

ANNEX RESEARCH

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INDUSTRY TRENDS

Updated 11/17/06, 8:00AM PDT; adds "[Up Mount Market Cap](#)"...

Analysis of Hewlett Packard's Fourth Quarter Results

New King of the Hill

HP Continuing to Fire on All Cylinders: Revenues and Profit Margins Growing Across All Product Lines and Geographies

SCOTTSDALE, Nov 16 - It is official now. Meet the new king of the (IT) hill: Hewlett Packard. HP is now the largest IT company in the world (\$91.7 billion vs. \$90 billion for IBM). More importantly for its shareholders, HP got to the top while improving profitability across its business lines. The fourth quarter fiscal 2006 results showed that the company is firing on all cylinders (which was also the theme of [our last quarter's report on HP](#)). All of its major product lines in all geographies grew their revenues as well as profit margins.



Fourth quarter revenues were up 7% to \$24.6 billion, while net earnings more than four-fold since a year ago to \$1.7 billion. And cash flow from operations more than doubled to \$3.2 billion (from \$1.4 billion last year).

"All of this resulted in the most balanced (business) segment profitability performance in many years," said Mark Hurd, HP's CEO, in a post-earnings teleconference.

Asked by an analyst to comment about the company's cost structure, Hurd replied that the company was not about to rest on its laurels, despite the significant profit margin improvements.

"We certainly aren't taking any victory laps around here," he said. "We've got work to do. But we are pleased with the progress."

For the full fiscal year 2006, that ended Oct 31, HP earned \$6.2 billion, up nearly three-fold from \$2.4 billion a year ago, on revenues of \$91.7 billion, up 6% over the corresponding figure in fiscal year 2005. That's slightly higher than Wall Street expected, the sixth time in a row that HP "beat the Street" since Mark Hurd took over as CEO in April 2005.

HEWLETT-PACKARD CO
as of 15-Nov-2006

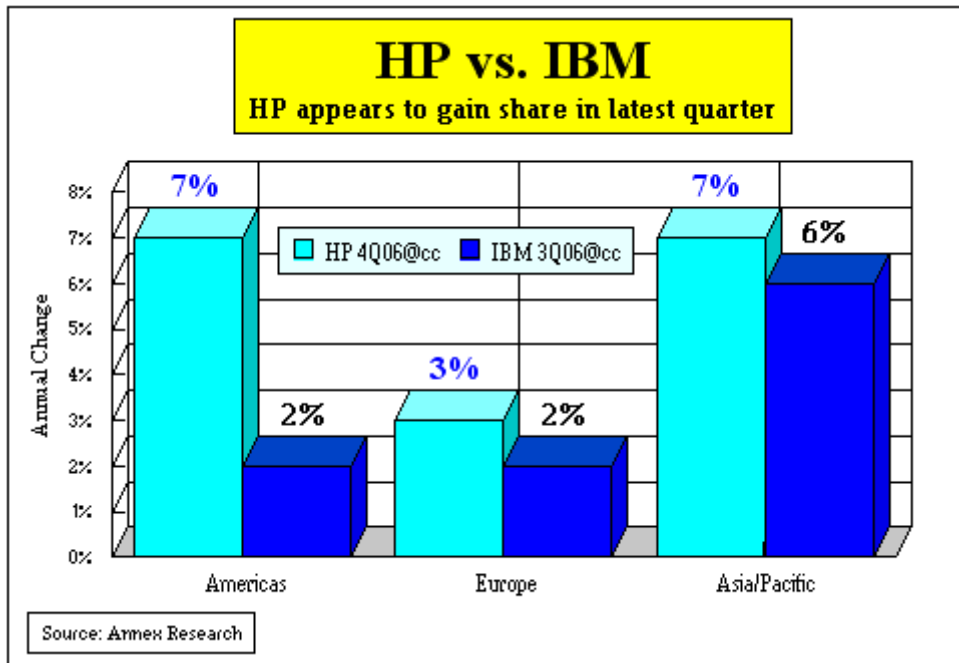
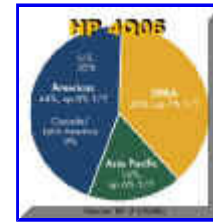


Naturally, Wall Street loves getting beatings like that. And the HP stock keeps setting multi-year highs, nearly doubling in value during Hurd's tenure so far.

The fact that the company managed to achieve that in the latest quarter in which its boardroom scandal dominated the news, attests as to the importance of building trust on Wall Street. Hurd's cache of personal credibility acted as a stabilizer in the storm. That's a lesson other CEOs can take on how to manage a business in a crisis. Keeping up the stock's upward momentum amid the boardroom maelstrom is, in our books, as big a feather in Hurd's cap as anything else he has accomplished in his 18 months at the HP helm.

Business Segment Analysis

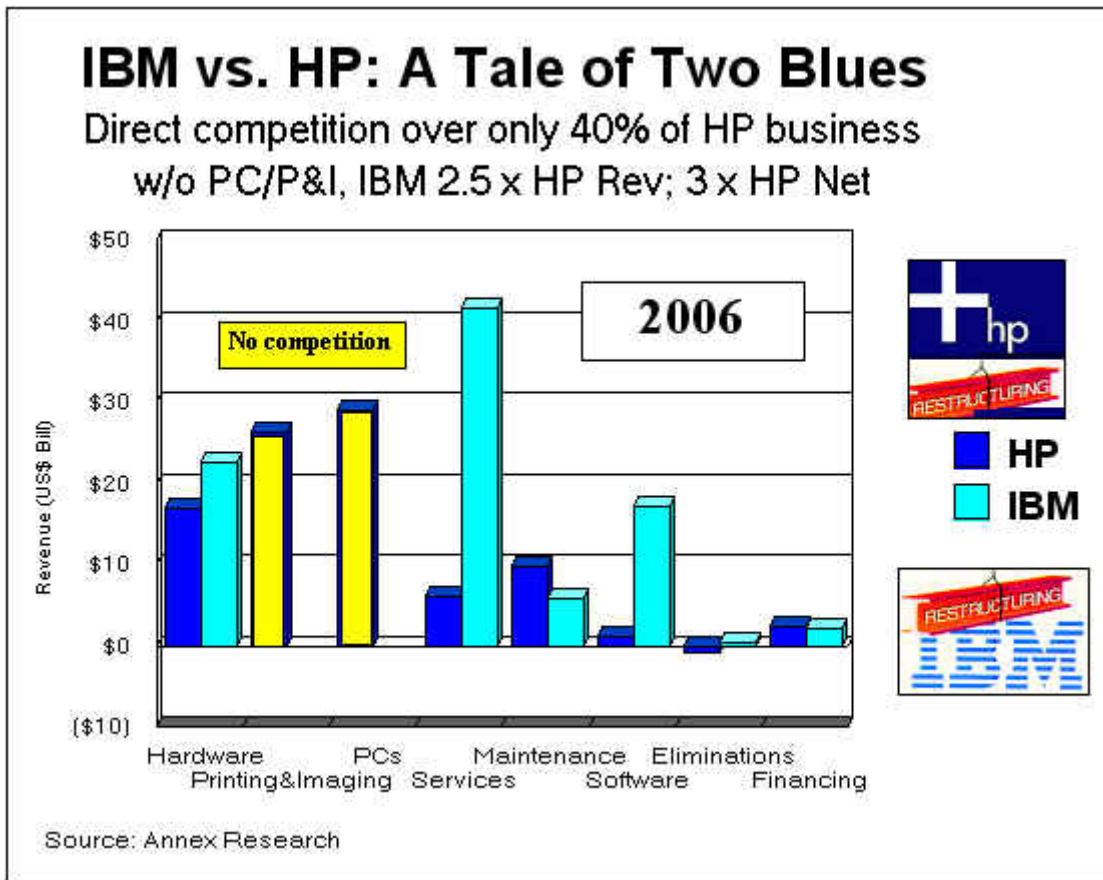
Geographies. HP's business in the Americas grew 8% to \$10.8 billion in the fourth quarter, while revenues in Europe rose 7% to \$9.7 billion, and Asia/Pacific was up 6% to \$4.0 billion. In constant currency, the Americas grew 7%, Europe rose 3%, and while Asia/Pacific grew 7%.



Hurd said HP believed it had gained market share as a result. That certainly appears to be the case relative to Big Blue in terms of revenues, even in IBM's otherwise excellent third quarter (see "[A Slam Dunk Quarter](#)", Oct 2006). In constant currency, Big Blue's business in the Americas and Europe rose 2%, while in Asia/Pacific it increased 6%. So HP's revenue growth rates have exceeded those of IBM in every major geography.

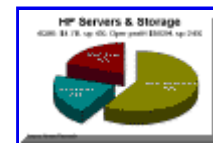
IBM vs. HP: A Tale of Two Blues - Updated

Last June, we brought you a comprehensive analysis of IBM vs. HP, on the eve of a change of leadership atop the IT industry (see "[A Tale of Two Blues,](#)" June 2006). Now, here's an update to it.

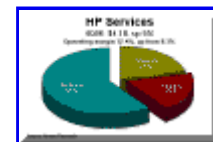


As you can see from the above chart, one has to be careful not to jump to conclusions regarding HP's apparent revenue share gains. A segment-by-segment market share analysis would likely yield vastly different results, more in IBM's favor. That's because IBM and HP compete directly only over about 40% of HP's business (IBM is not in the PC and desktop printing business). Which means that in an apples-to-apples comparison of the markets in which the two companies do compete, Big Blue is actually about 2.5 times the size of HP revenues, and about three times its net earnings. (For a table detailing this comparison, [Annex Clients should click here](#)).

Hardware. Take the computer hardware, for example, a \$17 billion-business for HP, and a \$23 billion-segment in IBM's case. As you saw in Big Blue's last report card, its (STG) hardware business is growing at 10%. HP's Enterprise Servers & Storage (ESS) unit, on the other hand, reported a 4% growth in the latest period (we figure ESS had about a 2% revenue increase for the full fiscal year).



Services. But HP did gain share on IBM in the services market. Its services business grew by 5% in the latest quarter to \$4.1 billion, while IBM Global Services revenues rose 3% (2% in constant currency) to \$12 billion in Big Blue's third quarter.



"We are very particular about how we grow our services business," said Hurd during the Q&A with analysts. He added that the company was rather "picky" about the kinds of deals it chooses to pursue. No wonder that its services operating margins surged from 8.3% last year to 12.4% in its fourth quarter.

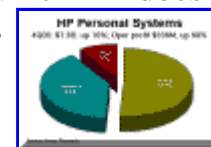
The Managed Services (outsourcing) revenue was up 16%, while Consulting and Integration revenue rose 7%. The Technology Services (maintenance) was flat.

Software. Meanwhile, back to IBM vs. HP comparisons, HP's (much smaller) software business outgrew IBM's by 14% to 9% in the latest period. But HP software will quickly gain respectability in terms of size, too, as it digests the just-completed acquisition of Mercury. After the Mercury business is integrated within HP, Hurd said back in August that he expected this \$349 million-unit to become about a \$2 billion operation, growing at 10% to 15% per year, and delivering an operating margin of about 20% (see "[HP Firing on All Cylinders](#)," Aug 2006).



Other Business Segments

Imaging & Printing. As for the other business segments in which HP does not compete with IBM, the Imaging & Printing (I&P) unit continues to be HP's most important profit contributor by far. With revenues of over \$26 billion, this is HP's second largest unit. But its \$1.1 billion operating profit and a 14.8% margin make it the No. 1 at the bottom line.



Meanwhile, I&P is also growing in line with HP. In the fourth quarter, its revenues rose 7% to \$7.3 billion. Within that total, the supplies grew 9%, business hardware revenue increased 8%, while consumer hardware rose 2%.

Printer unit shipments increased 17% year-over-year, with consumer printer hardware units up 16%, and commercial printer hardware units up 20%.

PCs. The \$29 billion-PC unit is the company's largest in terms of revenues. And it also grew in double digits (up 10%) to \$7.8 billion in the latest quarter. But this is also arguably the company's most improved operation. For, its operating profit surged 68% to \$336 million in the latest quarter, up from \$200 million the year before.



Notebook revenue grew 24% while desktop revenue was flat. Commercial client revenue grew 4% year-over-year, while Consumer client revenue increased 19%.

Summary & Outlook



HP executives estimated that the full year FY07 revenue would be approximately \$97 billion, up 6% from the just-finished fiscal year. Considering the robustness of demand in the global IT industry and the Mercury acquisition (and thus addition to the company's financial), that appears to be a conservative forecasts.

But then, setting the bar low enough is how one gets to exceed expectations. And HP's Hurd has proven to be a master at that.

[Annex clients: Click here for detailed HP forecast tables](#)

Happy bargain hunting!

Bob Djurdjevic

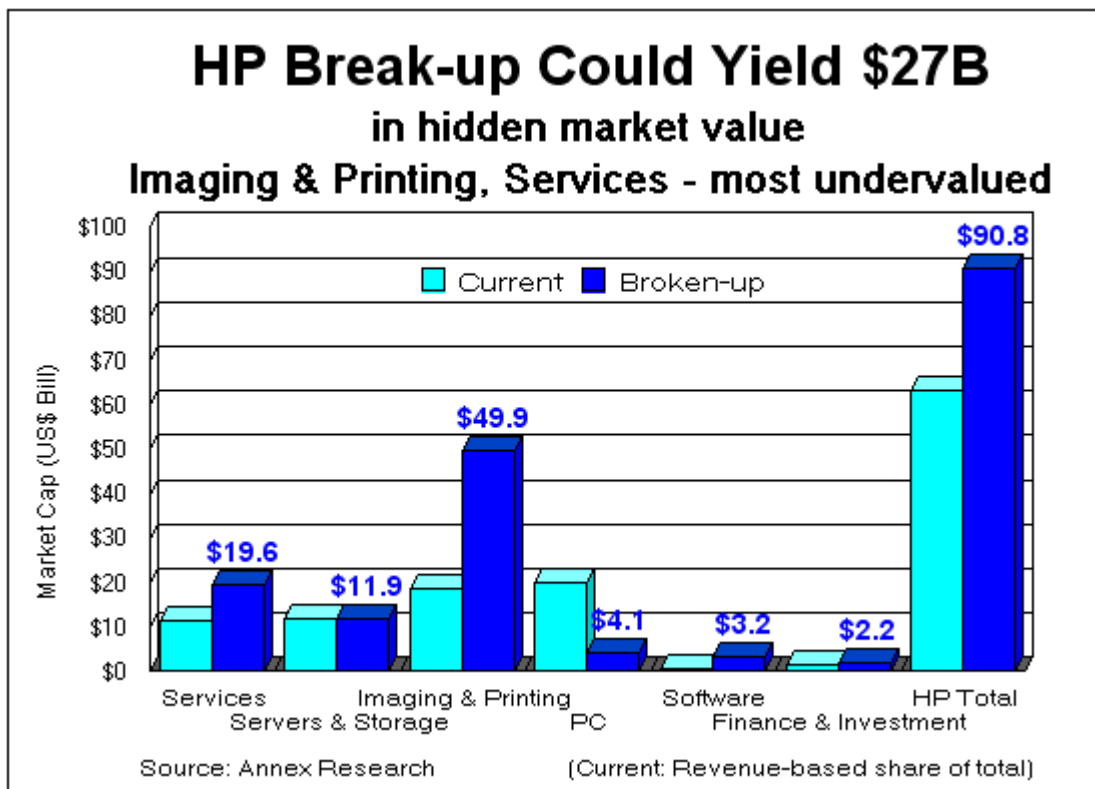
"Up Mount Market Cap" - An Update

SCOTTSDALE, Nov 17 - When Mark Hurd took over as HP CEO on Apr 1, 2005, the HP stock was trading at just a little over \$21 per share. So in a piece titled "[Up Mount Market Cap](#)" (Apr 7, 2005), we offered some advice about how to get the HP shares moving up.

"Increasing the shareholder value was the last on the list of attributes the HP board was looking for, according to what Patricia Dunn, Chairwoman of the Board, said as she introduced Mark Hurd as the new CEO. We think it should be first, or close to first. The reason is that HP's is one of the most undervalued stocks in the IT industry."

(An excerpt from "[Up Mount Market Cap](#)," Apr 2005)

We figured the company was worth about \$91 billion, while its actual market cap was only about \$64 billion at the time.

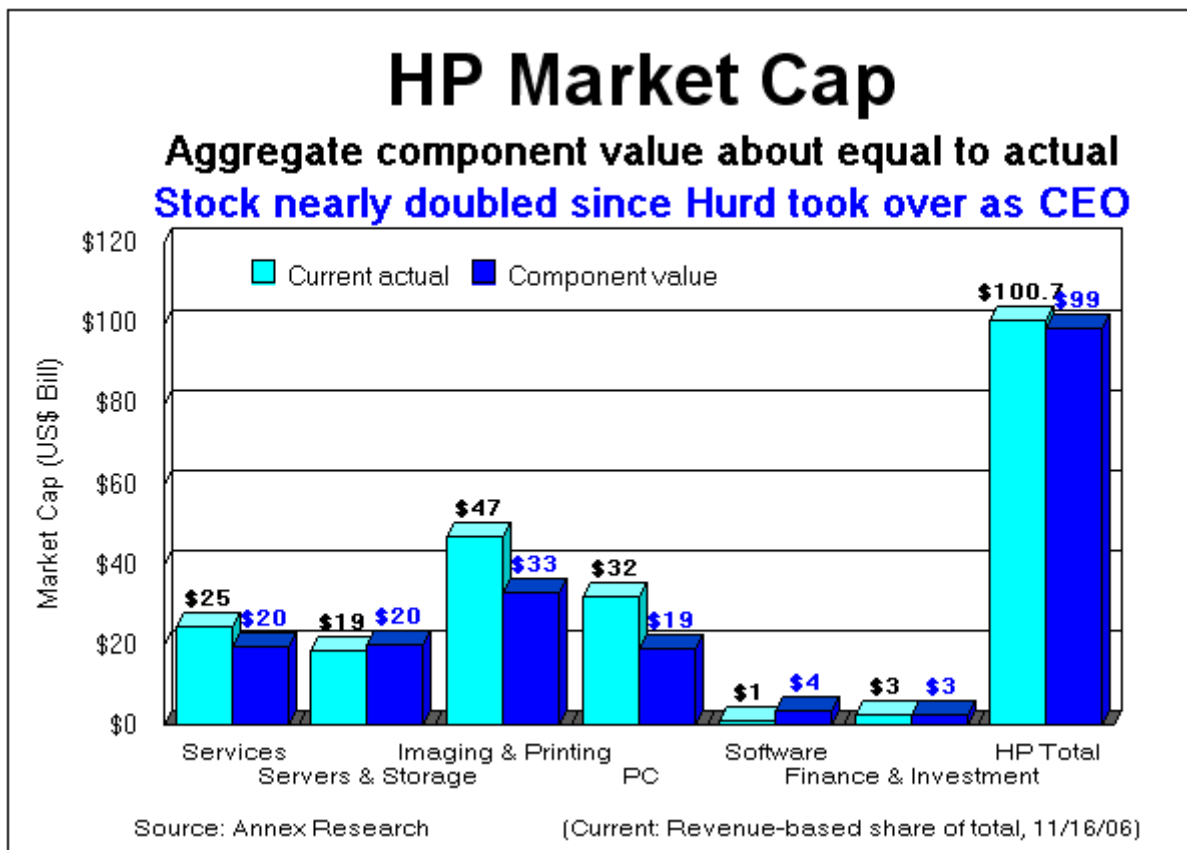


So we analyzed at the time a break-up scenario for HP, which is what some Wall Street pundits were recommending at the time, and concluded that the potential carrot (a \$27 billion market cap boost) was not sufficient justification for it.

"Breaking up the company is not as compelling an option at HP as it was with IBM in 1996. The relatively modest (44%) stock price gain may be attainable by other means, too, while keeping the company together."

(An excerpt from "[Up Mount Market Cap](#)," Apr 2005)

Well, 18 months later, everyone can see that indeed, there was another way of boosting shareholder value and scaling Mount Market Cap.



Today, we figure the company is worth about \$99 billion, based on our analysis and valuation of HP's individual business units. Which is roughly what its current market cap is (\$101 billion). In other words, for once, Wall Street has got it right. But not for long...

Wall Street: Perverse and Insatiable

Consider this mornings action in HP stock, for example. Based on its excellent fourth quarter results, you might expect the stock to be up, right? Well, think again.



HP shares slip in early trading despite excellent 4Q report

HP shares are down about a point in early morning trading. Surprised? You should not be. Here's what we said yesterday afternoon to a reporter even before the HP fourth quarter earnings were released:

Guess if there is a lesson other CEOs can learn from this Hurd example, it is the importance of building trust on Wall Street. His cache of personal credibility acted as a stabilizer in the storm. In my books, keeping up the stock's upward momentum amid the boardroom crisis is as big a feather in Hurd's cap as anything else he has done in his short time at HP.

But here comes the catch now. Is there such a thing as "too much credibility?" No one can walk on water, yet Wall Street just about seems to expect him to do that every quarter.

After you exceed the Wall Street expectations as many times as he has already done, guess what... they expect you to exceed them again. And if you "just" meet them, or exceed them only slightly, the market may react as if you missed the target and sell off the stock.

Perverse? Perhaps. But that's Wall Street for you.

In short, what I am saying is - I would not be surprised to see a sell-off in the HP stock unless after the results come out unless the 4Q is really another whopper of a strong quarter.

(An excerpt from comments to a reporter *prior* to HP release, 11/16/06)

Well, now you can see for yourself how perverse and insatiable Wall Street can be. Even "excellent" is not good enough if you keep excelling. That's the banality of success. Can you imagine what would happen if HP ever stumbled?

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