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Acquisitions

Compaq, HP Try Painting Rosy Picture

Daniel Fisher, 03.11.02, 3:45 PM ET

NEW YORK - **Compaq Computer** and **Hewlett-Packard** are trying hard to make investors believe their proposed $20 billion-$22 billion merger will create a whole that is worth more than the sum of the parts. But Compaq investors have had painful experience that shows just how hard it will be for management to pull it off.

According to the scenario set out in their Feb. 5 proxy statement, Hewlett-Packard (nyse: HWP - news - people) and Compaq (nyse: CPQ - news - people) will be able to hack at least $2.5 billion in annual costs out of their combined structure by 2004, while simultaneously increasing revenue 8.5% to $88.7 billion. Earnings are expected to hit $1.52 per share in 2003, while operating margin, a desultory 1% for the combined company last year, climbs 8% to 10%.

That scenario has been endorsed by consultants McKinsey & Co., who have been paid $9 million so far for their work, as well as investment bankers Goldman Sachs and Salomon Smith Barney, who stand to reap $42.5 million in fees if the deal is approved in back-to-back shareholder meetings two weeks from now.

Compaq investors have heard this kind of story before, however. Back in 1998, the Houston-based personal computer maker paid $9.6 billion for **Digital Equipment**. **Eckhard Pfeiffer**, then the chief executive, boasted that DEC would help accelerate Compaq's goal of reaching $50 billion in revenue by 2000. Instead, revenue peaked at $42.4 billion in 2000 and fell to $33.5 billion last year, 13% below the combined revenue of Compaq and DEC in 1997. Instead of profits, the new company piled up $2 billion in losses.

And the prospects for Compaq and HP don't look any brighter. To arrive at their 2004 revenue estimate, the companies' well-paid advisers seem to have examined historical growth rates at both companies, interpolated them into the future and whacked 4.5% off the total to reflect the inevitable loss of business that occurs as two companies trim sales forces and eliminate product lines. But that still implies an 8% increase from current revenue. In recent months, both companies' sales have been declining. Compaq's revenue fell 21% to $33.6 billion last year, while HP's fell 7% to $45.2 billion.

Roger Kay, a computer analyst at market research firm IDC, estimates flat to slightly higher revenue for the total U.S. personal computer market this year. To grow revenue in that environment, Compaq and HP will have to demonstrate more skill in the middle of a merger involving at least 15,000 layoffs and untold product changes that they were unable to muster when they were on their own.

Everybody knows the PC market is a mess. What about the higher-end stuff? Compaq and HP are boasting the combined company will be No. 1 in Unix-based servers, No. 1 in Linux and No. 1 in servers based on Windows/Intel technology. That won't last long, competitors say. The new company is betting heavily on a next-generation **Intel** (nasdaq: INTC - news - people) chip, the Itanium, which is expected to arrive in 2004. Until then, it will be stuck selling machines that run its old versions of Unix, with questionable ability to switch the systems over to the new Itanium technology when it arrives.

Sun Microsystems (nasdaq: SUNW - news - people) and **IBM** (nyse: IBM - news - people), meanwhile, have a clearly defined upgrade strategy for their Unix and Linux machines, which run on proprietary chip designs.

Compaq and HP's installed customer base "is fair game for IBM and Sun," says Jon Power, chief executive of Sector7, an Austin, Texas-based computer consulting firm that has worked with such organizations as **Blockbuster** (nyse: BBI - news - people) and the City of New York.

City Guide | **San Francisco**

As fog envelops the city, and the muted foghorn of the Larkspur ferry and the distant bell of a cable car carries over the waters of the bay, it's easy to see why crooner Tony Bennett left his heart in San Francisco. One of the most beautiful cities in America, it maintains it historic charms despite being the unofficial capital of the technology universe. The dot com party may be over in the Bay Area but that doesn't mean there still aren't many terrific hotels, restaurants, night spots and shops.

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"The folks at IBM are licking their chops."

The outlook for the services business is hardly any brighter. Compaq bought DEC for its services business but hasn't managed to grow it much since. Revenue grew an anemic 1.6% to $6.8 billion last year, up 8% from the year before the merger. IBM's services revenue, meanwhile, rose 5.4% last year.

Long before 2004, investors could be disappointed. Compaq has a well-deserved reputation for "stuffing the channel," or selling hardware to dealers in the fourth quarter with price guarantees and return agreements that come back to haunt it in the first. Compaq's revenue has fallen an average of 15% from the fourth quarter to the first in recent years, and earnings have plunged an average 57%. The second quarter tends to be even worse: Compaq reported second-quarter losses in three of the past six years as it wrote down inventory and took restructuring charges.

Analyst Ashok Kumar with U.S. Bancorp Piper Jaffray in Minneapolis suspects Compaq will have a similar surprise in store for investors this year, after reporting revenue rose a surprising 14% from the third quarter to the fourth quarter of last year, including an eyebrow-raising 33% in Europe.

"These guys gussied up the December-quarter numbers," says Kumar. "Channel-stuffing is part of Compaq's genetic code."

Investors will find out if he's right on April 15, three weeks after they vote on the merger.

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