Rarely has a merger transaction generated as much controversy and acrimony as the recent acquisition of Compaq (NYSE: CPQ) by Hewlett-Packard (NYSE: HWP). It essentially pitted the founding families against the second generation of professional managers installed by the company founders, the fathers of the current protagonists. However, given the very atypical market reaction to the deal’s announcement - even the target firm’s stock fell by an astounding 10.29% on the next day - investors apparently had ample reason to be sceptical about the proposed merger.\(^1\) In this case, you are asked to analyze the merits of the acquisition from the perspective of the merging companies, the dissenting shareholder, and, ultimately, the institutional investors whose vote will decide the outcome.

The stock movement by and large jibed with analysts’ takes on the deal. Although the merger is supposed to begin adding to the bottom line by 2003, there will be “immense execution issues that will only be addressed over a multiyear period,” said Goldman Sachs analyst Laura Conigliaro. Added Merrill Lynch analyst Thomas Kraemer: “The jury is still out on this one. They have two years of no growth and then a massive integration.” The idea behind the deal is that combining the two tech giants will put them in a powerhouse position in almost all facets of the computer market, allowing them to ride out shrinking sales and an economic slowdown. The companies are hoping that combining their market shares will help them flatten competitors such as Dell Computer, which has surged to the top of the PC market.\(^2\)

Carly Fiorina, Michael Capellas and other people close to the deal have engaged in a relentless sales effort. Curiously, the founding families and the foundations they control learned of the deal from newspapers and the CEOs of HP and Compaq only briefed them a week after the merger’s announcement on September 10, 2001. Such communication lapses are serious when the other “party” is your dominant shareholder and could threaten a deal.

Compaq board member Tom Perkins, for one, is out to see that these early communication mistakes with the family foundations are not repeated. Perkins, one of the first MBAs hired by Bill Hewlett and Dave Packard, established HP’s computing division in the 1960s and co-founded Kleiner Perkins, the preeminent Silicon Valley VC firm that seeded Compaq as well as Tandem, which Compaq later bought. “My fingerprints are all over this deal,” he quips. “If Walter Hewlett wins this battle, HP will be another Polaroid or Xerox: conservative, risk averse, too reliant on its technology,” he says. “Too many companies have fallen into this trap. This is really a proxy battle for the heart and soul of Hewlett-Packard.”

So, when making your pitch for or against the deal (presentations), think of a typical large shareholder (write-ups). Imagine a senior portfolio manager at Deutsche Asset Management (DBAM),\(^1\)

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\(^1\)Valued originally at $25 billion, the deal was standing at $19.7 billion a month later.

\(^2\)However, Dell (Nasdaq: DELL) may actually benefit from the merger. Dell “is well-positioned to leverage its business model with 7 percent operating margins versus below breakeven for both (HP’s) and (Compaq’s) PC divisions,” said U.S. Bancorp Piper Jaffray analyst Ashok Kumar. Dell was up 93 cents, or 4 percent, to $22.31.

Now, how would you go about assessing the deal’s impact on competitors?
a large institutional investor, that hold a substantial block of Hewlett Packard (NYSE: HWP) in their accounts for various clients. A shareholder’s vote has been called for March 2002 together with a special meeting of shareowners on March 19, 2002 to decide on the proposed acquisition of Compaq Computers Corporation by HP. As you know, there is substantial opposition from within the firm and certain shareholders against the deal. In particular, Walter Hewlett has led a relentless campaign against the merger arguing that the projected synergy gains are illusive, the acquisition too expensive, and that HP cannot possibly integrate such a large company as Compaq without losing its competitive strength.

While Walter Hewlett, the last remaining representative of the founding families on HP’s board, is leading a very public campaign against the deal, the remaining institutions affiliated with the founders have quietly joined him and announced their decision to vote against the merger. Controlling jointly about 18.4% (or more than 350 million shares), the various Hewlett and Packard foundations now have to convince a large fraction of the 53% institutional ownership to vote with them to derail the merger. Institutional investors not only view the deal less negatively, but also abhor the uncertainty that a prolonged (proxy) fight would bring; while risk is good for return before you buy the stock, it is counterproductive once you hold the shares (why?). The dark horses in these strategic speculations are the 28.4% of retail investors, a large fraction of whom work for HP and have also good reasons to be sceptical about the merger.

Assuming that institutional shareholders are by and large in favor of the deal, and retail investors more likely against it, the current indications predict at most 53% of shareholders in favor and at least 46.8% against the acquisition (management holds 0.2% and is, obviously, in favor of the deal). Hence, as a large institutional investor, DBAM’s vote of its 1.3% in HP stock (about 20m shares) could decide the final outcome all the more that pundits are predicting a really cliff-hanger. While the Hewlett and Packard families can follow their emotions and put their money where their hearts are, a professional money manager does not have this luxury. At DBAM, you have to objectively decide the merits of the proposed acquisition by analyzing the value it might create or destroy on the basis of all available financial information, industry forecasts, the combined firm’s competitive strengths, and real options created by the merger.

The stock market reaction to the merger announcement on Labor Day 2001 was stunning: both stocks lost ground on the next trading day with CPQ down 10.29% and HWP down 18.14% from the previous close in heavy trading. However, as you know, simple stock returns do not tell the whole story. To gain a better understanding of the market’s assessment of the merger announcement and ensuing fight over HP’a corporate strategy, you should also carry out simple event studies of the

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3Technically speaking, Deutsche Asset Management is an investment advisor: the firm makes investment decisions on behalf of other institutional investors. It is called an advisor because it does not physically hold the funds itself in accounts, but advises (as in “orders”) the trustee who physically administers the money and carries out the investment orders of the advisor.


5Two major institutional investors, Wells Fargo and Banc of America Capital Management, joined the California Public Employees’ Retirement System (CALPERS), the largest U.S. pension fund, in declaring two weeks before the vote that they will vote against the deal. Furthermore, institutional investors often held shares in both companies; an example in point is Putnam Investments, which holds 68.9 million shares of Compaq and 46.2 million shares of Hewlett-Packard.

6What about customers? A Merrill Lynch survey of 100 CIOs ahead of the vote showed that more than 40 percent of Hewlett-Packard and Compaq users registered their opposition to the deal, with just over 25 percent in favor.

7It has been reported that Walter Hewlett spent close to USD 100m of his own money opposing the deal. Given that his private fortune is just that - private - it is very hard to verify such estimates.

8Early in the day, investors rallied around Compaq, but by the market’s close, the company’s stock had sagged $1.27, or 10 percent, to $11.08 on heavy trading. HP dropped throughout the day to close at $18.87, down $4.34, a loss of 18 percent. By the end of the week, HP was down 25% and Compaq 16% cutting more than $5b from the deal
various twists and turns in this saga look at their impact on shareholder wealth. Focus on a couple of key announcements and use the results to strategically bolster your point of view; statistical significance might become an important issue in this respect. As a reminder, a typical event study proceeds as follows:

1. Identify important announcements in the merger process and determine the precise announcement date from the case materials or news wires, company websites, etc.

2. Organize the stock price data contained in the case materials into date-matched continuously compounded returns.


4. Fix an event window around each announcement date, e.g., from 2 days prior to 2 days after the announcement, say, and calculate the cumulative abnormal return $\text{CAR}_i(-2, 2)$ by adding up the abnormal returns: $\text{CAR}_i(-2, 2) = \sum_{t=-2}^{2} \text{AR}_{it}$. You can repeat the procedure for the three day window from one day before to one day after the announcement, i.e., $\text{CAR}_i(-1, 0)$, or, for that matter, any other cumulative abnormal return $\text{CAR}_i(\tau_1, \tau_2)$ where $\tau_1$ and $\tau_2$ are the window’s start and end dates, respectively.

5. Assess the statistical significance of each $\text{CAR}$.

6. Finally, to see the total shareholder wealth effect you compute cumulative abnormal wealth created by multiplying the appropriate $\text{CAR}$ with the company’s market capitalization $K_{i-11}$ on $t = -11$, the eve of the event window around the announcement date: $W_i(\tau_1, \tau_2) = \text{CAR}_i(\tau_1, \tau_2) \cdot K_{i-11}$.

Note that write-ups and presentations espouse very different perspectives. Presentations are meant to reflect the perspective of HP (and Compaq) management or the dissenting shareholders (Walter Hewlett) and their advisors. Write-ups are executive memos to DBAM’s senior management. Here are the details:

- **Write-ups** (DBAM’s perspective) consist of executive memos to DBAM’s senior management (e.g., from its chief equity investment officer) outlining the issues from the point of view of a typical large institutional investor, making a recommendation for DBAM’s vote, and explaining the analysis behind the voting recommendation.

- **Presentations** (Goldman Sachs’ or Walter Hewlett’s perspective) analyze the case from the point of view of HP’s financial advisors (Goldman Sachs) or the HP Family Foundations.

This case is a **research case**: on the basis of these case instructions you have to produce our usual write-up (2 plus 6 format) or presentation but with a twist. In addition to the attached case materials, YOU are responsible for finding further information to back up your case work, and are required to put together a file containing the fruits of your research. So, submissions consist of three files: the 2 page write-up, the analytic appendices and the supporting documentation file (electronic form preferred).

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9 As always, groups are free to volunteer for class presentations in which case they only need to turn in the slides (file and hardcopy) as well as a file of supporting research material. This time, all the write-ups need to be submitted electronically as well. The file naming convention is as follows: HPQ <Case, Analysis, Presentation or Documentation><group number>.extension.
Needless to say that most of the information should come from on-line sources and that your research is heavily dependent on net information. Here are a couple of pointers: go to the websites of the companies involved, especially the investor sections, MSN.com Investor or Yahoo Finance, SEC-Edgar (who is Edgar?) for recent filings, find out who advised the parties and get analyst presentations, etc.

1. Analyze the two companies and the industry’s evolution. What is the rationale for the merger? Why now?
   (a) Identify the two company’s strengths and weaknesses and research their (recent) corporate past. What is the state of the industry at the time HP and Compaq decided to tie the knot, and what role did each of them play in bringing the deal about? Who is more likely to benefit from the merger?
   (b) Analyze the transaction. What are the terms of the deal? Its time table?
   (c) Find out whether the merger is a “merger of equals” or an acquisition. What did each party hope to gain? To avoid? What problems would the merger solve for each company?
   (d) Determine the major challenges of such a merger. What are its costs and benefits to the companies (employees and management), their shareholders, and their customers? Discuss worst and best case scenarios.

2. Value the deal on a stand-alone basis, i.e., derive both Compaq’s and HP’s intrinsic value before any synergy, growth opportunity, or restructuring gains.
   (a) As a preliminary step, calculate the appropriate WACCs for HP, Compaq, and their combined entity. Be careful to avoid typical pitfalls and mistakes in the calculation of the combined entity’s beta, D/E ratio, and, ultimately, WACC.
   (b) What is the value of HP and Compaq without merger related benefits and costs on a stand-alone basis? Fully document your analysis and assumptions.
   (c) How large is the acquisition premium (before the adverse stock market reaction) that is to be explained in terms of the merger-related benefits?

3. The deal only makes sense if the hoped for synergies materialize and quickly so. What is their nature and where are they expected to come from? Are they realistic and what would be a good benchmark to judge them?
   (a) Analyze the expected synergies, their nature, origin, and unlocking costs on the basis of the supplied information. What is their present value, their net present value? Carefully document your sources and assumptions.
   (b) Translate the direct and indirect costs of the proposed transaction into “deadweight losses,” i.e., merger-related negative synergies. Contrast them with the hoped for synergies and value them both on the basis of the publicly available information.
   (c) On the basis of publicly available information, back out the the maximal synergy investments \( K \) that HPQ can afford in light of the acquisition premium \( c \) and the present (current) value of future synergy cash flows. Is it reasonable? By what benchmark?
   (d) Carry out a full real options analysis of synergies and other growth options created through the merger. Assume an 18 months time horizon for the final investment decision
from the date of the announcement of the merger. Given the stated willingness to invest in synergies and growth opportunities, how large should the acquisition premium have been in your opinion?

4. Many publicly quoted companies such as HP still have strong ties to their founding families long after professional managers have taken over from the family. As a legacy of their origin, such companies often have dominant, non-institutional investors such as the foundations set up by Bill Hewlett and David Packard. Analyze the benefits and complications that can arise from such ownership groups.

(a) Research the legal and economic foundations of proxy fights. How is this instrument typically used in M&A transactions by the various parties? Why is it the weapon of choice for Walter Hewlett?

(b) Explain the ownership of both Compaq and HP, the governance issues that result from it, and any possible management challenges they create. What impact does the large component of family ownership have on the merger?

(c) What are typical deal risks, i.e., events that might derail a and where would proxy fights figure in your list?

(d) Determine Walter Hewlett’s motivation in waging his very public proxy fight in light of the $675m breakup fee that risks costing HP dearly. If the deal is as beneficial to shareholders as HP management claims, why does he oppose it? In whose interest is he acting and who, do you think, does he represent? From the benefit of HP shareholders, are his actions value creating or destroying? What about Compaq’s shareholders?

5. In light of the synergy analysis, stock price reaction, and proxy fight, how should DBAM vote? Use the supplied data to analyze what the market thinks about the outcome of the vote and examine three points of view before making your recommendation:

(a) Institutional Shareholders’ Services (ISS), a firm advising institutional investors that do not have the analytic resources to carry out full-fledged analyses of proxy fights.

(b) Goldman Sachs, the financial advisors to HP.

(c) Walter Hewlett, representing the largest shareholder group.

6. Follow up on the proxy vote and what happened after the merger. How well is HPQ doing? Where are they in terms of identifying, analyzing, and unlocking synergies? What does the market think of the integration effort and how well has the combined entity performed?

Groups 1, 3, 5, 7

Working for Friedman, Fleischer & Lowe, financial advisors to Walter Hewlett, you have prepared a presentation to key shareholders urging them to vote against the deal. While important institutional investors have come out against the deal, HP has recently garnered the public support of more than 8 percent of shares, led by large shareholders such as Barclay’s Global Investors, Putnam and Alliance Capital and a smattering of pension funds including the State Teachers Retirement System of Ohio. The battle is on for the hearts and minds of the remaining undecided investors.

\(^{10}\)Ford Motor Corp. is an interesting exception to this rule in that executive responsibility has alternated between family members and outside professionals.
Groups 2, 4, 6, 8

You are a senior investment banker at Goldman Sachs appointed by HP management as financial advisors on the deal. In this capacity, you have given an assessment (“fairness opinion”) of the deal’s merit from HP’s shareholders point of view (ANNEX B -Opinion of Goldman, Sachs & Co. of the joint proxy statement/prospectus, dated February 4, 2002). Working with Hewlett-Packard’s senior management, you have prepared a presentation to HP’s institutional shareholders meant to persuade them of the merits of such a deal. It is an uphill battle given that several major institutional investors, such as Wells Fargo, Banc of America Capital Management, and the California Public Employees’ Retirement System (CALPERS), have come out against the merger.

Please note the following ground rules for the case write-ups:

• the *maximal group size* is 5; every group member gets the same grade

• at most 2 pages of *analysis* and 6 pages of *technical appendices*;

• show your work, staple the pages together and be *professional*;

• *late write-ups* will not be accepted for any reason; they are due at the *beginning of class* for which the discussion is scheduled;

• *graded write-ups* will be available a week later.