
HP – EDS Acquisition Market and Customer Impacts

Client Communication

May 16, 2008

On Tuesday, May 13th, HP confirmed that it is planning to acquire EDS for \$13.9B in a deal that is expected to close in the second half of this year. EDS is currently the second largest IT outsourcing services provider and HP the fifth – together they will put themselves in a stronger tier 1 position with IBM, with some 210,000 employees in over 80 countries and combined services revenue of over \$39B (IBM will still be larger, with over \$54B in services revenue). The new IT services group will be named “EDS – an HP Company,” and will be based at EDS’ current corporate headquarters in Plano, Texas. It has been reported that the merged services organization will be run by EDS’ current Chief Executive Officer, Ron Rittenmeyer, who will report directly to HP’s CEO, Mark Hurd, although we believe this structure may only be temporary.

The combination will significantly impact both the IT outsourcing and business process outsourcing marketplaces. When combined, HP and EDS will offer greater competition to IBM and will be a formidable opponent for the other major IT global services companies including Accenture, TCS, CSC, Wipro, and Infosys. In the short term, however, we expect IBM and others to move quickly to lock up current and prospective customers through contract extensions and new long term agreements (five years or more) while HP and EDS work through the inevitable integration challenges that have complicated so many recent major IT mergers, which are particularly nettlesome in professional services combinations. These challenges will likely be accentuated by the distinct cultural differences between the two companies, which may prove to be the single largest obstacle to a successful business and workforce integration.

I. Our view of the transaction

We believe that if the cultural and other integration challenges can be overcome, the combined entity should positively impact HP, EDS and the marketplace. From HP’s perspective, the addition of EDS will add new customers of significant value (there is relatively little overlap between the customer portfolios), greater experience and capability in the IT infrastructure and BPO areas, an enhanced ability to pull-through more hardware and software, and scale that has eluded it through organic growth. For EDS, HP will provide greater financial stability, increased technological innovation, a growth trajectory that EDS has struggled to obtain on its own, the ability to compete head-to-head with IBM more effectively, greater off-shore capabilities, and the opportunity to cut costs (largely with personnel reductions) and improve margins that have lagged the industry.

From a market perspective, HP’s choice to make such a significant investment in growing its services capabilities is a bullish statement on the future prospects of outsourcing – both ITO and BPO. This

could be interpreted as a commentary that outsourcing services while not panaceas, are critical levers enabling companies to compete effectively across the globe and their use should continue to increase. The creation of a stronger, more capable provider should drive differentiation from IBM and other providers through improved offerings, innovation, and business terms.

II. What it means for current and prospective customers

For those current and prospective outsourcing customers, what's in store for you in the near term? Below, we provide our initial thoughts on the key questions being posed by our clients.

Will the planned merger have any impact on transactions that are currently in progress?

From HP's and EDS' perspectives, no. The two companies are not permitted to share competitive information regarding their current pursuits until such time as the merger becomes final. Each company must continue its respective sales activities in the same manner that it has completed them prior to the merger being announced, i.e., completely independent from one another.

Alternatively, customers currently engaged in a competitive procurement should be mindful of the prospective merger, giving strong consideration that the acquisition may become final within the year, and possibly even prior to a new customer Agreement being executed. In particular, customers and potential customers should consider the following:

- When down-selecting to the final two to three vendors in a competitive bid process, make sure to include at least one vendor in addition to HP and/or EDS so the process remains competitive even in the event of a merger
- If you have become dissatisfied with HP or EDS, or moreover plan to eliminate either HP or EDS (either because of poor incumbent performance or because of a poor showing during the competitive process) from a sourcing initiative, think very carefully before awarding your business to the other as you may end up back where you started
- Recognize that gaps in delivery that are apparent with one vendor may in fact be filled by the combined entity – although be wary of the “promise” of this integration occurring in the near term after the acquisition is finalized as integration occurs over time
- It is possible that EDS may be willing to be more aggressive in closing certain transactions, as there may be incremental personal incentives in place for near-term performance. Because of this, you may have the opportunity to negotiate more favorable terms
- Prior to making final downselection decisions, make sure that you engage legal counsel to develop the appropriate assignment and successor terms. Although it is critical to have these terms in any Agreement with HP or EDS, best practice would suggest these terms are equally important for Agreements with all other vendors, particularly in light of additional combinations anticipated in the future

If we have a current Agreement with either EDS or HP, what impacts should we expect?

None, at least for right now. Until such time as the acquisition becomes final, the two companies will neither be permitted to share customer information nor engage in joint customer planning or integration activities. Once the acquisition is finalized, the companies will formally begin to engage in integration activities, which will likely include everything from operational support systems (e.g., help desk tools, monitoring devices, provisioning, billing), to infrastructure (e.g., data center rationalization, server consolidation), to customer support processes, to organization and account teams (where we expect significant staff reductions).

The impact on current customers will likely vary based on the number of years remaining in the current Agreement (i.e., for customers that are near the end of their current Agreement, it is not likely that material changes will be experienced) and the quality of the vendor's current performance (both objective as measured through SLAs and subjective based on customer satisfaction). In either case, customers should review their existing Agreements to: i) ensure that they are not subject to any modifications that can be imposed upon them based upon the changes to the vendor entity; and ii) determine if they can use the change of control to modify, or even terminate, their existing Agreements to the extent there is a desire to do so. In the event of the latter, the capability to make modifications may provide a customer with leverage to enhance existing terms and/or services.

If we are planning to issue an RFP in the near future, to which company should we send the RFP, HP or EDS?

Both – assuming both vendors were on your list independent of any acquisition announcement. Until such time as the acquisition is finalized, HP and EDS are required to continue business as usual as it relates to customer sales and delivery. Further, there is always the possibility that the merger will not go through.

Will the consolidation of these two companies reduce competition in a manner that will be detrimental to companies wishing to outsource?

We do not believe so, and in fact, it may galvanize the market in a manner that is beneficial to customers in the long run. While the impact of the acquisition will be situational, we offer the following observations:

- For those companies that are predisposed to a single vendor solution for all of their outsourced IT services, the merger offers a more formidable competitor to IBM, which has historically enjoyed a relative market advantage due to its financial strength, size, and ability to bundle IT hardware and software with outsourced services
- For those companies that have moved or will be moving to a multi-vendor solution for their discrete IT services, the competitive landscape, while effectively reduced by one vendor through the merger, has never been stronger. For example, Forrester Research includes 12 vendors in its "Leaders" segment in the "Forrester Global Wave of IT Infrastructure Companies"

We've read that other acquisitions or alliances will likely follow – what should we do in anticipation?

While industry analysts speculate that there may be additional acquisitions or combinations on the horizon – particularly including one or more of the large India-based outsourcers such as Wipro, TCS, or Infosys, we remain confident that the competitive landscape will remain strong. Greater consolidation is likely to enhance service offerings, fill in geographic gaps, and enable providers to more cost effectively deliver services, which should in turn benefit customers' cost competitiveness. We remain resolute, however, that the appropriate structures need to be developed and implemented to maximize opportunities for our clients during vendor selection and transaction activities.

III. Contact us with any questions

We put together this overview based upon questions we've received this week from clients. We recognize there may be a number of other questions or those that are more specific to particular situations. Please contact us to discuss any questions that you might have in this regard.

Regards,

Steve Martin
202-439-7200
smartin@paceharmon.com

David Rutchik
202-345-3921
drutchik@paceharmon.com