of quick questions.

First of all, on your last call, you indicated that you had just begun discussions with European work councils involving layoffs. To what extent have these progressed more rapidly than you expected so that you might actually see some of this restructuring impact from that aspect of it, perhaps even in the October quarter?

In addition, you've talked about double-digit unit growth in the hardware part of printers, but on the consumer side, it was 8%. Is 8% unit growth in consumer printers enough to actually kick-start consumables growth in the October quarter and what will it take actually to get that into double digits on a sustainable business?

And then finally, is it still reasonable to think about printer profitability in terms of a 13 to 15% range? Thanks.

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

Thanks, Laura. Let me go back to your, take them in the order that you asked them. I think in terms of the works councils, those discussions are just beginning now.

I think the thought that we'd see meaningful impact, or material impact in Q4 would not be the right thing to consider. So I would think we should see little to zero of any impact of that in Q4. I'll let Bob take --

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Bob Wayman - *Hewlett-Packard - CFO*

On consumer printing units, you know, I don't know if I would use the word "kick-start" in terms of supplies, but certainly the last two quarters showing consumer unit growth of 12% in Q2 and 8% in Q3, you know, that's, those are good numbers especially compared to a year or so ago when the unit growth was basically zero and fundamentally bouncing plus or minus around zero.

So it's a noticeable difference, and we hope we'll begin seeing some reflection of that in better supplies growth, whether it be Q4 or beyond, we'll just have to see.

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

I think, Laura, just a little more comment. These are good numbers, you know, from perspectives. You know, there's a tale.

So, you know, the question we get into a lot of modeling about whether there's a six-month tail, seven-month tail, eight-month tail and it depends a little bit by segment and certainly sometimes even by individual buyers. So the thought that we would see a meaningful Q4 impact again probably a bit early to see that. We'll see.

Laura Conigliaro - *Goldman Sachs - Analyst*

Can I just ask something, a couple of things? First of all, do you feel that, I guess from your early discussions with European work councils, do you feel confident enough that, because we all know that those are typically harder areas to move off the mark when it comes to restructuring and layoffs. Do you feel confident enough that this will basically be able to get done in the timeframe that you had originally planned?

And also, as far as the printer thing is concerned, basically, since there's such a different equation now between overall hardware unit growth, consumables and mix, is it, should we even be thinking about hardware growth on the consumer side as perhaps tipping over into the double-digit area again?

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

Let me go at the European question. I'll have Bob go back on the printer question.

But on the European question, I wouldn't tell you about something I didn't think we'd get done. So we will be, you know, very focused on meeting and achieving the plan that we've laid out, Laura.

Bob Wayman - *Hewlett-Packard - CFO*

Laura, whether we can sustain anything in the double-digit area of unit growth in consumer, I mean, who knows. That's certainly well ahead of what most analysts view the market will grow at. Something that will be tough to do for the long-term, but, you know, we don't have a particular number in mind, we're just trying to get as much market share as we can in those spaces and drive as much supplies growth as possible.

Regarding your earlier question, yes, we continue to stand by our 13 to 15% operating margin as the best range of forecast for profitability in IPG.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Laura. We'll take one, we'll take the next question, please.

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Operator

Sir, our next question is from the line of Keith Bachman with Banc of America Securities.

Keith Bachman - Banc of America Securities - Analyst

Hi, guys. Bob, to start with, Mark, this is my dozen questions. Mark, Bob, to start with you, in the OID line, the 119 bridging back to the negative 87, could you review that for me again? Trying to understand what was the driver of that significant difference please.

Bob Wayman - Hewlett-Packard - CFO

Okay. So you're comparing to what quarter?

Keith Bachman - Banc of America Securities - Analyst

So in this quarter you had 119 interest and other income positive.

Bob Wayman - Hewlett-Packard - CFO

Correct.

Keith Bachman - Banc of America Securities - Analyst

And I'm just trying to understand that's a pretty significant bridge from what you had done last quarter in particular and I know you had some charges in there, but I'm trying to understand what was the significant driver and more importantly, what's the sustainable number going forward there?

Bob Wayman - Hewlett-Packard - CFO

The sustainable number is around interest income. As I indicated in my comments, we have paid down debt. We are seeing higher interest rates. We are generating cash. Cash balances are going up. So that's the fundamental, and that's been there all along. If you compare to, been there all along, but it's getting better.

If you compare to the prior quarter, Q2, we had a significant impact of sales and use tax showing up in other expense fundamentally.

Keith Bachman - Banc of America Securities - Analyst

So if I think, what else was in the 119 that made it such an extraordinary large number? It was it a roughly \$0.02 different from my model. Because presumably what, I don't think you're suggesting that you're going to have 119 million of interest income going forward, are you?

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Bob Wayman - *Hewlett-Packard - CFO*

Well, almost. Do the math on 14.6 billion in cash, this amount of debt. The one other thing that's bouncing around is currency, and we certainly had favorable currency this quarter.

Keith Bachman - *Banc of America Securities - Analyst*

Okay.

Bob Wayman - *Hewlett-Packard - CFO*

Okay?

Keith Bachman - *Banc of America Securities - Analyst*

Okay. Let me try to change directions. In Services, Mark, I know you mentioned that you were trying to get it up to acceptable levels, but are we talking kind of 9% or 10% or is there any color on what the level is and or what would be the key drivers to moving Services margins up?

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

Sure. Again, as I said earlier, I'm not going to give you the exact number, but I will tell you that we actually have three different business models within Services.

As we talk about Services as an entity, in there we have a Consulting and Integration model which is a business model that we have opportunity to improve, and we will, and their metrics around utilization and availability and non-availability and I can go through a whole slew of those metrics which give us opportunity for work. We have Managed Services business that, of course, has opportunities for us to improve as we do things in our Managed Services contracts that are also an opportunity.

And then inside what, you know, what we would call internally TS, or more of our traditional break-fix service, we get issues like cost per call, revenue per call, remote resolution, all these kind of activities, we have opportunities to do yet more.

So really it is, Keith, in the end an aggregation of those three things that perform HP Services and we'll try to be more illuminating on that when we get together in December.

Keith Bachman - *Banc of America Securities - Analyst*

Okay. Fair enough. I'm just trying to sneak two quick ones on the financial side. Bob, could you just confirm please that the treatment of amortization of intangibles and restructuring charges has been consistent over the past few quarters?

Bob Wayman - *Hewlett-Packard - CFO*

Yes, it has.

Keith Bachman - *Banc of America Securities - Analyst*

Okay. The final one is tax rate next year. What should we be thinking about?

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Bob Wayman - *Hewlett-Packard - CFO*

I'm not giving any next-year guidance at this point.

Keith Bachman - *Banc of America Securities - Analyst*

Not even on tax?

Bob Wayman - *Hewlett-Packard - CFO*

Not even on tax. But, you know, I think what most folks have out there is what I would do, and that's extrapolate.

Keith Bachman - *Banc of America Securities - Analyst*

Okay, thanks very much.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thanks, Keith. Next question, please.

Operator

Sir, our next question from the line of Richard Gardner with Smith Barney.

Richard Garner - *Smith Barney Citigroup - Analyst*

Thank you very much. You were very clear that you're happy with your channel inventory levels pretty much across all product lines. I am wondering if you have any visibility into industry channel inventory levels and whether you have any concerns that others might be building some inventory in particular in Europe?

And then second, just the standard question about component supply constraints potentially in the second half, and the commodity pricing environment. Is there a significant risk that component constraints could limit your ability to ship as many PCs as you would like?

And then finally, nobody's asked the demand question. I'm just wondering if you can give us a qualitative assessment of what you think IT demand is like I guess across the major geographies and the major product categories, and has there been any significant change in one direction or the other here over the past quarter or two? Thank you.

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

Okay. I'm writing as fast as I can here. First one, let me take a couple of them and I'll let Bob fill in where I missed.

On the macro level demand, I think our best commentary on it would be we see it steady, stable. I think those would be the best words we could use to see how we see it.

Secondly, I have no idea on channel inventory and no comment to make on channel inventory of any competitor.

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Bob Wayman - *Hewlett-Packard - CFO*

So component constraints. Things are tightening up out there a little bit, and we're seeing some cost reduction or pricing, you know, that was coming down, stabilizing and some signs of tightening and going up.

Our forecast that we provided you we feel good about. We feel we can achieve supplies at that level. There are points at which we wish we could get a little bit more and ship a little bit more, but that's something we're always working with.

You know, by category, flat panels certainly are tightening up, memory is tightening up, so those are the areas we're watching. Even a few categories of microprocessor, a little bit of tightness. Obviously PC demand has been above what most folks have forecast and we are where we are.

With regard to macro demand I would just add one other thing. I absolutely agree overall we don't see any fundamental change but it just varies quite a bit by geography.

For example, China and India continue to be extremely strong growth areas. China for us up 40% year-over-year, India up 56% year-over-year. Not a big base in India, but, you know, reasonable. So we're continuing to have to play effectively in the right markets to capture the kind of revenue growth that you see in our statement.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Thank you, Rich. Next question, please.

Operator

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

Ben Reitzes - *UBS Warburg - Analyst*

Thank you. A couple of things I guess is the norm here. In terms of my model I see the U.S. actually beat expectations more than the other geographies. So any more color on geography with regard to how maybe you did competitively in the U.S.? That would be helpful. It seems that Europe and Asia were in line with my model but the U.S. was good.

Then with regard to SG&A, you had about 6% of, I believe, sequential decline in SG&A, usually it's been flat to down 2%. I was just wondering if you got any restructuring benefits in the quarter or if the restructuring took place too late? I would say assume that you didn't get any, but just wondering what, Mark, you were able to do to get SG&A down so much?

And then with regard to guidance, just anything you want us to think about, Mark? Do you want us to think that we flow through the better interest income for the reason for the raised EPS or is there something that you want us to take away that's better than expected, maybe margins or something?

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

Sure. We'll tag-team it.

Back to your question on the regions. They were roughly in line with our expectations. I think you saw broad-based, we didn't have a one-region dominant story here.

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The Americas had good growth, EMEA had good growth, APJ had good growth even with the effects of currency they were in the range of our models. So that was good.

Clearly, we've got an issue as we look forward trying to pinpoint where the Euro heads and where some other currency heads. I'm sure you're hearing that across the board and as you know, Europe is our biggest region from a revenue perspective, so we're very sensitive to the movement of currency particularly in that geography. But even stripping that out, I think our performance by region was in line with our expectations.

Clearly, I'm going to let Bob talk a little bit about SG&A, but clearly we set out a model that's not short-term, and so as you begin to think about your models as you were laid out, and I'm talking about our models internally, we're working hard to be very careful with how we spend money, and so this is not a one-trick thing. I mean we're trying very hard to optimize our human financial capital across the Company.

Bob Wayman - *Hewlett-Packard - CFO*

Just one other comment on the U.S. number. Do remember that last year's Q3 was depressed and one of the reasons for revenue depression was U.S. centric, that is what we call the fusion-conversion issue was a U.S.-based issue. So the growth rate might be there for just a bit higher and I don't know if your model was rate-based or dollar-based, but anyway, that could affect the rate.

SG&A, yeah, it came down nicely, you know. It did have the benefit of some restructuring. As you know, we took some charges in Q1, Q2, and in Q3, and certainly those cumulatively do give us some benefit in terms reducing expenses.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

We'll take two more questions please, Operator.

Operator

Yes, sir, our next question will be the line of Bill Shope with JP Morgan.

Bill Shope - *JP Morgan Chase & Company - Analyst*

Okay, great, thanks. Looking at the Printing margins, obviously they're lower than they have been historically, but, you know, looking at what at least I was anticipating in this environment, they were actually better than I expected.

Did you see some benefits from your workforce reduction efforts in this segment this quarter? Should we expect that to flow through in the next quarter?

And then my next question would be looking at the workforce reductions, it's my understanding that reductions in temp in consulting workforce is incremental to your announced restructuring actions. Did you have any reductions there in this quarter and do you plan any in the coming quarters?

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

Let me start with yes and yes to your first two questions. As related to the non-core HP workforce, we have not announced anything on that, and so we continue to look through everything in the Company to make sure we have an appropriate level of spend, and we'll also look at balancing those costs as appropriate.

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So as I think we've tried to be clear with our tone that we're not about the job of having waste in the Company. We're obviously trying to be as efficient as we possibly can and I think we'll continue that.

Bill Shope - *JP Morgan Chase & Company - Analyst*

Okay, great. Thank you.

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

Thank you, Bill.

Brian Humphries - *Hewlett-Packard - VP Investor Relations*

Okay, next question, please.

Operator

Sir, our next question is from the line of Kevin Hunt with Thomas Weisel Partners.

Kevin Hunt - *Thomas Weisel Partners - Analyst*

Hi, thank you. I had questions on three different areas. First on storage. You gave a number of 44% year-over-year in the mid-range. I wonder if you had a sequential number?

And then kind of along the same lines as that question, within storage, you talked about year-over-year growth but that was kind of obviously off a pretty lousy year last year. What was, and you were actually down sequentially. How should we be thinking about storage? I mean, is this something I can sustainably grow or should it be, are we thinking it's going to flattish year-over-year going forward? So that's the first one.

And the second one is on Printing. I think you started some pretty aggressive cost cutting before Mark out there, and I wonder if you can just quantify for us what contribution that may have had to profitability this quarter, so, you know, out of 13% was there 100 basis points, 200 basis points made from cost reductions? Any kind of color you can give there?

And finally, I wonder if you can give us a unit or an ASP numbers on notebooks for the quarter on top of the 21% revenue growth?

Bob Wayman - *Hewlett-Packard - CFO*

So first question, EVA quarter-to-quarter was up 19. Okay?

Kevin Hunt - *Thomas Weisel Partners - Analyst*

Okay.

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Bob Wayman - *Hewlett-Packard - CFO*

Let's see. Storage overall, I don't know.

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

Yeah, again, I think that as I said earlier, we're not, you know, no one's taking a lap around the building here to celebrate the performance in storage. We had a weak compare. We've made an introduction of our mid-range product line that we believe has been well accepted. So we believe that's progress, but I think we've got some time here to see continued performance, so I'm not ready to commit to you.

I think, again, comparatively when you look at the PSG performance, you see sustained improvement over a period of time. We need the same type of thing from a storage performance perspective before we're going to be willing to say we're there so to speak.

So I think that we've got more work to do in storage and we know and we'll get about the job of getting that done.

Bob Wayman - *Hewlett-Packard - CFO*

Kevin, notebook ASPs were down 15%. Now keep in mind that our product line in notebooks a year ago was not what it should have been and certainly the new product introductions were designed and priced at just a much better spot.

So don't think of this as cutting prices on a fixed notebook product, but rather repositioning with more competitive product, and even with that decline, notebooks were nicely profitable for us.

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

Okay. Thank for your questions. Before wrapping up I want to summarize today's call by saying that I'm pleased with our execution in the third quarter, that we delivered double-digit revenue growth, strong margin improvements in key segments, double-digit unit growth in Imaging and Printing, and \$2.2 billion in cash flow from operations.

We did this in a period when we also made good progress reviewing our operations and making a simpler, nimbler HP with fewer matrices, clearer accountability, and greater financial flexibility. We also announced the restructuring program will improve our cost structure and allow us to become more competitive and we strengthened our management team with some key hires.

I'm encouraged by what we've achieved to date but more hard work is ahead of us. The quarter's performance represents a solid team effort and now we're focused on the fourth quarter. The good news is I believe the people of HP know what we have to do.

We'll wrap it up with that and thanks again for joining us on today's call.

Operator

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

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