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MARKET RESEARCH BULLETIN

# HP to merge with EDS – It's bigger than Texas

## Asia Pacific Services

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## KEY POINTS

Late on the 12th of May, 2008, rumors that EDS and HP were looking at a merger were confirmed by both parties, the deal has not been inked at this time, but it is heading along a path towards integration. In this document we will call the merged entity HP/EDS, I anticipate that the name HP will not be changed, a separate services brand is unlikely, and inappropriate.

- The combined entity would have revenues of U$126B, and services revenues of US$39B. Clearly HP/EDS would consolidate its position as the largest IT company in the world, the merged entity would be the second largest services company in the world, but now instead of HP being approximately US$38B behind IBM, the gap is now US$15B.
- Overall it would give strength and market leadership for HP/EDS in the Infrastructure services market for both support and outsourcing service delivery models. In addition the enhancement of the consulting and SI business of HP would be significant, although this will still clearly trail IBM and Accenture from a revenue and market leadership perspective.
- Integration is always a challenge for transactions of this nature, size and scale, and HP through the Compaq saga is well aware of this. Whilst EDS is a Texan company, very centralized in Plano, the Compaq history in Texas and a Texan CEO in Mark Hurd will be a significant asset for HP in the integration, assuming no Houston/Dallas rivalry occurs.

## THE ANNOUNCEMENT

The actual announcement was in the Wall Street journal on the 12th of May, 2008. Both parties have confirmed that talks are proceeding, but that naturally they are non binding at this point in time. It is a positive match, large IT mergers or acquisitions are difficult, no-one knows this better than HP with Compaq. If it is confident enough to go through similar stress and disruption for the services arm as it did the PC and server business, then clearly it can see the benefits of it, and is aware of the potential costs of the transaction.

HP has been shopping around for a significant services firm for many years now, since it tried (fortunately unsuccessfully) to pay US18B for PWC in 2000. They have looked at firms such as CSC, Bearing Point and in some respects Accenture, but to date have held off arguably waiting for a transforming deal such as EDS.

The combined company will provide momentum and scale for what would be a very significant competitor to IBM and other services providers. The following table provides some key metrics for the two firms, and the merged entity

**Table 1: HP and EDS – Quick Figures**

| | HP | EDS | HP/EDS | IT Industry Ranking |
|---|---|---|---|---|
| **Total Revenue** | **104.3** | **22.1** | **126.4** | **1** |
| Services | 16.6 | 22.1 | **38.7** | 2 |
| Business Process Outsourcing | 0.25 | 3.07 | **3.32** | 3 |
| IT Outsourcing | 4.56 | 11.93 | **16.49** | 2 |
| Consulting and Integration | 3.15 | 4.9 | **8.05** | 3 |
| Infrastructure Support Services | 8.63 | 2.2 | **10.83** | 1 |
| **Total Employee Numbers** | **172,000** | **140,000** | **312,000** | **2** |
| Services Employee Numbers | 65,000 | 140,000 | **205,000** | 2 |
| Global Delivery Employees | 25,000 | 41,000 | **66,000** | 6 |

Source: Springboard Research, 2008
Revenue is for the 2007 Fiscal Year
All Values are US$B

# OUTCOMES

This is a significant deal, it provides scale and instant credibility to HP's outsourcing business in particular, this is a long time coming. Firstly however I want to focus on what it does not provide. Clearly the applications space whilst improved, is a challenge for the merged firm. EDS does bring some clout to the table, (30% of new deals for EDS at the current time are application based), but it still is lagging behind IBM and Accenture in this regard. (To make it the truly perfect storm for IBM, they should go and call Accenture, that combination, whilst unlikely in the extreme now would be very potent).

The benefits and challenges of the deal is highlighted below.

### *Key Benefits*

- Scale of services capabilities, the new entity will be number one, two or three in the key markets for IT. EDS's support business will get clear scale, HP's fledging and limited BPO business will get significant scale, particularly in the processing side, as will IT Outsourcing and Consulting and Systems Integration.

- Introduction of new accounts, EDS and HP have very limited competitive overlap as observed by Springboard, their services focus has been in different markets, and focus areas. There is a large upside available as a result.
- Market making power is for the taking, the combined entity will get the attention of virtually every targeted CEO and CIO due to the increased client list and momentum.
- Ability to scale EDS offerings to the mid-market. Whilst no vendor has truly done well in the mid-market, HP has the products to win a strong share, EDS can work to productize its capabilities to make it more attractive and viable in the space.
- Both vendors have had recent ongoing transformations to recover market confidence (which is uncertain at the best of times), switching a quick integration should be relatively easy. The downside to this will be change fatigue for employees. Some HP Services employees have lived through about 4 acquisitions from DEC, Compaq, HP and now EDS .
- Cultural issues may be less than at first glance between a product company and a services led company. This is due to the Texas factor. Mark Hurd is a Texan, and Compaq of course was Houston based, so that will increase the weighting of commonality. Ironically enough 4 of the 6 lauded data centers that HP are constructing for its internal IT are in Texas. It will be interesting to understand the status of that transformation with the on boarding of 140,000 or so new employees.
- Increased vertical depth is clear, HP has leadership in key verticals such as Communications and Manufacturing, however EDS will give significant boosts to the Financial Services, Transport and Distribution, and particularly Public Sector markets, traditionally weak markets for HP in most services geographies.
- The US services business, particularly the Consulting and Outsourcing market is tough for HP historically, EDS, whilst gaining approximately 50% of revenue from outside of the US, has a much stronger US business that can allow HP to develop appropriate scale around.

### *Key Challenges*

- A slow drawn out and public transaction, such as the HP – Compaq deal will have a significant negative impact, it must be done relatively quickly and cleanly, otherwise clients will be lost, and employees will be hard pressed to remain focused.

- 100 day plans and transition need to accelerate. HP/EDS will need to ensure that they are moving in terms of client, partner and employee engagement and integration from the beginning of the deal, this is critical, time will be so vital in terms of maintaining momentum with clients and to build the benefits of the integrated organization.

- Reaction of EDS alliance partner will be volatile. As mentioned elsewhere EDS has the Agility Alliance, this has proved to be a quite successful approach. Whilst key partners such as Cisco, Intel and Microsoft are shared, EMC, Dell and Sun will be clearly concerned with this move, and will look to protect an installed base that has accompanied EDS in its services engagements. This is going to be a critical area to watch for all parties.

- Currently there is no “head” of services at HP. Each of the three HP Services business units report into the respective heads of TSG (Technology Systems Group). The balance is significantly affected by this transaction, so there is going to have to be some fundamental change to the HP structure to encapsulate the new scale and reduce the reliance on HP product for HP Services.

- Head office location. Clearly the head office for HP/EDS will not change, however EDS has a strong historical and cultural link with Plano and the Dallas Metro area. Currently HP is organized without a head of services, nor a notional head office. It seems likely that Plano will be a choice for this.

- As highlighted within the overall services market, consulting and BPO are still weak for the merged entity in relative terms. As an immediate lack of CEO relationships will lock HP/EDS out of some transactions, it would not surprise for a secondary smaller and targeted acquisition with a firm that can provide even more relationships with CEO’s than EDS.

- Employee retention will also be key, clearly there will be some redundancy in terms of the integration of the organizations, this needs to be handled as ever in a way that does not impact on employee satisfaction, productivity or morale. HP have been in this environment before, and managed to achieve reasonable success.

- Momentum in global delivery must be accelerated. Table 1 highlights that, by Springboard Research’s calculations, the merged entity will be only the 6 largest global delivery player, and it needs to rapidly accelerate resources to an offshore environment, (which it is doing) or risk not being able to manage cost and flexibility requirements of services delivery. Both firms were slow to move in the initial acceleration of global delivery, and whilst having impressive capabilities are playing catch up to more application based providers such as Accenture, Wipro and TCS.

### *Winners and Losers*

The caveat of appropriate integration is clearly attached to this.

### *Winners*

- Clients who will get more integrated services and end to end capabilities
- Accenture – Whilst the love between Accenture and HP will largely be further smothered, Accenture will know that IBM has to focus more on the merged HP/EDS entity from a competitive view allowing them a little breathing space. The risk is the depth of HP/EDS relationships in infrastructure may block Accenture out from related discussions
- Microsoft, SAP and Oracle will be able to focus more on a broad range of scaled solutions reflecting the best of HP and EDS.
- Corporate banks and lawyers who specialize in Mergers and Acquisitions. Springboard Research believes that this deal may spark further consolidation, scale is clearly key here, and aside from IBM, HP/EDS, and in the Applications space, Accenture, the rules for what scale is have been recast. It may occur that as Oracle has sparked massive consolidation in the Software space, this deal will do the same for services.

### *Losers*

- IBM clearly are the target of the transaction, and will need to have even more competitive focus on the merged entity. In many ways, IBM did not really take the HP Services business with the credibility that it may have deserved. Now it will be aware of HP/EDS in each and every infrastructure transaction
- Sun, Dell and EMC can expect a risk of a staged transition out of EDS and the Agility Alliance, they will need to respond to this, and perhaps look to acquire services providers to maintain relationships
- CSC, Fujitsu, Unisys and other smaller services companies are challenged. If the merged entity is able to maintain the HP culture of customer satisfaction, and EDS's capability of significant IT transformation, it will make it harder for these smaller entities to engage with large Fortune 500 organizations

## FOCUS POINT

The HP/EDS deal is a game changer for the IT Services industry. If executed it is one that will allow the merged entity to significantly build penetration within IT budgets and to start to link IT and business through EDS's capabilities in business process. Clients will be potential winners, and HP will also gain across the product set, as a result of increased access into new accounts. Whilst Texas provides commonality and may ease the integration challenges, integration will need to be at light speed to keep up with business dynamics. Bottom line is that execution of the integration will ensure what the deal is remembered for.

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