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Annex Bulletin 2007-31

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## Profitable Growth Continues

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SCOTTSDALE, Aug 16 - HP did it again. Ever since Mark Hurd took over HP's helm in April 2005, he has been raising the bar of expectations one quarter only to exceed it the next. And he did it again in the company's third fiscal period. Excluding one-time charges, the company earned 71 cents per share, five cents higher than the average Street estimate. Revenues jumped by 16% to \$25.4 billion, more than 5% or over \$1 billion higher than what analysts had expected.

The "hero of the quarter" was again HP's PC line of business, whose revenues surged by 29% to \$8.9 billion. HP's results are even more impressive when one looks at its PC profit margins. They were also up, and by quite a bit - from 4% of revenue a year ago, to 5.8% in the latest quarter (see the chart).

With Dell struggling, and Lenovo sputtering in the U.S. market, HP results are showing how wonderful it is to have a near monopoly in any business, even the low margins one, like the PC.



Notebooks soared by 54%, while desktops jumped by 12%. And it was the consumer

side of the business that led the surge, up 46%. The commercial PC sales weren't too shabby, either, rising by 19%.

In short, this was such a gangbuster quarter for the HP PC business that the company's new CFO, Cathie Lesjak, felt compelled to pour some cold water on the possible overheated market enthusiasm, while raising the overall fourth quarter outlook.

"We do not believe it is prudent to set investor expectations that our Personal Systems business can continue to grow at almost three times the market rate," she said, "nor do we think it appropriate to build a cost structure on that basis."



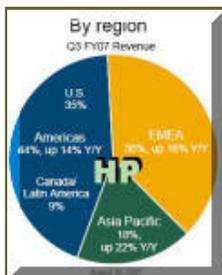
It worked. The HP stock surged initially by about three points in after-hours trading following the release of the 3Q results, only to give up most of those gains in the aftermath of the conference with analysts. It still finished up for the night at \$46.45, 40 cents higher than the Aug 16 closing price.

It was a modest gain considering how balanced HP growth has been, and given that the company raised its earnings outlook to \$0.80-\$0.81 per share, a 18% to 19% growth year over the prior year's fourth quarter. The HP CFO also guided the Street to 4Q revenues of \$27 billion to \$27.2 billion, a relatively conservative 10% to 11% year-over-year increase considering the recent track record. And the company's CEO also finished on a bullish note.

"We had a strong quarter characterized by our strongest revenue growth since 2000, share gains in our key businesses, solid expense discipline, operating margin expansion and significant share repurchases," summed up Hurd. "I am confident that we can continue to execute with discipline and post a strong close to the year."

Yet the relatively small stock increase illustrates just how bearish the stock market mood has become. Even a company with stellar results, such as HP, only gets meager credit in share prices.

### Balanced Growth



The company deserved better than that. For, all of its lines of business in all geographies grew in the third quarter, and all of them reported improved profitability, too.

The "BRIC countries" (emerging markets in Brazil, Russia, India and China), for example, grew by 35%. They now account for 8% of the company's revenues, according to Lesjak, the CFO.

In terms of geographies, Asia-Pacific was up 22%, EMEA grew by 16% and Americas' revenues increased 14% (see the chart). Can't ask for more balanced double-digit growth, can you?

**Imaging & Printing Group's (IPG)** revenue grew 8% year over year to \$6.8 billion. On a year-over-year basis, supplies revenue

Q3 FY07 revenue by business

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was up 9%, commercial hardware revenue grew 6% and consumer hardware revenue rose 10%. Printer unit shipments increased 10%.

Operating profit was \$981 million, or 14.5% of revenue, up from \$884 million, or 14.2% of revenue, in the prior-year period. In other words, the company's most profitable unit did its share of heavy lifting to support HP's bottom line.



Ditto re. the smaller and less profitable **Enterprise Storage and Servers (ESS)** unit. It reported revenue of \$4.5 billion, up 10% from a year ago. The Intel server revenue increased 16%, with blade soaring by 81%. Storage revenue grew 6%, while tape business declined. The "business critical" (mostly Unix) server revenue declined 3%.

But the ESS operating profit was \$464 million, or 10.2% of revenue, up from \$296 million, or 7.2% of revenue, in the prior-year period. So overall, a very solid quarter for HP servers and storage.

**HP Services (HPS)** third quarter revenue increased 8% to \$4.2 billion. It is the new quarterly record for this HP business unit, exceeding even last year's 4Q total, traditionally the biggest quarter of the year (see the chart).



The Technology Services business grew 5%, while Consulting and Integration revenue rose 11%. Outsourcing revenue jumped 11%.

Operating profit was \$430 million, or 10.3% of revenue, up from \$364 million, or 9.4% of revenue, in the prior-year period. So HPS is another unit that keeps raising the bar and making the jump over it quarter-after-quarter.



**HP Software's** growth was boosted by last year's acquisition of Mercury Interactive. As a result, its revenue surged by 74% to \$554 million.

As for the company's pre-Mercury software, the OpenView grew 14% excluding the new acquisition.

The HP Software profit was \$81 million, or 14.6% of revenue, up from \$13 million, or 4.1% of revenue, in the prior-year period - a huge jump. So the software margins are now on a par with the perennial HP profit champ - IPG. But this business unit is 12 times smaller than the printing division,

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so its impact on the bottom line is commensurately less significant.

### Summary: Profitable Growth to Continue?

So HP continued to deliver profitable growth to its shareholder, quarter after quarter, delighting them with upside surprises each time. How long can this continue, especially in light of the financial credit crunch and jittery investors? One analyst posed a question like that to Mark Hurd.

"The obvious question on everybody's mind is whether you have seen any changes in demand out there related to the recent turmoil in the financial markets?" Richard Gardner of Citigroup asked the HP CEO.

Hurd tried to duck the question by pleading "I am not an economist."

"I don't have any data that would indicate to me any material change in demand in any segment or any market," he added. "So I will just leave it at that. Obviously, we will continue to monitor things. But that is what we have seen. So I will leave it there."

Well, every CEO has to either "be an economist," or have them on his executive staff to help him guide the corporate ship through turbulent waters. So not having an economic degree is hardly an excuse for not having an informed opinion. And Hurd clearly sounded uncomfortable voicing his.

We don't know if that's typical among the Dow Jones Industrials and the S&P 500 CEOs. We have a feeling it may be. Who wants to out on a limb and make a forecast that may be interpreted as gloomy, adding more fuel to the fire of market despair? But for the sake of HP shareholders, we certainly hope that the company does have a "Plan B" - what to do if the strong demand is has been experiencing starts to dry up.

Knowing Mark Hurd and seeing his track record in the last 2 1/4 years, we have a feeling he does have a "Plan B" but would rather not talk about it. Fair enough.

The company's optimistic outlook for the fourth quarter, however, suggests that the "Plan A" (profitable growth) is still something everyone is banking on.

*Happy bargain hunting!*

*Bob Djurdjevic*

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