



The H-P Compaq Merger Two Years Out: Still Waiting for the Upside

Published : October 20, 2004 in [Knowledge@Wharton](#)

Its name is synonymous with the evolution of Silicon Valley and technological innovation. Its array of products and services is the broadest in the tech sector. Its brand is known and respected by consumers and corporations alike. And it pulled off the biggest-ever tech merger more than two years ago.



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So why are people still asking some hard questions about the overall prospects for Hewlett Packard? The reason, say experts at Wharton and elsewhere, is that more than two years after its blockbuster acquisition of Compaq Computer, the reconfigured H-P remains a work in progress. Chairman and CEO Carleton (Carly) Fiorina has made strides in integrating the operations and cultures of the two companies. But if H-P's stock price is any indication of the company's prospects, investors still harbor concerns about whether the merger will ultimately strengthen the Palo Alto, Calif.-based company against its two chief competitors, Dell and IBM.

Wall Street raised eyebrows about the wisdom of the consolidation as soon as plans for it were disclosed three years ago. On Sept. 4, 2001, the day that HP and Compaq announced the merger, H-P's stock closed at \$18.87, down sharply from \$23.21 the previous trading day. On May 3, 2002, when the deal was officially consummated, the stock ended the day at \$17.44. As of Sept. 21, 2004, the shares stood at \$18.70 -- down 19% from the beginning of the year, according to a research report by Goldman Sachs. In what may be another sign of the times, Fortune magazine's just-released list of the 50 most powerful women in American business gives the top slot to eBay CEO Meg Whitman. Fiorina had won that honor every year since the list was started in 1998.

"The question is, 'What is the value of the combined assets of these companies?'" asks [Harbir Singh](#), a Wharton management professor who specializes in studying mergers and acquisitions. "That's one reason the stock has not done so well over the last two years. People haven't seen the upside." Adds Megan Graham-Hackett, an analyst at Standard & Poor's who follows the tech industry: "The jury is still out" on whether the merger was worthwhile.

H-P is a sprawling, global company. Its products and services range from handheld devices, PCs, printers and digital cameras to servers and enterprise solutions. It ranks 11th among Fortune 500 companies, has annual revenues of more than \$78 billion, employs 145,000, and ranks first globally in printers; Windows, Linux, Unix and Blade servers; pocket PCs; and total disk storage systems.

Singh and another member of Wharton's management department, [Saikat Chaudhuri](#), give Fiorina and her colleagues high marks for tackling the often difficult and tension-ridden job of merging two large entities. "My sense is that they have been able to do a lot of [positive] things, post-merger, in terms of the operational side," according to Singh. "It seems they have not had major battles after the merger, which is typically the case with many large transactions."

"The merger is on track and is proceeding much better than expected," says Chaudhuri. He views the acquisition of Compaq as just one "building block" in Fiorina's attempt at a long-term transformation of HP. "It's not just about HP buying Compaq; it's about a systematic renewal of Hewlett-Packard." Referring to a bitter shareholder battle in 2002 with a member of the Hewlett family and others who

opposed the acquisition, he adds: "We know about the hostile context in which it was pursued and how difficult it was to pull this thing off."

Chaudhuri says Fiorina and senior H-P executives have done a "fabulous" job at integration. Fiorina has retained H-P's traditional commitment to innovation but has said that the new company would have to be more results-oriented than it had been before and be able to move faster to meet new challenges.

At the time the merger was announced, people at Wharton and on Wall Street wondered where the benefit was in acquiring a PC maker like Compaq at a time when PCs were well on the road to becoming low-margin commodities. To be sure, Fiorina's idea of achieving economies of scale in the PC business was a sound one, giving H-P, already reaping hefty profits from its printer and print-cartridge products, a shot at competing with Dell, a low-cost, direct-marketer of PCs, according to Wharton faculty members. But how was a merger going to allow H-P to go head to head with IBM, which not only sells PCs but is a leader in the high-margin server, consulting and service businesses, or EMC, a key player in data storage?

'A Big Ungainly Place'

Chaudhuri believes the decision to merge was sound. "H-P was caught in the middle and so was Compaq," he recalls. "If you think about it, H-P at the time was pretty strong on the consumer side but didn't have an adequate presence on the corporate side. So when Carly Fiorina came in she focused on why some areas weren't growing."

Rather than engage in a series of acquisitions to strengthen the company in areas where it could more readily compete with IBM, Fiorina opted to acquire Compaq, which, while best known for its PCs, also had enterprise businesses that it had built up through earlier acquisitions of its own. "It's not that the acquisitions didn't go so well, but they were underutilized because the critical mass was not there," according to Chaudhuri. "So, for [H-P and Compaq] it made sense to merge because of these complementarities."

But management professor [George Day](#), who was critical of the planned merger in 2001, continues to have reservations about the decision today. "It's still a big, ungainly place. What is their positioning in the market? I think there's some ambiguity about that. People aren't sure what the brand stands for and how all this stuff fits together."

There has been talk that the sum of H-P's parts may be worth more than the whole, and that the company should be broken up. But Day says such a decision should not be talked about glibly since it would be irreversible. He says Fiorina still has an opportunity to achieve her vision as did -- irony of ironies -- another CEO (Louis Gerstner) at another tech firm (IBM), which in the 1980s was deemed a lumbering dinosaur that had seen better days and whose stock was a fallen star.

"Wall Street may say, "Break the damn thing up,"" Day notes. "Analysts [often] have good insights, but they made the same proposal in 1992 when Gerstner came on board. It's a nice parallel. Gerstner was confronted, when he first arrived, with the idea of, 'Let's break up IBM into six or seven different businesses.' Well, it would have been the worst possible decision for IBM." Gerstner went on to transform and resurrect IBM and is now considered a legendary figure in corporate America.

Day says IBM's experience offers both lessons and a cautionary tale for Fiorina. "If Carly's going to make this thing work, she's going to have to do something like Gerstner did: pull things together and create solutions at the level of market segments. Each part of the organization that reaches the customer should have the autonomy to pull together whatever the customer wants, supported by product groups. That's not

a bad strategy. H-P is really a product-centric company. If they can move to become a customer-focused company, with the products feeding into those customer groups, then they may have a chance. But the problem with that strategy is we have a player [IBM] that's already done that. HP is trying to be cost competitive with Dell and be the same kind of integrated-solutions provider that IBM has become. If that doesn't work -- if it's clear IBM has too big a lead -- then HP, which has this hugely profitable printer business, has to think about breaking up."

Graham-Hackett of S&P, who downgraded H-P shares to hold from accumulate in August, says the company has been successful in several areas. It has, for example, boosted sales of low-end servers and wrung costs out of its PC business. In addition, the company has added to its staff in its information technology consulting business. But H-P will remain vulnerable until it beefs up its capabilities in services even more. "The argument H-P makes is it can participate in areas IBM focuses on, as well as Dell ... But if you're looking out several years, it's hard to ignore the fact that, with the modernization of the hardware industry, you have to have a differentiated strategy and a competitive advantage. H-P doesn't have the services that IBM has."

Graham-Hackett adds that H-P remains heavily dependent on imaging and printing systems. These operations accounted for 31% of corporate revenue and 74% of total operating profits in fiscal 2003, while services contributed 17% of total sales. "One reason you would want to buy H-P is because of the lucrative cartridge business," she says, "but that wasn't one of the reasons for the merger."

Another challenge: ensuring that demand for its PCs stays high. The company has a huge installed base of H-P and Compaq customers. Graham-Hackett says it will be "interesting to see, as this equipment gets too old, if customers stick with H-P or if they switch to another vendor."

H-P has a stellar brand name that should help it battle any competitor, says Wharton marketing professor [Xavier Dreze](#). "They're known as a technical company at the forefront of technology, so that's something that can be seen as common among all their segments."

Honing the Message

Wharton's Singh says he is uncertain whether the merger will eventually reap more dividends than it has so far. But he thinks H-P could have tried to obtain the same benefits through an alliance with Compaq rather than embark on an acquisition. "A broad-based joint venture between H-P and Compaq could have achieved many of the same goals without H-P being involved in Compaq's lower-margin businesses. That may have been a better bet. If the joint venture does well and there is the potential for value creation, and getting to know one another better, then maybe a merger is the next step."

Chaudhuri is more optimistic about H-P's future. "We can expect H-P to much more aggressively pursue the whole networked computing environment and offer the whole gamut of services to clients. This is not a seamless process yet for them, but if they carry on the momentum they have had over the last two years, they definitely will be able to do this in a reasonable time frame. In five years I expect to see them competing head to head with IBM."

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