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Board Focus on M&A

A Closer Look at Technology, Media, and Telecom

Battening Down the Hatches in 2009

Valuations appear to have bottomed out in the broad TMT sector, but the technologies that have always driven the sector will continue to affect TMT activity, especially as globalization and technology blur boundaries between industries. On the other end of the spectrum, media companies that haven't adequately diversified their lines of business are scrambling to cut costs and simply survive. Experts from Houlihan Lokey and Alston & Bird LLP discuss these and other trends in the TMT industry as boards focus on their companies' strategic direction during a year of economic uncertainty and increased risks.

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Everyone is looking ahead and searching for signs of economic recovery. Could you discuss deal activity in the TMT sector, especially toward the latter half of this year?

Janine Brown: Generally, we are seeing an increase in deal activity, but I'm not sure we're seeing a sustained, appreciable increase. I don't think we're getting a very clear picture yet, particularly when you think about the drivers of deal activity, and I'm not sure there is likely to be substantial activity anytime soon. And, even as people continue to be concerned about valuations, the credit crunch is still out there.

One of the things I was looking at recently involved trends in online advertising. Looking at the end of the second quarter, was there truly a rebound? I think people are saying that conclusion is mistaken, and maybe we saw activity leveling off in May. We often talk about advertising in terms of newsprint and traditional media, but even with digital online searches and the extent to which you can track what's going on in the advertising markets as revenues continue to dip, the numbers suggest we haven't seen bottom.

A bright spot may be that when we look at what's going on in the economy as a whole, the vast amount of information that is so critical to every aspect of society is even more critical now. Therefore, the need to transport, organize, and view all the data and information really drives much of the TMT activity. That's good news for the sector. Even though there are all these micro-level issues that impact what the deal activity looks like, from a macro level, it bodes well for the sector as a whole.

Chris Wilson: We have definitely seen a pickup in deal activity and, depending on the segment, we've even seen a pickup in financing activity. That is quite remarkable when you realize that some of the companies are part of what I would call the middle-market segment, which has been impacted by credit prices.

To break it down, as far as the big companies, AT&T did a deal for Waveport and also bought some of the excess Alltel properties that Verizon was forced to spin off. Frontier, a RLEC (rural local exchange carrier), bought quite a few noncore markets from Verizon. Each of these transactions was very strategic. With the Waveport deal, AT&T was really diving into some complementary wireless services with respect to Wi-Fi, and it was expanding coverage for its mobile network when it bought the excess Alltel markets. Frontier is all about critical mass. Its Verizon deal was a huge transaction relative to its size. As another example, we're working with NTT Communications out of Japan, which has announced the acquisition of Pacific Crossing, a subsea cable operator whose PC-1 network connects the United States to Japan. And then there's the Windstream acquisition of D&E Communications, which is another RLEC—all bigger companies, all making strategic transactions.

On the data center side, we've seen deals such as Host My Site buy Hosting.com. These are much smaller, middle-market companies, but they're getting deals done despite

having to raise financing. We're seeing a little more capital flowing into the middle market, but it's flowing on a sector-by-sector basis. The strategic acquirers, however, are definitely spending some of the capital on their balance sheets for very strategic transactions.

In telecom, activity has been centered on areas perceived to have growth possibilities—wireless, data centers, and hosting. On the flip side for the RLECs, such as Frontier and Windstream, their top line is shrinking and there's certainly less financing and deal activity. Yet when you have businesses that are shrinking, it's all about getting critical mass so that you can leverage some type of fixed overhead. Therefore, I would say we see strategic deal activity going on in sectors that are growing, but on the other hand, we've seen more consolidation activity within the sectors that are experiencing a secular decline, such as RLECs.

Can you give a general overview of the valuations we're seeing in the overall TMT sector?

Brown: There is so much uncertainty as to whether or not valuations have truly bottomed out. Everyone is trying to look into a crystal ball. It does seem like recent indicators in this sector— particularly when you take into account the Sun/Oracle deal, as well as the fact that there's competition going on in connection with a variety of these acquisitions, —suggest that we've hit bottom and perhaps are working toward a rebound. The current activity between NetApp and EMC surrounding the acquisition of Data Domain is an example of the competitive process that's getting a lot of attention. Dell recently announced that it is looking to be more acquisitive. So, when you bundle together those activities and announcements of that nature, it seems that valuations are beginning to trend up.

Wilson: We've definitely seen valuations increase, and it's gotten significantly better. An example on the RLEC side is the CenturyTel deal for stock. There were meaningful premiums paid in that transaction, which was done at 4.2 times EBITDA. The Verizon deal was done at about 5 times EBITDA (also a stock deal) and then the Windstream/D&E deal was done at slightly less than 5 times EBITDA. You can see just by those numbers a nearly 10% increase in multiples from the lower fours to the mid- to lower fives. So we have seen higher multiples emerge, and I think that has helped spark some of the deal activity.

Could you talk about some of the more noteworthy deals that have happened over the last six months?

Brown: There's Intel's announced acquisition of Wind River Systems, which is about an $880 million deal. And other larger deals—there's Ebay's acquisition of Gmarket, which is a $1.2 billion deal, and Broadcom's announced acquisition of Emulex Corp, which was about a $900 million deal that was dropped. We're continuing to see larger deals, and I think that's because you've got so many players in this sector that have cash. For example, Dell has completed a billion-dollar debt offering. Like other TMT players, it does have the cash. But that's been countered by the question of whether or not valuations have bottomed out which affects whether people are ready to pull the trigger. I think it does mean that when you've got a number of companies in the sector that aren't quite so reliant on financing, they're more likely to do larger deals. We all sort of look and ask, "What might Google and some of the larger players such as Microsoft and Yahoo do?" Obviously, these significant players could drive activity for the latter part of 2009.

Another thing I would note is that because there's a drought of IPOs, particularly in the TMT sector, there is pent-up demand for exit strategies. That bodes well for M&A because it means one exit strategy opportunity is eliminated, so we're more likely to see dispositions and divestitures.

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> **— Janine Brown,** Alston & Bird LLP

Wilson: The only meaningful deal so far this year has been with respect to the Verizon sale of these noncore lines to Frontier. It really boils down to the fact that the big strategic guys want to invest in their future, and for some of them that means investing in growth areas like wireless or data and for others that means continuing to build critical mass as they think about their top lines shrinking. On the telecom side, in terms of very big deals, I don't see that many coming down the pike, frankly. The $8.6 billion Frontier deal might be the biggest deal this year. One thing to note is that the biggest deal this year will be smaller than the biggest deal last year, and I also think we're going to see fewer deals.

Looking at the media side, it has been hit by a cyclical and secular downtrend. Valuations are low for the traditional media names, so no one is a seller at the moment. Now the secular downtrend is really due to the industry model being disrupted by online distribution. Most media are ad-supported, yet those ad dollars are going to different outlets than those the traditional media companies generally derive revenues from. In addition, advertising spending is declining with the economy, which is the cyclical part of the downtrend.

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Jason Hutchinson: Despite the business environment and market decline, tech M&A has seen a number of high-profile transactions and merger discussions, including Oracle's acquisition of Sun Microsystems and Intel/Wind River, along with the Microsoft/Yahoo and Broadcom/Emulex saga. These transactions are on the heels of last year's HP/EDS ($14B), Oracle/BEA ($8B), Brocade/Foundry ($2.6B), and CBS/Cnet ($1.9B) deals. In addition, a lot has been written about the hostile nature of deals involving Microsoft and Broadcom, but we also saw high-profile public attempts by Samsung for SanDisk ($5.8B), Microchip for Atmel ($2.4B), and Vishay for IRF ($1.6B). Investment bankers and lawyers are talking a lot about hostile transactions and encouraging these approaches, but they have been largely unsuccessful and costly. However, you are seeing a greater impact from shareholder activism. For example, with Sun/IBM/Oracle, large shareholders encouraged management and the board to participate in industry consolidation in order to create shareholder value. Likewise, shareholder activists like Carl Icahn have helped change management and boards of directors and have encouraged companies to become more shareholder focused.

Another trend relates to the slower growth rates and maturing of several sectors within technology. Traditionally, many of the leading technology companies were built around a single product or innovation. As these markets matured, consolidation and diversification became necessary to drive growth. So if you look at a lot of these businesses, they had success with their initial product or service, but oftentimes struggled to diversify outside of that area of expertise. For example, companies like Microsoft in software and Google in search, continue to look for their next significant platform opportunity. And I think over the next three to five years, you're going to continue to see a tension with mature tech companies between the impact of spending and R&D investment to diversify and the opportunity to maximize value through a sale or merger. As a result, we will continue to see merger/divestitures and restructurings in maturing sectors like software, semiconductors, Internet, and networking.

What are some of the trends shaping the media sector, and do you see any good news around the bend?

Brown: I don't think there is any particularly good news for traditional newsprint given what we've seen in the news, whether it's the *New York Times* or the *Boston Globe* or Denver's *Rocky Mountain News* or the *Chicago Tribune*. It's been predicted that, over the next year to year and a half, one out of every 10 print publications is either going to reduce its overall print run by more than half or will cease physical printing (i.e., go online or shut down completely). And that sounds like a conservative figure to me. Over the past year, more than 6,000 journalists have lost their jobs, more than any period since this has been tracked, which is not all that long—30 to 35 years.

Then there is the broader issue that we just don't have the readership to support traditional newsprint, so to what extent are we going to sacrifice what has been the traditional job journalists have had in terms of being the watchdog over government abuse and the power of special interests? Interestingly, this leads to the role of the social networks. The political unrest in Tehran might well be an example of what happens when traditional newsprint or journalists in general are not able to cover the news, and as a result, social networks are often how we ultimately end up obtaining that news.

Wilson: To sum up, the media segment has been characterized by cyclical and secular trends, often leading to restructurings, with the bigger, more diversified companies still trying to make strategic acquisitions in the Internet space, such as Fox's deal with MySpace and Microsoft's deal with Facebook. Less-diversified media companies are really just focusing on battening down the hatches. Some of that means Chapter 11 restructuring, some of that means out-of-court restructuring, some of that means trying to figure out any way possible to cut costs.

What about deal volume trends, specifically in tech?

Hutchinson: In terms of overall macro themes, the two biggest things that have changed for tech in the last decade are IPOs and P/E buyouts. We went through an IPO window that goes back to 1999 and 2000 when there were 300 to 400 IPOs for a couple of years. This created a lot of small, public technology companies that are now orphans in the public markets. During the first tech downturn, even with the dramatic drop-off in IPOs, many bankers and venture funds thought the IPO window would someday return to provide liquidity. Instead, the IPO market never really returned and venture capitalists had to adjust their model and wind down. The private equity wave that exceeded $700B in 2006 and 2007 is likely to have a similar result. Many sellers and private equity firms are waiting for the financing markets to return, but we all understand that leverage ratios and "covenant light" terms are unlikely to approach those levels again. The IPO and private equity bubbles should continue to reinforce strategic transactions and the importance of integration over financial engineering.

With regard to deal activity, mid-market and public-to public deals have continued to be very active. The biggest change in volume remains the drop-off in private equity buyouts that are down about 60% in terms of deal value. Those deals were driven by leverage and the flexibility of debt financing.

In the future, deal volume will also be impacted by restructuring transactions that involve many of the larger technology buyouts. As we see high-profile financing and debt issues force restructuring of companies like Nortel, Qimonda, and Spansion, we will also see the need for divestitures and divisional sales that will drive transactions from several large private equity buyouts, such as Freescale and NXP.

Brown: Just picking up on some of those broader themes and trends, the question also remains as to the extent of the government regulation that may or may not apply to private equity firms. For now, you simply have many private equity firms sitting on the sidelines. Back to Jason's point, we've sort of seen the era of the LBO, but we are getting to a point where we're really looking at equity buyouts, and that may be a trend that we see throughout 2009.

Hutchinson: All-equity buyouts is a trend we've started to see, but I think it will be short-lived. People are trying to bootstrap buyouts and capital structures, but I'm not sure the returns and ability to finance will create the same upside relative to the execution risk for many of these buyouts in tech.

In closing, could you each discuss the general trends that are driving M&A in the TMT sector as boards and companies forge ahead?

Hutchinson: Obviously, a big trend we've seen is the weeding out of investment banks, with the demise of firms like Lehman and Bear Stearns, and the collapse of leveraged products. In the wake of the financing bubble, bankers will need to develop new ways to demonstrate to clients that they can add strategic value to the process (in addition to financing and capital). When you start to see companies like Oracle execute transactions internally, people are questioning the advisory role of bankers. However, as we have seen in the past, there are significant risks to boards when companies work in a vacuum and attempt to advise themselves. Companies and boards may begin to ask for advice that is independent and strategic, in order to ensure that the rationale for a transaction and the risks are properly balanced. As the lines between hedge funds, investment banking, private equity, and commercial banking create more conflicts of interest, you should start to see companies and management teams seek advice that is more objective and independent.

Brown: Some of what may be playing out relates to the question of what the Obama administration's view is going to be with respect to antitrust issues. I think everyone perceives that there will be an elevated level of scrutiny applied to acquisition activity. It will be interesting to see whether that truly happens, particularly when you contrast that with what is seemingly a call to relax the antitrust restrictions that would otherwise apply, for example, to traditional print media. We'll have to see how this plays out.

There's also the question of the level of regulation that will be applied to the financial industry and that will likely impact the timing of a rebound in the credit markets. Given the extent to which private equity has been such a significant player in the M&A markets, we'll need to see what level of regulation will apply to the private equity firms, let alone the hedge funds, to help determine how the

sector is going to rebound. Nonetheless, there are probably two or three themes playing out in the TMT sector that, despite the economic uncertainty, would suggest we're going to see levels of M&A activity increase: one is the geographic boundaries that continue to blur because of globalization; next, the technology boundaries that continue to blur because of convergence; and, three, the whole notion of industry boundaries blurring, particularly because of the need to see growth when organic growth is generally unavailable in so many areas. So, I think you'll see M&A activity driven by the need to grow.
If you think about the technology trends generally—convergence, cloud computing, mobility—the disruptive technologies that have always driven the sector—they've not gone away and they're likely to continue to play a significant role in what companies in the sector do, even in the short term.

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This raises an interesting question as to whether or not there is anything in particular about the current environment that increases the level of risk assessment for boards of directors. Given the level of economic uncertainty, it would not be at all surprising that boards of directors are more concerned than ever about the strategic direction of their companies. And, you know, a board might become much more conservative, given that it doesn't know what the rebound is going to look like. Boards will need to preserve cash and be very mindful when considering what the enhanced hurdles are that any acquisition would need to meet, in terms of looking at the numbers and trying to determine what's accretive and what's not. It would seem to suggest that boards are going to be even more conservative. On the flip side, there is an increased level of shareholder activism that is likely to continue to play itself out and, in doing so, influence board decisions and force boards to act. So we're going to get to a new balance, if you will, as we hopefully see the economy rebound.

Wilson: This gets back to the strategics that have been investing in their business and focusing on their core growth areas, and you have to carve out media because they, as we said, are battening down the hatches for survival, and there is a specific reason they've been doing that. Deal activity by strategics is increasing because, one, valuations are lower, and two, competition, because there are far fewer private-equity-based LBO buyers with which to compete. The competition from financial buyers is also less, so they're related. Valuations are lower, and one of the reasons is because there are fewer buyers, specifically financial buyers, because they cannot do LBOs. So I think from past perspective, the strategics have been really focusing on investing to drive the growth part of their business. They believe they are seeing valuations starting to move up, and they see that the LBO competition is still out of the market. Those things are making it more interesting for them to act now, rather than later. We've seen some of the big strategics do deals, particularly in the data center area.

In summary, I think the smart strategics have a demonstrated appetite to invest in their business. Most of them have the financial wherewithal and are enjoying the fact that there's less competition. As a result, they are being aggressive, and I will tell you we've seen more interest lately out of strategics than I've seen in the last 12 to 18 months.

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