

HP Compaq: The merger decision

Instructions and questions

Please read and analyze the case 'Hewlett-Packard – Compaq: The Merger Decision'. You are welcome to collect any additional information on the companies and industries involved in the case.

- 1) Based on information available at the time of the merger, would you have recommended the merger?
 - a) If yes, explain the reasons and discuss the recommendations you would have made regarding the strategy for the combined companies.
 - b) If not, explain the reasons and discuss the strategy you would have recommended to HP.
- 2) Please collect up-to-date information on the companies and industries involved in the case. Based on this information, what is your evaluation of the merger now?

The project report should be no longer than 3 pages (double-spaced, typed). In addition, you may submit up to 12 pages of exhibits (total ≤ 15 pages).

Suggestions to answer questions

Question 1 – either SWOT or 5 Forces type analysis no matter which option we say. We can focus more on the differences if we say no, etc.

Show stock price info (in case) in one chart.

Complete a financial analysis of the purchase – can pull from some of the exhibits (this needs to be analysis based off exhibits)

Speak to the supposed synergies/cost reductions \$2.5 billion

Profitability of the different business segments at each and/or what the combined business would be.

Question 2 - stock price analysis from date of announcement forward

Competitors and % of business in each segment (IBIS world)

Has the stock price gone up/down – do they hold a bigger % of business in the segments

Profit or margin analysis

KRISHNA PALEPU
JONATHAN BARNETT

Hewlett-Packard–Compaq: The Merger Decision

For the past two-and-a-half years, the HP Board of Directors and management team have been evaluating the best strategic move for HP. Together, we debated the hard questions, we looked at all the alternatives and we became convinced that a merger with Compaq is the single best way to create shareowner value and return HP to industry leadership.

—HP CEO Carleton Fiorina, HP 2001 Annual Report

We profoundly disagree with management's assertion that HP needs to make this large and very risky acquisition. To undertake the proposed merger is to make a big, long-term, bet-the-company move. It worsens the HP stockholders' portfolio of businesses. It does not solve key strategic problems. It creates enormous immediate risk and intermediate-term incremental challenges, and it comes at a very high price.

—HP Dissident Board Member Walter Hewlett, 2001 Proxy Statement

On March 19, 2002, amid boos from the audience at a special meeting for shareholders, Carleton (Carly) Fiorina, president and CEO of Hewlett-Packard (HP), announced the shareholders' approval of the acquisition of rival Compaq Computer by a "slim but sufficient" 51.4% margin. The controversial \$24 billion deal marked the largest merger in the history of the computer industry. At its core, the merger was designed to create a global technology powerhouse that could provide end-to-end products and services increasingly demanded by lucrative enterprise (large-scale business) customers. In so doing, the merger would position the combined company to challenge industry leader IBM.

The March 19 meeting capped off a bitter six-month proxy fight that pitted HP heir and dissident HP board member Walter Hewlett, who opposed the merger, against HP's new CEO and its remaining board members, who favored the acquisition. When HP first announced its intention to acquire Compaq on September 4, 2001,¹ the news sent HP's and Compaq's stock prices down approximately 19% and 10%, respectively. Some seven months later, on the day of the March 19 meeting, shares of HP and Compaq continued to trail preannouncement levels by 19% and 10%, respectively. The slim approval margin coupled with the severity of the market's reaction left many wondering whether the deal was a good one.

¹ HP and Compaq issued a joint press release announcing their intention to merge late in the evening on September 3, 2001. September 4, 2001, was the first trading day that reflected the merger news.

Professor Krishna Palepu and Research Associate Jonathan Barnett prepared this case. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Industry Background

The computer hardware industry in 2001 was highly competitive and marked by frequent product introductions, continuous improvement in product price/performance characteristics, and fierce competition. In the face of continuous change, participants were either able to quickly tailor their product and service offerings in a way that allowed them to operate profitably, or they were acquired or dissolved. IBM and Dell were examples of firms that succeeded by pursuing divergent strategies. IBM pursued a full-service provider model and was well entrenched in high-growth, high-margin businesses. Dell pursued a focus strategy, centered principally on lower-margin segments of the industry—personal computers (PCs) and servers. Compaq, once the industry leader in PCs, faced significant challenges as it tried to regain its position in the industry through a series of acquisitions that proved somewhat difficult to digest.

IBM

IBM introduced its first computer in 1952. Throughout the 1960s and 1970s, IBM's combined strength in research and development (R&D) and marketing earned it market share near 80%. In 1981, the IBM PC was introduced, giving rise to a PC industry based on Microsoft's Windows operating system and Intel's computer chips (collectively referred to as the "Wintel" standard). Because Wintel standards were open and available to all PC manufacturers, many PC clone manufacturers entered to compete with IBM. Compaq initially, and Dell later on, became the PC industry leader, posing significant challenges for IBM. As a result of rapid advances in computing power, PCs were increasingly able to handle complex computing tasks, challenging the role of high-priced mainframe computers, which were the mainstay of IBM. As a result, after earning \$6.6 billion in 1984, IBM began to erode in performance. In 1992, IBM lost \$5 billion, and in 1993 losses grew to nearly \$8 billion, making it the worst year in IBM's history. That same year, CEO John Akers was replaced by Louis Gerstner, the first outsider to run the company.

Gerstner set a new course for IBM that centered on offering customers "integrated solutions"—comprehensive, end-to-end solutions consisting of hardware, software, and services. This was a marked difference from the predominant industry model, which emphasized selling individual components and left the integration task to customers. In offering integrated solutions, Gerstner sought to recapture lost PC margins by bundling PCs with higher-growth, higher-margin offerings, led by software and high value-added services. Moreover, in response to what Gerstner described as a new era in computing—deemed network-centric computing and exemplified by the Internet—IBM shifted its hardware focus away from low-margin PCs toward more profitable servers and storage, which enabled networks to function.

Gerstner believed the transition to a networked world would create considerable demand for highly profitable services, and he moved quickly to establish IBM's position in the then-nascent services market. In 1995, IBM formed IBM Global Services (IGS), a single, global team that delivered seamless, integrated solutions to customers worldwide.² In 1996, IBM merged its consulting practice into IGS, making IGS the world's largest information technology (IT) services provider. This decision reflected a shift in IBM's services philosophy from merely offering services as an after-sales activity such as maintenance to a broader, and more profitable, approach of assisting customers in every facet of their ongoing business operations.

² "IBM Global Services: A Brief History," IBM Corporate Archives, May 2002.

Between 1995 and 2001, IGS revenue and employee count increased at a compound annual rate of 9.5%. Much of this growth was the result of an expanded portfolio of offerings that included many more e-business services as a result of the powerful effect of the Internet on commerce. By 2001, IGS had become the world's largest consultancy, systems integrator, and strategic outsourcing leader. In 2001, IGS revenue topped \$35 billion, with a backlog of \$102 billion, and surpassed IBM's hardware revenue for the first time. That same year, IGS accounted for 41% of IBM's total worldwide revenue, 47% of pretax profit, and with 148,300 employees, nearly half of the company's workforce. In 2001, IBM not only led the industry in IT services, but it was also the number one or two company in total software—including high-growth Web software, servers, high-end disk storage, and maintenance.³

IBM's integrated solutions strategy offered customers the benefits of a one-stop shopping experience with packaged solutions offered at a predictable price. Though the strategy met with initial success, it involved one potential challenge. Since IBM manufactured much of the hardware that could form a part of the solution its IT consulting and services arm might advocate to a client, customers might be concerned about a potential conflict of interest. As a result, some customers still preferred to work with independent consultants, such as Accenture, that could both recommend best-of-breed solutions and implement them.

Dell Computer

Dell Computer was principally focused on selling built-to-order, competitively priced PCs and servers. Dell was founded on a simple, yet powerful, concept: "by selling computer systems directly to customers, Dell could best understand their needs and efficiently provide the most effective computing solutions to meet those needs."⁴ In the words of Michael Dell, "the competitive advantages of the direct business model entailed great prices on the latest relevant technology, outstanding reliability and superb service."⁵ In addition, high levels of customer satisfaction engendered loyalty and led to repeat purchases.

Dell's early business model consisted of buying component parts wholesale, manufacturing IBM computer clones, and selling them by mail order to customers who did not want to pay the higher prices charged by computer stores. In addition to eliminating the retail markup, the direct-to-customer model circumvented the need to maintain months of aging and costly inventory, which was particularly advantageous given increasingly shorter component product life cycles. In the absence of inventory stockpiles, Dell was able to introduce the latest technology more quickly than companies with slow-moving, indirect distribution channels. Moreover, with Dell's focus on computers based on open standards, customers got the benefit of extensive research and development from an entire industry, rather than from a single company. As a result of these advantages, Dell was able to sell PCs at about 40% of the price of a comparable IBM machine.⁶ The business model was an instant success, and by 1992, just eight years after its founding, Dell was included among the *Fortune* 500 list of the world's largest companies. The following year, Dell joined ranks as one of the top five computer system makers worldwide.

Because the Internet promised to further reduce operating expenses by better coordinating customer and component parts orders, Dell moved quickly to launch www.Dell.com in 1994. As the new system was phased in, component inventory was nearly eliminated, and as the system proved

³ "IBM Global Services: A Brief History," IBM Corporate Archives, May 2002.

⁴ "Dell at a Glance—Company Facts," Dell Computer Corporation.

⁵ Dell Computer Corporation 2001 Annual Report.

⁶ As reported by Hoover's Online.

viable, Dell moved quickly to refine it. In 1996, Dell began selling PCs through its Web site and added online technical support in 1999. By 2001, nearly half of the company's \$32 billion in revenue came from Internet-based sales.

Dell's Internet-based direct model not only improved profitability and preserved the advantages of the mail-order model, it offered the added advantage of allowing Dell to move closer to its customers, to better understand their needs, and to tailor the organization to better serve them. Whereas Dell's initial success stemmed from its ability to offer significant price discounts because it sold direct, Dell's success after implementing the new model stemmed from the close relationships it built with its major customers. Indeed, Dell exploited the direct model to lock customers in.

Dell used its abundant profits and cash flow to fuel growth primarily in major corporate accounts. In 1996, Dell began a major push into the network-server market, followed by the introduction of workstations in 1997 and storage products in 1998. In 2000, Dell broadened its high-end network servers and Internet-related services offerings and formed a division for its storage operations.

In 2001, Dell was ranked first in global PC market share. Dell also held the number one ranking in worldwide workstation shipments and was ranked first in the U.S. for standard Wintel architecture-based servers. Despite a challenging industry environment, in fiscal 2001, Dell set company records in unit shipments, revenue, net profit, earnings per share, and cash flow per share. It was also ranked number one in service and customer satisfaction in nearly every industry survey, including receiving the "Reader's Choice" award for service and reliability from *PC Magazine* for the ninth consecutive year.⁷ Dell was also extraordinarily profitable. For fiscal years 2001, 2000, 1999, and 1998, Dell's return on invested capital was 355%, 243%, 195%, and 186%, respectively.

Compaq Computer

Compaq Computer was founded in 1982 to manufacture and sell portable IBM-compatible computers. The company sold its first computer in January of 1983 and by year-end had recorded \$111 million in sales—the greatest first-year sales record in the history of American business.⁸ Compaq's early success was due, in part, to its emphasis on leading-edge technology—what it referred to as "high performance PC technology"—and this edge continued to fuel sales records in subsequent years.⁹ In 1987, Compaq was the first company to surpass \$1 billion in sales in the first five years of operations, and in 1988 it became the first company to surpass \$2 billion in six years.¹⁰

To sell its products, Compaq leveraged the dealer and supplier network built around the IBM PC. Rather than create a large sales force, Compaq gave exclusive rights to dealers for sales and service of its products and by 1990 had networks in 152 countries. In the wake of the 1991 U.S. recession and in response to aggressive price competition, Compaq adopted a price trendsetter strategy in 1992. To that end, Compaq cut its gross profit margins in half and instituted a price war. IBM responded by introducing aggressively priced PCs; however, by 1994 Compaq surpassed IBM to become the world leader in PC sales.

⁷ Dell Computer 2001 Annual Report.

⁸ "Chronology of Computer History," <http://www.cyberstreet.com/hcs/museum/chron.htm>.

⁹ Compaq Computer 1988 Annual Report.

¹⁰ Compaq Computer 1987 Annual Report.

While Compaq's dealer network supported its rapid growth, it also added a layer of expense that put Compaq at a cost disadvantage to Dell. In 1997, amid heightened PC price competition and diminishing margins, Compaq responded with a two-pronged strategy: emulate Dell by introducing a direct Internet sales channel, and emulate IBM by transforming itself into a full-line provider.

Compaq's direct channel dramatically reduced its own inventory and that in the dealer channel and improved the PC division's cost structure. However, fearing the alienation of its dealers and, in turn, a potential loss of market share to competitors, Compaq continued to ship its products through the retail channel. As long as Compaq continued to fill orders through its dealers, it could only narrow, but not eliminate, the cost advantage of vendors that shipped direct. Furthermore, as long as dealers controlled the customer interface, Compaq was prevented from developing closer relations with customers, such as those fostered by Dell.

In emulating IBM, Compaq sought to shift its business mix away from PCs and toward more profitable higher-end computers and services. To implement this strategy, Compaq acquired Tandem Computer in 1997 and Digital Equipment Corporation in 1998. Tandem enabled Compaq to offer high-end, mission-critical business computing. Digital added minicomputers, a midrange server line, an enterprise sales force, and a field service operation consisting primarily of engineers and maintenance technicians.

Compaq's acquisition of Digital significantly impacted 1998 operating results. Consolidated revenue increased 26.8% to \$31.2 billion, almost entirely due to the addition of Digital. However, Compaq ended the year with a net loss of \$2.7 billion because of both large write-offs of purchased in-process R&D and merger integration expenses. Compaq expected to report better profit results in subsequent years as it reaped the benefits from the Digital acquisition. However, despite earlier reassurances, on April 9, 1999, Compaq announced that first-quarter earnings would be less than half of Wall Street's consensus estimate as a result of heightened competition and lower-than-expected sales. The news stunned the investment community and caused many to question Compaq's ability to effectively compete while integrating the two companies. The announcement, which created both a credibility problem and loss of investor confidence, triggered a 22% decline in Compaq's stock price. In swift response, Compaq's board ousted its CEO.

In July 1999, Compaq's board announced that its chief information officer, Michael Capellas, would assume the CEO position. "It's hard to describe 1999 as anything but a tough year for Compaq, its employees and its stockholders," recounted Capellas in his first letter to shareholders. "In a strong technology market, our performance was . . . disappointing. Our commercial PC business was hampered by a selling and distribution model that was no longer profitable. We lacked focus. Neither our customers nor our employees clearly understood who Compaq was or where we were going. In this environment, we needed to make some significant changes, and we did."¹¹

Compaq's 1999 revenues reflected the first full year of operations that included both the Tandem and Digital acquisitions. For the year, consolidated revenue increased 24%, gross margins declined to 22.7% due to aggressive PC price competition, and operating expenses increased 26%. Factoring in a one-time gain from the spin-off of Alta Vista, an Internet search engine acquired in the Digital deal, Compaq finished the year with \$569 million in net earnings. Compaq shares ended the year down 36%. In 2000, Capellas made the Internet Compaq's primary focus. That year, Compaq began to deliver improved execution. Sales increased 10% to \$42 billion, gross margins increased 0.8% to 23.5%, and operating expenses as a percentage of sales declined 3% to 18%.

¹¹ Compaq Computer 1999 Annual Report.

In 2001, the U.S. economy in general, and the technology sector in particular, softened considerably, due in part to the collapse of the dot-com sector. A dramatic slowdown in business investment was compounded by the September 11 terrorist attacks and tipped the U.S. into its first recession in a decade. Further exacerbating matters was the fact that the economic slowdown was global in scope and included both consumer and business spending. The market downturn took a heavy toll on the high-tech sector, and for the first time in nearly a decade, the information technology industry contracted.

For the year, Compaq's consolidated revenue fell 21% to \$33.6 billion. Revenue was negatively impacted by price competition in PCs and low-end servers and by promotions aimed at reducing channel inventory. As a result, gross margins declined 2%. In this environment, Compaq continued to cut costs, lowering operating expenses by 6%. Cost-reduction efforts were not enough, however, to counterbalance declining sales and margins. Compaq ended the year with a \$785 million net loss, of which \$587 million was attributed to the Access (PC) business (see **Exhibit 1** for a detailed description of Compaq's segments and recent segment performance). In an attempt to further shift emphasis from hardware to services, Compaq bid for consulting firm Proxicom but lost out. Compaq shares lost more than 35% for the year. Despite ongoing efforts to transform Compaq from a PC company into a full-service enterprise computing company, Compaq still faced significant strategic and financial challenges.

One Wall Street analyst commented on Compaq's continued challenges as follows: "Compaq needs to dramatically reduce its cost structure, or it may never be able to fend off Dell in the PC and industry standard server markets. [T]he company also needs to further strengthen its high-end server strategy and its customer perception. Further, to build a true service-centric model, Compaq needs to increase its exposure to value-added professional services, as opposed to slower-growing maintenance services."¹²

Hewlett-Packard

Founded in 1939 in a garage by Stanford University engineers William Hewlett and David Packard, Hewlett-Packard had since grown to become one of the world's leading providers of computing and imaging solutions and services. With 87,000 employees, operations in 120 countries, and revenue of nearly \$45 billion in fiscal 2001, HP competed in nearly every major IT product segment.

As reported in the company's annual report, HP sought to be the category leader with respect to each of the specific products and categories in which it competed, and it actively expanded into new and adjacent markets.¹³ As of October 31, 2001, HP's three major business segments included Imaging and Printing Systems, Computing Systems, and Information Technology Services (IT Services).¹⁴

HP's Imaging and Printing Systems division marketed a broad array of products ranging from low-end printers and supplies to commercial printing solutions. In 2001, the Imaging and Printing Systems division was ranked number one in the \$25 billion global printer market, with 40% market share. In 2001, 2000, and 1999, the division accounted for 43%, 41%, and 43% of HP's revenue and 106%, 65%, and 64% of HP's earnings from operations, respectively.

¹² Bill Shope, "Compaq Computer," ABN-AMRO Inc., December 19, 2001.

¹³ Hewlett-Packard 2001 10-K.

¹⁴ HP utilized an October 31 fiscal year-end.

HP's Computing Systems division marketed systems targeting the consumer, commercial (small and midsized businesses), and enterprise segments. With global market shares of 7% and 13%, respectively, HP was ranked fourth in both the \$153 billion PC market and in the \$50 billion server market. In 2001, 2000, and 1999, the Computing Systems division accounted for 40%, 42%, and 41% of HP's revenue, respectively. The division reduced HP's overall operating income as a result of a loss in 2001, and it accounted for 23% of operating income in 2000 and 1999.

HP's IT Services division marketed design and installation services, hardware-related support and maintenance services, and increasingly consulting and outsourcing services. IT Services was HP's fastest-growing segment, and in 2001 the division was ranked eighth in the \$666 billion global services market. In 2001, 2000, and 1999, the IT Services segment accounted for 17%, 14%, and 14% of HP's revenue and 18%, 15%, and 16% of HP's earnings from operations, respectively.

(Exhibit 2 further describes HP's three business units and summarizes recent segment performance. Exhibit 3 provides market share estimates for HP and its competitors in the segments in which it competed.)

Late 1990s: Stalled Growth Necessitates Change

In 1998, HP Labs upheld its reputation as a prodigious source of innovation with the introduction of 20 new printing and imaging products—the largest rollout in the company's history. Despite the company's being armed with a suite of new products and against the backdrop of an IT infrastructure-spending boom that began the preceding year, HP's sales growth declined to a 15-year low. Notwithstanding cost-reduction initiatives that included "difficult but necessary" voluntary-severance programs and manufacturing consolidations, "unacceptably high expense growth" contributed to a decline in earnings from operations and net earnings of 11% and 6%, respectively.¹⁵

While HP management pointed to a weakened macroeconomic environment and competitive price pressures in PCs and printers to help explain its slumping sales, industry observers cited management's inability to keep pace with changing market conditions as a key contributor. Specifically, critics chastised HP management for failing to follow Dell's lead in adopting a low-cost, Internet-based direct sales channel to offset its reliance on the retail channel.¹⁶ HP similarly trailed IBM in establishing itself as a leading provider of both Internet-related products and integrated solutions. In response to criticism and in an effort to improve efficiency, in 1998 HP began to take the steps needed to offer customers the ability to buy PCs online. Despite these efforts, HP's sales continued to decline in 1999. In March, after 33 years of service and under mounting pressure for change, CEO Platt announced his retirement.

Reinventing HP to Lead in the Internet Age

In July 1999, HP's board appointed a new outside president and CEO, Carly Fiorina, with a mandate for radical change—to reinvent HP to lead in the Internet age. A self-described "change CEO," Fiorina had a reputation for being a salesperson extraordinaire at AT&T and Lucent. She also had the requisite expertise in the Internet domain and had previously overseen the large-scale spin-

¹⁵ Hewlett-Packard 1998 Annual Report.

¹⁶ All told, HP channel partners included approximately 20,000 retail outlets.

off of Lucent from AT&T. For all of these reasons, Fiorina was selected by the board to be part of HP's answer to stalled growth.¹⁷

Little more than three months after taking the helm and in her first letter to shareholders, Fiorina promised balanced revenue and earnings growth, targeting 12%–15% growth in 2000. Fiorina also identified the following six strategic priorities that would reposition HP for sustainable growth:¹⁸

1. Accelerating growth in existing businesses
2. Streamlining the existing decentralized operating model to fuel growth opportunities
3. Implementing a “total customer experience” approach—with the aim of turning the customer experience into a source of competitive advantage
4. Taking advantage of HP's strong balance sheet and cash generation capability to fund new growth initiatives
5. Leveraging HP's market position to drive the adoption of next-generation appliances, e-services, and infrastructure in high-growth markets
6. Creating e-services ecosystems and placing HP at the center by exploiting HP's reputation for being the best partner in the industry

Much as Gerstner had reasoned earlier, Fiorina believed that advances in technology, increased competition, and changing customer requirements were rapidly transforming the structure and economics of the IT industry. Indeed, Fiorina's decision to join HP was based, in part, on her belief in HP's ability to respond to these changes by transforming itself into a leading provider of integrated solutions: “It was clear to me when I came here in July 1999 that customers would deal with fewer players and this would lead to a structural shift. It was clear HP could lead: It was global, it had the scope and scale to do sustained R&D, and it had a powerful brand with positive associations.”¹⁹

Guided by the company's new strategic objectives, Fiorina quickly set out to transform HP into a Web services powerhouse that provided all the equipment and related services corporations would need to do business on the Internet. To that end, Fiorina confronted HP's fragmented empire, which she described as “fat and slow,” and revamped HP's organizational structure, collapsing 83 independent product lines (and 83 separate sales forces) into 17 product categories. Fiorina also created a more effective selling organization by establishing three front-end sales forces, for consumer products, corporate products, and HP consulting services. They would market and sell products made by three back-end groups—printers, computers, and technology consulting services.

Not content to stop there, Fiorina scrapped HP's profit-sharing plan in favor of a double-barreled pay-for-performance incentive program tied to revenue and profit growth. She also supercharged innovation by implementing a new incentive program that would double the number of patents filed in the following year. Fiorina's reach extended to HP's culture as well. As she explained in her 2000 letter to shareholders, for decades the HP Way served as a guiding set of principles that shaped actions and differentiated HP as a place to build a career. In recent years, however, the intent of those principles became clouded and was used to justify behavior such as conflict avoidance, excessive

¹⁷ In March 1999, HP announced it would split into two companies, spinning off its flagship and smaller Test and Measurement division as Agilent Technologies, while keeping the HP name on its vast computer products operations. HP's executive search criteria included identifying an individual who had previously overseen a similar spin-off.

¹⁸ Hewlett-Packard 1999 Annual Report, Letter to Shareholders.

¹⁹ HP 2000 Annual Report.

focus on consensus, and weak performance management. In 2000, HP management defined what new ways of working together would be required going forward and captured these requirements in *The Rules of the Garage*, which preserved and built on the beliefs and core values inherent in the HP Way.

Amid these changes, HP posted four quarters of improving top-line performance in 2000 and achieved 15% revenue growth. Leading sales growth contributors included a refreshed server product line and significant organic growth in consulting services. Indeed, during 2000 HP backed its commitment to its services business with the hiring of 1,700 consultants. Management announced it would continue to grow services organically as well as to consider other ways to capitalize on this increasingly important area. While meeting its revenue growth target, HP missed its earnings target, delivering just 6% growth in net earnings.²⁰ HP's share price declined 31% for the year.

In 2001, HP had to contend with the dramatic slowdown in business and consumer spending that marked the 2001 U.S. recession. However, HP management failed to heed signs that tech buying started to wane in the fall of 2000. While the company assured Wall Street that it would make its first-quarter numbers, results were 25% below the Street's expectations. News of the earnings shortfall caused a 14% decline in HP's stock price and cast doubt over Fiorina's credibility.

Fiorina responded with a renewed effort to improve HP's cost structure. To that end, HP asked 80,000 employees—nearly the entire workforce—to take a pay cut and laid off close to 8,000 workers. Further efforts to streamline HP's operating model included outsourcing PC manufacturing, relocating low-end printer manufacturing to the Asia Pacific region, and rolling out a Build-to-Customer-Order program that offered consumers and enterprise customers the ability to configure and purchase notebook PCs directly from HP over the Internet.

Despite management's efforts, HP's 2001 net earnings declined 89% on an 8% decline in revenue. Revenue from the Printing and Computer divisions declined due to both a decrease in sales unit volume and pervasive price competition. As a result, earnings from HP's Printing and Services divisions helped offset the Computer division's \$450 million loss. IT Services revenue increased 6% due, in part, to the division's winning several substantial outsourcing agreements with customers including Nokia, Sara Lee, Halliburton, and Qwest Communications. HP's Services division also established key alliances with Accenture and the Management Consulting Services practice of PricewaterhouseCoopers.²¹

Growth in HP's profitable Services division coupled with ongoing cost-reduction initiatives were not enough to overcome investors' concerns about how HP would fare in both the current recession and beyond in the emerging tech landscape. This concern was reflected in HP's stock price, which declined 35% for the year. Faced with the first worldwide recession since 1975 and the worst annual decline in U.S. spending on IT since 1958, Fiorina's quest for profitable growth would ultimately lead her to consider potential acquisitions, including that of Compaq (see **Exhibit 4** for ratios used to evaluate the profitability and operating, investment, and financial management of IBM, Dell, Compaq, and HP).

²⁰ In 2000, HP's net earnings (after tax) from continuing operations before extraordinary items and cumulative effect of changes in accounting principles increased 14.7%, in line with sales. However, after factoring in income from discontinued operations, HP's net income increased just 6%. Based on these results, Fiorina claimed she fulfilled her promise of delivering balanced growth in revenue and earnings yet also claimed failure in meeting profitability targets.

²¹ Hewlett-Packard 2001 Annual Report.

The Merger

The merger of HP and Compaq is the best way to strengthen our businesses and improve our market position, deliver more of what our customers need, enhance opportunities for our employees and increase the value of our shareowners' investments.

—HP CEO Carly Fiorina, 2001 Letter to Shareholders

In early 2001, faced with a myriad of challenges, Fiorina hired consulting firm McKinsey & Co. to help evaluate strategic options for the future growth of the company. The options the company faced included a go-it-alone plan, one that would split the company up, and one that would grow IT Services by buying tech-services companies. HP previously attempted to expand its services business in late 2000 when it approached PricewaterhouseCoopers to discuss acquiring its consulting practice for a price in the vicinity of \$17 billion to \$18 billion; however, talks ended without an agreement.²²

Also in early 2001, Fiorina contacted Compaq CEO Capellas to determine his interest in licensing HP's UNIX operating system, HP-UX. After several days of deliberation, Capellas contacted Fiorina to suggest that the synergies between HP and Compaq went beyond HP-UX and, in turn, raised the idea of a possible business combination.

After further discussion, Fiorina and Capellas determined that there was sufficient interest to seek authorization from their respective boards to further consider the combination (see **Exhibit 5** for background information for each of HP's board members). That authorization was granted, and, in turn, Compaq retained consulting firm Accenture to assist in assessing the attractiveness of the merger. Thereafter, HP, assisted by McKinsey, and Compaq, assisted by Accenture, separately conducted a comprehensive business due diligence investigation of the operations of the other.

HP and Compaq also engaged investment banks Goldman Sachs and Salomon Smith Barney, respectively, to advise their directors regarding the financial aspects of the business combination. Goldman's initial feedback to HP: the stock would take a 10%–15% hit right off the bat because of the massive risk of merging two \$40 billion behemoths with such a big stake in the low-margin PC business, adding, "Are you sure you want to do this?"²³

Over the next several months, representatives from HP, Compaq, McKinsey, Accenture, Goldman, and Salomon met repeatedly to discuss the business combination. In August, McKinsey delivered a report to HP's board detailing how HP could make the merger work. McKinsey concluded that most botched tech mergers involved companies trying to buy their way into new businesses they knew little about. This deal, on the other hand, could be more like successful mergers in other industries where similar companies combined, such as Exxon and Mobil.²⁴

On September 3, the boards of HP and Compaq convened separately to consider the terms of a proposed merger agreement that had been negotiated by their respective management teams. Backed by the strategic analyses of McKinsey and Accenture, advisors from Goldman and Salomon presented their financial analyses, each concluding that the exchange ratio provided for in the merger agreement was, at the time of the meeting, fair to HP and Compaq shareholders (see **Exhibits 6 and 7** for Goldman's exchange ratio and contribution analysis). Based in part on this finding, both boards voted unanimously to approve the merger agreement and resolved to recommend that their shareholders vote for the merger. Indeed, the merger decision hinged on majority shareholder

²² Subsequently, in July 2002, IBM purchased PricewaterhouseCoopers' consulting arm for \$3.5 billion.

²³ "Carly's Last Stand?" *BusinessWeek*, December 24, 2001.

²⁴ *Ibid.*

approval on the part of both companies. That night, the boards executed the merger agreement and issued a joint press release announcing their decision.

As set forth in the merger agreement, HP would acquire all of the outstanding stock of Compaq in exchange for 0.6325 shares of HP common stock for each outstanding share of Compaq stock and the assumption of options based on the same exchange ratio. The estimated purchase price of \$24 billion was derived using an average market price per share of HP common stock of \$20.92, which was based on an average of the closing prices for a range of trading days (August 30, August 31, September 4, and September 5, 2001) around the announcement date (September 3, 2001) of the proposed merger.²⁵

Management's Reasons for the Merger

HP management contended that while the marketplace was changing, with customers increasingly demanding full-line end-to-end hardware and service providers, neither HP nor Compaq was in that position alone. However, together they could replicate IBM's model. "We get a time at bat against IBM every single time," claimed Fiorina.²⁶ Indeed, HP would not only enjoy top market share in printers, PCs, and storage, it would also have the second-largest server business and the third-largest tech-services organization.

In a proxy statement provided to shareholders, HP management identified several potential benefits from the merger:²⁷

1. Personal Systems: Improved Economics and Innovation

HP and Compaq needed to improve the economics of their PC businesses to effectively compete with industry leader Dell. Management predicted that the combined company would have a lower cost structure due to economies of scale. HP would also be able to leverage Compaq's progress in developing a direct sales channel, yielding a more flexible distribution model.

2. Complementary Leadership in Key Markets

Compaq's strength in industry standard servers coupled with HP's Linux and UNIX offerings would result in an industry-leading product line spanning the entire server category. In addition, Compaq led in overall storage. By adding HP's strength in high-end storage, the combined company would be the industry leader in both the enterprise storage segment and the fastest-growing sub-segment—storage area networks. The combined company would also be better positioned to provide integrated solutions that met the needs of customers as a result of having a broader portfolio of products and services. In doubling HP's sales force, the merger would also allow HP to increase account coverage and better compete for important customer engagements around the world.

3. IT Services: Strengthened Business Provides Critical Mass in Key Growth Market

Management believed the merger would significantly strengthen HP and Compaq's combined services business for several reasons. First, the combined services business would have 65,000 IT architects operating in 160 countries, which would provide the critical mass needed to accelerate growth in this key market. The merger would also expand the support business, an important driver

²⁵ HP 2001 Annual Report, Note 6. Acquisitions and Divestitures.

²⁶ *The Financial Times* (London), May 1, 2002.

²⁷ Hewlett-Packard S-4 Report, January 14, 2002.

of customer loyalty, and would provide a larger customer base to sell to. The combined support business would, in turn, deliver a larger stream of predictable revenue with double-digit profits. Management also believed that the merger would result in a leading position in managed services—the fastest-growing service segment—mission-critical services (servers and solutions), and multivendor support.

4. Financial Benefits

According to plan, the merger would yield \$2.5 billion in annual cost savings by mid-2004. These cost savings would significantly improve overall profitability and were estimated to have a net present value in the range of \$5 to \$9 per share (see **Exhibit 8** for management's post-merger consolidated and segment-level operating targets and related assumptions). Over time, and as a result of the improved profitability, the merger would enable HP to increase investment in the imaging and printing business, currently the company's primary cash generator.

Walter Hewlett's Opposition to the Merger²⁸

Background to the dissent Despite backing by the CEOs of HP and Compaq, their respective boards, consultants McKinsey and Accenture, and financial advisors Goldman and Salomon, the proposed deal faced significant and powerful opposition. The most notable critic of the proposed merger was Walter Hewlett, 14-year HP director and son of HP cofounder William Hewlett.

In addition to his role as director, Hewlett was cotrustee of the William R. Hewlett Revocable Trust (the Trust) and chairman of the William and Flora Hewlett Foundation (the Foundation), which collectively owned 72.8 million shares—or 5.9%—of HP common stock. In this capacity, Hewlett was not only a powerfully symbolic HP figurehead, he was also HP's second-largest shareholder and an important voting constituent.

Hewlett first learned of Fiorina's discussions about a combination with Compaq at an HP board meeting in May 2001. For the next three months, during subsequent board meetings, Hewlett considered the merits of the transaction and voiced concerns centered on a growing conviction that the merger would destroy shareholder value. As a shareholder and director, Hewlett firmly believed in the board's fiduciary duty to pursue shareholder value and to guide HP to profitable growth.

Despite Hewlett's opposition, Fiorina continued to pursue the merger. On August 31, three days before the HP board would vote on the merger, Larry Sonsini, HP's legal counsel, told the board that the merger agreement required unanimous approval. In response, Hewlett made it clear that this requirement put him in an uncomfortable position, as he was not convinced that the merger was in the best interest of HP.

Sonsini asked to speak with Hewlett outside the presence of the rest of the board and told him that HP would proceed with the merger whether or not he voted in favor of it. However, if Hewlett voted against the merger, the agreement could not be signed without renegotiation, which might result in HP's having to pay a higher price. Sonsini further advised Hewlett that even if he voted for the merger as a board member, he could subsequently vote against it as a stockholder.

Hewlett believed it was his duty to negotiate the lowest possible price for Compaq if the merger was to be submitted to a shareholder vote. Since the merger would be approved without his vote, Hewlett decided to vote for the merger as a director and to give shareholders the chance to make their own decision. On September 3, during the telephone call in which the proposed merger was

²⁸ Content from this section was derived from the Hewlett-Packard Schedule 14-A Proxy Statement, December 27, 2001.

approved by HP's board, Hewlett informed the board that he might not support the merger as a stockholder, adding that if the shareholder vote were to occur that day, he would vote against it.

Hewlett's concerns about the transaction seemed to be confirmed by the stock market's negative reaction to the proposed merger. On November 5, 2001, two months after the initial announcement, HP's share price trailed the preannouncement level by 27%, representing an aggregate loss of \$12.3 billion of market value. During the same time, an index of comparable companies increased 9.9%.²⁹ Hewlett viewed the market's reaction as a sign of significant shareholder dissatisfaction.

After the proposed merger was announced, the Hewlett Foundation's independent stock committee asked the Foundation's chief investment officer, Laurence Hoagland, to analyze the merger. Hoagland was previously CEO of Stanford Management Company, which oversaw Stanford University's investment portfolio.

Separately, Hewlett and cotrustee Edwin Van Bronkhorst—former HP CFO—engaged Friedman Fleischer & Lowe, LLC (FFL), a San Francisco investment bank, to evaluate the merger on behalf of the Trust. Hoagland and FFL separately determined that the merger was not in the best interest of the Foundation or the Trust, and, in turn, both entities decided to vote their shares against the merger.

Armed with two independent analyses that supported the market's reaction, Hewlett decided to make his views known publicly in an effort to terminate the transaction and the uncertainty surrounding HP's future. On November 6, 2001, Hewlett announced that the Foundation, the Trust, Hewlett's sisters Eleanor and Mary, and he would vote against the merger. Later that same day, David Woodley Packard, son of HP cofounder David Packard, announced that he too would vote against the merger. News of the opposition on the parts of Hewlett and Packard sent HP shares soaring 17%. The market's reaction reinforced Hewlett's belief that the merger was not beneficial for HP.

Within weeks, HP's largest shareholder, The David and Lucille Packard Foundation (the Packard Foundation), which owned 10.4% of HP common stock, conducted its own independent analysis. The Packard Foundation's board consisted of five Packard family members and seven additional members including a former CEO and a former COO of HP. To assist it in determining how to vote its shares, the Packard Foundation's board retained consulting firm Booz-Allen & Hamilton (BAH). On December 7, the Packard Foundation announced that it too would vote against the merger. Shares of HP and Compaq closed down 2% and 14%, respectively.

Despite the market's reaction and opposition by the Hewlett and Packard families, Fiorina was determined to take the merger to a vote. In response, and acting on behalf of the Trust, Hewlett initiated a proxy war and began to take the steps needed to solicit votes against the merger.

Hewlett's reasons for voting against the merger Hewlett concurred with Fiorina that the marketplace was changing. However, he believed acquiring Compaq was not the solution. Rather than merge, Hewlett favored strengthening HP's profitable printing business and shedding all noncore businesses.

²⁹ The index of comparable companies consisted of Accenture Ltd., Apple Computer, Computer Sciences Corporation, Dell Computer, Electronic Data Systems, EMC Corporation, Gateway Inc., IBM, KPMG International, Network Appliance, and Sun Microsystems. These are the same companies used by Goldman in its "Selected Companies Analysis" in connection with rendering its fairness opinion to HP.

In a proxy statement issued by Hewlett to HP shareholders, Hewlett offered the following four reasons for voting against the merger:³⁰

1. HP's Business Portfolio Will Be Worse

The proposed merger would dilute HP stockholders' interest in the profitable imaging and printing business and increase their exposure to an unprofitable PC business. Further, the imaging and printing segment had at least 10% normalized operating profit margins, and the market was expected to grow at over 10% per year. Conversely, the PC segment was unprofitable, and that market was expected to shrink for the next several years and then grow at less than half the rate of the imaging and printing market (see Exhibits 9 and 10 for HP and Compaq's combined *pro forma* business mix and margin analysis).

2. The Integration Risk of the Proposed Merger Is Substantial

No significant combination involving a computer company had ever met expectations. The odds were against success in this merger, particularly since HP management had no experience with a merger of this magnitude. Further, HP management described the transaction challenge as "a massive integration effort . . . in the midst of reinvention." The complexity of putting two companies together in a difficult economy, when each was undergoing its own transition, presented daunting and unacceptable challenges. Moreover, even if the cost synergies were achieved, it was likely that merger-related revenue losses would offset or exceed them. Analysts estimated revenue losses could be as high as 15% in 2002 and 17% in 2003. These estimates were substantially greater than HP's forecast of 5%.

3. The Financial Impact on HP Stockholders Has Been and Will Be Negative

The market had twice made it clear that the proposed combination would destroy value for HP shareholders—once when HP's stock price dramatically declined after the proposed merger was announced, and again when HP's stock price dramatically increased after the Hewlett and Packard families made their opposition known (see Exhibits 11 and 12 for stock price reaction on key event dates).

In addition, since the announcement of the merger, Wall Street estimates for the future financial performance of Compaq became available and were significantly lower than the estimates considered by the HP board at the time it approved the merger. This meant that HP stockholders were getting too little of the combined company relative to HP's contribution to earnings. On the announced terms of the merger, HP stockholders would own 64.4% of the combined company and HP would contribute 66.5% of the combined company's net income in calendar 2002. But based on First Call's revised earnings estimate, which was 33% lower than the estimate cited in HP's solicitation materials, HP would contribute 87.1% and 76.7% of the combined earnings in calendar years 2002 and 2003. Compared with an exchange ratio resulting in HP stockholders owning 80% of the combined company, the existing terms of the merger resulted in the transfer of \$13.7 billion in value from HP stockholders to Compaq stockholders. Based on the revised estimate, HP would pay 82.6 times Compaq's 2002 earnings, rather than the agreed upon 22.2 price-earnings multiple.

Furthermore, despite management's assertions that a key asset of the combined company would be a stronger balance sheet, the credit agencies disagreed. Shortly after the transaction was announced, Moody's downgraded HP's long-term debt by two notches from Aa3 to A2, and

³⁰ Hewlett-Packard Schedule 14-A Proxy Statement, December 27, 2001.

Standard & Poor's put HP on CreditWatch with a negative outlook. Ss&P explained its decision as follows:

If the merger is completed, Compaq's ratings would be reviewed for upgrade reflecting its acquisition by a stronger credit. The CreditWatch negative placement of HP is based on the acquisition of a lower-rated company with a similar-size revenue base and S&P's concerns about integration and business disruption risks inherent in a merger of this size in the highly competitive and rapidly evolving technology market.

Thus, the merged balance sheet would be worse than that of HP on a stand-alone basis, resulting in a lower credit rating, greater equity risk, and a higher cost of capital. In contrast, Compaq's stockholders were getting a great deal at HP stockholders' expense. Compaq would get a business lifeline to the profitable imaging and printing business, a better credit rating, and the security of greater earnings coverage for its PC losses.

4. HP's Strategic Position Will Not Materially Improve

The proposed merger would not materially improve HP's strategic position for several reasons. First, the proposed merger would dramatically increase HP's market position in unattractive lower-end commodity businesses, such as PCs and low-end servers. Regarding PCs, though the combined company would have a 60%–70% share of the retail consumer PC market, neither company had a profitable PC business model. Further, neither company had successfully transitioned to a direct distribution model to become more cost competitive with Dell. Compaq had made some progress in the U.S. and almost none in the rest of the world. Analysts estimated that approximately 3% of HP's sales and 20%–30% of Compaq's sales were direct. Analysts also estimated it would take several years for Compaq to become competitive with Dell. The combination of two unprofitable businesses, in an increasingly competitive market, that individually made little progress in developing a direct distribution model, was unlikely to become a source of profit in a combined company.

Regarding servers, the proposed merger would not materially improve HP's market position in midrange and high-end servers or in high-end services, all of which had higher profit margins than PCs. Compaq's server market share was primarily in the low end of the market, where margins were lower and under increasing pressure from Dell. Entry-level servers accounted for 76% of Compaq's 2000 server revenue, and average selling prices for entry-level servers had fallen 52% from 1997 to the third quarter of 2001. In the midrange and high-end server markets, the combined company's market share would still trail IBM's by a considerable margin. And in terms of storage, Compaq's storage business was attractive, but it was also relatively small and did not justify taking the risks of the proposed merger.

HP's strategic position would also not improve because the deal would divert management's attention and financial resources from HP's preeminent imaging and printing business. In this fast-moving market, HP could not afford to wait for its other businesses to become profitable. Diversion of management attention during the integration process and underinvestment in imaging and printing could have a significantly adverse impact on HP's leadership position.

The merger would also do little to increase HP's consulting and outsourcing capabilities, which had higher profit margins than its existing hardware support and maintenance services. HP management acknowledged that high-growth consulting and outsourcing capabilities were needed to compete with IBM in selling high-value-added, end-to-end solutions. However, Compaq's service business, like that of HP, was focused on the lower-growth, lower-margin hardware support and maintenance segments.

Opinions of Capital Market Intermediaries

As a result of the voting decisions made by the Hewlett and Packard family members, approximately 16% of HP's outstanding common stock was positioned against the merger. Of the remaining voting shares, 25% were held by retail investors, and 57% were held by institutional investors.

Needing only a majority vote, Fiorina and Capellas conducted an intensive coast-to-coast road show courting institutional investors, and in an effort to enhance their credibility, they engaged Institutional Shareholder Services (ISS) to evaluate the deal. ISS billed itself as "a leading independent provider of proxy voting services for institutional investors."³¹ On March 5, 2002, ISS advised institutional shareholders to vote for the merger. ISS Vice President Patrick McGurn explained, "My initial reaction was in line with Walter's. My gut instinct was, they've got to be kidding. But after 20 meetings and incalculable hours pouring over management's plan for weaving the two companies together, we had a high enough confidence level to say the risk was manageable."³²

The views of other independent intermediaries were varied. Analysts in favor of the merger felt that the combination was the best available option for two firms that were struggling to compete and cited the proposed cost savings as one of the primary benefits. "There's enormous opportunity for synergies," said Deutsche Banc Alex Brown analyst George Elling, who expected HP shares to be worth \$40 if the companies executed as planned.³³ "Without this merger, HP wouldn't have the sales horsepower to compete with Sun or IBM," added analyst John Jones of JB Ventures.³⁴ Jones also noted that the tech giant would have not one but two cash cows—HP's \$9 billion ink-cartridge business, plus a computer-repair business double the size of HP's. This, in turn, would allow HP to fund more than \$4 billion in R&D, up from the \$2.6 billion it currently spent.

Critics of the deal included UBS Warburg analysts Don Young and Anthony Torna. Adamant in their opposition, Young and Torna downgraded both companies from buy to hold and reduced their 12-month price target for HP from \$37.50 to \$18.00.³⁵ "We do not like this deal," asserted the analysts, adding, "we do not find the strategic rationale of this merger to be attractive."³⁶ Young and Torna shared Hewlett's concern that the deal would dilute investors' exposure to HP's profitable imaging business while significantly increasing investors' exposure to the commodity PC business: "Our prior positive view of HP was solely based on the value in the imaging business as we believe HP's server business is poorly positioned and its PC business is late to endorse direct distribution."³⁷ They also questioned the strategic benefits of combining HP's and Compaq's service businesses. "When one looks at the quality of services, the unattractive maintenance business dominates HP's [and Compaq's] mix while outsourcing/consulting/systems integration dominates that of IBM. . . . This is not another IBM! This deal does not result in HP becoming a stronger challenger to IBM in the enterprise space," concluded Young and Torna. Indeed, to become a stronger challenger, HP would

³¹ As described on ISS's Web site (www.issproxy.com/about/index.asp), ISS's core business consisted of analyzing proxies and issuing informed research and objective vote recommendations. ISS also operated an institutional business that served the corporate market with a variety of governance tools assisting management with executive and director compensation modeling, capital structure planning, and understanding corporate governance best practices.

³² "HP and Compaq: What's an Investor to do?" *BusinessWeek*, March 18, 2002.

³³ George Elling, "Hewlett-Packard," Deutsche Banc Alex Brown, September 19, 2001.

³⁴ "HP and Compaq: What's an Investor to do?" *BusinessWeek*, March 18, 2002.

³⁵ On March 18, 2002, the day before the HP shareholder vote, the closing stock prices for HP and Compaq were \$19.25 and \$10.36, respectively.

³⁶ Don Young and Anthony Torna, "Hewlett-Packard," UBS Warburg Research Note, September 6, 2001.

³⁷ *Ibid.*

likely need a follow-on acquisition (see **Exhibit 13** for a services comparison of HP, Compaq, and IBM).³⁸

Echoing similar sentiments, J.P. Morgan H&Q analyst Daniel Kunstler commented, “Hewlett Packard’s and Compaq’s heritage is in the computing business but they’ve lost their competitive advantage and they want to get it back through services . . . that goal is their pipe dream. . . . In terms of creating better value for shareholders, they are better off not doing this deal.”³⁹

Critics also questioned the risk involved in taking on Compaq’s PC business. Though Compaq had made strides toward becoming more efficient through outsourcing production, streamlining distribution, and selling more on the Web, its PC unit still lost \$587 million in 2001. If Fiorina aimed to turn a 3% operating profit, Compaq would need to extend its own efficiency gains and teach HP to do the same. Yet, to the extent that HP and Compaq continued to rely on the retail channel, Dell’s leaner model would continue to have a low-cost edge. “Dell’s advantage is large and increasing,” claimed CEO Michael Dell.⁴⁰

A final concern was the difficulty in integrating two large-scale businesses. Critics echoed Hewlett’s observation that large technology mergers had a history of failure. However, Fiorina was well aware of the challenge. In an effort to improve the odds of successfully integrating the two companies, Fiorina and Capellas formed integration teams, ultimately involving more than 1,000 staff who spent an estimated 1.3 million man-hours planning in minute detail. These plans, made far in advance, eventually helped convince ISS to support the deal.

On balance, Banc of America analyst Joel Wagonfeld concluded that the trade-offs in whether to merge or not included faster revenue growth and a higher net income margin in the next few years for a stand-alone HP, versus faster growth in earnings and market-leading positions as a combined entity (see **Exhibit 14**).⁴¹

The Shareholders Vote

The 51.4% shareholder approval margin reflected a high level of uncertainty concerning the merits of the merger. It also prompted a lawsuit brought by Hewlett alleging that HP improperly pressured the asset management arm of Deutsche Banc to reverse its voting decision at the last minute. Deutsche Banc controlled 1.3% of the company’s shares and originally decided to vote more than 25 million shares against the merger. However, on the day of the vote, the bank changed course and voted 17 million votes in favor of the deal.

While the narrow victory allowed HP’s management to proceed with the merger, many observers wondered whether the move would truly help or hurt the company’s strategic and financial position in the long run. The acrimony surrounding the deal also raised important questions related to corporate governance—including the appropriate roles of management, the board, and various advisors and intermediaries—in the complex world of mergers and acquisitions.

³⁸ Don Young and Anthony Torna, “Hewlett-Packard,” UBS Warburg Research Note, September 6, 2001.

³⁹ “A New Computing Giant?” *The New York Times*, September 5, 2001.

⁴⁰ “HP and Compaq: What’s an Investor to do?” *BusinessWeek*, March 18, 2002.

⁴¹ Joel Wagonfeld, “The Hewlett-Packard/Compaq Merger,” Banc of America Securities, October 2001.

Exhibit 1 Compaq Segment Descriptions

Enterprise Computing

Enterprise Computing designed, developed, manufactured and marketed advanced computing and telecommunications products and solutions for enterprise customers worldwide. The segment consisted of three global business units: Industry Standard Servers, Business Critical Solutions and Enterprise Storage. Enterprise Computing accounted for approximately 32%, 34%, and 34% of Compaq's revenues in 2001, 2000, and 1999, respectively. In 2001, Compaq's Enterprise division shared the number one ranking with EMC Corporation in the \$50 billion storage market, with 17% market share. Compaq's Enterprise division also held the number three ranking in the \$50 billion server market, with 13% market share.

Access

The Access segment delivered products and solutions designed to provide home and business users with anytime, anywhere access to information, communication and entertainment. For the business customer, the Access segment offered a broad range of commercial computing devices, services and solutions, including desktop, notebook, and workstation computers and a full line of Compaq branded monitor and networking products. For the consumer customer, the Access segment offered products and technologies that worked together to help the home or home office user to simplify their lives, connect their world and have fun including desktop and notebook Internet PCs and a line of monitors and printers sold under the Compaq brand. In addition, the Access segment offered a line of personal devices and solutions marketed under the iPaq brand, targeting the convergence of business and home computing. These include entertainment and communications products, home networking products, desktop computers, microportable projectors and devices used to access the Internet. The Access segment accounted for approximately 45%, 49%, and 47% of Compaq's revenue in 2001, 2000, and 1999, respectively. In 2001, Compaq's Access division held the number two ranking in the \$153 billion PC market, with 11% market share. The Access division was also ranked eighteenth in the \$25 billion printer market, with .7% market share.

Compaq Global Services

The Compaq Global Services segment helped customers manage the complexities and risks of multi-vendor/multi-technology information technology environments in over 200 countries. Global Services' solutions were optimized for the highest levels of performance, availability and security, and the division was the industry leader in delivering enterprise solutions based on Microsoft Corporation's technologies. Compaq's Global Services segment consisted of four global business units: Customer Support, Systems Integration, Managed Services and Financial Services. Customer Support offerings included lifecycle support services, business-critical services and high availability support services for multi-vendor, multi-technology hardware and software products. Lifecycle support services consisted of installation, user assistance, maintenance, upgrading, replacement and disposition services available through a product's end of life. Systems Integration meant designing, configuring and installing a variety of computers and other information technology devices, often from different vendors and performing different functions, to provide a unitary system within a user environment. Systems Integration offerings included end-to-end information systems consulting, technical and application design services, systems integration, Internet and network architecture, project management services and e-business solutions. Managed Services offerings included outsourcing and resource management services, as well as business continuity and recovery services. Financial Services offerings included customized enterprise financing solutions that encompassed computers, networks and technology upgrades, as well as asset management services for large and multi-national business customers. Asset management services involved the tracking, recovery, reconditioning and disposition of equipment. Compaq Global Services accounted for approximately 23%, 18%, and 19% of Compaq's revenue in 2001, 2000, and 1999, respectively. In 2001, Compaq's Global Services division was ranked ninth in the \$666 billion services market, with 1% market share.

Source: Compaq 2001 10-K Report.

Exhibit 1 (continued) Compaq Segment Performance for the Years Ended December 31
(in millions)

	2001	2000 ^a	1999 ^a	1998 ^a
Enterprise Computing				
Revenue	\$10,699	\$14,253	\$12,947	NR ^b
Annual growth rate	-25%	10%	NA ^b	
Percent of total segment revenue	31.89%	33.76%	33.67%	
Operating Income	163	1,656	674	NR
Annual growth rate	-90%	146%	NA	
Percent of total operating income	25.51%	62.68%	71.25%	
Compaq Global Services				
Revenue	\$7,789	\$7,483	\$7,413	NR
Annual growth rate	4%	1%	NA	
Percent of total segment revenue	23.21%	17.72%	19.28%	
Operating Income	1,062	884	998	NR
Annual growth rate	20%	-11%	NA	
Percent of total operating income	166.20%	33.46%	105.50%	
Access				
Revenue	\$15,193	\$20,624	\$18,128	NR
Annual growth rate	-26%	14%	NA	
Percent of total segment revenue	45.28%	48.85%	47.15%	
Operating Income (loss)	(587)	145	(437)	NR
Annual growth rate	-505%	-133%	NA	
Percent of total operating income	NM ^b	5.49%	NM	
Segment Eliminations and other				
Revenue	(\$127)	(\$138)	(\$41)	NR
Annual growth rate	-8%	237%	NA	
Operating Income (loss)	1	(43)	(289)	NR
Annual growth rate	-102%	-85%	NA	
Consolidated Segment Totals				
Revenue	\$33,554	\$42,222	\$38,447	NR
Annual growth rate	-21%	10%	NA	
Operating Income	639	2,642	946	NR
Annual growth rate	-76%	179%	NA	

Source: Compaq 2001 10-K Report.

^aSegment results reflect changes made during 2001 in the organization of Compaq's businesses and its expense allocation methodology. In 2001, Compaq combined its commercial personal computing business with its consumer business to form the Access segment. In addition, the results of Compaq's financing business, which were previously reflected in the Other segment category, were included in the Compaq Global Services segment in 2001. Further, Compaq allocated certain expenses, such as information management, facilities and marketing costs, to the segments during 2001. The effect of this change in expense allocation was to lower segment operating profit by the amount of the allocated costs. Segment financial data for the fiscal years ended December 31, 2000 and 1999 has been restated to reflect these organizational changes. Finally, segment data in prior years was reported on a geographic versus business unit basis and is therefore not reported (NR) here. In turn, growth rates were not available (NA) in 1999.

^bNR—Not Reported, NA—Not Applicable, NM—Not Meaningful.

Exhibit 2 Hewlett-Packard Segment Descriptions

Imaging and Printing Systems

HP's portfolio of printing and imaging offerings ranged from low-end printers and supplies to commercial printing solutions. Imaging and Printing Systems provided laser and inkjet printers, copiers, scanners, all-in-one devices, personal color copiers and faxes, digital senders, wide-and-large format printers, print servers, network-management software, digital photography products, imaging and printing supplies, imaging and software solutions, and related professional and consulting services.

Computing Systems

Computing Systems provided a broad range of computing systems for the enterprise, commercial, and consumer markets. The products and solutions ranged from mission-critical systems and software to personal computers for the business and home. Major product lines included UNIX and PC servers, desktop and mobile personal computers, workstations, software solutions, and storage solutions.

IT Services

IT Services provided consulting, education, design, and installation services, ongoing support and maintenance, proactive services like mission-critical support, outsourcing, and utility-computing capabilities. Financing capabilities included leasing, automatic technology-refreshment services, solution financing, and venture financing.

Source: Hewlett-Packard 2001 10-K Report.

Exhibit 2 (continued) Hewlett-Packard Segment Performance for Years Ended October 31

(in millions)	2001	2000	1999	1998	1997
Imaging and Printing Systems^a					
Total net revenue	\$19,447	\$20,476	\$18,550	\$16,709	\$15,986
Annual growth rate	-5.0%	10.4%	11.0%	4.5%	NA
Percent of total segment revenue	43.4%	41.0%	42.6%	41.3%	43.9%
Earnings (loss) from operations	\$1,987	\$2,746	\$2,355	\$2,043	\$2,037
Annual growth rate	-27.6%	16.6%	15.3%	0.3%	NA
Percent of total operating earnings	105.7%	64.8%	63.8%	62.6%	59.8%
Computing Systems^a					
Total net revenue	\$17,771	\$21,095	\$17,814	\$17,315	\$15,500
Annual growth rate	-15.8%	18.4%	2.9%	11.7%	NA
Percent of total segment revenue	39.7%	42.2%	40.9%	42.8%	42.6%
Earnings (loss) from operations	-\$450	\$960	\$850	\$480	\$581
Annual growth rate	-146.9%	12.9%	77.1%	-17.4%	NA
Percent of total operating earnings	NM	22.7%	23.0%	14.7%	17.1%
IT Services					
Total net revenue	\$7,599	\$7,129	\$6,255	\$5,685	\$4,804
Annual growth rate	6.6%	14.0%	10.0%	18.3%	NA
Percent of total segment revenue	17.0%	14.3%	14.4%	14.0%	13.2%
Earnings (loss) from operations	\$342	\$634	\$575	\$748	\$797
Annual growth rate	-46.1%	10.3%	-23.1%	-6.1%	NA
Percent of total operating earnings	18.2%	15.0%	15.6%	22.9%	23.4%
All Other^b					
Total net revenue	NR ^c	\$1,299	\$886	\$773	\$84
Annual growth rate	NA ^c	46.6%	14.6%	820.2%	NA
Percent of total segment revenue	NA	2.6%	2.0%	1.9%	0.2%
Earnings (loss) from operations	NR	-\$103	-\$71	-\$5	-\$11
Annual growth rate	NA	45.1%	1320.0%	-54.5%	NA
Percent of total operating earnings	NA	NM ^c	NM	NM	NM
Total Segments					
Total net revenue	\$44,817	\$49,999	\$43,505	\$40,482	\$36,374
Annual growth rate	-10.4%	14.9%	7.5%	11.3%	NA
Earnings (loss) from operations	\$1,879	\$4,237	\$3,689	\$3,266	\$3,404
Annual growth rate	-55.7%	14.9%	13.0%	-4.1%	NA

Source: Hewlett-Packard's 1997-2001 annual reports and casewriter's estimates.

^aIn the second and third quarters of fiscal 2000, HP made certain strategic changes to its organizational structure. These changes included the movement of its appliances business from the Computing Systems segment to a separate operating segment, and the movement of the majority of its services business related to imaging and printing from the Imaging and Printing Systems segment to its IT Services segment. The appliances operating segment is included in "All Other" since it did not meet the materiality threshold for a reportable segment. Segment financial data for the fiscal years ended October 31, 1999 and 1998 has been restated to reflect these organizational changes.

^bHP's immaterial operating segments were aggregated to form an "all other" category.

^cNR—Not Reported, NA—Not Applicable, NM—Not Meaningful.

Exhibit 3 Hewlett-Packard 2000-2001 Market Share Estimates by Business Segment

Segments:	Information Technology Services	Personal Computers	Servers	Printers
2001 Estimated worldwide market size in billions:	\$666 ^a	\$153	\$50	\$25
Market share rank:				
Rank: 1	IBM	Dell	IBM	Hewlett-Packard
Market share:	5%	14.1%	26.5%	40.4%
Rank: 2	EDS	Compaq	Sun Microsystems	Epson
Market share:	2.9%	11.3%	16.7%	14.5%
Rank: 3	Fujitsu	IBM	Compaq	Canon
Market share:	2%	8.1%	13.4%	8.9%
Rank: 4	Computer Sciences	Hewlett-Packard	Hewlett-Packard	Xerox
Market share:	1.60%	6.9%	12.9%	8.4%
Rank: 5	Accenture	NEC	Dell	Lexmark
Market share:	1.50%	5.0%	6.8%	7.4%
Rank: 8	Hewlett-Packard	--	--	--
Market share:	1.10%			
Rank: 9	Compaq	--	--	--
Market share:	1%			
Rank: 18	--	--	--	Compaq
Market share:				0.7%

Source: Compiled from Gartner Dataquest (as reported in *The New York Times*, September 5, 2001).

^aActual market size in 2000.

Exhibit 4 FY 2001 BAV Ratios for Hewlett-Packard, Compaq Computer, IBM, and Dell Computer^a

DECOMPOSING PROFITABILITY: DUPONT ALTERNATIVE	Hewlett-Packard	Compaq ^b	IBM	Dell
NOPAT/Sales	1.0%	-2.3%	9.2%	8.8%
x Sales/Net Assets	2.98	3.11	1.89	18.94
= Operating ROA	3.1%	-7.3%	17.4%	129.3%
Spread	-2.8%	-7.3%	16.7%	129.3%
x Net Financial Leverage	0.07	-0.11	1.21	-0.68
= Financial Leverage Gain	-0.2%	0.8%	20.1%	-88.3%
ROE (Operating ROA + Spread * Net Financial Leverage)	2.9%	-6.5%	37.4%	41.0%
EVALUATING OPERATING MANAGEMENT	Hewlett-Packard	Compaq ^b	IBM	Dell
Key Growth Rates:				
Annual Sales Growth	-7.5%	-20.5%	-2.9%	26.2%
Annual Net Income Growth	-89.0%	-238.0%	-4.8%	30.7%
Key Profitability Ratios:				
Sales/Sales	100.0%	100.0%	100.0%	100.0%
Cost of Sales/Sales	73.5%	78.8%	65.0%	79.8%
Gross Margin	26.5%	21.2%	37.8%	20.2%
SG&A/Sales	16.1%	15.9%	20.0%	10.0%
Other Operating Expense/Sales	6.8%	7.8%	6.2%	1.8%
Investment Income/Sales	-1.0%	0.0%	0.0%	1.7%
Other Income, net of Other Expense/Sales	-1.0%	0.0%	2.2%	0.0%
Minority Interest/Sales	0.0%	0.0%	0.0%	0.0%
EBIT Margin	1.7%	-2.3%	13.8%	16.6%
Net Interest Expense (Income)/Sales	0.1%	0.0%	0.3%	0.0%
Pre-Tax Income Margin	1.6%	-2.3%	12.8%	16.6%
Taxes/Sales	0.2%	-0.6%	3.8%	3.0%
Unusual Gains, Net of Unusual Losses (after tax)/Sales	-0.5%	-0.7%	0.0%	-0.2%
Net Income Margin	0.9%	-2.3%	9.6%	8.8%
EBITDA Margin	4.7%	1.8%	16.6%	10.6%
NOPAT Margin	1.0%	-2.3%	9.2%	8.8%
Recurring NOPAT Margin	2.4%	-1.7%	7.6%	7.0%
EVALUATING INVESTMENT MANAGEMENT	Hewlett-Packard	Compaq ^b	IBM	Dell
Working Capital Management:				
Operating Working Capital / Sales	12.4%	5.1%	13.1%	-5.2%
Operating Working Capital Turnover	8.08	19.69	7.63	-19.41
Accounts Receivable Turnover	5.28	4.00	2.79	12.23
Inventory Turnover	5.83	12.24	11.35	65.08
Accounts Payable Turnover	6.58	6.25	6.60	7.19
Days' Receivables	69.15	91.29	130.61	29.85
Days' Inventory	62.58	29.83	32.15	5.61
Days' Payables	55.44	58.43	55.29	50.75
Long-Term Asset Management:				
Net Long-Term Assets Turnover	4.73	3.89	2.51	9.58
Net Long-Term Assets / Sales	21.1%	27.1%	39.9%	10.4%
PP&E Turnover	10.06	9.78	5.14	41.88
Depreciation & Amortization/Sales	3.0%	4.1%	5.6%	0.6%
EVALUATING FINANCIAL MANAGEMENT	Hewlett-Packard	Compaq ^b	IBM	Dell
Short-Term Liquidity:				
Current Ratio	1.53	1.31	1.13	1.48
Quick Ratio	0.83	0.96	0.95	1.30
Cash Ratio	0.26	0.22	0.10	0.80
Operating Cash Flow Ratio	0.17	0.12	0.14	0.05
Debt and Long-Term Solvency:				
Liabilities-to-Equity	1.39	1.06	3.15	1.16
Debt-to-Equity	0.35	0.11	1.39	0.10
Net-Debt-to-Equity	0.07	-0.11	1.21	-0.68
Debt-to-Capital	0.26	0.10	0.58	0.09
Net-Debt-to-Net Capital	0.06	-0.12	0.55	-2.15
Interest Coverage Ratio:				
Interest Coverage	3.08		47.02	
Payout Ratio:				
Dividend Payout Ratio	152.2%	-21.5%	12.5%	n/a
Sustainable Growth Rate:	-1.5%	-7.9%	32.8%	41.0%

Source: Business Analysis and Valuation (BAV) Model version 2.31, HBS Courseware #103-701.

NA = not available; n/a = not applicable.

^aRatios involving balance sheet items are based on the beginning balance sheet.^bPlease note that Compaq's ratios may be misleading, since net income was negative in 2001.

Exhibit 5 Hewlett-Packard 2001 Board of Directors

Philip M Condit Director since 1998 Age 58	Mr. Condit has been Chairman of The Boeing Company since February 1997, its Chief Executive Officer since April 1996 and a member of its board since 1992. He served as President of The Boeing Company from August 1992 until becoming Chairman.
Patricia C. Dunn Director since 1998 Age 47	Ms. Dunn has been Global Chief Executive of Barclays Global Investors since 1998 and its Co-Chairman since October 1995. Ms. Dunn oversees the activities and strategy of BGI, the world's largest institutional investment manager, having joined the firm's predecessor organization, Wells Fargo Investment Advisors in 1978.
Carleton S. Fiorina Director since 1999 Age 46	Ms. Fiorina became Chairman of the Board in September 2000 and was named President, Chief Executive Officer and director of HP in July 1999. From October 1997 until she joined HP, Ms. Fiorina was Group President of the Global Services Provider Business of Lucent Technologies, Inc., a communications systems and technology company. From October 1996 to October 1997, she was President of Lucent Technologies' Consumer Products Business, and from January to October 1996 she was Executive Vice President, Corporate Operations. Ms. Fiorina is a member of the Board of Directors of Cisco Systems, Inc., and also serves on the U.S. China Board of Trade.
Sam Ginn Director since 1996 Age 63	Mr. Ginn served as Chairman of Vodafone AirTouch Plc from 1999, following the merger of Vodafone and AirTouch, until his retirement in May 2000. He was Chairman of the Board and Chief Executive Officer of AirTouch from December 1993 to June 1999. Mr. Ginn is also a director of Chevron Corporation.
Richard A. Hackborn Director since 1992 Age 63	Mr. Hackborn served as Chairman of the Board from January 2000 to September 2000. He was HP's Executive Vice President, Computer Products Organization from 1990 until his retirement in 1993 after a 33-year career with HP. He is a director of the William and Flora Hewlett Foundation and the Boise Art Museum.
Walter B. Hewlett Director since 1987 Age 56	Mr. Hewlett has been an independent software developer involved with computer applications in the humanities for more than five years. In 1997, Mr. Hewlett was elected to the Board of Overseers of Harvard University. In 1994, Mr. Hewlett participated in the formation of Vermont Telephone Company of Springfield, Vermont and currently serves as its Chairman. Mr. Hewlett founded the Center for Computer Assisted Research in the Humanities in 1984, for which he serves as a director. Mr. Hewlett has been a trustee of The William and Flora Hewlett Foundation since its founding in 1966 and currently serves as its Chairman. Mr. Hewlett has served as a director of Agilent Technologies, Inc. since 1999. He is the son of the late HP co-founder Mr. William R. Hewlett.
George A. Keyworth II Director since 1986 Age 61	Dr. Keyworth has been Chairman and Senior Fellow with the Progress & Freedom Foundation, a public policy research institute, since 1995. He is a director of General Atomics, Vapotronics, Inc., and Bravo Labs. Dr. Keyworth holds various honorary degrees and is an honorary professor at Fudan University in Shanghai, People's Republic of China.
Robert E. Knowling, Jr. Director since 2000 Age 45	Mr. Knowling was President and Chief Executive Officer of Covad Communications Company, a national broadband service provider of high-speed Internet and network access using DSL technology, from July 1998 through November 2000. He also served as Chairman of Covad from September 1999 to November 2000. From 1997 through July 1998, Mr. Knowling served as the Executive Vice President of Operations and Technologies at US WEST Communications, Inc. From November 1994 through March 1996, he served as Vice President of Network Operations for Ameritech Corporation. Mr. Knowling is a director of Ariba, Inc., Heidrick & Struggles International, Inc. and the Juvenile Diabetes Foundation International. He also serves as a member of the advisory board for both Northwestern University's Kellogg Graduate School of Management and the University of Michigan Graduate School of Business.
Robert P. Wayman Director since 1993 Age 55	Mr. Wayman has served as an Executive Vice President responsible for finance and administration since December 1992 and Chief Financial Officer since 1984. Mr. Wayman is a director of CNF Transportation, Inc., Sybase Inc., and Portal Software, Inc. He also serves as a member of the Kellogg Advisory Board to Northwestern University School of Business and is Chairman of the Private Sector Council.

Source: Hewlett-Packard 2001 Proxy, February 27, 2001.

Exhibit 6 Goldman Contribution Analysis

The following is an excerpt from Hewlett-Packard's January 14, 2002, Proxy Statement:

Contribution Analysis:

Goldman Sachs performed a contribution analysis in which the company analyzed and compared:

- The relative contributions to be made by each of HP and Compaq on a percentage basis to the revenue, operating income, profit before taxes and net income of the combined company on a pro forma basis assuming the completion of the merger; and
- The relative ownership of the combined company implied from their relative contributions, on a percentage basis, by the shareowners of HP and the shareowners of Compaq on a pro forma basis assuming the completion of the merger.

The relative percentage contributions made by each company are shown in the table below under the caption "Percentage Contribution to the Combined Company." The contribution analyses that Goldman Sachs performed did not take into account any revenue gains or losses or expense synergies expected by HP management to be achieved by the combined company following the completion of the merger.

In connection with its contribution analysis, Goldman Sachs also used the relative percentage contributions of HP and Compaq to the revenue, operating income, profit before taxes and net income of the combined company to derive a range of implied exchange ratios for the merger of between .524 and 1.000 in comparison to the actual exchange ratio for the merger of .6325. The results of this analysis are presented in the table below under the caption "Implied Exchange Ratio."

For comparative purposes, Goldman Sachs calculated the relative implied ownership of the combined company using the exchange ratio in the merger of .6325 of a share of HP common stock for each share of Compaq common stock. The results of the relative implied ownership are presented in the table below under the caption "Percentage Contribution to the Combined Company."

	Percentage Contribution to the Combined Company		Implied Exchange Ratio
	Hewlett-Packard	Compaq	
Revenue			
CY2001	55.7%	44.3%	0.994
CY2002	55.5%	44.5%	1.000
Operating Income			
CY2001	58.3%	41.7%	0.895
CY2002	59.9%	40.1%	0.840
Profit Before Tax			
CY2001	65.0%	35.0%	0.619
CY2002	63.6%	36.4%	0.658
Net Income			
CY2001	67.8%	32.3%	0.547
CY2002	66.5%	33.5%	0.582
FY2003	68.8%	31.2%	0.524
FY2004	68.2%	31.8%	0.537
	Percentage Contribution to the Combined Company		Actual Exchange Ratio
	Hewlett-Packard	Compaq	
	64.4%	35.6%	0.6325

Source: Hewlett-Packard, January 14, 2002.

Exhibit 7 Goldman Sachs Historical Exchange Ratio Analysis

The following is an excerpt from Hewlett-Packard's January 14, 2002, Proxy Statement:

Historical Exchange Ratio Analysis:

Goldman Sachs performed a historical exchange ratio analysis in which the company compared:

- a series of implied exchange ratios for the merger derived from historical trading prices of HP common stock and Compaq common stock over certain specified periods of time beginning August 31, 2001, the last trading day prior to the public announcement of the merger; and
- the exchange ratio in the merger of .6325 of a share of HP common stock for each share of Compaq common stock.

Goldman Sachs calculated the implied exchange ratios by dividing the closing prices per share of Compaq common stock for the relevant period of time, by the closing prices per share of HP common stock for the same period. The results of Goldman Sachs's implied exchange ratio analysis are presented in the table below under the caption "Implied Exchange Ratio."

In connection with its historical exchange ratio analysis, Goldman Sachs also calculated the extent to which the exchange ratio in the merger of .6325 of a share of HP common stock for each share of Compaq common stock exceeded, on a percentage basis, each of the implied exchange ratios derived from historical trading prices. The results of this analysis are presented in the table below under the caption "Premium to Implied Exchange Ratio."

Historical Period	Implied Exchange Ratio	Premium to Implied Exchange Ratio
As of August 31, 2001	0.532	18.9%
20-day average	0.568	11.3%
60-day average	0.558	13.4%
120-day average	0.578	9.5%
360-trading-day average	0.571	10.8%
1-year average	0.597	6.0%
3-month high	0.627	0.9%
3-month low	0.494	28.1%

Source: Hewlett-Packard Proxy, January 14, 2002.

Exhibit 8 HP and Compaq Combined Fiscal 2003 Margin Targets and Sources of Cost Savings**Consolidated results:**

Operating margin: 8%–10%
 EBIT margin: 9%

Segment Operating Margins:

Enterprise division: 9.2% vs. HP's fiscal 2001–3.2% margin
 Access division: 3% vs. HP's fiscal 2001–4.2% margin
 Services division: 13.7% vs. HP's fiscal 2001 4.5% margin

Anticipated cost savings by 2004:

Source:	Amount:
Administrative/IT costs	\$625 million
Cost of Goods Sold	\$600 million
Sales management	\$475 million
R&D efficiencies	\$425 million
Indirect purchasing	\$250 million
Marketing efficiencies	\$125 million
Total savings	<u>\$2.5 billion</u>

HP management further estimated that these cost savings had a net present value in the range of \$5–\$9 per share.

Management's estimates were based on the following assumptions:

P/E multiples	15–25X
Discount rate ^a	15%
Tax rate	28%
Weighted average contribution margin	12%
Reduction in revenue	4.9%

Source: Compiled from Hewlett-Packard Form S-4, January 14, 2002; Thomson Financial Datastream; and casewriter's estimates.

^aOn September 4, 2001, the announcement date of the merger, the 5-year and 10-year Treasury rates were 4.63% and 4.99%, respectively. On this same date, the betas for HP and Compaq were 1.32 and 1.45, respectively.

Exhibit 9 Pro Forma Business Segment Mix as a Percentage of Revenue—Hewlett-Packard, Compaq, and IBM (\$ millions)

	FY2001E		2001E		2001E		2001E	
	HP	Percent	Compaq	Percent	HP & Compaq	Percent	IBM	Percent
PCs	\$9,158	21%	\$14,873	43%	\$24,031	31%	\$14,087	16%
Servers:								
UNIX	3,226	7%	2,651	8%	5,877	7%	NA	NA
Industry Standard	1,775	4%	6,926	20%	8,701	11%	NA	NA
Servers total:	5,001	11%	9,577	28%	14,578	19%	11,720	13%
Storage	2,627	6%	2,048	6%	4,675	6%	2,980	3%
Software	868	2%	0	0%	868	1%	12,768	4%
Total Computing	17,654	40%	26,498	77%	44,152	56%	49,788	55%
Services	7,625	17%	7,897	23%	15,522	20%	35,462	39%
Technology	0	0%	0	0%	0	0%	8,233	9%
Printing	18,954	43%	0	0%	18,954	24%	0	0%
Other	1,157	3%	0	0%	1,157	1%	4,989	6%
Elim	-1,084	-2%	-147	0%	-1,231	-2%	0	0%
Total	\$44,306	100%	\$34,248	100%	\$78,554	100%	\$90,239	100%

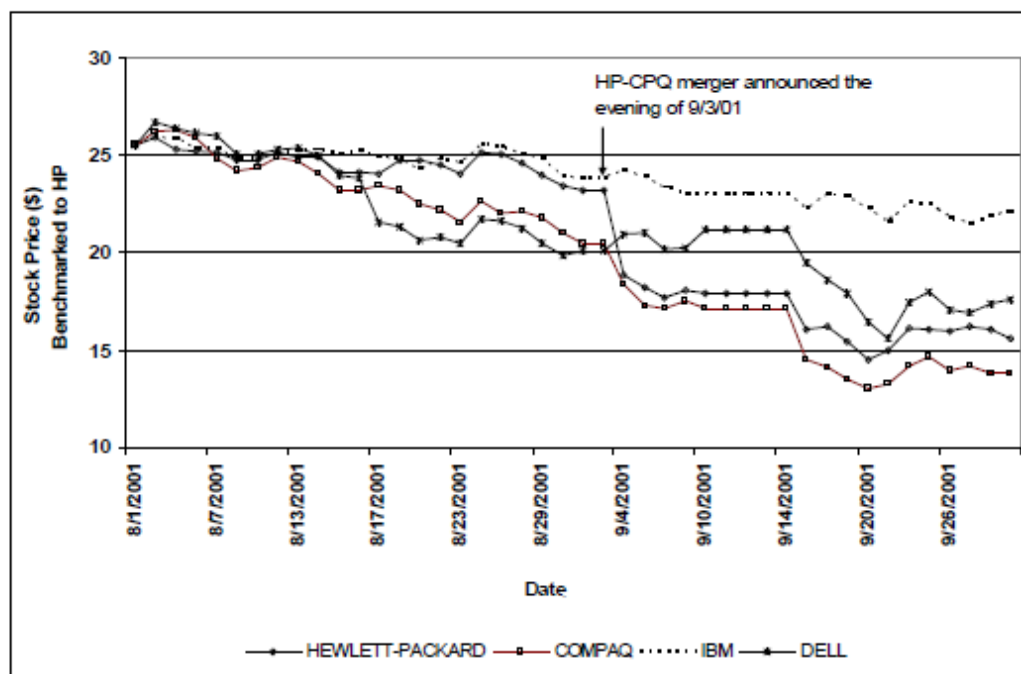
Source: Compiled from UBS Warburg, September 6, 2001.

Exhibit 10 Combined Hewlett-Packard-Compaq Product Line Margin Analysis

	% of Revenues	Operating Margin Model	
		Low	High
PCs	31%	1%	4%
Servers:			
UNIX	7%	0%	8%
Industry Standard	11%	5%	8%
Storage	6%	5%	8%
Software	1%	-5%	10%
Services	20%	5%	9%
Printing	24%	11%	14%
Other/elim.	-1%	0%	0%
Total	100%	5%	8%

Source: Compiled from UBS Warburg, September 6, 2001, and casewriters' estimates.

Exhibit 11 Relative Stock Price Performance—HP, Compaq, Dell, and IBM—August 1, 2001 through October 1, 2001



Source: Compustat.

Exhibit 12 Hewlett-Packard and Compaq Stock Price Reactions on Key Event Dates

Event	Event Date	HP Stock Price Day Before	HP Stock Price Day Of Event	Percentage Change	Compaq Stock Price Day Before	Compaq Stock Price Day Of Event	Percentage Change
Initial merger announcement	4-Sep-01	23.21	18.87	-18.70%	12.35	11.08	-10.28%
Walter Hewlett announces that his family members, the Foundation, and the Trust will vote against the merger. ^a	6-Nov-01	16.89	19.81	17.29%	8.99	8.50	-5.45%
The Packard Foundation announces it will vote against the merger.	7-Dec-01	23.52	23.00	-2.21%	11.32	9.70	-14.31%
ISS advises institutional investors to vote in favor of the merger.	5-Mar-02	20.6	20.18	-2.04%	10.58	10.98	3.78%
HP shareholders narrowly approve merger vote.	19-Mar-02	19.25	18.80	-2.34%	10.36	11.14	7.53%

Source: Compiled from Thomson Financial Datastream and casewriter estimates.

^aDavid Woodley Packard announced later that day that he too would vote against the merger.

Exhibit 13 2000 Services Comparison—Hewlett-Packard, Compaq, Hewlett-Packard and Compaq, and IBM (\$ millions)

	FY2000		FY2000		FY2000		FY2000	
	HP*	Percent	Compaq*	Percent	HP & Compaq*	Percent	IBM	Percent
Outsourcing	\$642	12%	\$675	11%	\$1,317	12%	\$13,597	41%
Business Innovation and Integration ebiz Integration Sell and support Strategy ERP Infrastructure	1,010	19%	1,687	27%	2,697	24%	12,757	38%
Maintenance and Training	3,598	69%	3,779	62%	7,377	65%	6,796	21%
Total Services	\$5,250	100%	\$6,141	100%	\$11,391	101%	\$33,150	100%
% of Revenues	11%		15%		13%		38%	

Source: Compiled from UBS Warburg, September 6, 2001, and casewriters' estimates.

*Excludes financing operations.

Exhibit 14 Hewlett-Packard vs. Hewlett-Packard and Compaq—Anticipated Trade-offs

On its own, HP could grow faster in the next few years...

	2001	2002	2003	2004	Growth Rate
Annual Revenue (\$bn)					
HP/Compaq	\$77.80	75.7	81	88.4	3.60%
HP	44.2	48.8	51.5	54.5	7.30%

And net income margins would be higher...

	2001	2002	2003	2004
Net Income Margin				
HP/Compaq	2.3%	3.6%	5.3%	6.5%
HP	3.4%	4.9%	6.1%	6.3%

However, in buying Compaq, HP can expand profits faster...

	2001	2002	2003	2004	Growth Rate
Net Income (\$bn)					
HP/Compaq	\$1.80	2.7	4.3	5.6	45.90%
HP	1.5	2.3	3.1	3.4	32.10%

And set itself up for leadership in key markets...

			Industrywide	Industrywide
Product/ Service	HP and Compaq	Market share/Rank	Gross Profit Margins	Annual Growth Rate
Printers ^a	\$19.40	39.0%/1	31%	7.0%
PCs	24.5	21.1%/1	1%	0.0%
Servers	12.5	26.7%/2	21%	3.1%
Storage	6.4	26.3%/1	37%	3.0%
Services	15.4	2.6%/3	20%	11.4%

Source: Compiled from Gartner Inc., IDC, Credit Suisse First Boston, and company reports.

^aIncludes ink cartridges and accessories.