

## Why IBM wants Sun

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*If IBM CEO Palmisano succeeds in acquiring Sun Microsystems, both companies could gain. But so far, Wall Street is lukewarm.*

A potential marriage between tech giants IBM and Sun Microsystems is rattling the tech industry. The two companies are in merger talks, and IBM (IBM) has offered \$6.5 billion in cash, according to a report in The Wall Street Journal.

There are plenty of reasons for IBM CEO Sam Palmisano to pursue to want to buy Sun Microsystems (JAVA). While computer hardware has steadily become a less important part of IBM's business, Sun is much more than a hardware company. It has been one of the most important Silicon Valley innovation factories of the past two decades—much of it in software. Combining IBM, the innovation leader of the East, with Sun, an innovation leader out West, would yield a formidable player.

Sun's major innovations have included the Java programming language for Internet computing, the powerful Solaris operating system for server computers, and its newer technologies for inexpensive server computers that are powered by microprocessors from chipmaker Advanced Micro Devices (AMD). The company is strong in several important server markets, including telecommunications, the federal government, and Web 2.0 companies that rely on user involvement and content. Sun also has a loyal following of more than 1 million corporate software developers and 9,000 independent software makers.

What's more, Sun is available. It has been promoting itself to other major computer companies, according to The Wall Street Journal. And the price may well be right. Yes, \$6.5 billion represents a 100% premium over Sun's closing share price on Mar. 17 and would be IBM's largest acquisition ever. But IBM has more than \$13 billion in cash and can easily afford it. Representatives of IBM and Sun declined to comment on the report.

### IBM shares down

Wall Street analysts were initially lukewarm about the deal. Maynard Um of UBS (UBS) pointed out there is considerable overlap in the two companies' server offerings. Soon after the beginning of trading on Mar. 18, IBM's shares slumped 2.40, or 2.5%, to 90.53; while Sun's shares rallied 3.11, or 62.58%, to 8.08.

If the deal goes through, IBM's challenge will be to continue its steady march of profit margin improvements. For IBM executives and many of the analysts and investors who follow the company, revenue growth takes a back seat to profit, which is paramount. Recent financial results show the company's hardware division had 8% pretax profit margins, compared with 32% for software and 12.4% for services. IBM's margins would take a hit if Sun's products are added to the mix, and it will be under the gun to make the deal pay off.

Sun could help IBM with the transition to what many see as the next era in corporate computing—the delivery of products and services via the Internet, in what's referred to as cloud computing. IBM has long dominated as a supplier of computers and services for corporate data centers, but as more and more corporations shift to having their computing tasks done in huge, efficient data centers managed by others, IBM can't rest on its laurels. Sun is announcing its own cloud computing strategy at an event in New York on Mar. 18, and it has a strong collection of technologies—which include Solaris, low-cost servers that are powered by AMD microprocessors, and the open-source MySQL database. "Ultimately, every major

computer maker will have a cloud," says Lew Tucker, vice-president and chief technology officer of Sun's cloud computing division, who spoke to BusinessWeek on Mar. 17.

#### Sun's cloud advantage

In the world of cloud computing, powerful and inexpensive technologies will rule the day. Sun would bolster IBM's position in data-center technology, where it competes hard with Hewlett-Packard (HPQ) and Dell (DELL) and where it faces a new challenge from Cisco Systems, which just this week entered the market for data-center server computers.

While Sun has a penchant for inventing things, it hasn't been so successful when it comes to figuring out how to wring sales and profit from its innovations. IBM, through its large services organization and vast sales force, is expert at packaging up technologies into service offerings that are attractive to corporate tech chieftains. So another potential advantage of this merger is that IBM could market Sun's technologies more effectively.

There's an additional element of the story that shouldn't be underestimated. This could be a defensive move. Sun's revenue growth has been stagnant for three years, and IBM depends on Sun as an ally in its battles against Microsoft (MSFT). Sun owns Java, is a major player in the open-source computing world, and supports open computing standards—all of which are major counterweights to Microsoft's Windows and Office software monopolies. When Sun weakens, Microsoft gets stronger. Bad news for IBM.

There's no assurance this deal will go through. Talks could break down. It's even possible that another bidder might emerge. Cisco (CSCO) and Hewlett-Packard are both possibilities. But if it pans out, an IBM-Sun deal would mark a seismic shift in the tech industry.

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