

September 12, 2008

## IT Industry Update

### ■ Technology Landscape

The global economic slow down is providing grounds for a different perspective on the future of the high tech industry. A more austere IT spending environment does not have the same market industry ecology as the overly watered, overly fertilized past and we are witnessing a true shaking out in the industry. The excess juice is evaporating and a more arid technology market is emerging. Companies that do not stay close to the spending streams of the market will increasingly find it more difficult to sustain themselves. Marginal high tech products will not generate revenues. There is a big difference between a market that buys products in order to keep up with everybody else and a market that buys only when necessary.

### ■ A Way Ahead: the HP Model

HP's upcoming analyst meeting this Monday is a prime opportunity to present a more comprehensive discussion of our view on the IT industry. While Dell thinks cutting costs is the way to prosperity, the HP solution to slowing demand, maturation of the markets and commoditization of the PC is to purchase EDS and get a seat at the table of the world's largest IT buyers. This is a move Dell could never have pulled off, and probably never would have contemplated. And while most analysts coming out of the HP meeting will probably focus on the trees of earnings revision, we prefer to focus on the forest of the changing IT industry and how one company, HP is positioning itself.

### ■ Rising Above the PC Mosh Pit

Ever since Mark Hurd took the reins at HP, he's been working diligently to put the company on track as one of the premier information technology companies. With the acquisition of EDS, Hurd took a giant step toward that goal and is now, we believe, close to rising well above the ranks of the PC products mosh pit. Not that HP necessarily wants to be out of the PC business, but we think it is obvious to Hurd by now that he is not going to put the company on the trajectory of his vision by selling PCs, servers and storage. And in our opinion, selling PCs, servers and storage is not the up and to the right trajectory companies should be targeting.

### ■ A Front Row Ticket

HP has long been a leader in open systems technology, but has never had a front row ticket in the mainframe data center arena. All that is about to change very quickly for HP after ponying up almost \$14 billion for EDS and a full calendar of meetings with every major data center customer on the planet. The community of mainframe customers and vendors is relatively tiny, but the leverage is enormous. Certainly, part of the purchase price HP paid for EDS was its customer dowry so it can sit at the table with decision makers that they previously had no pull with. That's not to say that HP was lacking for relationships, but it shows the belief that Hurd has in doing things the old-fashioned way - which is getting to know your most important customers better than your competitors do.

### Spotlight

Company	Ticker	Price	Rec.
Dell	DELL <sup>58</sup>	\$19.18	Hold
Hewlett	HPQ	\$47.19	NR

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## He's Looked at Clouds, and It's a Cash Pump

Some believe the EDS acquisition is a move by HP to start a business in cloud computing services. It's possible that there was some cloudy motivation in this deal, but we don't think that was the main attraction. The real reason was more likely cash flow - every month like clockwork, to establish a financial foundation to support more risky business ventures, such as cloud-style services. EDS has a cost structure that works for mainframe services, but it is unlikely that those mainframe dynamics could be competitive for cloud services, competing with companies like Google, Microsoft, Salesforce and Amazon. Think of EDS as a cash pump to siphon as much revenue as possible from the most lucrative market in the history of technology, not as a nursery for nurturing new businesses.

## The Road to Profits is Not Paved with Commodity Components

Hurd appears to have found some techniques for improving HP's hardware revenues sales, but it's not clear that there is any sustainable advantage in an industry that integrates commodity components. See Dell as the poster child of commodity integration. Of all the hardware businesses, we believe storage has the best profitability future, but HP is a long ways from being a driver in this highly competitive industry and it's not clear that they have much potential to grow past their current installed base. This is where the relationships forged by EDS may be the most helpful - not in selling more products in the short term, but in replacing competitive storage products in years to come as those products reach their end of life. That will never happen, however, if HP doesn't find a way to develop more competitive products. An acquisition of an able-bodied startup is their best bet and it would not be a big surprise to us if HP were to make a bid for 3Par, Compellent or even Network Appliance. Given the lack of success demonstrated by HP's storage acquisitions in the last several years, it's not at all clear that HP would know how to pull it off.

## Servers Aren't the Answer

The server business is unlikely to ever generate large profits again. There are too many manufacturers fighting for their lives in this space and the migration of server applications to cloud services promises to make matters worse in the years to come. The move to consolidate servers as guest systems on virtual storage platform systems is probably already having an impact, even though most server companies would never admit it - or even acknowledge the problem. Virtualization continues to increase and the costs of using the technology are decreasing. At the end of the day, the result is less demand for server hardware.

## Servers Could Get Lost in the Cloud

If cloud computing becomes pervasive, the leading cloud services companies would have the most leverage and would not allow their server suppliers much margin. The situation would be similar to the one faced by the disk drive industry until it figured out a major consolidation was necessary to reduce the industry's capacity. The difference is that the barriers to entry for disk drive manufacturing are much higher than they are for server manufacturing and there will probably always be loss-leading competitors with a bent for making economic suicide.

## The Challenge of Integration

For any company in the IT industry growing via acquisition, which is required given the low organic growth rates, integration is imperative. With the EDS deal done, the main concern for Hurd now is integrating EDS into HP's operations and culture. There is a big difference between the thinking that happens in the mainframe data center world and the open systems world. For starters, most things in the mainframe world involve enormous scaling and that has a profound impact on the

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entire organization, including product development, technical support, finance, sales, marketing - you name it.

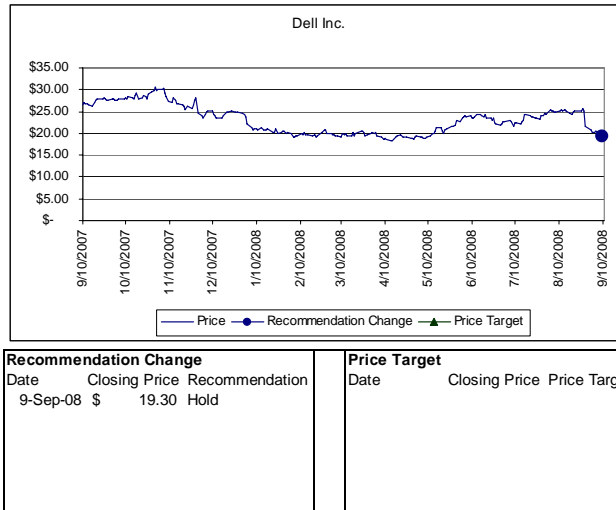
### **Integration Takes Time**

We're not sure the Street understands, and whether Hurd knows it or not, most of the people at HP won't understand half of what the EDS people try to tell them until they get more experience with EDS' business. There's no way that is going to be easy for HP, unless they take a hands-off approach and let the integration occur over an extended period of time. That said, there is little doubt that HP will want EDS to be an integral part of HP, as opposed to being a wholly owned subsidiary. If they are going to leverage EDS the most, they need to work closely on business planning - a process that will take a great deal of time and many iterations. Hurd seems to be very talented and hard working and he will need all of that to make the EDS acquisition work out smoothly. Nonetheless, the acquisition of EDS, while having risks, is an excellent and bold move.

### **Bottom Line**

The next big, new idea that has been the cornerstone of high technology is becoming more difficult to find. In other words, the low hanging fruit in technology has been consumed. What the market needs and wants, is what the new HP can offer – stability. For many portfolio managers, that is the kind of stock they are looking for.

Risks: The primary near term risks are macro - slowing global economies and adverse currency moves



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