After IBM, what now for Sun?
Steve Hamm

The decision to end takeover talks with IBM leaves Sun Microsystems and its CEO, Jonathan Schwartz, with a complex problem.

Now that merger talks between IBM (IBM) and Sun Microsystems (JAVA) have broken off, the future of Sun, long one of the tech industry's most innovative and dynamic companies, is in doubt.

The breakdown puts Sun in an extremely weak position, and analysts expect its stock price to come under severe pressure. The stock had been trading at about $4 a share, but rose to above $8 when word of the IBM talks leaked in late March. "Sun is now sort of damaged goods," says Peter Falvey, a partner at Boston-based Revolution Partners, which invests in Silicon Valley firms. "If IBM got under the covers and didn't like what they saw, then what does that mean for other potential buyers?"

Only a couple of companies stand out as potential acquirers. Cisco Systems (CSCO), the networking giant, recently got into the computer server business, and Oracle (ORCL), the world's No. 2 software maker, has long been a close partner with Sun, which specializes in making the kind of servers large companies use to run Oracle database software. But neither of those organizations is a natural fit, since they're not computer companies, per se. The two largest computer makers, Hewlett-Packard (HPQ) and Dell (DELL), are very unlikely to show interest in Sun. Both are committed to selling so-called industry-standard servers that run on microprocessors made by Intel (INTC) and Advanced Micro Devices (AMD).

Sun sought assurance of IBM's commitment

IBM and Sun had been talking for more than three months, but a disagreement over price and some terms of the agreement led to the break-off, according to people close to the negotiations. Neither IBM nor Sun would comment or even acknowledge that they had been negotiating. Toni Sacconaghi, an analyst at Bernstein Research, says: "I am worried that Sun's customers won't continue to hang in [in] uncertainty, wondering if Sun will be an independent company and whether all its technologies and platforms will be supported. Clearly, this could have a material impact on business going forward."

Earlier, the companies had been talking about a price in the $10- to $11-per-share range, which valued Sun above $7 billion. But IBM pressed for a lower price, and on Apr. 4, Sun insisted on the higher one. Sun also wanted assurances that IBM would remain committed to the deal even if it ran into serious objections from government antitrust authorities, according to the sources.

The deal would have faced intense antitrust scrutiny and been one of the first major test cases for the Obama Administration in signaling its posture toward antitrust policy. Through the combination, IBM would have had a monopoly-strength position, with 65% of the market for server computers based on the Unix operating system. However, IBM does not have anything near monopoly power when the entire computer server market is taken into account. A Sun acquisition would have increased its share of the market by nearly 10%, to 42%, but it faces fierce competition from the world's two leading computer companies, Hewlett-Packard and Dell.

For IBM's part, it was concerned that some of Sun's partnerships carried with them terms with which IBM was uncomfortable. The sources would not provide details, but it's possible the

concerns centered on Sun's close relationship with Oracle. The software maker is a fierce competitor with IBM in the database market.

IBM's soaring stock

On Apr. 4, after the two sides reached an impasse on price and other considerations, Sun's negotiators terminated their exclusivity agreement, opening the company up to talks with other potential acquirers. IBM then broke off the negotiations, the sources said.

The breakup is far more meaningful to Sun than it is to IBM. Sun is mired in financial trouble—losing nearly $1.9 billion in its last two quarters as demand plummeted for its high-end servers. The company has fired 2,800 employees so far this year in budget-cutting moves. IBM, on the other hand, is one of the strongest players in the corporate computing business, showing a profit gain in the fourth quarter in spite of a 6% revenue contraction. IBM's stock has soared by 21% so far this year, while the stock price of its main rival, HP, has declined by 6%. Still, the Sun deal would have bolstered IBM's position in the high end of corporate computing and in the nascent market for so-called cloud computing services.

If Sun can't find a merger partner or turn itself around, it could mean a downward spiral for one of the mainstays of the computer industry. Sun was formed in 1982 when a trio of Stanford University graduate students collaborated to build a revolutionary desktop engineering computer. Since then, the company has been at the front of one advance in information technology after another, including Web technologies such as its Java programming language. Its executives understood the importance of the Internet early, coining the motto "The network is the computer." During the dot-com boom, Sun's server computers became standard equipment for Web sites such as Yahoo (YHOO) and Amazon.com (AMZN). But after the bust Sun was buffeted by the rise of the Linux open-source operating system and computers using less-expensive processor chips from Intel and AMD.

Other formerly great computer companies, including Digital Equipment Corp. and Compaq, were acquired and lived on within other companies. The fate of Sun now hangs in the balance.

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