



## Instant Insight

September 4, 2001

### Hewlett Packard Acquires Compaq

*By Charles King*

Hewlett-Packard announced today that it is acquiring Compaq Computer Corporation for approximately \$25 billion in stock. The deal has been approved by both companies' Boards of Directors and is expected to close in the first half of next year, pending regulatory and shareholder approvals. The new company would have combined revenues of \$87 billion, pro forma assets of \$56 billion and annual operating revenues of \$3.9 billion. The company would employ more than 145,000 people and have offices in 160 countries. HP predicts the new company would save approximately \$2.5 billion per year by combining operations. The company would be broken into four divisions; a \$20 billion imaging and printing business, a \$29 billion access devices division, a \$23 billion IT infrastructure business and a \$15 billion services arm. The figures are based on trailing revenues of the two companies.

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Big news, no doubt. What we believe makes this news even bigger is that it is an acquisition that unlike many others (Excite/@home comes to mind) makes sense when one considers where the computer industry is headed. Make no mistake about this deal. It is not about PC sales. It is about stepping up to the big leagues and offering end-to-end hardware, software and services solutions. In other words, it is a manifestation of HP's aspiration to be a direct competitor with IBM. The combined revenues and earnings put this new behemoth in the same league as IBM. But it is not just about size. It is about complementary parts.

HP offers a substantial line of mid-range servers and office products – including its \$20 billion-a-year printer business – and has a good foothold in the mid-range business market. It does not, however, offer much on the high end. Compaq, with its Himalaya servers, covers this base in a way that gives this new company a credible counter pitch to IBM in the big hardware market.

Furthermore, this merger offers the new company a notable improvement in its services arm, a direct result of Compaq's purchase of Digital several years ago. This element of the combined companies is as important or more so than the hardware synergies we have mentioned above. Simply stated, if there were not a sizable service component to this deal it would not make sense. With Compaq's increasing focus on services in the past year, it shores up a weakness that HP was unable to correct internally and positions the company more favorably against IBM and its long established brand and reputation for offering hardware, software and services.

Also adding to the positive side of the ledger is the alignment of the combined executive team. HP CEO Carly Fiorina will assume the title of Chairman and CEO of the new company, while Compaq CEO Michael Capellas takes over as President. We have watched Fiorina's tenure at HP with increased concern, as the company has faltered and lost ground under Fiorina's leadership. Capellas has been more effective in his role at Compaq, and we believe handing him the responsibility of day-to-day management of the company makes sense. Fiorina can now move into a more detached visionary role, creating a path to a graceful

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eventual departure. Capellas, meanwhile, has a chance to get his legs underneath him during that time period.

If a merger can be thought of as two separate balls of twine being tied and wound together, the twine representing HP and Compaq is currently somewhat frayed and tangled. Both companies are in transition; HP is in the midst of a Carly Fiorina-led move toward a services-focused business model, and Compaq is proceeding with a massive re-branding effort combined with migrating its high end computing products to Intel's 64-bit Itanium chipset. Given the potential difficulties posed by these complications, considering the merger's benefits/problems on a point-by-point basis may be of use.

- ◆ Access devices (PDAs, desktops, laptops) – HP gains significantly here. Adding together Compaq's still substantial market share to HP's more modest position will ensure a return to the #1 position, at least temporarily. Compaq's access device re-branding (EVO) could provide the companies' combined offerings some protection against a surging Dell.
- ◆ Servers (Wintel) – Both companies have strong products here, so some squishiness (i.e. position/prestige loss) is likely to occur. Since HP is the acquiring company, Compaq engineers might want to start revising their resumes.
- ◆ Servers (UNIX) – Compaq gains, since HP is further along in their efforts to port HP-UX to the Itanium chipset. At the same time, HP gains with Compaq's well-regarded product line.
- ◆ High end computing – A definite win for HP, since Compaq's Himalaya can compete head-to-head with IBM's mainframe products. Despite reams of PR to the contrary, sales of HP's Superdome have been disappointing.
- ◆ Storage – HP gains significantly from Compaq's #2 position (behind EMC) in the enterprise storage space.
- ◆ Printers – Compaq gains measurably by becoming part of an organization that has been regularly buoyed by its top position in the printer market.
- ◆ Services/software – Compaq's well-entrenched position in services and consulting should bolster HP's efforts to gain traction in this space.

While the two companies appear to have much to be happy about with the deal, what should end users think? It depends. The strength of Compaq's access devices and HP's printing and networking technologies will allow the combined company to offer both consumers and business clients the widest integrated computing product set in the tech industry. At the same time, the companies have been plagued by confusion in their go-to-market strategies, and HP in particular has a reputation for instituting needed changes at glacial rates of speed. If HP and Compaq can overcome both internal and external hurdles and make this deal work, they have the potential of creating and occupying a unique market position that will benefit both the company and its customers.

If customers have so much potential happiness to anticipate, does the competition have much to fear? It depends on the competitor.

- ◆ IBM – The resurgent Big Blue is one obvious target of today's announcement, and while much has been made of the combined revenues of HP and Compaq in 2000 being nearly as large as IBM's, they came from substantially different sources. With its abandonment of desktop PCs, IBM is now essentially a business computing company. Subtract the printer and consumer access device revenues from HP and Compaq's balance sheets, and the companies generated less than half the revenues that IBM did in 2000. Is this a big deal? Only for those who argue the combined HP/Compaq is poised to take on and defeat IBM at its own game. It won't happen now, with and given the time the acquisition will take to complete and the fact that IBM is continuing to move aggressively, it won't happen any time soon.

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- ◆ Dell – A great deal of noise is also being made about the deal's impact on the PC market, and there at least is some meat to consider. While Dell is the company most have picked as the loser here, Gateway is in greater peril to our way of thinking, given that it is already on the ropes with substantial losses and layoffs. Dell's loss of the top PC sales spot is, at most, a temporary setback. The company has already proven that it can own the market on its own terms. Unless HP decides to approach PC sales with a substantially different strategy than it has in the past, expect it to snatch defeat from the jaws of victory, pushing Dell back into the #1 position. PC technology is achieving parity across vendors as profit margins continue to fall. In other words, PCs are commodities. We envision a time when PC sales will mean far less to HP and Compaq than they do today. The acquisition of Compaq, and the way it bolsters HP's higher end offerings, is a tacit admission of this fact.
- ◆ Sun Microsystems –At this point, Sun's continuing insistence on the superiority of its own proprietary technologies (which contradicts the rest of the industry migrating toward open standards and moving high end products to Intel's Itanium chipsets) sounds uncomfortably close to the strategy Apple Computer has followed downward to a 3% market share. Additionally, Sun's position as head cheerleader for the Anything But Microsoft team makes it difficult for the company to reap any tangible benefits from Intel's premiere status. What does the HP/Compaq deal mean to Sun in the short term? The company will endure more competition in the mid-to-high end server space, and additional pressure on Sun storage partner EMC, as HP promotes Compaq storage products. Given ongoing consolidation across the tech space, it would not surprise us if Sun were to seek the protection of a partnership or acquisition deal with some Wintel stalwart such as Novell.
- ◆ EDS/Accenture/PriceWaterhouse – The HP/Compaq deal suggests that the progress of hardware vendors toward leveraging their products into ongoing services is no fluke. IBM has been leading the charge, but virtually all hardware players are looking for places to join in the melee. How this will affect services and management specialists such as EDS, Accenture and PriceWaterhouse over the long term remains to be seen, but we expect continuing consolidation of players in the space to occur, and will not be surprised if acquisitions play a major role moving ahead.

Given the overall benefits of the deal and the way they address larger marketplace issues, HP's acquisition of Compaq qualifies as a classic consolidation done well. Given that, everyone has earned the right to sit back, put their feet up and crack open a cold one, right? Not so fast. From where we sit (sans cold one) we can see a couple of issues that might trip up HP as the company heads toward its victory lap and the cheers of an adoring crowd. First, we have some concern regarding regulatory issues, especially in Europe, where the EU recently scotched the GE/Honeywell deal. Given that many of the layoffs in the HP/Compaq deal are projected to come from Europe and Asia, we expect the deal may encounter heavy weather on the Continent. Additionally, while we posited a number of competitive issues, marketplace theory and practice tend to be two very separate critters. We expect that hardware vendors across the industry are meeting to discuss the ramifications of this merger and how to address it. The need to move forward quickly and decisively while executing an extremely complex reorganization will be critical to this enterprise, but that skill has seldom been associated with HP's more deliberative corporate culture. The merger's success will hinge more on how the company reshapes itself internally as on any Compaq technology it acquires.

However the deal shakes out, we believe the primary reason for HP to continue moving forward is because this deal is the right thing to do. Looking ahead, we believe a time is approaching when technology vendors will offer and users will demand more powerful and flexible methods for accessing and using technologies. Some larger vendors are already preparing for a day when provisioning computing as a service will be the rule rather than the exception. To our way of thinking, while the road to Hewlett-Packard's acquisition of Compaq might include more than its share of bumps, the deal is necessary if either company hopes to continue to compete and to survive.

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