
HP Acquiring EDS: What Does This Mean for Customers and the Outsourcing Market?

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Hewlett-Packard (HP) has announced plans to acquire Electronic Data Systems (EDS) in a deal expected to be finalized during the second half of 2008. The announcement signals the most significant change in the information technology services market in a number of years. Clients with active agreements with either HP or EDS have time to assess the impact on their organization. Additionally, there is unlikely to be a significant impact on pending proposal processes since, until the acquisition is finalized, EDS and HP must by law continue operating as separate entities. The creation of this combined services and hardware firm is a positive development for the outsourcing market. HP, along with EDS, has the potential to become a formidable competitor to IBM. The addition of another Tier 1 competitor will provide clients with additional options for their outsourcing transactions. The HP deal is also likely to trigger additional consolidation, as small and mid-sized service providers attempt to stay competitive with the IT services giants.

Deal Background

According to a press release issued by HP on May 13, 2008, HP will acquire EDS pursuant to a signed agreement at an enterprise value of approximately \$13.9 billion (cash and debt), or approximately \$25 per share. The parties anticipate that they will finalize the international deal by the end of 2008—a very aggressive target in our opinion. The newly merged services entity will be branded as “EDS—an HP company” and will maintain its headquarters at EDS’s current Plano, Texas location. Both companies also plan to maintain and integrate their current leadership. The extent to which HP’s existing consulting and outsourcing activities will be included within the Plano operations is not yet clear.

If successfully completed, this deal will create the world's second largest provider of technology services behind IBM and will earn an estimated \$39.4 billion in technology services revenue, compared to IBM's estimated \$54.1 billion earned last year. HP estimates that the new entity will own 7% of the market share for technology services behind IBM's 10% share. The new entity will employ approximately 210,000 employees in over 80 countries. According to an article published by Dow Jones & Company, Inc., the agreement provides for termination rights for both HP and EDS, as well as a potential \$375 million breakup fee that EDS will pay to HP under certain circumstances in the event that the merger fails to finalize.

Interacting with EDS and HP

a. Change in Control

Customers of EDS and/or HP should review their current agreement's change of control provisions (if applicable) in order to best assess their rights in the event of the HP-EDS merger. However, because most standard change of control clauses are not effective until the change of control has actually occurred (as opposed to being effective upon the notice of a change of control), current EDS and HP customers will likely have time to review their agreements and plan accordingly. Pillsbury understands that EDS is currently undertaking a review of its contracts' change of control provisions to plan for the finalization of the merger. While EDS believes that most of its contracts contain some form of a change of control provision that is generally fair to both parties, Pillsbury's past experience indicates that some clients may use the acquisition as a means for significantly restructuring or (potentially) terminating their existing outsourcing relationship on terms favorable to the customer. For now, we urge clients to proceed carefully and not engage either HP or EDS in such discussions without first developing a complete understanding of their available options.

b. Pending Proposals With EDS or HP

For potential customers currently in the request for proposal (RFP) or bidding stage of a deal with EDS, HP or both competing for your business, you have different considerations than those customers already committed to a deal and need to address your situation promptly. Until HP's acquisition is final, HP and EDS are required by law to operate completely independently of each other and may not share commercial secrets—including information related to confidential bids. As such, until the merger is final, potential customers should proceed on a basis that assumes the current bidding process will continue on a competitive basis in a business as usual manner. However, some attention should be given to situations where HP or EDS either are or may become the two finalist bidders.

When drafting an agreement after down selection, customers should keep the merger in mind. A prudent potential customer should ensure that all assigns and successors of the supplier, whether it be EDS or HP, will be appropriately covered in the agreement, particularly regarding the right of the supplier to assign the agreement and associated licenses and regarding the indemnification rights under the agreement. An additional consideration for potential customers is that of determining whether the parties wish to designate third party beneficiaries of the agreement and ensuring that any new entity will be properly included or excluded from that category.

Announcement's Impact on the Outsourcing Market

Once the transaction is complete, HP will become the second largest IT services provider in the world and the combined entity will join IBM as the only Tier 1 outsourcing player in the marketplace. The acquisition will create a financially sustainable outsourcing service provider that is well positioned to compete with

IBM. The deal also alleviates some uncertainty among would-be customers about EDS's financial stability and future. Significantly, the combination will also result in a greater geographic footprint for both organizations. HP's sales expertise and market-leading hardware and software production, along with EDS's service delivery capabilities, will create a combined entity that is a viable alternative to IBM. The announcement should be viewed as a positive development for increased competition in the outsourcing market. One can expect that each of IBM and HP will seek to differentiate itself from the other by emphasizing its use of market-leading technology and automation and by adopting and deploying industry standard processes and procedures like ITIL (IT Information Library).

Much attention has been focused on the lack of overlap between HP's and EDS's current lines of business. This variation in commercial strengths not only provides for a strong pairing, but to the extent overlap does exist, HP may be able to leverage duplicate resources to develop its business process outsourcing (BPO) capabilities. BPO is an area where the combined entity will still fall short. Finally, the combination presents opportunities for existing HP and EDS clients. The combined entity will result in greater synergies and opportunities for value generation.

After the acquisition, HP and EDS will still face significant challenges in the marketplace. In particular, HP must build on its existing offshore workforce to develop an even broader and deeper capability to serve its increasingly global customer base. The majority of the EDS workforce is located in the United States, and without the necessary global component, HP cannot meaningfully compete with IBM. The ultimate value of the acquisition to the marketplace depends on HP's and EDS's ability to integrate their service offerings. Past history for both companies, HP with Compaq and EDS with AT Kearney, indicate the problems associated with such combinations and the challenges the new entity will face in seeking to rebrand itself. Concern that a battle may potentially arise among HP and EDS senior managers for control of the services business makes the integration job only more difficult.

The Future of the Outsourcing Market

The HP-EDS announcement signals a possible trend toward future consolidation among outsourcing service providers. HP and EDS will clearly want to be thought of as leading this activity in the market. For medium-sized firms, such as Computer Sciences Corporation and Accenture, the deal ratchets up the pressure to grow in order to remain competitive.

Competing against large firms the size of HP-EDS and IBM will be difficult without further market consolidation. Cash-rich Indian firms such as Infosys Technologies, Wipro Technologies, Satyam Computer Services and Tata Consulting Services are best positioned to spearhead this type of consolidation. These Indian firms are also likely to continue positioning themselves as viable alternatives to the large, high-end IT services firms. Private equity firms may also assume a prominent role as service providers start to grow through acquisition.

We obviously express no opinion on the value of the proposed acquisition to either the HP or EDS stockholders.

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