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Analysis of HP's Third Fiscal Quarter Results

Firing on All Cylinders

Stock Sets New Multi-Year Record in After-hours Trading

SCOTTSDALE, Aug 16 - Hewlett-Packard Corp. is firing on all cylinders. Revenue was up 5% (6% in constant currency) to \$21.9 billion in the company's third fiscal quarter, while net income surged 17-fold to \$1.4 billion. (Last year's net numbers was low because of a tax charge that HP took when it repatriated \$14.5 billion of foreign earnings in the U.S.). Operating margin jumped by 2.5 points, and the company also generated \$2.6 billion in cash from operations.



No wonder Wall Street applauded the results that slightly exceeded its expectations, sending initially the HP stock up 4.4% to over \$36 in after-hours trading. The stock had also risen by almost five points in the last five trading days in advance of the latest earnings release.

But what was particularly impressive about this HP quarter was that the results were so *balanced*. Revenue growth and profitability improvements were achieved in all geographies and across all of the company's major business segments. This was the fifth consecutive quarter that HP has beat Wall Street expectations during Mark Hurd's 16-month tenure as CEO.

In other words, almost everything Hurd has touched since taking over HP's helm seems to have come out smelling like roses. "You will see us spend money to lower our cost structure, and and save money to invest in growth," Hurd told the analysts.

And they loved it. HP shares added almost two additional points of growth after Hurd's remarks during the teleconference with analysts.



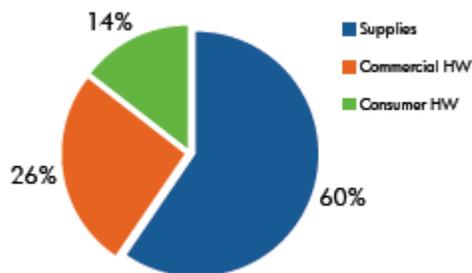
For, that's the kind of stability and predictability Wall Street adores. Just take a look at the above five-year stock chart. "Up, up and away" would be a suitable title for it since Hurd took over in April of 2005. HP shares are up about 80% since that time.

Commenting about the latest results, Hurd said, "I am particularly pleased with this performance because this is typically seasonally our weakest quarter. We continue to focus on profitable growth, and continue to execute well in sweet spots of the market - consumer, mobility and emerging markets."

Business Segment Analysis

Imaging & Printing Group (IPG). HP's most profitable unit grew by 5% in the third quarter to \$6.2 billion on double digit growth in unit shipments (up 15%). Operating margins increased from 13% a year ago, to 14.2%.

Q3 FY06 revenue by business



August 16, 2006 <http://investor.hp.com>

Commercial printers led the surge with a 23% jump in unit shipments. Consumer printers rose by 13%. Supplies revenue, which accounts for the largest (60%) share of the total, grew by 9%.

Personal Systems Group (PSG). The PC unit was another stellar performer in the current quarter. Revenues surged by 8% to \$6.9 billion, surpassing the company average growth,

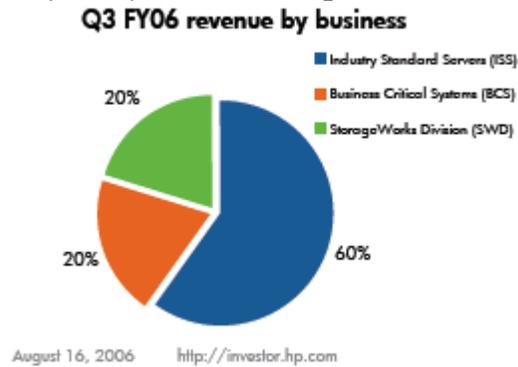
Q3 FY06 revenue by business



on a unit shipments increase of 14%. Operating profit also jumped from 2.6% a year ago, to 4% in the latest period.

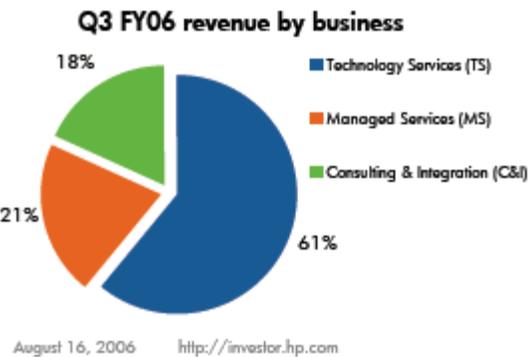
Consumer client revenue led the surge, rising 17%. Commercial business was up 4% year-over-year.

Enterprise Storage & Servers (ESS). HP's enterprise business also increased, albeit at a lower rate than other units (up 3% to \$4.1 billion). But HP's focus on improved profitability paid off. Despite a relatively slow growth, operating margin almost doubled - from 3.7% a year ago, to 7.2% in the latest quarter.



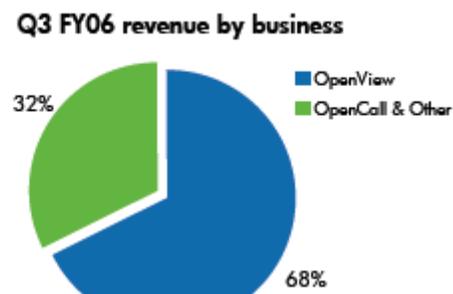
Intel-based server revenues, which account for 60% of the total ESS revenue, rose by 6%, with blade business surging 37% since a year ago. But "business critical" servers' revenue declined 6%, mostly due to the drop off in the PA-RISC and Alpha business. Storage revenues rose 5%, in line with HP's overall growth rate.

HP Services (HPS). HP Services' revenue rose 1% year-over-year to \$3.9 billion (up 2% in constant currency). As with ESS, despite a lower than average revenue growth, this HP unit also showed improved profitability. HPS' operating margins rose from 6.7% a year ago to 9.4% in the latest period.



Within HPS' lines of business, "Managed Services" (outsourcing) revenue grew by 9%, while Consulting & Integration business rose by 3%. The Technology Services (maintenance) business, HPS' largest segment which accounts for 61% of total revenue, declined 1%.

Software. HP software, a perennial money loser in the pre-Hurd era, swung into profits in the fourth quarter of the last fiscal year, and it stayed in the green. Furthermore, this is now HP's fastest growing business, even before the Mercury acquisition. In the latest quarter, HP software grew by 30% to \$318 billion.

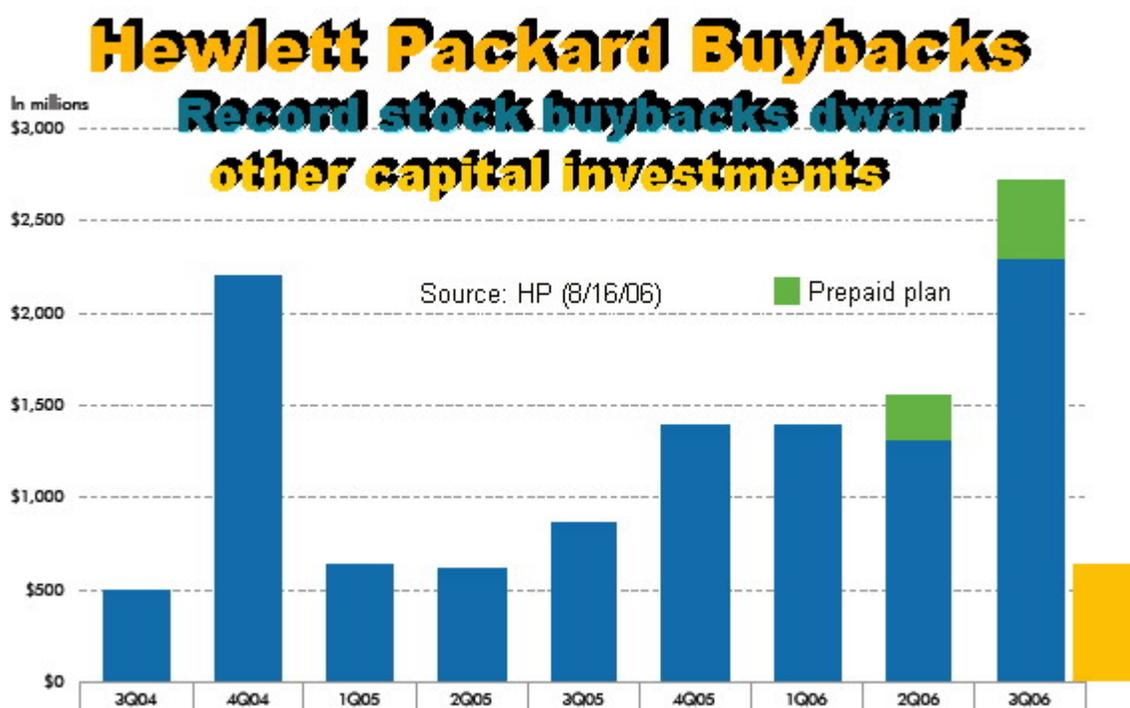


After the Mercury business is integrated within HP, Hurd said he expected this to be about a \$2 billion unit, growing at 10% to 15% per year, and delivering an operating margin of about 20%.

Talk about turning a loser into a winner!

Stock Buybacks

Having generated a ton of cash (\$2.6 billion cash flow) for its shareholders, the company's Board decided to share some of this wealth with its owners. Stock buybacks exploded in the latest period to over \$2.7 billion, exceeding the previous high-water mark, set in the fourth quarter of 2004.



This amount dwarfs the company's capital expenditures on plant and equipment which amounted to \$623 million in the current quarter.

Outlook

For the current quarter, ending October 31, HP said it would post revenue of \$24.1 billion, and operating earnings of 61 cents to 63 cents a share. Analysts had expected revenue of \$24.05 billion and operating earnings per share of 59 cents on average. For the full fiscal year, H-P projected operating earnings per share of \$2.31 to \$2.33, also above analysts' expectations of \$2.07.

Coupled with surging stock buybacks, and better-than-expected third

quarter results, this raising of the bar for the year-end results helped push the stock up in after-hours trading. It remains to be how much of the 6% gain the stock will keep in regular trading tomorrow morning.

Either way, HP shares are on an "up, up and away" long-term curve.

Happy bargain hunting

Bob Djurdjevic

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