



Market Roundup

December 14, 2001

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Founders' Families, HP Wrangle Over Compaq Acquisition

By Charles King

The David and Lucille Packard Foundation recently announced a preliminary decision to oppose HP's acquisition of Compaq Computer. The decision was hailed by HP board member David W. Packard, Walter Hewlett and other founding family members. Foundations, trusts and individual family members control 18% of HP shares. In response, HP and Compaq issued a joint statement voicing their continuing support of the deal, and HP CEO Carly Fiorina said her company will continue its plans with or without the foundation's support. Compaq CEO Michael Capellas circulated a company memo stating that Compaq is poised to move forward regardless of the deal's success or failure. The Packard Foundation issued a defense of their position, but said they would not attempt to influence other HP shareholders. Walter Hewlett circulated a letter to the boards of directors of both companies, urging a "speedy, mutual unwinding" of the deal.

While it has obviously been a busy time in the latest installment of *As the Merger Turns*, these events provide a window into how Silicon Valley family values have been clashing with perceived market/industry realities. First off, the common wisdom says that the HP/Compaq deal is dead in the water, or so claim the industry pundits and analysts who, to our way of thinking, have incorrectly characterized the acquisition as an inappropriate, PC-focused strategic move. Said pundits' delusions have been abetted by HP, whose inability to offer a believable, let alone compelling argument for the acquisition borders on criminal negligence. If the inarticulate PR efforts supporting the Compaq deal are an example of the "new" HP Way, is it any wonder why employees and stockholders have been looking for the exits?

That said, where do these recent events leave the HP/Compaq deal? From where we stand, if the deal falls through it will leave both companies limping toward a future where they will face difficult confrontations with competitors, such as a nastily revitalized IBM, without necessarily complete defensive and offensive arsenals. Not a pretty picture, but better, we believe, than the image of CEO Fiorina shoving the deal down the throats of unhappy major shareholders like a dose of viscous patent medicine. In our view, such a strategy combined with HP's sad performance under Fiorina will likely inspire institutional shareholders to abandon the company in droves, leaving HP hamstrung for capital to fuel post-acquisition rebuilding.

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Given the probable ugliness of these scenarios and the possible good a successful (if difficult) merger could engender, what exactly is the Packard Family Foundation up to? In a word: payback. While the marketplace (both stock and business) might reward a merged HP/Compaq, we doubt HP's founding families want Fiorina to get any credit for saving a company she has largely eviscerated. We believe that the deal as originally envisioned would allow Ms. Fiorina a graceful exit from the company she has crippled, and Mr. Capellas a logical entrance. Given this week's events, it appears that HP's founding families would prefer a deal that put Carly's head on a pike, after which an interim CEO steeped in the HP Way (both David W. Packard and Walter Hewlett come to mind) can gracefully guide the company back into less turbulent waters with Mr. Capellas' able assistance.

Intel Ships 'Building Block' Servers for Telecom Providers

By Charles King

Intel has announced that it is shipping its first carrier-grade server "building block" or modular products for telecom and service provider environments. The new products conform to ETSI/NEBS telecommunications industry requirements for withstanding excessive heat and cold, fires and earthquakes. Intel will initially ship two Pentium III-based dual processor products in 1U and 2U sizes. The company also expects to deliver products that contain Xeon processors later in 2002, and Itanium-based products in 2003. A "building block" product does not qualify as a complete server, but is simply a chassis with components including a hard drive inserted into the case. Manufacturers will install the processor and memory, and a Windows, Unix or Linux OS, then affix their own brands to the boxes. Intel expects a number of OEMs and telephone equipment manufacturers to begin shipping products based on these platforms in Q1 2002 for communications applications such as soft switches, VoIP, unified messaging and VPN.

To understand the import of Intel's new servers, it helps to know how similar products fit in the service provision space. For years, the requirements of telecom data centers have been served primarily by rugged, RISC-based UNIX boxes. Server offerings from Sun, HP, Compaq and others have vied for and historically dominated this market. However, we believe Intel's entry into the market could radically change this balance. First, Intel's "building block" products offer OEMs and telephone equipment manufacturers cost-effective methods of competing head-to-head with Sun, HP and Compaq. Second, considering the ongoing demand for carrier-class servers and the decreasing profit margins they offer vendors, Intel's products should help deliver compelling price/performance options for both OEMs and their service provider customers. Finally, by offering modular components, Intel is providing telecom customers an easy migration path away from a proprietary RISC-based past to an Intel-based future. In essence, these new products appear to be another step in Intel's strategy of driving industry standards by becoming the industry standard.

We also believe these products offer a tantalizing glimpse into what we call Service Computing, where increasingly powerful and commoditized hardware and software products will provide the means of delivering computing capabilities as effective and affordable services. Low-cost products for single-use telecom applications are one thing, but Intel's plans to eventually deliver similarly configured but considerably more powerful Xeon and Itanium-based building blocks suggest that a Service Computing future may be closer than many might think.

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Magic Lantern or Pandora's Box?

Byline

The FBI confirmed this week that the agency is working on a computer program dubbed "Magic Lantern" whose purpose would be to provide surveillance on computers used by targets of FBI investigations. While no details of the software have been released, Magic Lantern would essentially act as a wiretap on the target computer, recording everything from keystrokes to Web site visits and email. The method of placing this program on a computer would be akin to planting a virus, but without any announcement of its presence. It would then deliver the information it collected in an undetected fashion. A number of anti-virus companies publicly stated that they have not been approached nor are they inclined to give the FBI a "back door" through their AV programs to allow Magic Lantern to be placed on computers running those AV programs. Without that back door, it is unclear if Magic Lantern could successfully be installed.

Well, this opens a whole range of possibilities, some perhaps good and others certainly less than desirable. Let's start with some basics. Virus writers and anti-virus companies (not to mention IT security companies as a whole) are in a constantly escalating war. Once a new virus is produced, an antidote is found and deployed. What we envision here is a situation where Magic Lantern will be deployed, and then somehow "captured" and its code will be distributed over the Internet. The FBI will hasten back to its labs, and create a new version that will defeat counter measures taken by folks who don't want the FBI monitoring their computer usage. We believe that at some point the escalating spiral of measure/counter-measure will start rubbing up hard against personal privacy and confidentiality concerns, especially if the FBI finds Magic Lantern to be a very successful tool in fighting crime or terrorism. On a related note, we can't help but to assume that Magic Lantern-type technology will make its way into the broader consumer marketplace – just as it has within the corporate firewall – which could create real abuses amongst revenue-starved marketers who already surreptitiously gather as much information about online behavior as they can.

In a worst-case scenario, we can envision anti-virus firms selling "exemptions" to their AV software or personal firewalls to data-collection services to generate revenues. Just as search engines sell top placement to vendors in certain categories, what would prevent AV firms from essentially doing the same thing with data collection programs? While the most obvious answer is the maintenance of the "trusted third party" status that AV companies enjoy, it is easy to imagine a future in which the lure of sizable revenues could weaken the resolve of the most ardent AV vendors. While we have considered a few possible scenarios here, there are many others that could arise from a more permissive attitude toward computer wiretaps. With the aggressive pursuit of national security leading the government's activities these days, we hope a calculated and rational approach to virtual spying will be taken in both the public and private sectors to prevent the opening of a Pandora's Box of online abuses.

RealNetworks Gets Premium Placement on Compaq PCs

By Jim Balderston

RealNetworks announced that it has secured a deal in which the RealNetworks RealOne Player will ship on Compaq Presario PCs as the default media player. Under the terms of the deal, Presario desktop and notebook PCs will ship with RealOne software in early 2002. The RealOne player will serve as the default MP3 and CD player, as well as the video and music streaming media player. The early Presario units with RealNetworks technology installed will have the RealPlayer and RealJukebox. Later units will include the full-fledged RealOne player as it becomes available in the first half of 2002. Compaq will offer RealOne

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membership services to its existing and new customers through a RealOne button on the desktop, which will link users to a Web site jointly run by the two companies where subscribers can sign up for premium content from a number of media outlets and music companies.

Well, it shouldn't take much to figure out who this deal is aimed at. Microsoft has been taking a lot of heat for its ongoing bundling strategy that includes Microsoft products like Windows Media Player and photographic utilities (which has raised the ire of Kodak, among others). RealNetworks is simply trying to do what everyone else is; get as close to the consumer PC user as possible. Direct connect icons make things ever more simple for users, and RealNetworks has built a loyal following due to its first to market presence and its role as foil to the Redmond-based behemoth. This offering should help RealNetworks hold onto its market share in face of the ever-increasing Windows footprint and can also be considered a nice feather in Compaq's consumer product strategy cap.

But we have to note that this deal also benefits Microsoft, which is going to be under anti-trust scrutiny until the cows come home. This deal, and the existence of Kodak's photographic PC tools, allows Microsoft to point to viable, healthy competition in these areas, an effective foil to its critics' anti-trust claims. The real problem for RealNetworks is not in the player technology, but in the services (i.e., content) it can offer users. Microsoft has the cash on hand to buy its way into all sorts of media partnerships (MSNBC comes to mind), which could give the company a distinct edge down the road. While RealNetworks has content agreements from ABCNews.com, CBS, CNN, Fox Sports and others, one has to wonder if they have deep enough pockets to go head to head with Redmond when the giant takes note of their continued (if not growing) presence. For now, let it be said that competition is good for consumers, but we are not ready to lay down bets on the eventual winner in this race.

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