Picking a Big Fight With Dell, H-P Cuts PC Profits Razor-Thin

Risky Strategy Could Help Other Hewlett Businesses; Customers Are the Winners

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In the past decade, **Dell** Inc. has surpassed **International Business Machines** Corp., **Gateway** Inc., and Compaq Computer Corp., riding direct sales and ruthless efficiency to become the world's largest seller of personal computers.

Two years ago, **Hewlett-Packard** Co. looked like the next victim. Instead, H-P is fighting back, briefly overtaking Dell in PC sales late last year, and drawing Dell into a bloody war of attrition in which consumers are the big winners.

H-P's radical strategy for challenging Dell: selling PCs without worrying about profit.

"We think the PC business is strategic," says Chief Executive Carly Fiorina. She says she is willing to allow the company's $22 billion computer division to do little more than break even because PC sales help H-P make money on printers, consulting and consumer electronics. The company is content to sell PCs at "a very modest profit for now," says H-P Chief Financial Officer Bob Wayman.

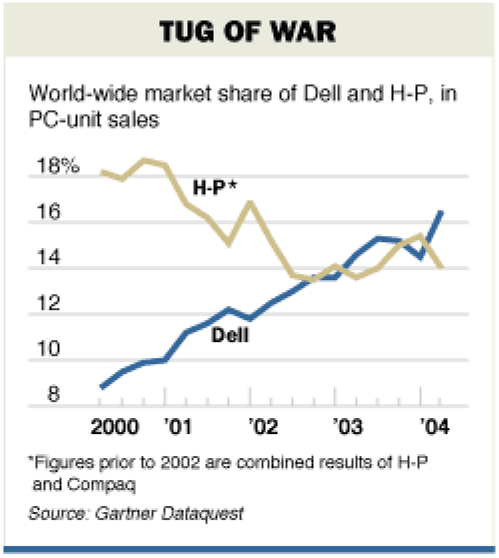
The result is the biggest threat yet to Dell, the PC industry's most profitable company. Having acquired Compaq in 2002, H-P is using its size to slash prices, in an attempt to undercut Dell's formula for gleaning profits in one of the nation's most competitive markets. The challenge puts pressure on Dell's earnings just as the tech industry is emerging from its prolonged slump and consumers are beginning to invest more in computers.

Still, for H-P, the strategy is a serious gamble. By cutting prices, the company earns less on each sale, leaving it with less of a cushion to absorb the inevitable shocks that roil competitive markets. H-P's profit margins in its PC division haven't exceeded 1% since the merger.

Dell continues to post solid profits; its operating profit margins of more than 8% are the widest in the industry. But its executives are complaining that H-P is subsidizing its PC business with earnings from other divisions, which to some suggests Dell is beginning to feel H-P's heat.

Dell President Kevin B. Rollins says H-P and other rivals have "deferred the serious pursuit" of profits, in favor of "unprofitable growth in an unsustainable effort to protect tangentially related businesses."

The subsidies impair "the economics of the overall industry," adds Michael S. Dell, the company's founder and chairman. "It's not a healthy process."



It is healthy for customers. Personal-computer prices industrywide fell by 9% during the first three quarters of 2003, according to Dell, compared with 4.5% a year earlier. Laptop prices fell even faster.

Corporate customers are exploiting the competition. Late last year, Getty Images, the Seattle photo distributor, asked H-P and Dell to compete for a sale of 500 desktop computers and 165 laptops. Kenneth Stringer, Getty's vice president of technical operations, specified how much he expected to pay for each computer.

"They both said, 'OK, we're ready to go there,' " Mr. Stringer says. But then H-P offered free advice for improving Getty's disaster-recovery plan and creating a digital archive of more than 70,000 film clips. "Dell seemed willing to compete on price, but as for the whole relationship, there wasn't much interest," Mr. Stringer says.

With $73 billion in annual sales, H-P offers a broader line of goods and services than Dell, with $41 billion in sales. And H-P isn't shy about tapping other parts of its empire to help sell PCs. Its credit arm offers generous financing terms. The consulting unit advises customers on how to save money on their technology operations. And H-P cuts prices on printers, cameras and other products bundled with its PCs.

The goal is to trump Dell's customer pitch, which usually starts with low prices, by making a broader pitch that includes product support and long-term relationships. Jim Milton, managing director of H-P Americas, who leads a force of more than 5,000 sales representatives, says, "When a customer calls, we darken the sky with resources and worry about how much to charge them later."

Only a few years ago, H-P didn't seem ready for a price war. In 2000, H-P and Compaq together sold roughly twice as many PCs as Dell. But they were losing money doing it. In the year ended October 2001, the computer divisions of H-P and Compaq lost a combined $1 billion. The two merged in May 2002.

Neither H-P nor Compaq could match Dell's mastery of the computer industry's central dynamic: falling prices. Most PCs are assembled from standard parts that all manufacturers buy at similar prices. Technological advances continually shrink the cost of disk drives, display screens and computer chips. Each week, those costs fall by roughly 1%, causing PCs to lose value even as they sit in warehouses or showrooms.

Beginning in the mid-1990s, Dell turned this to its advantage. It flourished by building computers to order and selling them directly to consumers and businesses over the telephone and the Internet. Dell PCs are built only after a sale is made, with components procured at the cheapest prices available, a cost advantage over rivals of roughly 6% per unit, according to Dell estimates.

As Dell was thriving, executives from H-P and Compaq mapped out plans to take the company on, even before H-P's $19 billion acquisition of Compaq became final. For nine months, a team met in a room in an isolated wing of H-P's Palo Alto, Calif., headquarters, the so-called clean room where executives shared secrets away from the still-competing operating units.

The team made plans to stop losing money in the soon-to-be-combined PC units of the two companies, agreeing to cut costs and close weak businesses as soon as the deal closed in May 2002. The executives killed H-P's Vectra desktops and Omnibook laptops and Compaq's Evo workstations, among other product lines.

The merged company, which kept the Hewlett-Packard name, became the biggest buyer of computer components including memory chips, semiconductors and disk drives. It quickly began leveraging that clout to negotiate for discounts, including 5% savings from the contract manufacturers that assemble its computers. Within months, H-P had shaved an average of $26 from the cost of building a PC, compared with Compaq's pre-merger costs, according to an H-P executive.

The result: H-P cut losses in the PC unit by roughly two-thirds in the fiscal year ended October 2002.

But the retrenchment came at a price. In the fall of 2002, Dell for the first time sold more PCs than H-P and Compaq combined. Senior H-P executives again changed strategy. The goal had been to turn losses into profits. Now, it settled for breaking even in the PC market and decided to go after market share by slashing prices and pumping up volume.

"I was worried we would be considered noncompetitive," says Duane E. Zitzner, a longtime H-P executive who was named to head the PC division of the new company.

H-P was sometimes willing to sell PCs at a loss to some big customers, the company's executives say, in hopes of ringing up profits on sales of related services such as financing and maintenance. Over the long haul, H-P hoped the cheap PCs would keep competitors, such as IBM and Dell, out of big accounts.

From a "war room" in California, Mr. Milton's H-P sales team guided representatives through negotiations, armed with a breakdown of Dell's production costs and details of its negotiating strategy in similar deals. Executives from H-P's five divisions hosted a daily 90-minute conference call to help reps put together package deals.

At Starbucks Corp., Walt Disney Co. and elsewhere, H-P lured new customers with technology "partnerships." The Starbucks marketing plan, with funding from H-P, lets coffee drinkers download songs at coffee shops, using wireless connections, which Starbucks hopes will attract more laptop-toting customers. To cement an alliance with Disney, H-P agreed to buy ads on Disney Web sites and at theme parks.

The cross-selling strategy doesn't always work. In 2002, H-P won a multiyear deal to supply PCs, and offer help-desk services, to the 40,000-student Katy Independent School District, west of Houston, which had previously bought computers from Dell. But less than six months later, the district canceled the deal amid complaints from teachers about long waits for assistance from the help desk. An H-P spokesman declined to comment on the case directly.

In spring 2003, Dell underbid H-P by roughly 5% and recaptured the district's PC purchases. Scott Wright, the school district's executive director of technology, says Dell delivers computers faster -- in less than a week compared to two or three weeks with H-P.

Dell says it encourages sales managers to walk away from unprofitable deals. "When the competition does desperate things, we're not going to follow them down a hole," says Mr. Rollins.

Beating Dell won't be easy. From a nerve center in Round Rock, Texas, just outside Austin, Dell executives tap the company's Web-based sales machine to monitor the profitability of every customer, product and promotion. Dell tracks component supplies, using pricing and promotions to shift customer demand to higher-profit products.

Like an airline selling flight seats, Dell uses "dynamic pricing" to adjust prices minute-by-minute based on demand, costs, competition, and even type of customer. On Dell's Web site recently, the same Optiplex business desktop PC priced at $1,498 for education customers was offered at $1,426 on a page devoted to health-care customers.

Dell is quick to capitalize on each H-P misstep. Last summer, H-P's PC unit reported a surprising quarterly loss. Unexpected supply bottlenecks prompted unusual price increases for the components used to make computers. Having managed the computer division to break even, the sudden component cost increases meant a loss. Ms. Fiorina, H-P's chief executive, blamed it on "overly aggressive" price cutting and promised "corrective action."

The next day, Dell trumpeted price cuts on a range of PCs. Some of the announced discounts were weeks old and others applied to discontinued models, but Dell proved its point: By selling direct, it can adjust prices immediately. H-P's network of retailers doesn't have such flexibility; it can take retailers weeks just to get ads into newspapers.

Despite Ms. Fiorina's pledge, H-P had little choice but to continue driving prices lower to boost sales. It sold the Atlanta weather forecasting firm Weather Channel Cos., nearly $500,000 in PC-based servers in December, knocking 30% off its prices with little haggling. "They really came in very aggressive on prices," says Kevin Gungiah, a director of systems administration at Weather Channel.

The discounts seemed to work. In the fourth quarter of last year, H-P sold more computers than Dell, and was quick to claim victory. "You see a company in Dell that is challenged in the way they never have been in their core market," said Ms. Fiorina. "And you have a company in H-P that is beginning to break away in terms of market share and revenue gains."

But the victory would soon be reversed, as Dell retook the lead in the first quarter of 2004. Dell's share of the world-wide PC market grew to 16.5%, from 14.6% in the first quarter of 2003, according to market researcher Gartner Inc. H-P's share was 14% in the first quarter, up from 13.5% a year earlier.

The industry was left wondering about the wisdom of H-P's tactics. H-P shipped more computers, especially laptops, toward the end of the year than its distributors and retailers could sell. The resulting inventory build-up depressed sales early this year and again cut into profits.

Goldman Sachs analyst Laura Conigliaro estimates that after adjusting for unsold computers, Dell's laptop sales grew more quickly than H-P's in the fourth quarter. H-P executives acknowledge that they still can't match Dell's financial tools or efficiency. Even now, only about one-fifth of its PCs are built to order.

Still, the competition with H-P may be taking a toll on Dell. Its higher profit margins give it more flexibility than H-P to lower prices and remain in the black. But Dell has been lowering prices faster than H-P in recent quarters, analysts say.

"We're going to trade No. 1 back and forth for quite a long time," says Ms. Fiorina. "We think we are putting plenty of pressure on their core business."

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