

HPQ

10/10/09 | current price: \$49.76 | 12-month price target: \$60 (24% premium)

INVESTMENT THESIS

HPQ has demonstrated impressive ability to position itself appropriately for long term growth. They have expanded into businesses with higher margins and are well positioned to grow faster than the market in their existing divisions. As technology spend begins to come back in late 2009 and early 2010, HPQ is well positioned to outpace the market and yield positive returns.

COMPANY DESCRIPTION

- Global provider of technology products, solutions and services
- Broad product offering in several key areas across the technology landscape including Personal Systems (33% of revenue); Services (26% of revenue); Imaging and Printing (22% of revenue); and Enterprise Storage and Servers (15% of revenue)

INVESTMENT MERITS

- **Cyclical bottom in technology industry has passed and HP has positioned itself well with a broad portfolio of products ensuring it will grow faster than the market**
 - Estimates are that IT spend will grow ~7% in 2010
 - HPs products span the consumer and enterprise segments with several market leading products
 - Actively gaining market share across the technology landscape – recently beat Dell to be biggest PC vendor in the US and surpassed IBM to be biggest blade computer vendor
 - The recent EDS acquisition allows it to further diversify its revenue and also promotes significant cross-selling between the hardware and services groups
 - Strong global presence (over 69% of customers outside US) helps HP mitigate effects of a potentially slower recovery in the US
 - Hardware refresh cycles that were skipped last year and new products (e.g., Windows 7) will drive increased adoption of technology over next 12-18 months – particularly in printer segment
- **Recent cost cutting has helped HP increase margins in recent quarters**
 - EDS acquisition increased mix of high margin products
 - After acquisitions, HP embarked on large cost cutting initiative trimming >\$300M run-rate costs
 - Reduced workforce by 16K with another 9K promised in next few quarters
 - Several efficiencies found in real estate (e.g., got consultants to work out of their homes)
 - Leadership has committed to improving operating margins in recent quarters – current leadership has not missed earnings guidance for 16 quarters lending credence to their assertion
 - Increasing sales in printer and server divisions helps HP reduce margins given high fixed costs of manufacturing and increasing power over suppliers
- **Trading at reasonably low valuation compared to comps and historical averages**
 - Average is 20-25x P/E and 1-1.2x P/Sales vs. current 16x P/E and 1x P/Sales

INVESTMENT RISKS

- **Technology spend does not come back as expected in 2010**
 - Highly dependent on macro environment
 - Less likely because firms have already gone ~12mos. without significant spend on technology indicating servers and computers are getting old
 - Most regions have already picked up through the end of Q3, the only lagging region is EMEA which has yet to show concrete signs of coming back
- **Component prices could increase and/or shortages could occur**
 - Thus far have not seen significant evidence of suppliers cutting back production facilities – most plants are just getting to full utilization
 - If this happens it would indicate that demand is picking up much faster than expected
- **Strong competition from other players**

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- Cisco is entering server market with blade server product – this is still a distant vision but could impact HPs sales in medium to long term
 - Oracle's acquisition of Sun disrupts some of the existing relationships that HP had with Oracle which could mean HP sells fewer servers to Oracle customers – however analysts believe Oracle might sell hardware assets with HP being a leading candidate to purchase them
 - Increasing price competition in the industry is always a threat
- **Valuation does not increase and stays at depressed levels**
 - For this to happen, street would need to discount long-term growth potential and seek higher discount rate for investment

PRICE TARGET \$60

- **Assuming multiples return to historic levels, HPQ should be priced appropriately at \$60 in 12 months**
 - Model assumes conservative figures for growth of 6% (street is at 4% and Gartner/Goldman are at 8%)
 - Moderate gross margin expansion was assumed as well to 2006/2007 levels – margins will likely be more than this given recent cost cutting initiatives
- Bear case assumes top line revenue growth of 2% from an already depressed 2009 basis

Purchase Price Analysis		
Current Share Price	\$	49.76
FD Shares outstanding (M)		2,371
Beta		1.00
FD Market Cap (\$M)	\$	114,689
Plus: Net Debt (\$M)	\$	(14,625)
Enterprise Value (\$M)	\$	100,064

Price Target	
Price Target	\$60.00
Difference	24%
Bear Case Price	\$40.00
Difference	-18%

Growth Sensitivity		
2010 Rev	Implied	
Growth Rate	EPS	Support
2.0%	\$4.04	Bear Case (10x P/E)
3.0%	\$4.14	
4.0%	\$4.24	Street Consensus
5.0%	\$4.32	
6.0%	\$4.42	My Estimates
7.0%	\$4.50	
8.0%	\$4.61	Gartner / Goldman

Earnings / Valuation Information - ADN Forecasts							
	2006A	2007A	2008A	2009 Q4 E	2009E	2010E	2011E
Financial Performance							
Revenue (\$M)	\$ 91,658	\$ 104,286	\$ 118,364	\$ 29,768	\$ 113,370	\$ 120,225	\$ 129,843
EBITDA (\$M)	\$ 9,880	\$ 12,413	\$ 14,296	\$ 4,434	\$ 14,935	\$ 17,790	\$ 19,053
Net Income (\$M)	\$ 6,198	\$ 7,264	\$ 8,329	\$ 2,611	\$ 9,248	\$ 10,478	\$ 11,230
Free Cash Flow (\$M)	\$ 7,923	\$ 5,729	\$ 10,805				
EPS (GAAP, \$)	\$2.18	\$2.68	\$3.25	\$1.10	\$3.90	\$4.42	\$4.74
Growth							
Revenue		13.8%	13.5%	8%	-4.2%	6.0%	8.0%
EBITDA		25.6%	15.2%	32%	4.5%	19.1%	7.1%
Net Income		17.2%	14.7%	23%	11.0%	13.3%	7.2%
EPS		22.9%	21.3%		20.0%	13.3%	7.2%
Profitability							
Gross Margin	23.6%	23.6%	23.4%		22.7%	24.0%	23.6%
EBITDA Margin	10.8%	11.9%	12.1%		13.2%	14.8%	14.7%
Net Margin	6.8%	7.0%	7.0%		8.2%	8.7%	8.6%
ROE	16.5%	18.9%	21.5%				
Valuation Multiples (end of period)							
Price / Sales	1.1x	1.1x	0.7x	1.0x	1.0x	1.0x	
Price / Earnings	18.9x	18.8x	11.2x	16.3x	12.4x	10.9x	
EV / Sales	1.0x	1.2x	0.8x	0.9x	0.9x	0.8x	
EV / EBITDA	9.6x	10.5x	7.0x	6.9x	6.7x	5.6x	
Price / FCF	11.7x	12.6x	6.7x	8.4x			
FCF Yield	5.6%	5.1%	10.8%				

Consensus Estimates				
Revenue (\$M)		\$ 29,768	\$ 113,376	\$ 118,027
Net Income (\$M)		\$ 2,702	\$ 9,296	\$ 10,161
EPS (GAAP, \$)		\$ 1.12	\$ 3.81	\$ 4.28

Share Price Forecasts - ADN Forecasts							
		2010	2011		2010	2011	
Price / Sales	0.70x	\$ 35.49	\$ 38.33	Price / Earnings	11.0x	\$ 48.61	\$ 52.10
	0.90x	\$ 45.63	\$ 49.29		13.0x	\$ 57.45	\$ 61.57
	1.10x	\$ 55.78	\$ 60.24		15.0x	\$ 66.29	\$ 71.05
	1.30x	\$ 65.92	\$ 71.19		17.0x	\$ 75.13	\$ 80.52
	1.50x	\$ 76.06	\$ 82.14		19.0x	\$ 83.96	\$ 89.99