The Demise of a Prized American Treasure

by Mohnish Pabrai

Hewlett Packard (HP) and Compaq represent the pinnacle of entrepreneurship and free enterprise, yet both companies could not possibly be more different. As startling as it may sound, HP was not created with a profit motive. When Bill Hewlett and David Packard setup shop in that famed Palo Alto garage in 1938, their mission was not to make a lot of money and get rich.

They set out to create a company where they could exercise their creative and entrepreneurial energies to build innovative products in their fields of interest and make meaning contributions to society at large. It did not stop there. They wanted to attract like-minded souls and create a passionate, dedicated team that fostered intense individual creativity. Finally, they wanted to be part of a company that was deeply committed to community involvement at all levels.

Like Konosuke Matsushita, they recognized that profits were necessary to fulfill all the other objectives of the company. Profitability was treated as the best single measure of their contribution to society and the ultimate source of corporate strength. They clearly laid out a profit maximization goal – but only to the extent that it was consistent with all the other objectives of the company.

Bill and Dave were intensely focused on achieving these lofty and counter-intuitive goals. They created a world class company which has met every objective they laid out and then some. While they became rich in the process, neither fixated on personal wealth or extravagant lifestyles. Both gave away 90+% their multi-billion dollar estates to their respective charitable foundations.

Compaq, on the other hand, was a Ben Rosen venture-backed well-funded startup that had a straight profit maximization objective. They wanted to build IBM PC-clones, scale up quickly and get to over $100 Million in revenues in its first year. Compaq achieved these monetary goals and became the first company in history to have over $100 Million in revenues in its first year.

Compaq has been a success in its own right. However, unlike HP, the DNA structure of Compaq is not that of an innovator. To put it bluntly, it is a profit maximizing focused PC-clone maker that has never delivered any meaningful innovations, nor has it been able to do anything but PC hardware. HP, on the other hand, has delivered a plethora of innovations in a diverse range of disciplines. Compaq's original DNA programming is diametrically opposed to the HP way. Blending these two disparate cultures would be like trying to mix oil and water – its guaranteed to fail. Ben Rosen is as sharp as they come. The only reason Compaq is being sold is because Ben believes that he has indeed extracted every ounce of profit out of it that he possibly could and continuing independently will lead to its eventual demise.

Another way to examine the merger is doing an intrinsic value analysis. At HP's present stock price, HP is paying about $21 Billion for Compaq. What is the future of Compaq? With revenues dropping from $42 Billion to $33 Billion in a year and profits dropping from $1.7 Billion to $170 Million, it's not a rosy picture. Figuring out Compaq's future is murky. I do see a business model and cost structure that's vastly inferior to Dell. My most optimistic assessment of Compaq's intrinsic value is well under $10 Billion. Adding in a Ben Graham margin of safety, I would not want to be paying more than $3-5 Billion for the company. Carly's paying 4-7 times optimistic valuation – and paying it with HP stock that, at present prices, is well under its intrinsic value. It's a very bad deal for HP stockholders and a blessing for Compaq shareholders.

So why is Carly hell-bent on pursuing this merger? The biggest mistake HP made was in hiring an individual as its CEO who fundamentally does not subscribe to the HP way. Bill and Dave were not money motivated. It was secondary. Carly needed an outrageous $75 Million+ package to sign on as CEO. That should have been the first clue to the board that she was the wrong choice. Secondly, unfortunately, many Fortune 500 CEOs measure their success by their rank on the Fortune 500. The ranking system is based on company revenues. If the list were based on the 500 companies with the largest free cash flows and then ordered by the average % increase in per share free cash flow over the last 5 years, we'd see radically different CEO behavior.

The only thing the merger accomplishes in the near term is a substantially higher on the Fortune 500 – which is precisely what a high-ego, low HP-way ethos CEO would want. The new HP, in the long run, will only be a small shadow of its present glory. The money hungry Carly will leave HP as the beginnings of this downward spiral starts to reveal itself – taking another $75 Million package and moving on – while we painfully witness the demise of a prized American treasure.

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