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We also conduct confidential consulting assignments for I.T. suppliers, enterprise I.T. users, as well as government economic development agencies.

HP's quest for a new business model

November 2011

For more than a year, HP has been struggling to define a new business model and corporate strategy that will allow it to turn the onrushing cloud computing era into reliable earnings and share price growth.

Some HP shareholders were undoubtedly wondering why change was necessary. Under former CEO Mark Hurd, who was forced out August 2010, HP had prospered. However, if the personal scandal that ultimately felled him had not occurred, it is likely that Hurd would still have been shown the door.

Why? Hurd's business model carried within it the seeds of its own eventual destruction. His system for growing earnings per share (EPS) and share price was powered by unsustainably low levels of investment in people and in key business processes. In the words of HP Chair Ray Lane, "Mark Hurd did not invest. He burned the furniture to please Wall Street".

Hurd's strategy may have been unsustainable, but he made it work for more than five years. His business model, relentlessly applied, increased revenue 58% from just under \$80-billion in FY2004, the year before he joined HP as CEO, to slightly over \$126-billion in FY2010, the year he left the company. Diluted earnings per share grew an even more impressive 224% over the same period, from \$1.14 to \$3.69.

HP's replacement CEO Léo Apotheker, who joined HP in Nov. 2010, moved to radically change the Hurd business model. Apotheker, who was a chief architect of SAP's success, was intent on imbuing both the company's client-side and server-side product portfolios with software that could be monetized for greater overall profit.


New software would help generate the higher gross margins required to fund necessary increases in levels of spending on wages and benefits, as well as higher investment in R&D and SG&A (selling, general and administrative). This would put HP in a position to fully leverage the cloud computing opportunity for higher EPS and share price growth.

However, investors grew impatient after the failure of Apotheker's first software-based initiative ... tablets based on the webOS operating system. Board members panicked and decided to hasten the process of improving profitability by spinning out the low-margin PC business, including tablets. Instead, the company turned its sights on the higher-margin server-side sector and acquired Autonomy, a fast-growing unstructured data specialist.

The decision to abandon PCs in favour of holding onto the more profitable printer and server-side businesses, did not sit well with HP's customers, suppliers, reseller channel, or investors. Apotheker was unceremoniously dumped to be replaced by Meg Whitman, former CEO of eBay who took just four weeks to reverse the decision to spin off the PC business.

Yet Whitman faces the same challenge that confronted Apotheker — growing gross profits to fund the higher levels of spending on salaries, R&D, acquisitions, sales and marketing that are necessary to capture the cloud computing opportunity.

Only the enterprise business sector has been able to generate both good revenue growth and acceptable profitability.



HP is searching for ways to generate greater growth from its printer business and find a solution to the Apple and Google problems facing its client devices business. However, Domicity believes Whitman will conclude that the main path to higher EPS growth lies in expanding HP's market position in enterprise server, storage, networking, software and professional services.

HP's Enterprise Business Group (EBG) contributed 44% of total revenue in FY2010. EBG's operating margins were 26% higher than the HP average. The enterprise business is sufficiently large and profitable to ensure that expanding this part of the company holds excellent potential to set EPS on a sustainable upward path and we believe the server-side business will get the lion's share of HP's spending on acquisitions and R&D.

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Prospects for profitable future server-side growth are particularly strong as the cloud computing gestalt sweeps over the I.T. world, driving medium and large enterprises to modernize their data centre operations for fear of falling behind.

Data centre modernization directed at cloud computing by service providers and enterprises will boost demand for new platforms and systems management software — higher margin areas where HP is very competitive.

CEO Mark Hurd reduced HP's share float by 683-million shares, generating a 27% higher EPS than without the buybacks.



The data management and analysis business, strengthened by the Autonomy purchase and a smaller acquisition that Apotheker engineered, Vertica, will likewise benefit from the growth of the cloud. There is an accelerating need for technology to wrest value from the torrent of data that Internet-based computing is throwing up.

EPS-centred business model

Figure 1 and **Figure 2** provide information and analysis regarding the key elements of HP's business model during Mark Hurd's regime.

Goal One for Hurd was to grow earnings per share, under the assumption that consistent EPS growth is a reliable driver of share price appreciation.

In theory, all public companies are EPS-centred.

However, there is a difference in kind between the near obsessive focus that Hurd's team applied to the question and the more lyrical approach of many multinationals.

Hurd employed a specific set of targeted strategies for growing the earnings numerator and for shrinking the per-share denominator of the earnings per share calculation.

The most straightforward part of his strategy — shrinking the per-share denominator — was accomplished by buying up HP shares and removing them from the float available for purchase by outside investors. HP has devoted several billion dollars of its cash flow every year to the acquisition of shares.

As CEO, Mark Hurd reduced HP's share float by 683-million shares, generating a 27% higher EPS than without the buybacks. HP spent \$35-billion on share repurchases between the start of FY2005 and the end of FY2010.

While HP was buying up shares to shrink the EPS denominator, Hurd was also intensely focused on growing earnings — the numerator of EPS.

The initial element of Hurd's strategy for growing the earnings numerator began with his predecessor CEO Carly Fiorina. Revenue was pumped up by targeting a broad swath of the global market for I.T. products and services sold to consumers, SMBs and large enterprises. In targeting most sectors of an I.T market worth some \$1.5-trillion annually, HP has been selling products and services through three business groups.

The largest of the three, the **Enterprise Business Group (EBG)**, sells servers, storage, network equipment, software and various professional services to public and private sector enterprises — from mom and pop businesses to the largest of multinationals. EBG generated revenue of \$57.2-billion in FY2010

(before eliminations for inter-divisional sales). Hurd's target for growing this business was to become the leader in delivering next-generation enterprise data center architecture and services.

During Mark Hurd's tenure as CEO, HP engineered 34 acquisitions, which were targeted to deliver 65% of new revenue.



HP's second largest product sector by revenue, the **Personal Systems Group (PSG)**, had \$40.7-billion in FY2010 revenue. PSG sells PCs, workstations and related peripherals to consumers and enterprises. Hurd focussed on growing this group's business by being the leader in *"always connected, always personal mobile experiences"* that drove a floundering move into smartphones and tablets.

HP's smallest product sector is the highly profitable **Imaging and Printing Group (PSG)** with \$25.8-billion in FY2010 revenue. It sells printing equipment, services and related ink and other supplies to individuals, enterprises and professional graphics operations. For IPG, Hurd's growth strategy focussed on leading *"a broad transition from analog to digital imaging and printing across the consumer, commercial and industrial markets"*.

A customer finance unit and a business incubator generated an additional \$4.9-billion in combined FY2010 revenue before eliminations. They support the line-of-business groups.

In seeking to maximize HP's share of the global I.T. market, Hurd's business model earmarked the

following three revenue growth drivers:

- **Acquisitions** — 65% of revenue growth
- **Market share gains** — 25% of revenue growth, primarily through aggressive commodity pricing of standardized products and related services
- **A big, new internally developed idea** — 10% of revenue growth.

Acquisitions — 65% of growth

During Mark Hurd's tenure as CEO, HP engineered 34 acquisitions, which were targeted to deliver 65% of its new revenue. These acquisitions were undertaken to help the product sectors enact their strategic mandates of dominating the data centre, winning in mobile client devices, and leading the digitization of all forms of printing. The acquisition campaign included several well-known companies — EDS, 3Com, Palm, Mercury Interactive — along with a raft of start-ups and mid-size competitors.

From FY2005 through FY2010, during most of which time Mark Hurd was CEO, HP's annual revenue grew approximately \$46-billion. Many of HP's acquisitions were privately-held and did not publish revenue data. Nevertheless, Domicity estimates that the total annual revenue run rate of the companies acquired during this period came close to the 65% of new revenue that Hurd had targeted. At the time of its acquisition, EDS alone accounted for more than \$20-billion in new annual revenue.

HP made these acquisitions with cash. Unlike Carly Fiorina's purchase of Compaq, Hurd did not permit the company to issue shares to cover all or part of an acquisition. Why? It would dilute HP's share float, increase the denominator of earnings per share, and thus work to counteract the company's principal

strategic goal of growing EPS (and share price).

HP's Hurd-era cash acquisitions were funded from the company's treasury or with new debt.

It could be argued that Hurd's cash-only acquisitions stance resulted in more care being taken with respect to choosing acquisitions and in negotiating the final price. By contrast, issuing new shares to make an acquisition is a bit like a national government printing money to fund a war ... something that can become undisciplined, or worse.

Market share gains were expected to deliver 25% of HP's revenue growth under Hurd's business model.



Market share gains — 25% of revenue growth

Market share gains were expected to deliver 25% of HP's revenue growth under Hurd's business model. This was to be achieved primarily through a commodity pricing model — aggressive pricing enabled by a heavy reliance on "industry standard" (most notably Wintel and Lintel) technology to deliver products and services. Relying on industry standard products was backstopped by an efficient value chain, applied to a very large addressable market of consumer and enterprise I.T. products and services.

Gross margin (gross profit divided by revenue) provides a rough cut for gauging company-wide pricing strategy. It can be used to get a handle on the degree of HP's price aggressiveness.

Gross profit, the money remaining from a company's revenue after the direct costs of production or service delivery (Cost of Revenue) are absorbed, including depreciation on buildings and equipment, pays for: R&D; administration, marketing, sales, and customer support expenses; any interest on debt; as well as payments (taxes) for government-supplied services. Ideally, after all expenses, there will be money left over to reward shareholders and to invest in growth initiatives. Companies with thin gross margins tend to have a commodity pricing model. Those with fat gross margins tend to have a high value-added pricing model. These days, companies in the I.T. industry typically opt for one model or the other. Being "caught in the middle" can be unfashionable.

As the cloud computing and convergence themes play out, HP's Enterprise Business Group bumps heads with five key competitors in the data centre: IBM, Dell, Cisco, EMC and Oracle.

Comparing HP's gross margin in fiscal 2010 against the corresponding FY2010 gross margin for each of these five key rivals is one way to highlight where HP stands on the commodity versus high value-added pricing continuum.

Posted fiscal 2010 gross margins are:

Dell.....	17.5%
HP.....	23.4%
IBM.....	45.3%
EMC.....	59.0%
Cisco.....	64.0%
Oracle.....	78.5%

This comparison makes clear that HP joins Dell in

employing a commodity pricing strategy. In the case of both HP and Dell this has been heavily influenced by their competition in Wintel PCs, but it spills over into their competition in server-side platforms.

During Hurd's five-year term, HP lowered its overall gross margin by 1%, even while reducing overall average prices well beyond that, thanks to supply chain-driven reductions to Cost of Revenue.

Based on the gross margin numbers shown previously, HP's pricing may appear to have been less aggressive than Dell. However, this was almost certainly not the case. During the Hurd reign, Dell was forced to price at levels that cannibalized its gross margins, EPS, and share price in order to minimize market share losses to HP, something we discuss further.

Big new ideas — 10% of revenue growth

Hurd's business model called for HP to come up with internally-generated ideas that could deliver the remaining 10% of annual revenue growth. Assuming the company wanted to grow revenue 10% annually, at FY2010 revenue levels, big new ideas from within the company's R&D establishment would need to generate about \$1.26-billion in new revenue for FY2011.

HP employs 30,000 engineers and scientists. One would think that such a large a group would have many big new ideas just begging to be monetized. Nevertheless, developing greenfield business opportunities that bring in revenue of \$1.26-billion every year is a daunting task.

In order to improve the chances of generating significant new money from the big ideas of its research staff, Hurd re-engineered HP Labs, the company's futures-oriented research establishment.

The goal of the reorganization was to increase the revenue and earnings generated from a given amount of R&D spending by focusing on a smaller number of high-impact projects, and by adopting a more venture capital-like approach to their selection and funding.

Tuning the value chain for increased earnings

Turning a large and growing revenue stream generated by acquisitions, market share gains and big new ideas into a large and growing earnings stream was the critical next step in Hurd's strategy to grow EPS and share price.

The Hurd team focused on managing HP's value chain to minimize the roughly \$115-billion in annual spending that now sits between the Net Revenue and the Operating Income lines on the company's income statement. This was achieved by taking cost out of HP's value chain ... mass layoffs, wage cuts, benefit stripping, rationalization of bricks and mortar, offshoring, and outsourcing.

The employee stakeholder group became fearful and unhappy. However, value chain optimization put pressure on some key competitors and warmed the hearts and pocketbooks of HP shareholders, not least of all those large holders of HP shares and options — Mark Hurd and his management team.

Particularly important in managing HP's immense value chain is achieving the right balance of make/buy decisions — should an activity be outsourced or should it be handled internally by HP's employees?

Maximizing value chain efficiency also turns on effective geographic rationalization of in-house and outsourced activities to ensure that inputs are procured from areas of the world where they are in best supply and that outputs can reach targeted

customers effectively and cost-efficiently. Should an activity be carried out in the traditional locale or moved offshore?

HP's Hurd-era supply chain strategy offloaded as much product development and production activity as possible, onto supply partners.



Coordinating a \$115-billion value chain, which is spread across the entire globe, to minimize costs and deliver acceptable customer satisfaction levels requires a powerful and efficient company-wide I.T. platform and software environment.

Shortly after becoming CEO, Hurd ordered a multi-billion dollar revamp of HP's internal data centres and related I.T. infrastructure. This was done primarily by using the company's own products, so that the new I.T. environment could not only tell Hurd and other HPers "the truth" about what was going on with the business, but could also be marketed to customers as a demonstration platform for HP's cloud-enabling products and services. The new I.T. platform underlay tight metrics-driven management systems engineered to achieve maximum value chain efficiency.

During the Hurd era, an efficient value chain converted a large and growing stream of revenue into a growing stream of earnings that pumped up the company's EPS and share price, even in the face of thin gross margins.

Even so, Domicity agrees with current HP management that Hurd's system was unsustainable; something we will explore further.

Hurd vs Dell — a good result for HP

The upside of HP's value-chain-driven strategies during the Hurd era can be seen when compared to archival Dell.

Both Dell and HP have focused on marketing x86 Wintel and Lintel technology, along with related products and services, to as much of the overall I.T. market as possible.

However, as [Figure 3](#) and [Figure 4](#) make clear, Dell and HP recorded significantly different financial performances in the Hurd years.

Although hampered by the recession, HP grew its revenue and net income at acceptable rates from FY2005 through FY2010, the period roughly corresponding to Mark Hurd's stint as CEO. (HP's fiscal year ends Oct. 31 and Dell's ends approximately three months later on the Friday nearest Jan. 31.)

Meanwhile, Dell turned in poor revenue and net income performance over the comparable term. Revenue increased only slightly and Dell's net income shrank significantly. The difference in the two companies' performance during the Hurd era is all the more striking because Dell had outperformed HP by a wide margin on revenue and earnings growth during the previous 10 years.

Domicity believes the difference between the financial performance of HP and Dell throughout the Hurd era can be explained by:

- HP's more aggressive use of acquisitions to fuel growth
- HP's value chain structure

Acquisitions contributed about 65% of HP's growth during the Hurd era and HP spent more on

acquisitions than Dell, both in absolute terms, and in proportion to the size of its business. Dell is now becoming significantly more acquisitions hungry.

The acquisition piece is not unimportant, yet Domicity believes the superior efficiency of HP's value chain was more critical in explaining the difference in the relative performance of the two companies.

HP used acquisitions more aggressively than Dell to fuel growth

Figure 5 provides a cumulative income statement analysis that combines the last six fiscal years of HP and Dell. It also provides a head-to-head comparison of each company's income statement for HP's FY2010 and Dell's FY2011.

For this analysis, we consider the relative value chains of Dell and HP in two parts:

- **Supply chain** — everything needed to get a product or service market-ready
- **Demand chain** — everything needed to sell and support a product or service

A third component of the value chain — supportive staff functions such as HR, accounting and finance, I.T., property management, and so on — are not considered here except as they affect SG&A spending.

Supply Chain — offloading costs onto suppliers

HP's Hurd-era supply chain strategy offloaded as much

product development and production activity as possible, onto the company's supply partners.

In Figure 5's comparative proportional income statements, the portion relevant to the supply chain is covered by the Cost of Revenue and the R&D expense categories.

When Cost of Revenue and R&D in Figure 5 are summed, these categories consumed 3.8% less of HP's revenue than Dell's, and for the cumulative six-year income statements, they were 5.1% less. Domicity estimates that HP's supply chain advantage over Dell was significantly larger than indicated by this 3.8% to 5.1% margin spread.

During the Hurd era, Dell's pricing levels generally proved to be too low to generate growth in the company's revenue and earnings. Yet, HP's pricing helped to produce relatively good revenue growth and better earnings performance than Dell.

Dell's FY2006 revenue was 64% of HP's comparable revenue in FY2005. However, Dell's FY2011 revenue was only 49% of HP's comparable FY2010 revenue. On the profit side, Dell's FY2006 net income was 150% of HP's. But Dell's FY2011 net income plummeted to just 30% of HP's for the comparable period. While pricing at levels to try to prevent inroads from HP into its customer base, Dell was unable to generate adequate revenue growth and profitability.

HP built its supply chain advantages by moving sooner and more aggressively than Dell to use offshore Original Design Manufacturers (ODMs) and contract manufacturers to handle product development and production tasks.

Meanwhile, Dell stuck with its build-to-order strategy past the point where it was delivering competitive advantage. HP also used its greater size to develop substantial scale advantages in the sourcing of

components and of manufacturing services.

Demand Chain — offloading costs onto the channel

Turning to the demand chain, Hurd's strategy was to offload as much activity as practical onto channel partners — retailers, direct online sales specialists, OEMs, VARs, large system integrators, outsourcers, and so on — and, in the process, to reduce expenditures on sales and customer support.

... most end users of HP's products are willing to, or even prefer to, buy through some type of reseller.



HP's SG&A spending, which covers most demand chain expenses, absorbed a smaller portion of HP revenue than Dell. Where Dell's direct sales model once delivered significant competitive advantage, this no longer seems to be the case in broad swathes of the market. HP developed a channel sales and support model that delivered adequate customer service for most customers, at less cost as a proportion of revenue, than Dell's direct sales model. HP's SG&A spending had dropped to 10.0% of revenue for FY2010 versus 11.9% for Dell in the comparable period.

HP's largest customers require a direct sales relationship. However, most end users of HP's products have been willing to, or even prefer to, buy through some type of reseller.

Dell has worked in recent years to build up a channel presence. Nevertheless, the company remains far back of HP and has been hampered by reseller distrust of a

company which for years had been a direct-only sales evangelist.

Dell did not find a way to relieve the value chain pressure exerted by HP while Mark Hurd was running the show. It must be some relief to Dell that HP is now more focused on generating greater profit margins from its PC business, and is more focused on beating Apple than Dell in client devices.

Hurd versus IBM — a less impressive result

Mark Hurd's value chain-driven strategies worked well against Dell, but much less well against IBM, its other great American computer systems rival.

A multi-year comparison with IBM highlights inherent weaknesses in Hurd's business model and shows why HP's new regime is working to retool the strategy.

Figure 6 shows that HP's annual revenue passed IBM's relatively early in Mark Hurd's term. HP's revenue edged slightly ahead in FY2006 and its lead continued to widen. In FY2005, HP's revenue was 95% that of IBM and by FY2010, HP's revenue had surged to 126%. (IBM's fiscal year ends on Dec. 31, two months later than the HP year end.)

Yet, it needs to be remembered that revenue is only significant as the raw material for net income and earnings per share. On the earnings front, IBM substantially outperformed HP during the latter years of the Hurd era (see **Figure 7**).

In FY2005, HP's net income was just 30% of IBM's. By FY2007, HP had increased this to nearly 70%. Then, in FY2008, the trend began to reverse. HP's net income ratio versus IBM fell back to 67.5% and dropped again in FY 2009 to 57%. The ratio only improved slightly to 59.1% in FY2010.

In order to produce net income equivalent to IBM, at FY2010 rates of relative net margin, HP would have had to generate \$213-billion in revenue compared to IBM's \$99.9-billion (rather than the \$126-billion HP did generate). This is a huge gap to close.

During Hurd's time, HP was not able to significantly damage IBM's high value-added model with its emphasis on the value chain. This is significant because a key part of Hurd's strategy was to use standardized products, sold at aggressive prices, to rip into the businesses of IBM and other high-margin server-side rivals more reliant on proprietary technology, including EMC, Cisco and Sun (now Oracle).

Figure 8 provides comparative cumulative income statements for HP and IBM for FY2005 through 2010 — the period roughly equalling Hurd's time at HP. It demonstrates just how different the two companies' business models really are.

A multi-year comparison with IBM reveals why HP's new regime has chosen to retool the strategy

IBM's gross and net margins are roughly twice those of HP. IBM leverages its considerable rates of "investment" in R&D and SG&A into the generous price levels that produce high profit margins. By contrast, HP's Hurd-era model stressed offloading as much R&D as possible onto suppliers including Intel and Microsoft, and onto ODMs. At the same time, HP was offloading SG&A expense onto its channel partners.

Comparing IBM's FY2010 income statement in Figure

8 to the cumulative income statement for the previous five years, it becomes clear that IBM's high value-added model is actually picking up speed. In FY2010, despite the onslaught of commodity-priced standardized products from HP, IBM's gross, operating and net margins were all significantly better than the company's five year average.

HP's challenge

HP's inability, in recent years, to cause significant problems for IBM, Apple, Oracle and some other high value-added competitors, highlights a critical flaw in Mark Hurd's business model; one that the current leadership must address.

Figure 9 recaps how the structure of HP's income statement changed under Mark Hurd, versus earlier periods of the company, going back to 1980.

The net margin (net income/revenue) that HP generated in FY2010 — 7.0% — does not differ wildly from the net margin 30 years before in FY1980, and most of the other years in between. However, HP took a completely different path to get to comparable net margins.

HP's gross margin was 52.4% in FY1980, significantly higher than even IBM produced in 2010. However, by FY2010, HP's gross margin had dropped to 23.8%.

Back in 1980, HP's strategy was not grounded on peddling industry standard technology at aggressive prices, but on selling highly featured, premium-priced products.

Spending on R&D (which Mark Hurd had driven down to a little more than 2% of revenue) was 8.8% in FY1980 and exceeded 10% in both 1985 and 1990. R&D at 10% of revenue was the level of spending that founders Bill Hewlett and Dave Packard favoured back in the days when innovation was HP's motive force.

As for SG&A expense, Hurd's team drove it down to an ultra-low 10% of revenue in FY2010, compared to 26.8% in FY1980.

HP also was regarded as one of the best places to work in America for most of the period from its founding in the late 1930s up until 2000.

This stands in stark contrast to a 2010 in-house workforce survey, whose results were revealed not long before Mark Hurd was forced out. It showed that two-thirds of the company's employees would rather work elsewhere, even at the same pay.

Job search sites were lit up during the Hurd years with complaints from HP staffers, expressed in language that would singe the ears of a stevedore.



Job search sites such as glassdoor.com were lit up during the Hurd years with complaints from HP staffers, expressed in language that would singe the ears of a stevedore.

Employee enmity to The Hurd Way was driven by a harsh work environment. An April 2010 Forbes article quoted a poster on glassdoor.com: "If you want to be kicked like a dog, come work here!". The unpleasantness of the work atmosphere at HP was greatly exacerbated by value chain-tuning measures such as offshoring, outsourcing, mass layoffs, salary reductions, and benefit stripping.

Under HP's Hurd-era HR policy, employees were regarded as an increasingly internationalized commodity, to be sourced as cheaply as possible, from

wherever the best price-performance could be obtained. Conversely, workers could be quickly discarded if their price-performance advantage eroded. Automating a job right out of existence was an even more preferable option.

This contrasted with the Hewlett-Packard of the founders, famous for an employee-centred business model known as "The HP Way". The founders shared a belief that creating a work environment that helped employees thrive would strengthen the business over the long-term. The right work environment would inspire employees to give the company their best and would attract superior recruits to work for the firm, creating a virtuous circle of innovation, revenue growth and high profitability.

Under The HP Way, employees were the company's main competitive differentiator. One now has to go to Google, NetApp and some of HP's other Silicon Valley neighbours to find anything like this HR philosophy.

The HP Way generated the sort of loyalty and commitment evinced by the following paen from an HP lifer, who was terminated during the Hurd era:

"I will miss the laughter and excitement of creating new businesses and improving processes.

I will miss the serious times when customers' needs were on the line.

We were all engaged for one purpose.

It was our finest hour.

I will miss saying I helped create a great HP product.

And now will relish in how it changed the world.

I wouldn't have missed that for anything.

How proud I am to have been an HP employee.

I would have worked for free for you HP.

I loved you that much."

By the end of the Hurd era, this sentiment was not shared by many at HP.

The chief criticism of Hurd's approach ... you can only squeeze spending and count the beans for so long. Eventually you have to plant some new beans if you want to continue growing your pile.

Profits from the cloud

Domicity argues at the outset of this piece that HP's new senior management needs to generate higher gross margins in order to fund commitments requiring increased investment in wages, R&D, sales and acquisitions. Figure 9 uses the historical record to show that there is scope for HP to generate these higher gross margins without killing growth.

HP's current management intends to position the company for more profitable growth by catching the cloud computing wave that is washing over enterprise I.T. departments and service providers.

For enterprise customers who are reluctant to put mission-critical data or applications outside the firewall, HP offers a modernized hybrid server-side computing environment that keeps key data and applications at home and limits use of the public cloud to non-critical processes.

Meanwhile, HP researchers believe they can develop a multi-tenant public cloud platform that is as secure as an internal enterprise I.T. environment. If HP can deliver the technology needed to allay security concerns, then the superior economics of the public cloud will attract workloads from enterprise customer

data centres at an accelerating rate. Many enterprises are anxious to use the public cloud to turn fixed I.T. costs into variable costs through pay-per-use or subscription pricing.

HP is investing heavily in a network of global data centres that will offer "enterprise-grade" public cloud hosting services and a range of "Everything-as-a-Service" (XaaS) offerings developed by HP Labs that are designed to solve the cloud security question.

HP's XaaS portfolio is being developed to offer: Storage-as-a Service, Compute-as-a-Service, as well as Platform-as-a-Service (PaaS).

If HP's sophisticated PaaS offering works, it will enable HP and third-parties to develop a new class of cloud-optimized applications using open source developer tools.

HP says that its differentiating factor from Amazon and other cloud hosters will be unheard-of levels of "enterprise-grade" security and reliability. HP hopes this will allow it to price at a premium and not get drawn into the downward price spiral that threatens to overtake the cloud hosting market.

A range of enterprise services from HP will encourage customers to take full advantage of its XaaS offering.

As well, with the acquisitions of Vertica and Autonomy, HP is jumping into real-time analytics. The cloud is expected to offer strong potential for providing analytics services in different vertical markets, designed to help customers strengthen business processes up and down their value chains.

HP's current vision also puts the Imaging and Printing and the Personal Systems businesses in the cloud, although these will be second-tier earnings generators beside the server-side operations.

The printing business is being positioned as the "off-ramp" for cloud computing, allowing consumers and enterprises to print colour copies from anywhere to anywhere. Having decided to retain the client-devices business, it remains to be seen how HP will retool this operation to turn back the Apple and Google threat.

Talk is cheap, particularly when it comes to cloud computing.



The company appears set to recommit to its Microsoft alliance for most client device platforms.

IBM's FY2010 results demonstrate the full revenue and profit potential of that company's decision to focus on the server side years ago. IBM generated a pre-tax margin after expenses of 18.3% on revenue of \$102-billion, before eliminations, while addressing a market space comparable to HP's server-side Enterprise Business Group.

In FY2010, HP's EBG, though a powerful #2 in server-side computing, generated an operating margin of 15.3% on revenue of \$57.2-billion, before eliminations, a little over half of IBM's revenue. (IBM's profit advantage is even greater than this comparison shows, because HP's operating margins are calculated before subtraction of significant "unallocated" costs.)

HP's server-side strengths

In seeking to expand its share of server-side markets, HP can count on significant strengths, including:

- sophisticated data centre technologies
- strong server-side hardware technology and

products — servers, storage, and networking — that can be configured as a converged and virtualized platform for supporting private and public clouds

- improving economies of scale for server-side hardware which will translate into better price flexibility
- competitive systems management and security software
- promising XaaS offerings and new generations of cloud-optimized hardware, based on HP Labs' technology
- a global chain of state-of-the-art data centres, under construction and optimized to host multi-tenant public cloud offerings for enterprise customers
- an extensive, geographically-distributed professional services organization
- a broad portfolio of technology and services alliances
- a powerful reseller channel and large internal sales force
- global reach in both established and emerging markets

HP's server-side weaknesses

HP faces significant barriers to success as it competes with other server-side powerhouses IBM, Oracle, Cisco, EMC, Microsoft, Accenture and others, including:

- relatively weak high-end consulting and applications-integration capabilities

- an anemic data management and business intelligence software offering (being addressed by big moves to deliver next-generation, real-time analytics)
- a vestigial presence in current-generation middleware and applications
- underdeveloped solutions-selling capability
- lateness into the cloud hosting market relative to some powerful early leaders, including Amazon, Google and Microsoft.

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HP hopes to eliminate these weaknesses by being first to market with next-generation cloud-enhanced technology, rather than trying to play catch-up in current generation technologies and products.

Conclusion

The HP built by Mark Hurd ran on unsustainably thin profit margins. The company's new management needs to establish a business model that generates higher gross margins and throws off more cash, for acquisitions and share repurchases, if HP is to reliably generate faster EPS and share price growth.

Cloud computing may offer opportunities for HP to generate profitable growth from its client device and printing businesses. However, Domicity is convinced that HP's best opportunities for earnings growth lie in expanding its position in server-side markets.

This Domicity e.paper is based on research for an upcoming, in-depth CORProfile® report on the strategies and operations of a leading cloud supplier. [CLICK HERE](#) to receive your advance report notice and to save 33% on early orders.



Figure 1
Key Elements of HP's Hurd-era Business Model

Increase share price — HP under Mark Hurd was managed with the objective of reliably increasing earnings per share in the belief that a rising EPS will drive a rising share price

Reduce the EPS denominator — The denominator of earnings per share was driven down by buying up billions of dollars worth of shares every year

Increase the EPS numerator — Hurd sought a large and growing revenue stream which could be turned into earnings through value chain efficiencies

Maximize revenue — To provide a large stream of raw revenue HP has been targeting a very large portion of the roughly \$1.5-trillion global information technology market

Sell I.T. to everyone — HP's targeting of the global I.T. market has encompassed global consumer, small business, and large public and private enterprises, plus it has sought leadership in both server-side and client-side products and services

Make acquisitions — Hurd devised a strategy that sought to grow revenue three ways: 65% from acquisitions; 25% from market share gains, thanks to aggressively-priced commodity offerings; and 10% from big new ideas out of HP Labs

Squeeze the value chain — Revenue growth was turned into earnings and cash flow, under the Hurd system, by squeezing the \$115-billion in value chain costs between HP's revenue and operating income lines; Hurd aggressively offshored and outsourced value chain costs onto suppliers and resellers

Repeat as needed — Cash flow liberated from a growing revenue stream resulting from an efficient value chain, was used to make more acquisitions to grow the EPS numerator and to buy up more shares to shrink the denominator

Source: DOMICITY LTD.

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Figure 2
Schematic of HP's Hurd-era Strategy

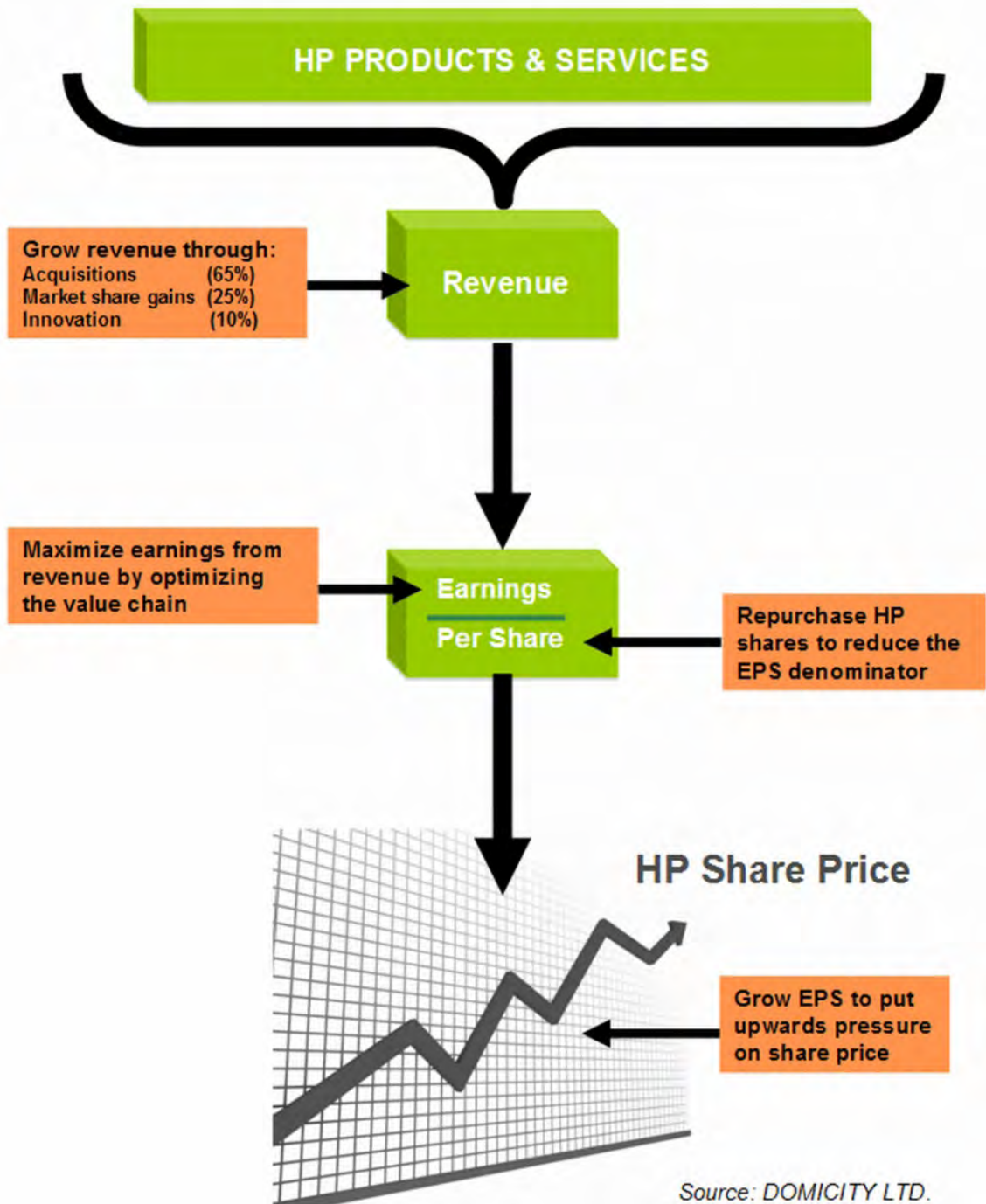
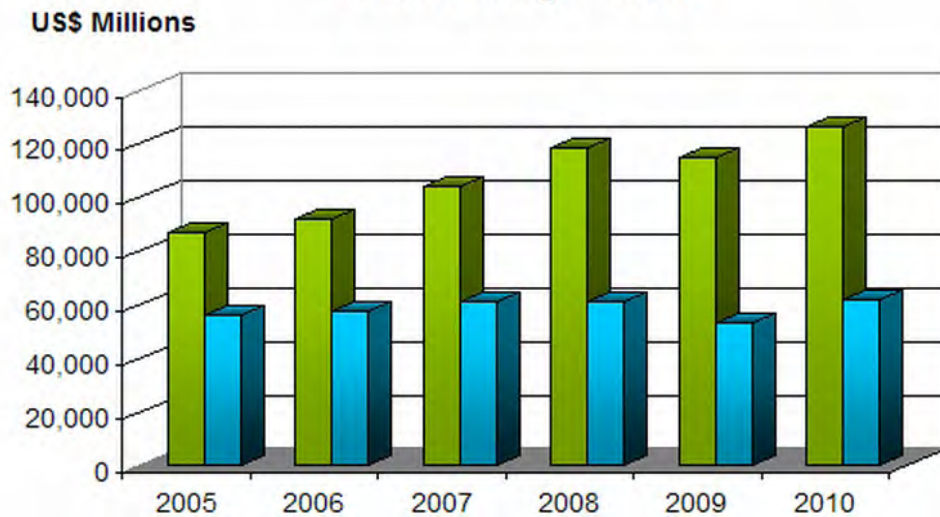


Figure 3
Revenue — HP versus Dell
FY2005 through FY2010

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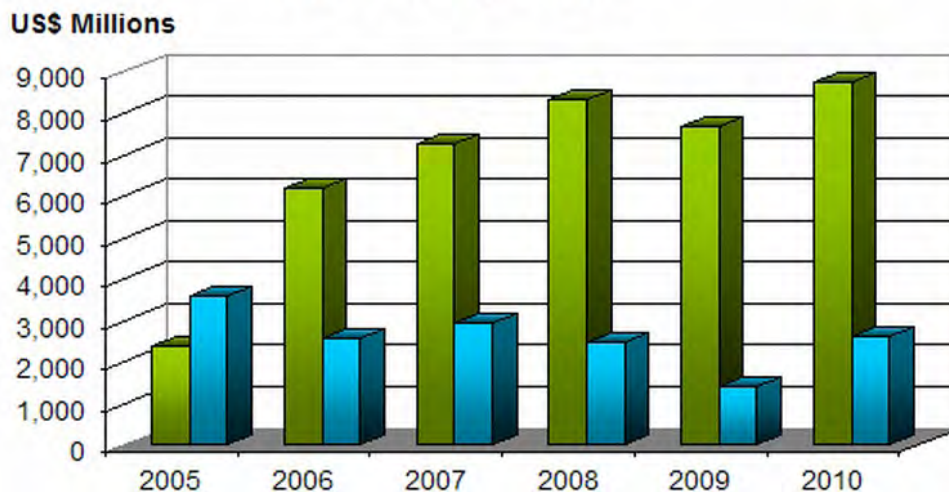


Note: Numbers are for fiscal year ending closest to the calendar year.

■ HP Revenue ■ Dell Revenue

Source: Corporate Reports

Figure 4
Net Income — HP versus Dell
FY2005 through FY2010



Note: Numbers are for fiscal year ending closest to the calendar year.

■ HP Net Income ■ Dell Net Income

Source: Corporate Reports



Figure 5
HP versus Dell
6-Year Income Statement Analysis

	Cumulative				Most Recent Fiscal Year			
	HP FY2005 through FY2010		DELL FY2006 through FY2011		HP FY2010 Ended Oct 31, 2010		DELL FY2011 Ended Jan 28, 2011	
<i>US\$ Millions</i> <i>Revenue = 100%</i>								
Net Revenue	\$641,589	100.0%	\$349,838	100.0%	\$126,033	100.0%	\$61,494	100.0%
Cost of Revenue	488,633	76.2%	287,146	82.1%	96,089	76.2%	50,098	81.5%
Gross Profit	152,956	23.8%	62,692	17.9%	29,944	23.8%	11,396	18.5%
R&D	20,013	3.1%	3,599	1.0%	2,959	2.3%	661	1.1%
Selling, General & Administrative	71,978	11.2%	39,406	11.3%	12,585	10.0%	7,302	11.9%
Total Operating Expense Before Special Charges	91,991	14.3%	43,005	12.3%	15,544	12.3%	7,963	12.9%
Operating Income before Special Charges	60,965	9.5%	19,687	5.6%	14,400	11.4%	3,433	5.6%
Special (Charges) or Income	(10,125)	-1.6%	0	0.0%	(2,921)	-2.3%	0	0.0%
Operating Income after Special Charges	50,840	7.9%	19,687	5.6%	11,479	9.1%	3,433	5.6%
Investment Income Net of Interest Expense	(67)	0.0%	791	0.2%	(505)	-0.4%	-83	-0.1%
Pre-tax Income	50,773	7.9%	20,478	5.9%	10,974	8.7%	3,350	5.4%
Income Tax and Other Provisions	10,163	1.6%	4,800	1.4%	2,213	1.8%	715	1.2%
NET INCOME	\$40,610	6.3%	\$15,678	4.5%	\$8,761	7.0%	\$2,635	4.3%

Source: Corporate Reports, DOMICITY LTD. calculations

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Figure 6
Revenue — HP versus IBM
FY2005 through FY2010

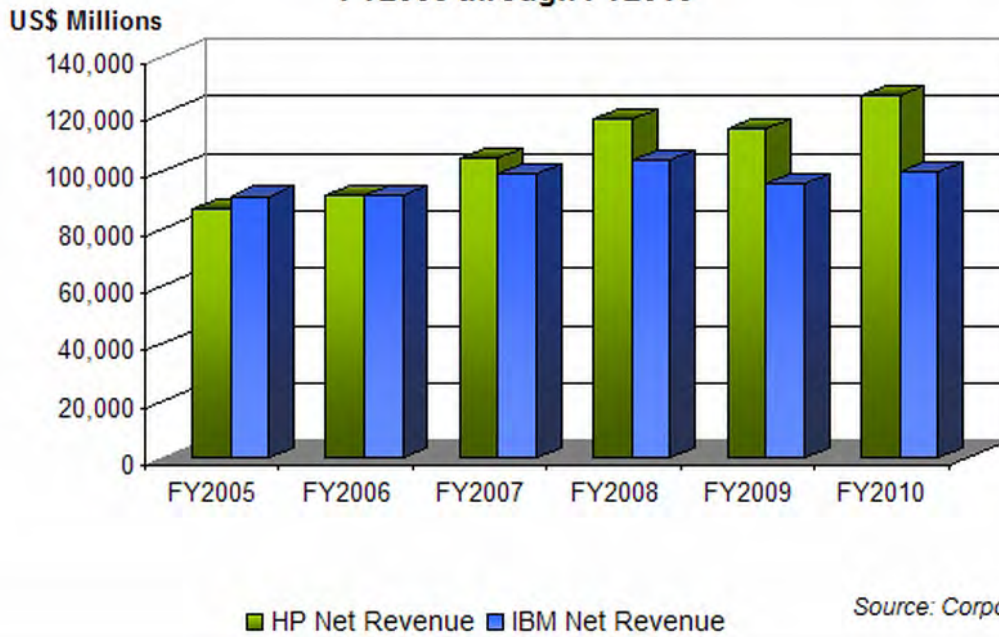
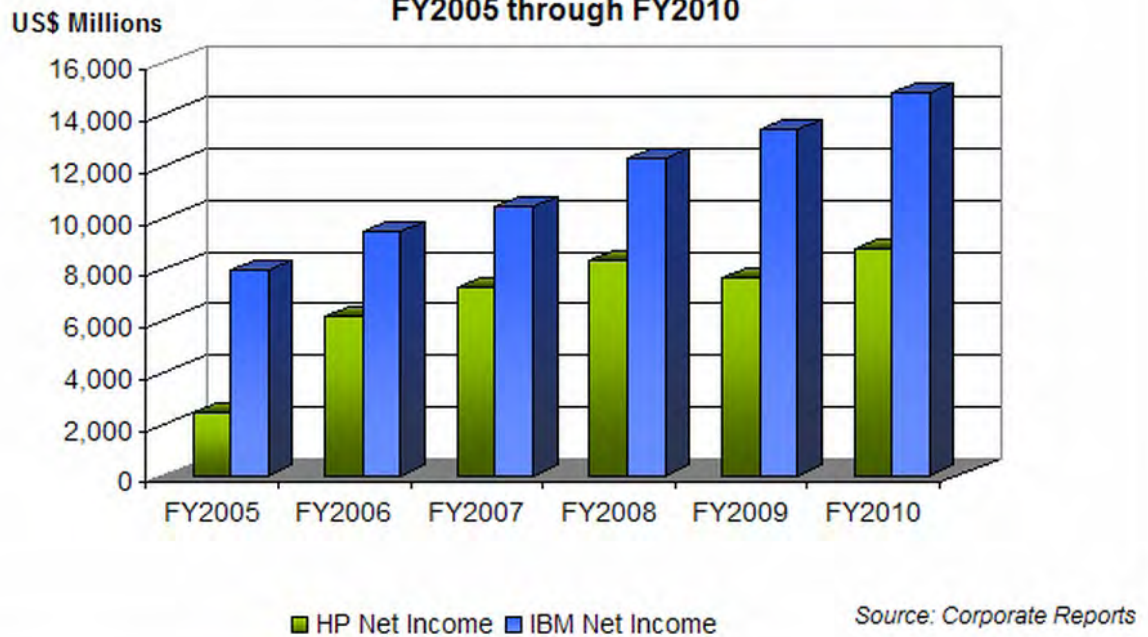


Figure 7
Net Income — HP versus IBM
FY2005 through FY2010





**Figure 8
HP versus IBM
6-Year Income Statement Analysis**

	Cumulative				Most Recent Fiscal Year			
	HP FY2005 through FY2010		IBM FY2005 through FY2010		HP FY2010 Ended Oct 31, 2010		IBM FY2010 Ended Dec. 31, 2010	
<i>US\$ Millions Revenue = 100%</i>								
Net Revenue	\$641,589	100.0%	\$580,602	100.0%	\$126,033	100.0%	\$99,870	100.0%
Cost of Revenue	488,633	76.2%	328,586	56.6%	96,089	76.2%	53,856	53.9%
Gross Profit	152,956	23.8%	252,016	43.4%	29,944	23.8%	46,014	46.1%
R&D	20,013	3.1%	36,285	6.2%	2,959	2.3%	6,026	6.0%
Selling, General & Administrative	71,978	11.2%	129,808	22.4%	12,585	10.0%	21,837	21.9%
Total Operating Expense Before Special Charges	91,991	14.3%	166,093	28.6%	15,544	12.3%	27,863	27.9%
Operating Income Before Special Charges	60,965	9.5%	85,923	14.8%	14,400	11.4%	18,151	18.2%
Special (Charges) or Income	(10,125)	-1.6%	7,127	1.2%	(2,921)	-2.3%	1,991	2.0%
Operating Income After Special Charges/Income	50,840	7.9%	93,050	16.0%	11,479	9.1%	20,142	20.2%
Investment Income Net of Interest Expense	(67)	0.0%	1,558	0.3%	(505)	-0.4%	(419)	-0.4%
Pre-tax Income	50,773	7.9%	94,608	16.3%	10,974	8.7%	19,723	19.7%
Income Tax and Other Provisions	10,163	1.6%	26,172	4.5%	2,213	1.8%	4,890	4.9%
Net Income	\$40,610	6.3%	\$68,436	11.8%	\$8,761	7.0%	\$14,833	14.9%

Source: Corporate Reports, DOMICITY LTD. calculations



Figure 9
HP Proportional Income Statement Analysis
FY1980 through 2010

Fiscal Year Ended Oct 31	1980	1985	1990	1995	2000	2005	2010
	<i>US\$ Millions</i>						
Net Revenue	3,099	6,505	13,233	31,519	48,782	86,696	126,033
Net Income	269	489	739	2,433	3,561	2,398	8,761
Proportional Income Statement							
Net Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Revenue	47.6%	48.7%	52.8%	63.5%	71.5%	76.4%	76.2%
Gross Profit	52.4%	51.3%	47.2%	36.5%	28.5%	23.6%	23.8%
R&D	8.8%	10.5%	10.3%	7.3%	5.4%	4.0%	2.3%
Selling, General & Administrative	26.8%	29.1%	28.0%	17.9%	15.1%	12.9%	10.0%
Total Operating Expense Before Special Charges	35.5%	39.7%	38.4%	25.2%	20.6%	16.9%	12.3%
Operating Income Before Special Charges	16.9%	11.7%	8.8%	11.3%	8.0%	6.7%	11.4%
Special Charges or Income	—	—	0.0%	0.0%	0.0%	2.8%	2.3%
Operating Income After Special Charges/Income	16.9%	11.7%	8.8%	11.3%	8.0%	3.9%	9.1%
Investment Income Net of Interest Expense	—	—	-0.8%	0.2%	1.5%	-0.2%	-0.4%
Pre-tax Income	16.9%	11.7%	8.0%	11.5%	9.5%	4.1%	8.7%
Income Tax and Other Provisions	8.2%	4.1%	2.4%	3.8%	2.2%	1.3%	1.8%
Net Income	8.7%	7.5%	5.6%	7.7%	7.3%	2.8%	7.0%

Source: Corporate Reports, DOMICITY LTD. calculations