

COMPAQ® COMPUTER CORPORATION
1986 Second Quarter Report



*Sharp increases in sales, earnings
and gross profit percentage led the
company to an outstanding quarter...*

To Our Stockholders:



OMPAQ® Computer Corporation continued to achieve excellent results during the second quarter of 1986. Year-to-year sales and earnings rose substantially and our gross profit percentage, a measure of our overall manufacturing efficiency, reached an all time high.

We also introduced an additional operating system for our computers, invested in a company that makes fixed disk drives, and continued to build our international operations. To accommodate our growth, we acquired acreage to provide for future expansion of our Houston corporate and manufacturing facilities.

Financial Results

Sales for the quarter, our second best ever, were \$147.1 million, a 24% increase over sales of \$118.9 million for the second quarter of 1985. For the first six months of 1986, sales were \$291.1 million, an increase of 35% from the \$215.9 million during the first six months of 1985.

Net income for the second quarter rose to \$9.6 million, a 70% increase from the \$5.7 million in the corresponding period a year ago. Earnings rose to \$.31 per share on a fully diluted basis, compared with \$.19 in the corresponding period in 1985.

Net income for the six months ending June 30, 1986 was \$18.0 million, or \$.57 per share on a fully diluted basis, compared with net income of \$10.3 million, or \$.36 for the first six months of 1985.

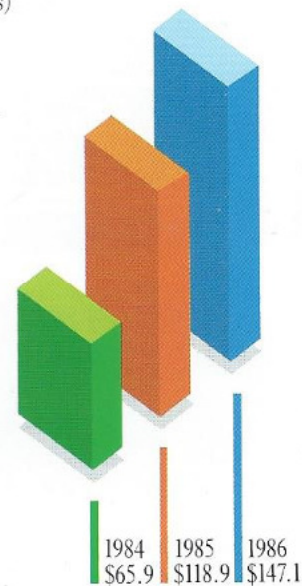
The improvement in net income is gratifying in light of substantial price reductions on our products in the first half of this year. The last reduction, in April, took from 3.5% to 26% off the suggested retail price of several of our products. A variety of COMPAQ options were also reduced in price.

In spite of these price reductions, our gross profit percentage reached a record 41.9% during the second quarter, compared to 31.5% in the same period a year ago. This sharp improvement reflects substantial gains in lowering the costs of manufacturing our products.

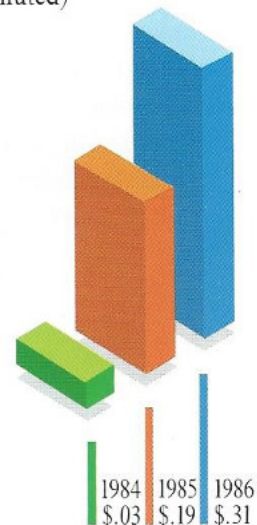
We have achieved these gains through engineering changes to the products themselves and by finding lower-cost sources of materials. We have also introduced numerous manufacturing efficiencies which will allow us to build increasing quantities of products while minimizing corresponding increases in people and overhead costs.

In other financial activity, COMPAQ Computer Corporation signed a new agreement July 18, 1986, for a \$100 million line of credit. The terms of the new agreement are more favorable than those of our previous \$80 million credit line. Because of our strong cash position, all of our new line of credit is available and unused.

Second Quarter Sales
(in millions of dollars)



Second Quarter Earnings Per Share
(Fully Diluted)





The new XENIX System V/286 adds greater versatility to our high performance computers and gives them additional appeal to large corporate customers.

New Software Introduced

In June, we brought an operating system to market called the XENIX[®] System V/286. This advanced software allows our personal computers based on the Intel[®] 80286 microprocessors to work together in new and versatile ways. With the system, three users at separate computers can work on the same program at the same time. They can all share data or exchange files from the same accounting package, for instance. By adding a board produced by another manufacturer, up to 16 people can access the system.

The XENIX system also enables people simultaneously to carry out multiple tasks on our computers. For example, a stockbroker can get information for clients, receive information from Dow Jones on his computer, and print out reports all at once.

The product was developed by Microsoft[®] Corporation, enhanced by COMPAQ Computer Corporation, and is a licensed derivative of the UNIX[®] System V operating system developed by AT&T[®]. It was available to Authorized COMPAQ Computer Dealers upon announcement.

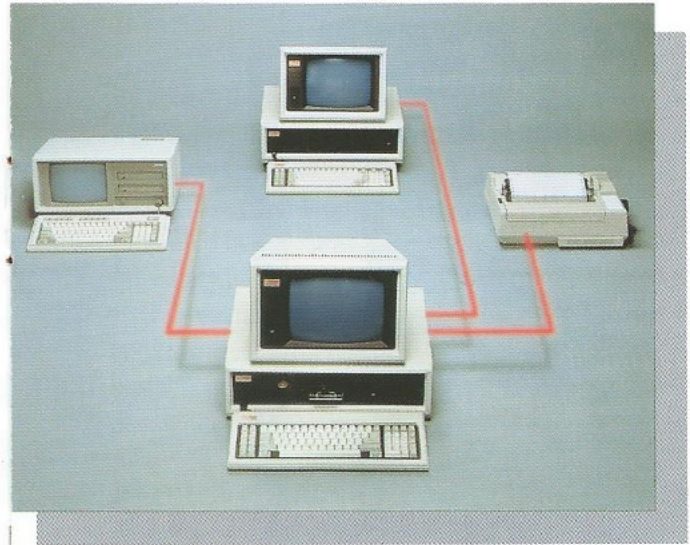
The XENIX system makes maximum use of the performance and features of the COMPAQ DESKPRO 286[®], including the 20-, 30-, or 70-megabyte fixed disk drives, internal fixed disk drive back-up and dual-mode monitor available on these products.

We do not expect sales of this software itself to add significantly to our revenues. Nor is this software meant to replace MS-DOS®, the operating system that we believe will continue to dominate the single-user, personal computer market. Rather, it will give our products additional appeal in certain organizations, such as the federal government and large corporations, where there is a demand for multi-user computing.

Equity Investment Announced

We invested during the quarter in Conner Peripherals, Inc., a company that manufactures Winchester-type fixed disk drives in San Jose, California.

The four month-old, privately-held firm will design and manufacture its own line of Winchester-type disk drives at its new California facility using advanced design technologies. It will provide us with another future source of high quality, advanced disk products. Conner will compete with other suppliers for our disk drive business.



The XENIX System V/286 allows three or more people, using the same program, to carry out a variety of tasks simultaneously.

SCARTATE IL N°1.



Come si chiama il Personal Computer professionale portatile più venduto del mondo? Non state ad indovinare, molto probabilmente dovreste scattare il primo nome che vi viene in mente. Non siamo parolosi del primo in ordine di tempo o del più famoso in Italia. Non è lui il N°1 che ci interessa. Avete un secondo nome? Ci dispiace, ma dovreste scattare anche questo. Con ogni probabilità si TRATTA soltanto e davvero di un N°2.

Non parliamo del N°1. Non viene dalla Silicon Valley e non è figlio del Sud Levante. Il PC professionale portatile più piccolo e più leggero, il vero N°1, viene dal Texas. Se questo vi fa venire in mente un nome, scartatelo. Il N°1 è quasi sconosciuto in Italia. Ma lo sarà ancora per poco, perché se girate pagina saprete tutto. Anche come si diventa N°1.

AFFERRATE IL N°1.



Compaq. Questo è il nome del PC professionale portatile più venduto nel mondo, il N°1. Un grande successo che ha il merito più semplice del mondo: il PC Compaq porta avanti i migliori Per due anni consecutivi e con due premi diversi infatti Compaq ha vinto il titolo di "Personal Portable dell'Anno". E chi vince in questi casi è sempre il migliore. Il successo Compaq non ha precedenti nella storia economica degli USA. Un vero record che però non è comune. È il N°1 sugli altri. La dimostrazione è il massimo Portable II, che vedete qui sopra.

In il mondo confrontato con il portatile più venduto del mondo il nostro Compaq Portable. Risultato: il Portable II è il 20% più leggero, il 15% più piccolo e, soprattutto, è da 1 a 5 volte più veloce. Pensate di altro PC non portatile. Utilizza tutti i vantaggi del software e più di 100 programmi per tutti i PC IBM e IBM compatibili. Anche con quelli che fanno bene già. Così si diventa N°1. Essendo sempre al meglio, il così siamo diventati anche il N°1 del mondo per i Business PC. Ma toglietelo. **COMPAQ**

Lavorare meglio è il nostro business.

International Growth Continues

We formed a sixth international subsidiary during the second quarter and will now market products through a new entity, COMPAQ Computer S.p.A. in Milano, Italy. Previously, our products were sold in Italy by independent dealers supported by COMPAQ Computer GmbH, our subsidiary based in Munich, West Germany. The establishment of an Italian subsidiary will help sustain our growth in Europe, where demand for advanced business personal computers is growing more quickly than in the domestic market.

Also during the quarter, distribution of COMPAQ products began in Thailand and the Philippines. The complete COMPAQ product line will be sold in these countries through Authorized Dealers. With these additions, COMPAQ products are now sold in 40 countries by a network of over 3,000 Authorized Dealers.

For the launch of our new Italian subsidiary, Italian magazines and newspapers carried ads featuring the COMPAQ PORTABLE II. The headline in the top ad tells readers to "Unpack Number One." Below, they are told to "Pick up Number One."

New Land Acquired

To accommodate our long-range plans, we took the opportunity to purchase 94 acres of wooded land adjacent to COMPAQ Center, our 55-acre headquarters site in Northwest Houston. We purchased the property for approximately \$9 million and expect to use it for additional office and manufacturing buildings as our needs require. The new acreage provides us with flexibility for our future growth.

Outlook

In general, we are optimistic about our results for the full year 1986. There are several reasons why:

The business personal computer market remains healthy. The market in the United States for business personal computers sold through computer dealer channels during the first half of 1986 showed a growth rate of approximately 16% over the first half of 1985, according to one independent research firm. While the rate is less than that of previous years, this growth provides reasonable opportunities for increased sales.

Our full-function, portable computers continue to lead their market. COMPAQ Computer Corporation is the world leader and standard-setter in full-function portable computers. We manufacture eight of every ten portable computers sold by computer dealers in the United States. Our portable models generate over half our unit sales.

Demand for our 80286-based computers is high. The fastest growing portion of our product families is made up of portable and desktop computers featuring the 80286 microprocessor. These computers, with their superior features and performance, meet the needs of experienced business personal computer users. Our newest product, the 80286 based COMPAQ PORTABLE II™ introduced in February 1986, has sold faster than any other COMPAQ product. In just five months, this lightweight portable, which features all the power of an IBM PC-AT® and more, has become our best selling portable product.

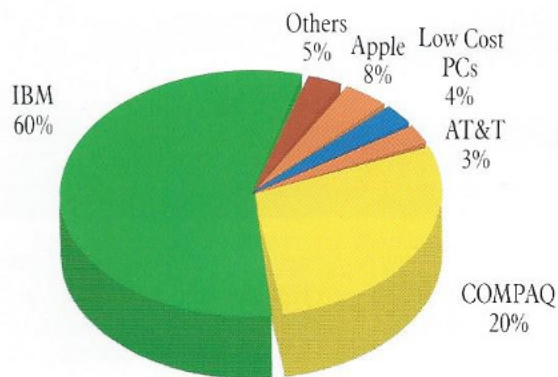


Our high performance personal computers featuring the 80286 microprocessor now make up the largest, and fastest growing, component of our business.

Price is not a driving factor in our market segment. We are carefully watching the many new competitors offering low-priced "clone" personal computers, some costing less than \$1,000. There is clearly a demand for commodity personal computers providing low function and low cost. However, this entry-level market is a low priority for COMPAQ Computer Corporation. Our greatest strengths are in high-performance personal computers and in portable computers.

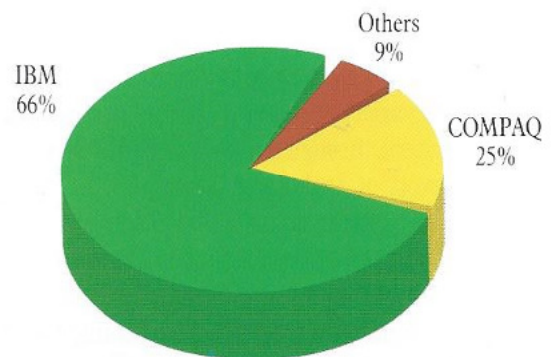
We estimate that in the second quarter, low-priced clones accounted for approximately 7% of units sold through dealers, but only about 4% of dollar revenues. Our Company, on the other hand, achieved a share of 20% of dealer revenues.

U.S. Business PC Market Share Dealer Revenue 2Q86



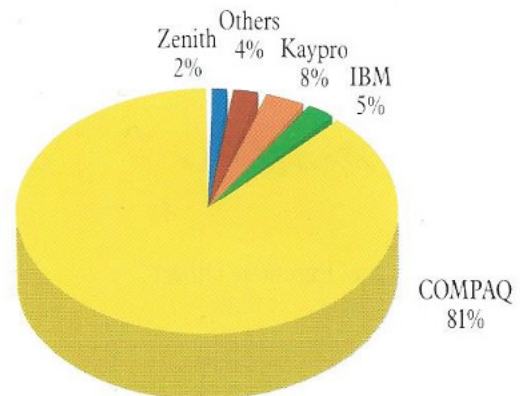
Source: Based on Future Computing Storeboard

U.S. Business PC Market Share Dealer Units 2Q86 80286 Products



Source: Based on Future Computing Storeboard

U.S. Business PC Market Share Dealer Units 2Q86 Portable Products



Source: Based on Future Computing Storeboard

One further point: Our studies indicate that price is not an overriding concern in the purchasing decisions of business personal computer users. In a survey we conducted in April, price ranked eighth in importance on a list of 10 factors among these users.

Their three top purchasing criteria were: product quality and reliability, service and support, and ability to run a large variety of software. We have consistently met these criteria through our well-designed products and our network of Authorized Dealers.

The manufacturing, financial, and marketing policies we have pursued to date have produced outstanding results. The marketplace, however, has become increasingly competitive and its growth rate overall has recently slowed. Our market research indicates that our increased emphasis on high performance computers is the correct strategy to follow in this environment. Through this strategy, and by bringing new and important personal computer technology to the marketplace, COMPAQ Computer Corporation should continue to be in a favorable position for further growth.



ROD CANTON
President and Chief Executive Officer
July 25, 1986



A number of manufacturing efficiencies during the quarter helped bring about the improvement in our gross profit percentage.

COMPAQ Computer Corporation
Consolidated Balance Sheet
(Unaudited)

	June 30, 1986	December 31, 1985
	(in thousands)	
Assets		
Current assets:		
Cash and short-term investments	\$ 56,089	\$ 76,984
Accounts receivable	79,667	83,624
Inventories	80,955	75,783
Prepaid expenses	3,445	3,291
Total current assets	220,156	239,682
Property, plant and equipment, less accumulated depreciation	86,875	66,733
Other assets	9,290	5,583
	<u>\$316,321</u>	<u>\$311,998</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Notes payable		\$ 15,000
Accounts payable	\$ 42,652	53,087
Other current liabilities	39,481	31,166
Total current liabilities	82,133	99,253
Long-term debt	73,829	75,000
Deferred income taxes	1,137	1,137
Minority interest in consolidated subsidiary	2,858	
Stockholders' equity:-		
Preferred stock: \$.01 par value; 10,000,000 shares authorized; none issued and outstanding		
Common stock: \$.01 par value; 150,000,000 shares authorized; 26,788,610 and 26,457,461 shares issued and outstanding	268	265
Capital in excess of par value	98,575	96,780
Retained earnings	57,521	39,563
Total stockholders' equity	156,364	136,608
	<u>\$316,321</u>	<u>\$311,998</u>

COMPAQ Computer Corporation
Consolidated Statement of Income
(Unaudited)

	Six months ended		Quarter ended	
	June 30,		June 30,	
	1986	1985	1986	1985
	(in thousands, except per share amounts)			
Sales	\$291,121	\$215,876	\$147,131	\$118,876
Cost of sales	<u>173,270</u>	<u>147,395</u>	<u>85,468</u>	<u>81,401</u>
	<u>117,851</u>	<u>68,481</u>	<u>61,663</u>	<u>37,475</u>
Research and development costs	11,461	7,448	6,529	3,546
Marketing and sales expense	43,738	26,878	22,455	15,851
General and administrative expense	26,457	14,141	13,207	7,031
Other (income) expense, net	<u>4,145</u>	<u>3,373</u>	<u>2,298</u>	<u>1,888</u>
	<u>85,801</u>	<u>51,840</u>	<u>44,489</u>	<u>28,316</u>
Income before provision for income taxes	32,050	16,641	17,174	9,159
Provision for income taxes	<u>14,092</u>	<u>6,324</u>	<u>7,547</u>	<u>3,481</u>
Net income	<u>\$ 17,958</u>	<u>\$ 10,317</u>	<u>\$ 9,627</u>	<u>\$ 5,678</u>
Earnings per common and common equivalent share	\$.64	\$.38	\$.34	\$.21
Earnings per common and common equivalent share—assuming full dilution	\$.57	\$.36	\$.31	\$.19

COMPAQ Computer Corporation
Consolidated Statement of Change in
(Unaudited)

Working capital was provided by:—

Operations:

- Net income
- Charges not affecting working capital
- Depreciation and amortization
- Working capital provided by operations
- Common stock issued on conversion of convertible subordinated debt
- Proceeds from sale of equity securities
- Proceeds from sale of convertible debt securities

Working capital was used for:

- Acquisition of property, plant and equipment
- Investment in subsidiary, net of working capital acquired
- Conversion of subordinated debt
- Other, net

Increase (decrease) in working capital

Increase (decrease) in components of working capital:

- Cash and short-term investments
- Accounts receivable
- Inventories
- Prepaid expenses
- Notes payable
- Accounts payable
- Other current liabilities

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COMPAQ[®]
COMPUTER CORPORATION