

ANNEX BULLETIN

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INDUSTRY TRENDS

Updated 5/16/06, 11:00pm PDT

Analysis of Hewlett Packard's Second Quarter Results

Beating the Street

HP Beats Wall Street's Expectation; Profitability Improving Across Its Product Lines

SCOTTSDALE, May 16 - In a quarterly dart game where hitting or missing the Wall Street mark seems to matter more than how much money a company makes, Hewlett Packard's CEO, Mark Hurd, hit the mark and beat the Street again. Net earnings surged by 51% to \$1.46 billion, or 51 cents per share. Wall Street had expected 46 cents per share. The HP stock rose more than three points in after-hours trading in response to the news.

HEWLETT-PACKARD CO
as of 15-May-2006

HP Stock Price



**2Q results exceed expectations,
lift the stock in after-hours trading**

Only three points? That was our reaction to the Wall Street reaction. For, the HP shares had been sliding steadily for the last week or so in anticipation of the second quarter results. The stock was down 1.6% in regular trading today finishing at \$31.11. As you can see from the above chart, the best-performing major IT stock of 2005 has been actually mostly flat-lining in the last three months, after setting a 52-week high of \$34.50 on Feb 16.

So the significant improvement in profitability across the board of HP product lines in the second quarter would rate more than just three points in market cap, in our books anyway. But then, we use facts and reason not hype and gossip. Which can be a handicap in a market driven by hype and gossip.

"HP delivered another solid quarter," said Hurd, the CEO, in a post-release teleconference with analysts. "We grew revenue, expanded margins and generated record cash flow... We are encouraged with our progress to-date."



The investors should be, too. And here's why...

Business Segment Analysis

Geographies. The Americas region, HP's biggest at 43% of total revenue, was also the best performer in the second quarter, especially as the strength of the U.S. dollar reduced the foreign currency translations by about 3% elsewhere. Revenues in the Americas grew by 10% to \$9.7 billion, while the business in

By region



Europe, the second largest area that represents 40% of the total, declined by 2% to \$9.0 billion. In constant currency, however, revenues in Europe grew by 6%.

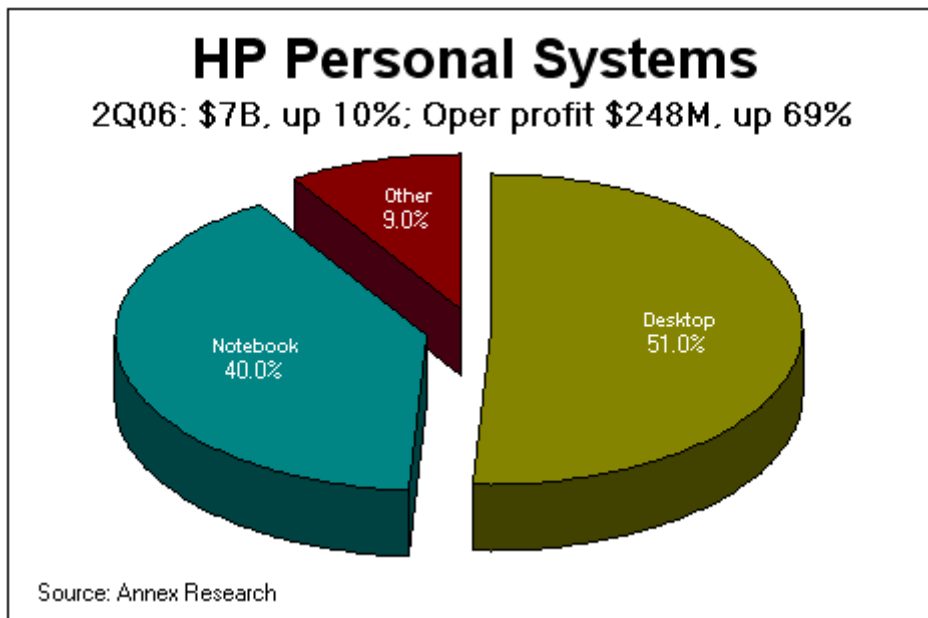
But the growth in Europe has not been evenly spread.

"I would describe it as Eastern Europe - pretty healthy; Western Europe - pretty blah," said Hurd, answering an analyst's question.

That pretty well matches up with our assessment and the reports we have been getting from other competitors. The "Old Europe" is a drag; the growth lies in the east in "New Europe" (see "[Go East, Young Man!](#)", Mar 2006).

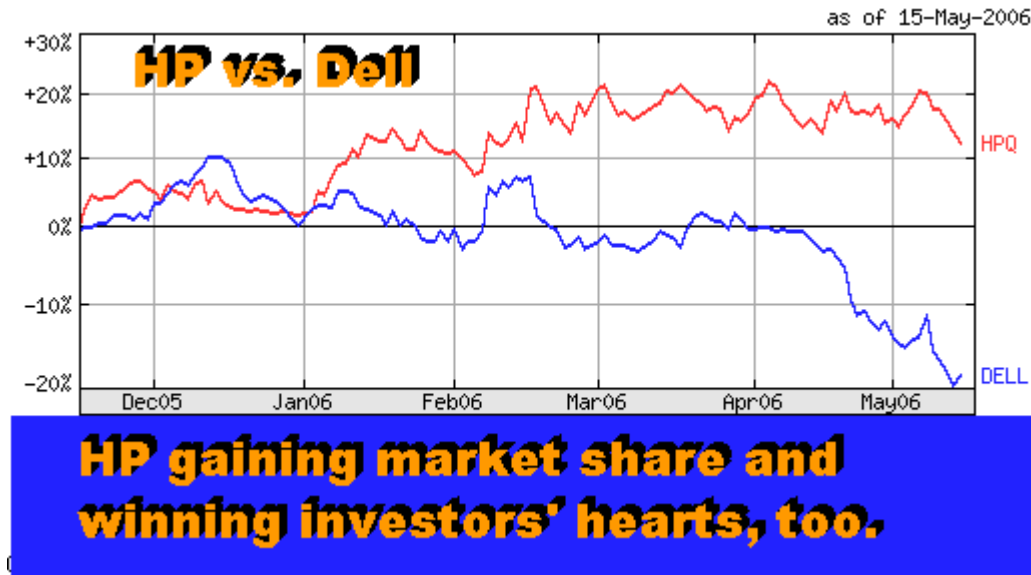
Finally, HP's Asia/Pacific region, which accounts for 17% of the total, reported solid growth in both actual and constant currencies. Revenues were up 7% as reported, and up 10% in constant currency.

PCs. Personal Systems Group (PSG) was the most-improved unit in HP's second quarter lineup. Its revenues grew by 10% to \$7.0 billion since the quarter a year ago, with unit shipments rising 16%. But what made this HP operation the second period champ was that its growth was accompanied by a 69% surge in its operating profit. It went from \$147 million a year ago, to \$248 million in the latest quarter.

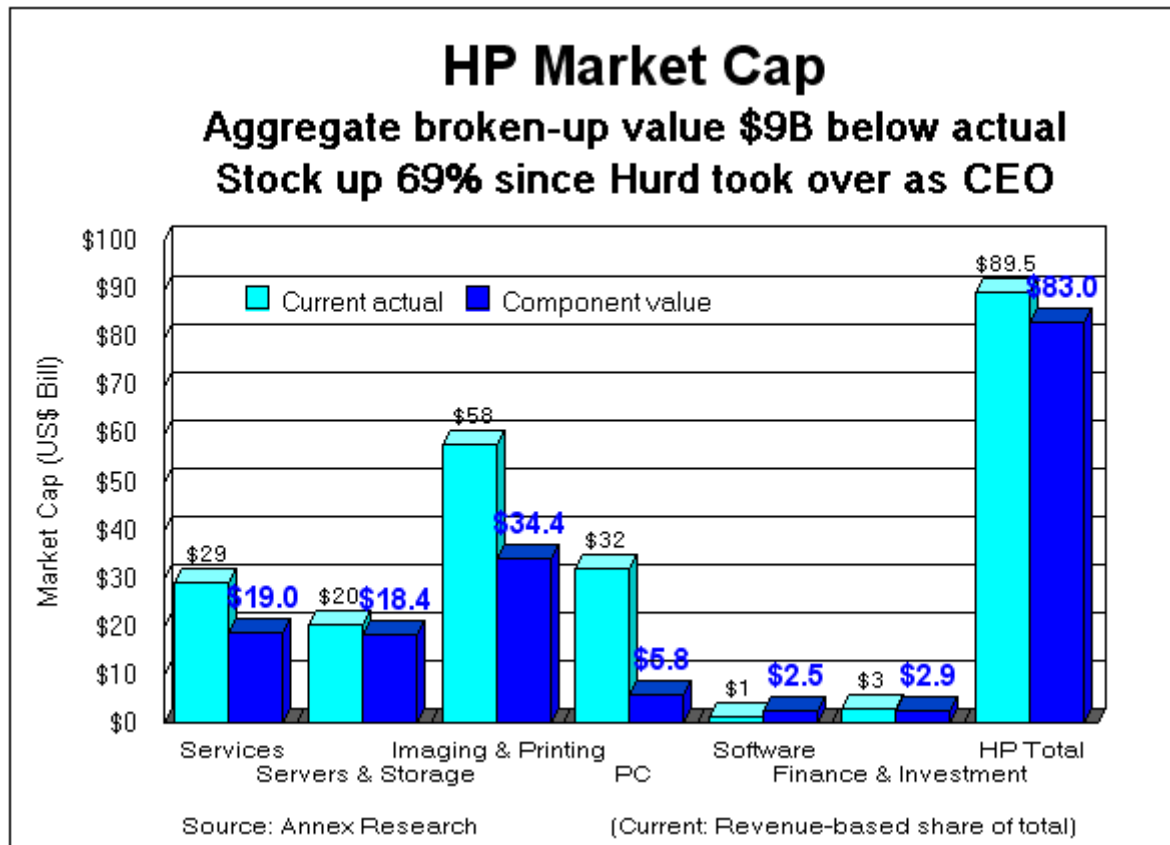


Within those totals, the action was clearly in the low end and consumer markets. Desktop revenues increased by only 1%, while notebook business grew by 27%. The trend was confirmed by consumer client

revenue that increased 24%, while its commercial equivalent grew by only 3%.



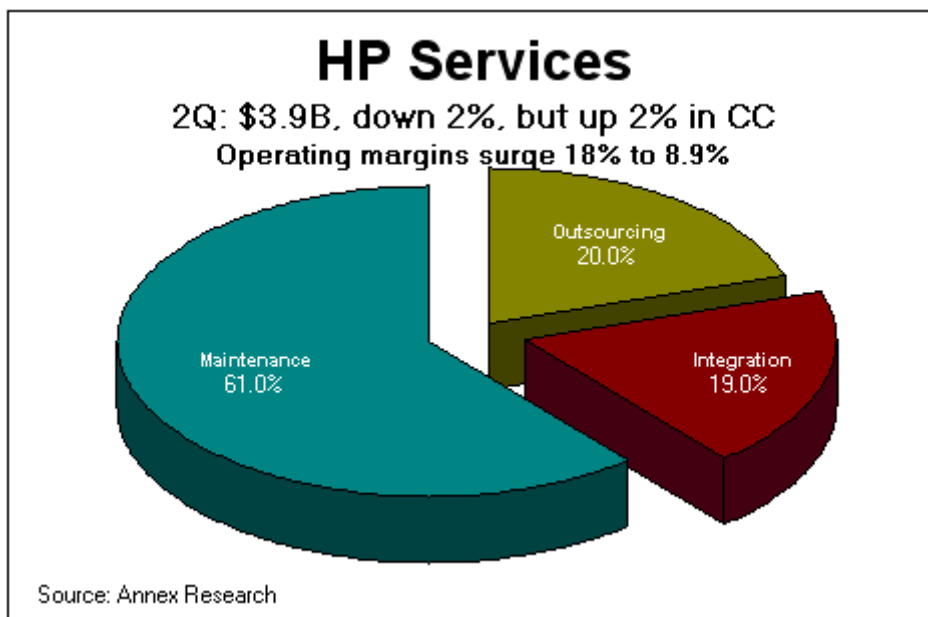
As a result, Hurd, the CEO, said the company believed it has gained market share against its competitors, most notably Dell. As you can see from the IBM stock price charts, looks like HP is also winning investors' hearts much better than Dell.



Last week, Dell issued a warning lowering its fiscal first-quarter earnings outlook due to, what it called, aggressive price cuts late in the quarter. The announcement sent its stock plummeting even deeper than it had fallen in the last six months.

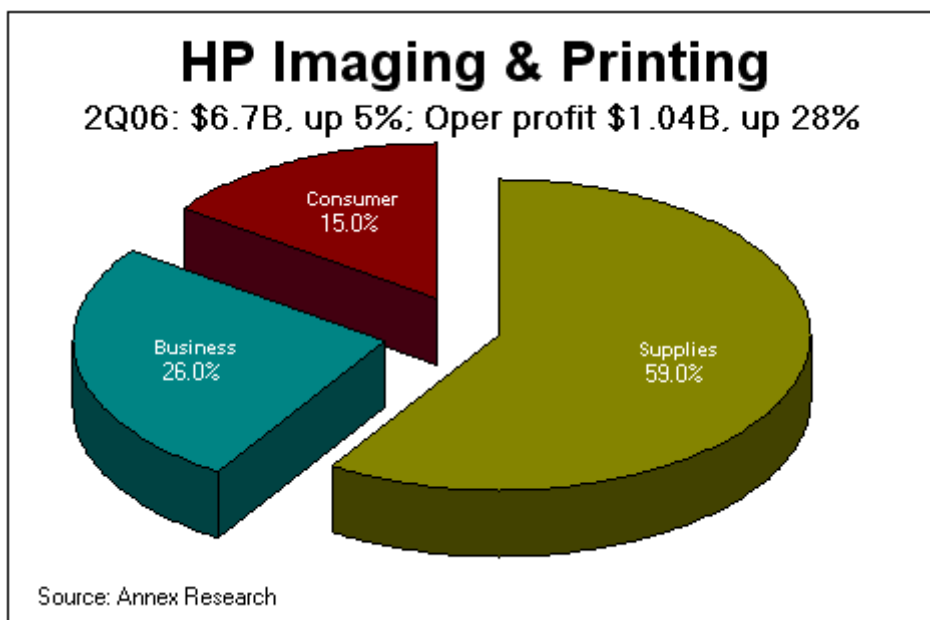
When such price wars between major vendors erupt, there is usually one winner - the customer. And the vendors that got out before the bloodbath. Big Blue must be wringing its hands in glee that it exited this brutal commodity market last year (see "[IBM PC Sale Okayed](#)," Mar 2005).

Services. HP Services (HPS) was the third most-improved unit - in terms of profitability. Its operating profit jumped 18% to \$345 million for a 8.9% operating margin. A year ago, HPS made only 7.3% from its operations.



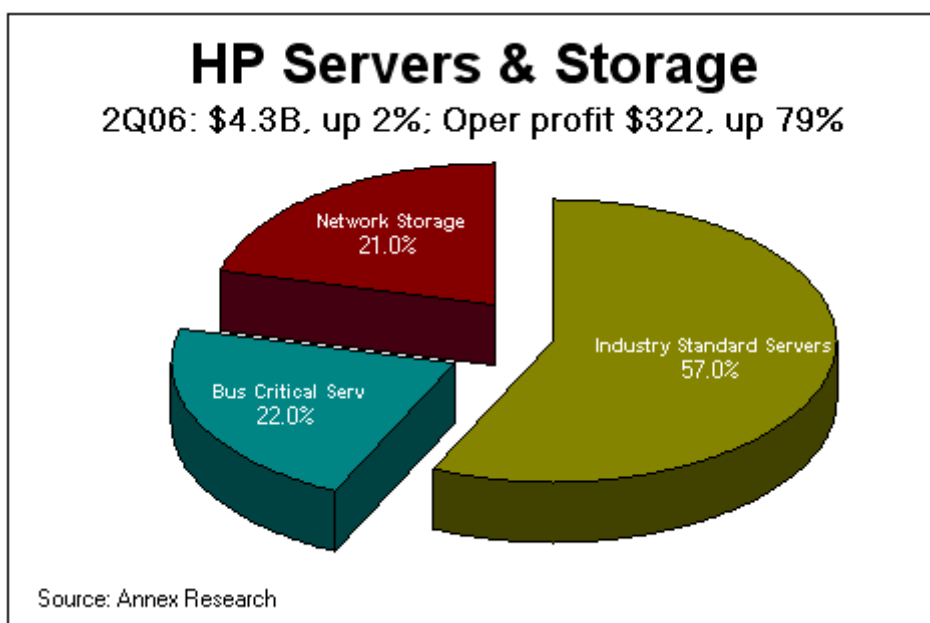
Maintenance revenue declined 4%, as did Consulting and Integration business - by 2%, but Managed Services (outsourcing) revenue grew 2%.

Imaging & Printing. Imaging and Printing Group (IPG), the company's second biggest and by far the most profitable unit, was the third most-improved operation overall in the second quarter. Its revenue grew by 5% to \$6.7 billion. But its operating profit surged even more - by 28% to \$1.04 billion.



Within that total, supplies revenues grew 10%, commercial hardware revenue grew 4% , while consumer hardware revenue declined 8%. HP said its color laser printer shipments and printer-based MFP shipments were up 38% and 44% year-over-year, respectively, while HP Indigo Press printed page volume grew by 42% since a year ago.

Enterprise Storage & Servers. Enterprise Storage and Servers (ESS) unit reported revenues of \$4.3 billion, up only 2% over the prior year period. But what ESS lacked in bulk, it more than made up in profitability improvement. Its operating profit was \$322 million, or 7.5% of revenue, up 79% from \$180 million, or 4.3% of revenue, in the prior year period.



The industry-standard (Intel-based) server revenue increased 4%, with blade revenue growth of 60%. But business critical servers' (Unix) revenue declined 7%, as Integrity systems growth of 93% was offset by declines in PA-RISC and Alpha.

On the plus side, networked storage revenue grew 8%, led by continued strength in external arrays. The high-end XP revenue grew 8%, while the revenue in the mid-range EVA line increased 46%, the company said in a release.

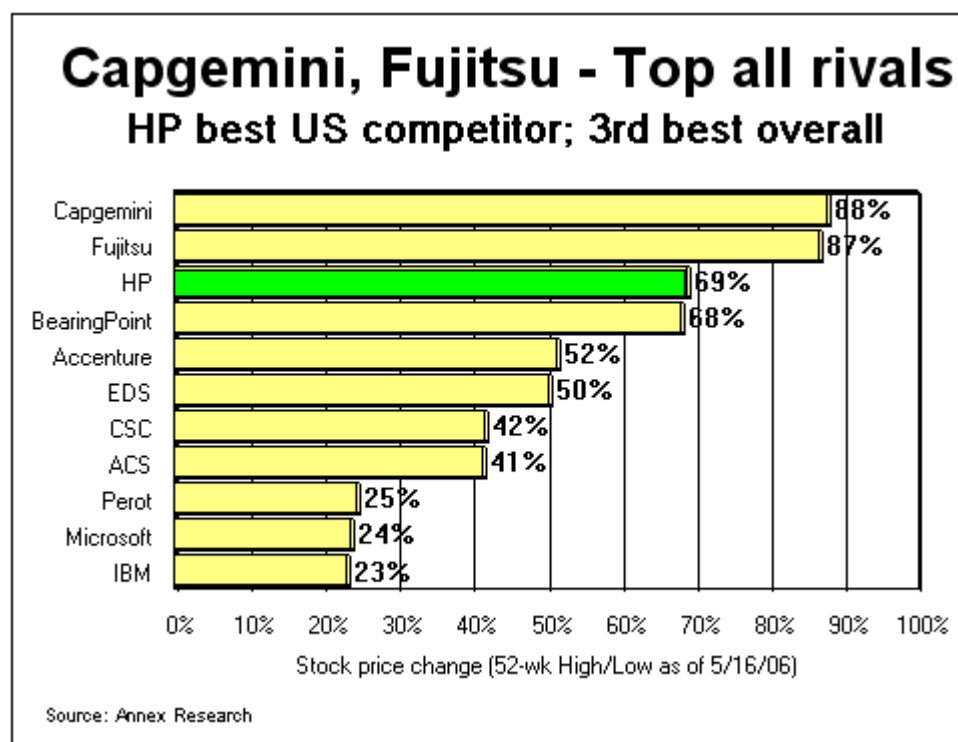
Outlook

HP executives warned several times during the conference with analysts that the company's third quarter (the current one) is traditionally its weakest. It was as if they were trying to tone down the enthusiasm that the positive second quarter results were likely to bring about. And maybe they were, especially in light of the Dell price cuts, for example, which are also likely to bite in the current quarter.

Nevertheless, despite the warnings, HP stuck with its full year FY06 revenue outlook of about \$91 billion, in line with current analyst expectations. This would put HP on track for a virtual tie with IBM, as least as far as our IBM 2006 forecast is concerned (see "[Steady As She Goes](#)," Apr 2006).

But that's where the similarities stop. Big Blue is expected to clear about \$9.8 billion at the bottom line this year, while HP is hoping for full-year net earnings of just over \$5.6 billion. And, of course, both computer industry giants are eclipsed by Microsoft's \$14 billion-plus net profit, almost equal to the combined IBM and HP net earnings.

But HP does stand out among all American rivals when it comes to stock market appreciation since Mark Hurd took over in April 2005 (see "[Up the Mount Market Cap](#)," Apr 2005). With the 69% rise in its stock market high relative to the low a year ago (5/16/05), HP is the best performing North American major IT company.



Interestingly, IBM is dead last, with only 23% high/low differential (see the above chart). But even Big Blue is looking good compared to Microsoft and Dell each of which have just set (today 5/16/06) their 52-week and multi-year lows. Ironically, one year ago today - May 16, 2005 - was the 12-month nadir for nine of the above dozen major IT stocks we follow.

So while most of the industry is zigging (upward), Microsoft and Dell are zagging (downward). Yesterday's Wall Street darlings have turned into pumpkins.

 [Annex clients: Click here for HP units' detailed results and forecast tables \(PDF\)](#) 

Happy bargain hunting

Bob Djurdjevic

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