Tech Buyouts Analysis and Trends

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Submitted to the Sloan School of Management In Partial Fulfilment of the Requirement for the Degree of

Master in Business Administration
at the
Massachusetts Institute of Technology
June 2006

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Submitted to the Sloan School of Management on 12 May, 2006
In Partial Fulfilment of the Requirement for the Degree of

Master in Business Administration

Abstract

In the backdrop of the dotcom bubble burst, companies cleaned up the excesses of the nineties and are more agile and efficient than ever before. However, companies face tremendous pressure to improve shareholder returns. A new trend is emerging as more and more capital is flowing into Private equity, especially in the buyout industry. Both established and entrepreneurial companies are exploring new ways to partner with Private equity firms to restructure and build long-term shareholder value.

In this thesis, I will perform an in-depth study of private equity led merger and acquisitions trends since the bubble burst. I will investigate the emerging trend of tech buyouts, activist led corporate governance reforms, analyse tech buyout transactions from 2000-2005 and comparative study of 3 tech buyout firms, and leadership challenges in the private equity industry.

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Acknowledgement

Completion of this work was made possible with the help of numerous dedicated individuals. First and foremost is my wife Rashmi. It is an understatement to say that it would have difficult to complete my studies at MIT without her. My father has been, and continues to be instrumental in encouraging me to follow my pursuits. I thank my brothers, Keshav and Mahendra for encouragement and support.

I thank my advisor Arnoldo Hax for his willingness to listen to my ideas and offer criticism. He went out of the way to create time for me and encouraged me to think creatively. I also want to thank Prof. Phil Cooper, Prof. Alex D’Arbeloff, and Prof. Ed Roberts for guidance and support. This has been an invaluable learning experience.

My classmates at MIT greatly enriched my learning experience. Special thanks go to my classmates Sloan Fellow students Dave Dozor, Frank Reynolds, Dave Lucchino, and Jim Skeffington. All of them provided me valuable support and motivation in the preparation of thesis. More importantly, they were eager to participate in stress relieving non-academic pursuits including “Sloan Unity” that helped make life bearable.

I would like to dedicate this thesis to the memory of my mother, Saroj Gupta. Her intelligence and unequivocal faith in my abilities were the greatest source of inspiration.
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Chapter 1 Introduction

1.1 Current Global Buyout Environment

The financial news on the “mega-buyouts” in technology oriented industry is quite popular these days, almost as the LBO wave of 1980’s, and the events seem to become fashion in modern private equity practice. The M&A markets today are buoyant with many opportunities. In the backdrop of the dotcom bubble burst and 2001 recession, companies restructured and optimized their operations, however, the continued economic stagflation and lack of liquidity in public markets is forcing them to look beyond traditional lenses to sustain high growth. In US, private equity M&A transactions rose sharply by 45% from $136.5 billion in 2004 to $198 billion in 2005, accounting for approximately 15% of the global M&A volume. The M&A activity in 2005 surpassed $1 trillion, up from $886 million in 2004. According to Dealogic, 2005 has been the most active year since 2000 for global M&A, with a total volume of $2.9 trillion.

Increased globalization and aggressive competition between strategic (corporate) buyers and financial buyers for acquisitions are giving sellers unique selling opportunities at very attractive terms. Although, the deal volume has remained consistent with 2004, the average transaction, in terms of dollar value has risen dramatically. Growing big and global funds will quicken and spread across continents in

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1 Thomson Venture Economics: Buyout$ article (4/3/2006) : Six Major catalyst of today’s M&A market, Author Dan deBrauwere
years ahead. This global expansion amongst competitors in addition to management
egos and investment banking incentives create a perfect storm for doing deals. The
paranoid corporations with ambitious plans will rapidly expand through merger and
acquisition. The favourable antitrust and regulatory environment will further stimulate
increased merger mania and question the role government will play if any to penalize
this growing big phenomena.

In the past decade, corporate restructuring was often done to respond to crisis,
however, today its way of life and companies consider it to be a proactive tool vs
remedial tool. Companies will forgo their original missions and enter new markets
creating opportunities for new owners of divested divisions to perform better.
Furthermore, the age of conglomeration is over and the trend to manage consolidation to
achieve counter-cyclical balances through unrelated diversification is considered
unproductive. Very few companies, such as GE have been able to sustain long term
success as a diversified conglomerate. It is clear that shareholders and manager will
achieve higher success through relentless focus on core competencies with strategic bolt-
on(s).

Even, carve-outs from large companies or combining smaller firms will keep the
trend alive to compete with the big companies. These small companies will exploit the
niche markets and deliver products faster with a hope to be acquired down the road by a
large buyer. This “rolling-up” of small or closely held firms will take precedence, a
phenomenon experienced traditionally in banking, newspaper, movie theatre, and radio
stations, etc.
The drop in trade barriers and increased globalization will exert increased pressure on US pricing and profits. This will affect both the manufacturing and services sectors. To cope up with these trends, aggressive proactive cross-border mergers will continue and the size and scope of these deals will increase leading to mega-mergers and formation of transitional corporations. This increased globalization will lead to unprecedented standardization and homogenization in world markets. Successful transnational corporations will find ways to meld managers of different nationalities and background into cohesive teams. The US model of independent thinking and decision-making will prevail to promote fast decision and free-for-all debate. Local autonomy with broad decision making authority will be norm in this new global economy.

Last but not the least, shareholders will get a stronger voice as a result of new stock exchange rules and launching of global stock exchanges (Archipelago). The passing of Sarbanes Oxley and increased administrative costs of Security and Exchange Commission (SEC) compliance and shareholder relations are resulting in increased reforms, thereby, distracting management from dealing with long-term goals. The conventional wisdom that you had to be public to achieve growth is now being questioned and increasingly public companies are becoming private.

1.2 Emergence of Tech buyouts

After the intense conglomeration era of 1960’s, the buyout industry came into existence initially with MBO’s targeting acquisition of non-core divisions of a large
diversified business. Subsequently, in the 1980’s, buyout industry started acquiring entire businesses. The intensity of buyout transactions as corporate raiders used unconventional acquisition tactics and junk bonds to acquire large established businesses. The largest takeover of all times was completed in this period – KKR acquired RJR Nabisco for $25 billion. The leveraged buyouts became a very lucrative business consisting of banks, insurance companies, investment bankers, pension funds and high net worth individuals. Some academic and industry experts conclude that the buyout industry in this period created significant value by eliminating financial inefficiencies and improving corporate governance. Some academics attribute the unprecedented economic growth in the 1990’s to this first LBO wave.

Following the buyout frenzy period of 1980’s the industry experienced slowdown. In the mid-nineties the industry re-emerged for a brief period of 2 years with buoyant mergers and acquisitions and after the shutdown of the high-yield market in 1998 the buyout industry was pronounced dead. In the late nineties, a period of dot-com growth, buyout transactions rose sharply and the acquisition multiples reached historic heights. Following the dot-com bubble burst many pronounced the buyout industry as dead.

The October 2000 issue of Business Week best states the recent attention that buyout funds get: "it may not be the glory years, but buyout shops are back, raising billions - and heading into unchartered waters." The competitive environment is certainly much more challenging than that of the 80s; yet the drop in returns isn't driving investors away. This is because the top 25% of LBO funds still regularly beat the
returns on the S&P 500 Index\(^2\). Trying to give an estimate of future industry average return is not only difficult but also not very useful in suggesting future trends. Instead, some qualitative characteristics of the future LBO market may be suggested as follows:

- More entrepreneurial focus
- Shift from financial focus to operational/strategic focus
- Global expansion

Looking forward, buyout deals are likely to exhibit a shift to more entrepreneurial businesses, a need for more operational expertise, and an expansion geographically to tap into vast opportunities in Europe and Asia. Since 2000, one of the fundamental shifts is the rise in alternative asset class as evidenced by the increase in capital flows in hedge funds, private equity, and venture capital firms requiring them to put capital to work and meet investment objectives. Private equity transactions today account for about 15\%, well above historical averages. In 2005, more than $172 billion was raised by private equity funds, according to Standard and Poor’s. Altogether, buyout fund managers have about $1 trillion\(^3\) in capital available to them, according to the Journal. Some of the largest corporations could wind up going private. "Nothing is off the table now," Carlyle co-founder and managing director David Rubenstein told The Journal.

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\(^2\) Perspectives (Volume 3, Issue 6) - Leveraged Buyouts: Inception, Evolution, and Future Trends, By Li Jin and Fiona Wang

\(^3\) CFO.com article by Stephen Taub, March 30, 2005 - Private-equity funds are getting bigger and doing larger deals
According to Buyouts article, March 20, 2006, which nominated Texas Pacific Group (TPG) as firm of the year, 2005 leveraged buyout market probably won’t be remembered by historians for breaking deal volume or fund-raising records. It will be remembered as a transformative year in which generalist firms finally turned their sight towards the new economy targets of high tech and global. TPG, well known for turnaround of Continental Airlines, is considered a pioneer in tech buyout, when it established $720 million fund in 1999 and made geek bets (Globespan Technologies, Zilog, Motorola’s semiconductor division). The firm successfully positioned for the tech-deal tsunami. In 2005, TPG announced mega-deals Lenovo, TIM Hellas (Greek cellular company), and also participated in record-breaking $11.3 billion Sun Guard acquisition. TPG is expected to raise upwards of $12 Billion for its fifth fund, almost double of its current fund ($5.3 billion) raised in 2003.

Silver Lake Partners led a group of buyout funds that agreed to buy SunGard Data Systems Inc. for $11.3 billion, the largest private-equity deal since Kohlberg Kravis Roberts’s $25 billion leveraged buyout of RJR Nabisco in the late 1980s. KKR is a participant in the SunGard deal.

Unlike traditional leveraged model in LBO’s, recent trends in tech buyout suggest that most private equity deals use more equity and less leverage. The use of equity seems attractive due to both rising interest rate environment and excess inflow of capital in private equity markets. In 2006 as Technology-on both the hardware and software side is expected to comeback, we expect tech buyout to continue to accelerate.
1.3 Key Issues on Discussion

Consequently, the basic direction of this thesis is to address the following themes, which would be properly explained, referred, and addressed.

1. Obtaining the current insights of common practices in private equity
   : Background of the industry, deal structures, and framework for restructuring
2. Identify emerging private equity and institutional investor led shareholder activism to reform corporate governance and implications in long run
3. Assessment and analysis of tech buyout in the context of global go-private trends
   : Sarbanes-Oxley implications, Post-bubble burst fund & transaction analysis
4. Comparative study of three tech buyout firms:
   : Firm overview, current strategy, and comparative analysis
Chapter 2  Private Equity Role and Models

2.1 Why Private Equity Partnership?

Many corporations are partnering with Private equity firms to increase shareholder value. In the past, these partnerships were associated with technology start-ups, where venture capitalist would collaborate with entrepreneur developing a innovative technology to build a large successful business, or a mega-scale leveraged buyout, where large investors such as KKR or Carl Icahn would take a controlling stake in the corporation and through restructuring improve its operating performance. After the LBO wave of the 1980’s, a whole new private equity industry has emerged, where corporations partner with different private equity specialist firms to finance and restructure at different stages of growth of the company.

After the Internet bubble burst, there has been shift from taking companies public in overheated IPO market to established companies looking at new ways to create shareholder value. The private equity industry is rapidly changing and becoming more institutionalized. The new and broader definition of a private equity partnership is an investment by a private equity firm or group of investment firms (venture capital fund, buyout fund, hedge fund, corporate investors, or private investors) in a subsidiary of a parent company. The investors provide both the capital and expertise to transform the subsidiary into a successful company. Subsequently, after successful transformation the
company exits, through sale or recapitalization or going public, and investors receive return on their investments.

2.1.1 Private Equity Partnership Models

Since, the inception of the private equity industry with venture capitalist, many models for partnership have evolved. Interestingly, the components of this partnership structure are fairly common as described below:

1. Entrepreneurs’ or parent contributes intellectual property, people, operations, products, other resources and a new entity (subsidiary) is formed

2. The new entity (subsidiary) is capitalized by equity funding from private equity investors (venture capitalist, buyout firms, hedge-funds, etc.)

3. Investors add their operational expertise and eco-system of partners to build the company. In many instances they hire management, board of directors, and provide strategic guidance. These investors usually participate in subsequent round of financing and play an important role in expanding the business through strategic mergers and acquisitions.

4. Investors offer the parent company or entrepreneurs a varying proportion of equity stake, warrants, royalties, notes, etc. to create a standalone entity. In many early stage partnerships a majority of proceeds from financing goes into operations, while in matured companies the proceeds may be split to pay the parent (example buyout) and streamline operating performance.
2.1.2 Private Equity Partnership Advantages

The success realized by many technology start-ups such as Apple, Sun Microsystems, Cisco Systems, etc. by partnering with venture capitalists, attributes to the contribution made by private equity investors. Similarly, many notable examples exist to prove the important role of private equity investors in improving large established companies e.g. Continental Airlines, Seagate, etc. The key advantages of private equity partnerships are as follows:

- **Provides risk capital needed to build a successful business.** Private equity investors finance the operations of the company or subsidiary through active participation. They continue to support the subsidiary through different stages of growth.

- **Respond to new market demands and/or enter new areas.** As companies face rapid changes in their industry, private equity partnerships allow companies to operate as private enterprises and make quick decisions. Similarly, companies faced with challenges to expand their technology offering into new areas through private equity partnership, who offer both capital and expertise in new unfamiliar areas, allows maximizing opportunities.

- **Maximize returns on restructuring goals (divestiture, carve-out, spin-offs).** The private equity investors help add value to a subsidiary and provide additional time to realize higher value at a later date, especially in a cyclical industry.

- **Build world class organization & eco-system to scale the business.** Today, Private equity firms are very specialized and bring a lot of industry expertise and
connections to the partnership. In addition to providing valuable guidance setting the strategy of the firm, they assist the company recruit the best management talent, partners, and customers.

- **Improve Corporate Governance.** Private equity firms play an important role in monitoring the management. They help establish the corporate governance rules, which are often more onerous than in public markets and help set a higher standard for governance. Many of the corporate governance acts were enacted as a direct contribution by private equity investors often referred to as shareholder activists. This is covered in chapter 3.

- **Bottom line focus and reality check.** Private equity investors are experts in the industry. They relentlessly focus on strategy and improving operational performance of the subsidiary. Through increased monitoring and aligning management incentives, they minimize agency costs and management’s propensity to invest in pet projects or waste corporate resources. Often times, lack of interest in a project by a private equity firm indicates that project is not viable or chances of commercial success are very low.

- **Assist in public offerings.** Private equity investors bring a network of industry connections and financing options at different stages of growth of the firm. As the company matures and they assess it to be ready to go public, private equity firms assist the firm in IPO. Many studies have shown that private equity assisted companies generate higher returns than non-PE backed companies in a public offering.
2.2 Private Equity Industry Overview

Private Equity (PE) describes a category of funds and investment companies that offer capital primarily to private businesses on a negotiated basis. PE firms include venture capital, mezzanine, expansion, and leveraged buyout funds. The goals and missions of each is different and are based on return prospects, industry expertise, amount invested, and transaction structures.

Since the early 1990s, PE funds have become a significant asset class because they offer an excellent risk/reward balance to investors, who are primarily institutions. During the 1980s, the PE industry was niche sector, with about $10 billion invested annually. Since 1990, however, the “niche” has grown: $730 billion has poured in to PE funds, with nearly half of that figure invested in the past three years. Top funds have realized a net internal return rate of about 17 percent over the past 12 years.

Many US institutional investors invest on average 7.5 percent of their total portfolios in alternative investment class (PE funds). Public and private pension funds constitute about half of US PE fund investors, and the other half includes investments from insurance and banking companies, endowments, foundations, and individuals whose aim is to diversify their portfolios.

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The Figure 2-1 shows the private equity value chain. PE firms are essentially mediators between limited partners (institutional investors) and the entrepreneurial and portfolio companies. Limited partners either invest directly in a fund or through a fund of fund. Large institutional investors often use advisors to commit capital in a fund and similarly PE firms use placement agencies to raise a fund. Similarly, entrepreneurial companies and growth companies use service providers (lawyers, bankers, accountants, etc.) to raise capital from private equity firms. In terms of the types of investments, some venture funds invest in the same rounds of financing as do buyout funds that offer expansion and growth capital. Also, publicly traded investment firms play the same role between public investors and the “issuer” market. Other firms want a controlling interest and others prefer minority investments. Deal structures differ based on the experience and preferences of the firm’s management. The list below is a representative set of investments made by private equity investors at different stages of growth of a firm:
• New ventures
  ▪ Early Stage
  ▪ Late Stage

• Middle-market private companies:
  ▪ Expansion.
  ▪ Change in capital structure (recapitalization).
  ▪ Change in ownership.

• Public companies:
  ▪ Going private.
  ▪ Leveraged buyouts.
  ▪ Carve-outs
  ▪ Private investment in public equities (PIPE).

PE firms in some cases take a controlling interest in the main investment, and management and company stockholders take minority stakes in working to grow the company to poise it for acquisition or investment. In other cases, PE firms use leveraged buyouts by combining bank and other financial and institutional debt including convertible subordinate debt and unsecured loans. Some PE firms invest only in areas of which they have expertise, while others diversity their investments. Many PE firms rarely get involved in an operating role in the firms they acquire or invest in. Their staffs simply act as consultants to help firms develop and prosper with the aim of enhancing its value or eventual sale or mergers. The Figure 2-2 shows the risk/return of common private equity investments. The long term returns on buyouts are typically net 10-15% and venture capital returns net 20-25%.
In the past, private equity firms typically purchased a private company, spruced it up, and then took it public or sold it to another operating company, hopefully at a profit. Today, more private equity firms are passing portfolio companies among themselves. Such deals, where investment firms are on both sides of a transaction, used to be relatively rare. In 2001, for instance, there were only $2.5 billion worth of such deals, according to Dealogic, which tracks merger-and-acquisition activity. In contrast, there were almost $41 billion worth in the first seven months of 2004.
2.3 Structures and Terminologies

Public and Private companies face tremendous pressure – to create and sustain – shareholder value by increasing return on capital and growth rates and the company's equity value. To achieve these objectives companies are constantly looking to find the right corporate structure. This is viewed by many financial economists as a market for corporate control and commonly referred to as mergers and acquisitions, buyouts, privatization and divestitures (spin-off, carve-outs, tracking stock). The three goals of the right corporate structures are:

- Align and achieve all potential net synergies
- Align claims on specific activity for both investors and employees value
- Align income rights and control rights

First, to achieve all potential net synergies, not only companies have to maximize positive synergies, but also reduce negative synergies arising out of lack of focus, bureaucracy, and agency issues such as cross-subsidization. They also need to consider the externalities generated from change in corporate structure, such as cannibalization of existing business or competing with their customers. Second, having claims that focus on specific activity is both beneficial for investors – option to diversify on their own and, for those who prefer pure-play, to recognize value and capitalize on an overheated market - and employees, who can be motivated and held accountable through focus. Finally, alignment of income and control rights, decide who owns the cash flows and votes for corporate control.
2.3.1 Drivers for M&A, Divestiture Activity

Mergers and acquisitions are concerned about changing ownership and management teams to shift corporate strategy. Whereas, corporate restructuring is concerned about changing ownership and control – change in management and incentives to improve financial performance - including leveraged buyouts (LBO), spin-offs, carve-outs, and privatization. There are many possible motivations for changing corporate structure, some explain the creation of new economic value for shareholders (Palepu, Healy and Bernard), while others explain a multi-cause story based on rationality of markets and buyers managers. According to Palepu, Healy and Bernard, some acquiring managers want to increase their power and prestiges, others, however, realize business combination provide opportunity as follows:

1. Take advantage of economies of scale
2. Improve target management
3. Combine complementary resources
4. Capture tax benefits
5. Provide low cost financing to financially constraint target
According to another study by Robert J Bruner, a multi-cause study, the corporate structure change activity can be classified as a matrix with four camps as follows:

1. Rational managers and markets: Assumes that managers and firms pursue competitive advantage within constraints of antitrust. In the event of external shock, firms and managers respond rationally making it difficult to determine negative returns from shock or merger. The key driver is to exploit profitable opportunities and avoid losses, which may include exerting capital market discipline to correct agency problems and improve governance.

2. Rational managers and irrational markets: Assumes that irrationality is expressed by overvaluation in capital markets. With information asymmetry managers are able to respond on behalf of shareholders. Firms conduct share-for-share transactions resulting in share-exchange deals near market peaks and cash deals as depressed.

3. Irrational managers and rational markets: Managers make decisions based on managerial ego or hubris and markets punish the firm. In this scenario, when firms do bad deals the buyers share prices drop significantly at deal closing.

4. Irrational managers and irrational markets: Both managers and markets exhibit irrational exuberance and herd behaviour. Market prices overshoot regularly or undershoot intrinsic values. Managers display deal frenzy and buyer’s shareholders approve acquisitions consistent with prevailing mania, even in a value destroying deals.
Another theory that explains the drivers for corporate structure change activity is the concept of “Creative Destruction” by Joseph Schumpeter. It seeks to explore the question, why corporate structure change activities follow the ups and downs of economic cycles? He observed that the key contributor to economic growth was the role of an entrepreneur. Entrepreneurs enter competitive fields with either new processes or products hoping to claim a cut of the profits of the industry, which describes the economy as ceaseless and self-generated change. Schumpeter concluded that business cycles arise because entrepreneurs swarm or cluster around opportunities. These clusters exhibit the presence of eco-systems that support technology entrepreneurial activities as observed in Silicon Valley, Boston (Route 128) belt, DC beltway, etc. As clusters become epicentres of this emerging industry, corporate structure change activity follow as a process of creative destruction as observed by layoffs, plant closings, and so on. The economy renews itself becoming more agile and resilient to economic shocks. To prevent the destruction is to prevent the renewal. This theory of creative destruction is further validated by work of Michael Jenson (1993), seeking to explain the wave of industrial restructuring of 1980’s and Bruce Wasserstein, who explains “merger business reflects the hubbub of our society with all bustling and pretense. It is at the edge of change and fashion, and yet a minefield for the unwary. Mistakes are common. Still, good, bad, or indifferent mergers and acquisitions are essential vehicles for corporate change. The patterns from industrial development through mergers, like those of economic activity, are crude and imperfect. However, there seem to be elemental forces, Five Pistons, which drive the merger process. They are regulatory and political reform, technological change, fluctuations in financial markets, the role of leadership, and the tension between scale and focus”.

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These explanations of corporate structure change activity through the lenses of creative destruction as a process of industrial renewal provides a richer framework for understanding. By mastering the basic understanding of economic turbulences – what is the form, how and which form it takes, and who exploits it – gives corporate structure change agents key drivers and a foundation for forecasting and executing complex M&A and buyout transactions.

2.3.2 Common Corporate Restructuring Options

Managers identify the right corporate structure and the field of merger and acquisitions and corporate restructuring provide the mechanism to get there. These techniques are broadly classified as Acquisitions and Divestitures and each consists of different types as explained below:

- **Acquisitions**
  - Financial Acquisition (exploits inefficiency)
  - Strategic Acquisition (exploits synergy)
  - Diversification/Conglomeration (transformation)

- **Divestitures**
  - Reverse Merger
  - Spin-offs, Care-outs, Tracking-stocks
2.3.2.1 Buyouts (Financial Acquisitions)

Financial acquisitions are usually motivated by inefficient management or market inefficiency. Of the two, acquisitions resulting from inefficient management are most prominent and are commonly referred to as LBO (Leveraged Buyout) and MBO (Management Buyout).

**Leveraged Buyout (LBO)**

Leveraged buyout is a financing technique used by a variety of entities, including management or a corporation or outside groups, such as corporations, partnerships, or investment groups. It uses a larger proportion of debt to finance the purchase and the company goes private and its shares no longer trade on the open market. Typically, most LBO transactions are done by private equity firms and the stocks purchased by them are held by a limited partnership consisting of large institutional investors.

The key characteristics of LBO are as follows:

1. *High debt.* LBO's leverage their target firms to align management and investors goals, requiring management to generate cash flows to pay down debt. The disciplining use of debt minimizes agency issues and management incentives to undertake wasteful projects and forces improvement in operating efficiency. In some situations, the interest tax shields from leverage could be an added benefit to the target firm.
2. **Incentives**: LBO's seldom change the management of the target firms. These managers are well motivated by giving significant ownership to align incentives with investors.

3. **Better corporate governance.** LBO's take the target firm private and the company is owned by few private investors. Empirical evidence suggests that private companies have better monitoring and are able to act expeditiously.

**Management Buyout (MBO)**

A management buyout (MBO) is a special type of LBO, when the management of the firm decides to take its publicly held company, or a division of a company private. Management usually borrows large sums and they convince existing shareholders to sell their stake by offering a premium above market price. Thus, management has more incentives to make the firm successful as a private firm than it was public. The key reasoning for this is that public corporations have agency costs, as they rely on managers as agents, to manage the company to maximize shareholder returns. However, managers have their own incentives, which may not be the same as that of shareholders. Some common principal-agent misalignment problems are managers undertaking pet projects that destroy shareholder value or managers devoting more resources to perks, jets, and offices. Since, management owns the firm through MBO, it eliminates some of these agency costs and monitoring is improved as the firm is taken private.

**Key Evidence on LBO, MBO**

The key evidence of financial acquisition gathered from the LBO wave of the 80's is the undoing the effects of bad diversification from the 60's and 70's. Some
practitioners credit the boom in the nineties to it. Professor Michael Jenson\(^5\) contends that the post-LBO corporation with highly leveraged structure, well motivated management with high percentage of ownership and close monitoring by buyout partners, is in better position to outperform than the pre-LBO firm. According to a study done by Steven Kaplan\(^6\) of the University of Chicago, a post-LBO firm is run more efficiently than its predecessor. This is reflected in the positive increase in operating income and margins after the buyout.

2.3.2.2 **Equity Carve-outs and Spin-offs**

Equity-carve out and Spin-off follow similar structures, except in equity carve out the equity interest is sold to outside investors and in spin-off the equity interest is sold to existing shareholders of the parent company. The general motivations for these types of restructuring activities are increased focus, less cross-subsidization (lower agency costs), pure-play offering better analyst coverage and greater opportunity to capitalize on overheated market.

An equity carve-out (commonly referred as a carve-out) is a sale of equity interest in a subsidiary by parents to investors. The subsidiary is a majority-owned or wholly owned by the parent and the equity interest is sold to investors in an IPO or to private


\(^6\) Steven Kaplan, “Management buyouts: Efficiency gains or value transfers,” University of Chicago Working paper No. 244, October 1988
equity investors in a private placement. There are two types of carve-outs (a) majority carve-out – more than 50% stake in subsidiary is sold to investors and parent owns less than 50% ownership (b) minority carve-out - investors are sold less than 50% stake in subsidiary and parent retains more than 50% ownership.

Some of the key goals for carve-out are:

- **Raising capital without dilution**: It allows parent company to sell equity in a subsidiary and raise capital without dilution or selling its own shares. Subsidiary may pay the parent company additional dividends or in certain instances assume parent’s debt and repay debt. Subsidiary may also IPO and the proceeds from the IPO’s provide additional cash to parent company.

- **Sharing risk with outside investors**: Carve-outs allow parent to partner with outside investors (private-equity or strategic corporate investors) to mitigate risks in subsidiary that needs maturing and external financing to become a successful venture.

- **Align Management incentives with operating results**: Carve-outs allows parents to uncover hidden value in subsidiary. By aligning management incentives (equity related incentives) with operating performance improvements, both parent and outside shareholders benefit.

- **Lower cost of capital and optimize leverage**: It allows high-growth companies to take advantage as market rewards pure plays over diversified companies. When a subsidiary is focussed on a sector that the market favours and offers higher P/E multiples, it allows the parent to raise capital on advantageous terms. Similarly, subsidiaries are able to easily attract debt on advantageous terms, allowing it to
optimize the leverage to industry comparable firms or in certain situations increase leverage above comps.

- *Get tax advantages:* Both parent and subsidiaries don’t pay taxes on proceeds or subsequent issuance of new shares.

- *Facilitate sale of subsidiary:* Many of the carve-outs act as springboard for spin-offs, establishing either a private value or public stock, research coverage for spin-off. This speeds up the due-diligence for potential buyers in event of public offering or private sale.

- *Address regulatory concerns:* In certain circumstances such as AT&T (1984 Ma-Bell divestiture), which was forced to divest subsidiaries for regulatory purposes.

A spin-off is created by detaching part of the parent company (subsidiary or business unit or loosely connected assets and operations) and creating a new company. The new company’s equity is shared by the parent company’s shareholders. The spun-off subsidiary uses publicly traded equity which is distributed to the parent’s shareholders and pays dividends. Most spin-offs are tax-free i.e. no taxes occur at the parent level and tax are deferred until sale of stock by shareholder. Whereas, in the case of a taxable spin-off, taxes are due at parent level and in certain conditions a taxable spin-off may also be considered as taxable dividend to shareholders. Minority carve-outs are often interim-step followed by spin-off. Some of the apparent benefits of minority carve-out are it enables parent to rollout operational separation in phases and at the same time mature the company under the supervision of the parent before spin-off or sale.
Some of the key goals for spin-off are:

- **Unlocking value in the subsidiary to parent shareholders:** Allows parent to divest non-core subsidiary, which otherwise is a viable business, and benefit as a standalone company. It allows parent to realize full value for parent shareholders which in a certain market conditions would not command a reasonable cash price for divestiture.

- **Public liquidity despite IPO winter:** Spin-off often is a valuable divestiture tool in depressed IPO market conditions or does not meet full requirements for successful IPO.

- **Indirect raises new capital:** A spin-off does not raise new capital, but, however many of the spin-offs are preceded by private-equity or strategic corporate investment or a follow-on public or private financing to raise new capital for subsidiary. Similarly, subsidiary may pay cash dividend or add leverage or reduce outstanding shares, thereby changing the capital structure.

- **Build a successful public company:** Spin-off provides management of the subsidiary a great tool to build a public company.

**Key Evidence on Carve-outs and Spin-offs**

Divestitures from carve-out or spin-offs exhibit dramatic increase in operating performance. For parent, the empirical evidence supports a relative growth from -3%, 3 yrs before spin-off to 7% growth in operating income from one year after deal to 3 yrs after deal. For the subsidiary the operating income rose approximately 24% relatively or 72% in absolute terms. Similar results were observed in stock price performance, where the parents had high stock returns before the deal and continued with 30% excess
returns over next 5 years. The short term announcement return was about 3% and in
equity carve-out was 1.5%. The chances of spin-off increased 5-fold after a prior spin-off.

Thermo Electron is considered a poster-child for minority carve-outs and Tyco as
a spin-off success. Recently a significant change occurred in the wake of corporate
abuses such as Tyco and WorldCom, where related party transactions between company,
officers and directors supposedly independent directors were beneficiaries of the CEO.
The sensitivity to shareholders and corporate governance rules will curtail
representatives of the parent company as board member in their carve-outs subsidiaries.

2.3.2.3 Going Private

Going from public to private ownership of a corporation's shares is usually
accomplished by either the company's repurchase of shares or a private investor
purchasing the public shares. A corporation will usually go private when its shares are
priced considerably below their book value and thus the assets can be bought cheaply.
Another reason a company's management may decide to go private is to ensure their own
existence by removing the company as a takeover prospect. The process by which all
publicly owned shares of common stock are repurchased or retired, thereby eliminating
listing fees, annual reports and other expenses involved with publicly owned companies.

A company becomes private through the repurchasing of all of a company's
outstanding stock by employees or a private investor. As a result of such an initiative, the
company stops being publicly traded. Sometimes, the company might have to take on
significant debt to finance the change in ownership structure. Companies might want to
go private in order to restructure their businesses (when they feel that the process might affect their stock prices poorly in the short run). They might also want to go private to avoid the expense and regulations associated with the remaining listed shares on a stock exchange.

Key motivations for going-private:

- To eliminate the significant costs of being a public company
- Perception that stock is not fully valued by the market or inability to fully unlock benefits of being public
  - Incentive Compensation
  - Access to Capital
  - Acquisition currency
  - Prestige
- Reduces or eliminates obligation to disclose competitive business and other sensitive information
- Allows for more corporate governance flexibility

2.3.2.4 Private investment in public entity (PIPE)

A PIPE is a private investment in public equity. It refers to a private transaction, typically an institutional investment, in a public company without a public offering. It refers to the sale of securities of a public company via a non-public offering. Private equity funds, venture capital funds, mutual funds, hedge funds, or other qualified investors' purchase of stock in a company at a discount to the current market value per
share for the purpose of raising capital. There are two main types of PIPEs - traditional and structured. A traditional PIPE is one in which stock, either common or preferred, is issued at a set price to raise capital for the issuer. A structured PIPE, on the other hand, issues convertible debt (common or preferred shares).

In a PIPE financing the issuer negotiates the sale of its stock directly with a small group of investors. The transaction is not publicly disclosed until is completed, thus eliminating any investor uncertainty which is typical in a secondary market offering. The confidential nature of a PIPE transaction enables investors to accumulate a position in a quality company directly – often at a discount to current market prices – without the risk of bidding up the stock price through open market purchase.

According to a Baystar Capital whitepaper dated October 2002, PIPE transactions resulted in smaller discounts than secondary market offerings. The analysis shows that PIPE transactions – particularly for those companies looking to access capital markets quickly and discretely without the increased visibility of secondary offering – can be equally attractive or even superior vehicle for fund raising.

The key innovation PIPE offers is flexibility to investors to structure contracts with varying degrees of asymmetry exposure to issuer’s equity. Since, risks can be curbed or expanded through customized terms a PIPE offers, it provides an alternative means of financing when funding through traditional vehicles would be nearly impossible. PIPEs

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7 BayStar White Paper (Private Investment in Private Equities), October 2002
differ from traditional forms of financing because they can be structured to provide the necessary protection or potential rewards to investors that allow companies to raise capital at high costs. The variety of terms and features, such as caps, floors, warrants, and discounts that can be negotiated allow investors to asymmetrically alter their exposure to the firm's equity. Chief among the variables of PIPE financings is the type of securities offered. A PIPE offering can, by definition, involve any type of security. The most common form of PIPE is an offering of common stock, but public companies also regularly use PIPEs to raise money through the sale of convertible debt instruments and convertible preferred stock. A typical PIPE transaction has two phases:

1. The issuer sells unregistered securities (common stock, preferred stock or convertible securities) in a private placement to investors (typically wealthy individuals, hedge funds or other institutional investors) at a discount to the market price.

2. Upon completion of the private placement there is a specified lock-up period (90 days, 6 months, 12 months or even longer), after which the issuer announces the transaction to the public and files a resale registration statement with the SEC. This filing enables the deal's investors to resell the securities in the secondary market at market price. If the market price when the shares are sold is greater than the discounted transaction price, the investors make a profit.

There is also an extreme variability in the types of companies seeking PIPE financings. They range the gamut from Pink Sheet-traded unheard-offs to multi-billion dollar market cap behemoths. For small, but profitable and growing public companies,
PIPE financings can be great options. For small, unprofitable and struggling public companies, the fees, costs and terms incorporated into such financings make them so painful for the issuing companies that they are preferable only to bankruptcy. Privateraise.com reports that of the 1,632 PIPEs raising more than $1 million each in 2005, 1,483 (or nearly 91%) of them were issued by companies with a market capitalization of less than $250 million and over half were issued by micro-cap companies with a sub-$50 million market cap.

In addition, the form of PIPE transactions varies widely. Some are heavily documented, negotiated and diligenced while others are closed within days. Some PIPEs are offered across a relatively broad number of prospective investors while many are taken down by a single purchaser. The average PIPE in 2005 raised $15.7 million (not including an unknown number of raises below $1 million each), including the unprecedented $2.4 billion private raised by public company Sovereign Bancorp.

2.4 Strategic Framework for Restructuring Companies

After the Internet bubble burst, the buyout industry’s focus has been in technology related industries. This has necessitated fundamental shift in their core business strategy from financial focus to operational/strategic focus. Therefore, in addition to financing expertise, these firms need to have strong strategy, technology and operating expertise to access the investment and monitor it. Furthermore to exploit portfolio synergies, scale and long term growth, buyout firms are increasingly using “strategy” as the core engine to drive deal sourcing, deal structure and transactions.
Prior to financing, sponsor buyout firms work closely with the board and management of the target firm to set the strategy.

Several strategy frameworks exist to develop strategy plan for a firm. One such contribution is a framework called “resource-based view of firm”, which is based on resource-based theory. At a business strategy level, explorations of relationship between resources, competition, and profitability include the analysis of competition, appropriability of returns to innovation, role of information asymmetry in creating profitability and means of assembling resources to sustain competitive advantage. Another popular strategy framework known as “Five Forces and Value-chain” was developed by Professor Michael E Porter of Harvard Business School. It suggests how firms can position themselves relative to competitors in a industry structure such that the firm can have competitive advantage relative to others using low-cost or differentiated strategy. Finally, a popular framework known as “Delta Model” was developed by Professor Arnoldo Hax of MIT Sloan School of Management. It defines a firm (extended enterprise) as a bundle of competencies that can be customized to deliver long term value to each customer as per their unique needs. The Delta model is particularly well suited for technology-related companies, which are under-going rapid transformation, or large established companies that need to be restructured.

Buyout transactions involve corporate control of a subsidiary or the whole firm with a strategy to enhance the efficiency of the target capable of operating as an independent entity and creating long term shareholder value. A given transaction is accomplished in three distinct steps (1) Deal sourcing – identifying and assessing a
target for buyout (2) Deal Execution – financing and monitoring the target (3) Deal Exit – liquidate position via IPO or merger or other mechanisms. Since strategy influences the outcome of buyout transactions, the use of strategic framework such as Delta model is a critical requirement.

2.4.1 Deal Sourcing

Deal sourcing is the most important step in a buyout transaction. PE firms typically source deals from established relationships such as bankers, venture capitalist, lawyers, limited partners, and personal contacts. Traditionally in the deal sourcing stage PE firms evaluated the target firms’ financial structure and business plan projections and spent most of its efforts and time in the deal execution stage, especially in creative financial engineering. On the contrary, today PE firms spend most of the time in the deal sourcing stage. In addition to evaluation of financial fit, PE firms work closely with the management of the firm to develop a post-financing restructuring plan with aggressive goals and clear exit options. They evaluate relative position of the firm or subsidiary, growth rate, relative share of market, and size using BCG’s relative growth matrix. Subsequently, they model firms’ (subsidiary) existing competitive position and post-restructuring position to evaluate the opportunity and develop a comprehensive post-financing operating plan.

Figure 2-3 describes a two step approach for deal sourcing in technology-oriented buyouts. The first step is the evaluation phase. In this phase we use BCG’s Growth share, which enables us to evaluate the relative position of firm and its competitors or divisions and identify core and non-core assets. The second step is strategy development phase
that is developed in partnership with the target’s management. This step consists of two distinct activities (a) evaluating restructuring choices and (b) development of a post-restructuring operating plan. To evaluate restructuring choices, we use the Delta model to segment customers and positioning the firm competencies (pre-restructuring and post-restructuring) on one or more competitive positions in the triangle. The Delta model supports 3 corners as follows (a) Best product – here competition is based on “product economics”. Target can have either a low-cost or differentiated competitive position in this corner (b) Total Customer Solution - here competition is based on “customer economics”. Target can have 3 competitive positions namely redefining customer experience, horizontal breadth, or customer integration and (c) System lock-in – here competition is based on “system economics” leading to competitor lock-out. The target can have 3 competitive positions namely restricted access, dominant exchange, or proprietary standard. The final step is to create a strategic agenda and intelligent budget to evaluate the opportunity.
2.4.2 Deal Execution

The deal execution step involves financing the target acquisition and monitoring the investment. Buyout firms work closely with the target’s board and management team to align the investment thesis and strategic agenda developed during deal sourcing.
Since, buyouts firms provide strong operating expertise to the target firm the granular matrix and intelligent budget developed as part of Delta model during the deal sourcing stage can be used to monitor the firm. For organic growth, the Delta model can be extended by refining the strategic agenda to meet new customer demands. Also, during this stage bolt-on acquisitions to grow the firm can be evaluated and monitored by refining it.

2.4.2.1 Generally Accepted Hypothesis for Tech Buyouts

With all the discussion and argument of 2.1 through 2.2 and empirical evidence of improved monitoring and reduced agency costs as buyout firms work closely with target, especially in technology sector where industry is rapidly changing, we are possibly able to support the hypothesis that “most private equity led restructuring tend to be justified by positive market valuation”.

However, one possible argument can be made that since the enactment of Sarbanes-Oxley (SOX), many firms are going private and that increased competition for mergers and acquisition between financial buyer and strategic buyer is increasing take over premium or EBITDA multiples. This generic but purely theoretical assumption must be carefully tested in general. We evaluate this hypothesis in section 4.2, but unfortunately, there are not many reliable research results on the relevance of SOX and go-private decisions. Also, the study in section 4.2 identifies those firms with few large owners and thin trades in public market benefit from go-private decision. This cannot be validated as long term financial performances are inconclusive, so we cannot support this hypothesis.
Chapter 3 Corporate Governance Trends

3.5 Overview

In the aftermath of corporate scandals of 1990’s, large institutional investors - private equity, hedge funds, and retirement funds- acting as shareholder activist have been playing active role in reforming corporate governance. The enactment of Sarbanes-Oxley 2002 and recent discussions in executive compensation are some of their recent contribution and they continue to play a critical role in reforming corporate governance. This section gives a brief overview of shareholder activism and analysis of interview results with academic and industry experts on future reforms.

3.5.1 Origins of Shareholder activism

Shareholder activism began in the 1930s, pioneered by the Gilbert brothers. At that time, shareholders knew very little about the inner workings of corporations, and annual meetings were essentially monologues by company chairmen. Attending the 1932 annual meeting of the Consolidated Gas Co., Lewis Gilbert was appalled when the chairman read through the company’s report, and, ignoring shareholders who raised their hands to ask questions, the chairman asked all present to proceed to lunch. This
incident provided the spark that ignited Gilbert’s lifelong commitment to “fight this silent dictatorship over other people’s money.8”

Financed by his inheritance, Lewis Gilbert recruited his brother, John, and a few other stockholders to form the first group shareholder activists. These early activist campaigned on issues such as making management more accessible, increasing disclosure of financial data, increasing dividends for investors, opposing staggered boards, and safeguarding the power of shareholders to affect the composition of the board.9

Although the preoccupations of these early activists continue to concern activists today, the relative importance of these issues has changed over time. In addition, the profile of activist groups has shifted to reflect changes in the composition of American shareholders. This shift has been particularly pronounced in the last couple of decades, as retirement systems have become major owners of public stock.

**3.5.2 Key Players in Shareholder Activism & Protection**

In the United States, the retail investors are the largest group of corporate equity holders. Collectively, retail investors hold 38.1% of stock market value. Since share

8 Lewis Gilbert, Dividends and Democracy (Larchmont, NY: American Research Council Inc., 1956)

ownership is dispersed among many small individuals, they are unable to effectively protect their interests from abuse by professional managers. If they are unsatisfied with management, the only recourse is to simply sell their stock.

Although mutual funds are more concentrated and hold the second largest portion of the market, 28.5%, they have not been active advocates for the protection of shareholder rights. Their focus is on analyzing companies externally, rather than on trying to actively influence company management.

In this environment, the work of shareholder advocacy has therefore largely fallen on pension funds, which hold about 11.1% of the stock market. The most active among these pension funds is the California Public Employee Retirement System (CalPERS), the world's fourth largest pension fund.

Other major players in the landscape include the investment analysts specializing in corporate governance, namely Institutional Shareholder Services (ISS) and The Corporate Library. Essentially, these organizations provide information and analysis on corporate governance to shareholders so that they can demand greater accountability from management and make better informed decisions during proxy meetings.

Another layer of protection to shareholders is provided by stock exchanges through listing requirements. In response to recent corporate scandals, NASDAQ and NYSE have been tightening requirements and providing guidance on corporate governance best practices.
Finally, the Securities Exchange Commission protects shareholders by ensuring adequate standards of disclosure to shareholders, and deters non-compliance and fraud through its powers of enforcement. Among the corporate governance issues being debated by the SEC and the shareholder activist community at large include internal controls, nominating procedures, board independence and leadership, whistleblower protection, best practices, and whether and how to modify the Sarbanes-Oxley Act of 2002.

3.5.3 Trends & Developments

Generally, greater awareness and regulation has raised the level of board commitment and involvement in company management. Shareholders have also become more active in monitoring performance. Recently, two new players have emerged as activist investors, namely hedge funds and labor unions. In a report released by Georgeson Shareholder, a proxy firm, the actual number of governance resolutions declined to 375 in 2005 from 414 in 2004; however, the influence of activist investors actually increased. In previous years, activists campaigned for changes in executive compensation and the removal of anti-takeover provisions, but recently, their focus has shifted to “majority vote” proposals. These proposals have been proposed mainly by union pension funds, and appeared in 55 proxy statements this year, as opposed to just 12 in 2004. These resolutions garnered majority votes in 13 shareholder meetings.

Hedge funds have also emerged as shareholder activists in an effort to boost returns on their investments. In the case of hedge funds, company management was more likely to reach settlements rather than go into all-out battle with fairly
sophisticated investors with adequate financial resources to combat effectively. Hedge funds are currently campaigning for change in household names such as OfficeMax, Time Warner, McDonald's and Blockbuster.\textsuperscript{10}

Another development is the growth of corporate governance monitors, such as publication by The Corporate Library.\textsuperscript{11} These periodic reports would function very much like S&P and Moody's reports in the credit industry, or Morningstar for mutual funds, where analysts publish their findings and opinions on companies, and make their ratings and predictions on company prospects available to the investor community.

Credit rating agencies have become more willing to downgrade debt, and insurance companies are now more likely to charge higher premiums for D&O liability insurance when they detect potential corporate governance issues. In short, market mechanisms are developing to put a price on poor corporate governance structures.

Finally, there is growing recognition that “one size does not fit all” in corporate governance and disclosure, and that the requirements of the Sarbanes-Oxley Act and other regulations may be impractical for smaller businesses, with some spending up to 2\%-3\% of revenue on internal controls to comply with Sarbanes-Oxley. It is likely that there will be different tiers of requirements depending on company size\textsuperscript{12}.

\textsuperscript{10} Hedge funds, unions boost US stock activism – report, Reuters, Dec 8, 2005.

\textsuperscript{11} Nell Minow, founder, the Corporate Library. See Acknowledgements for short biography.

\textsuperscript{12} Steve Bochner, chair of the Governance and Disclosure Subcommittee of the SEC Advisory Committee on Smaller Public Companies. See Acknowledgements for short biography.
3.6 Issues in Corporate Governance

This section covers some of the areas mentioned above in greater detail, and discusses what shareholder activists and regulators propose to address areas that need heightened shareholder protection.

3.6.1 Nomination and Election of Directors

"The corporate governance system in the US only appears to have been strengthened. The governance codes get publicity, but actual accomplishment does not equal the level of activity."\(^\text{13}\)

The quote above illustrates the frustrations of shareholders in influencing board membership in the US. To bring about change via proxy meetings of American companies, huge amounts of time, money and expertise is required, and the to date, only the most specialized investors, such as Carl Icahn, are able to successfully engage and change the course of underperforming corporations. The process involves obtaining shareholder majorities to nominate and replace directors through proxy meetings. Robert Monks argues that other countries provide stronger rights to shareholders, citing Britain, where it only takes 10% of shareholders to call a special meeting to decide on issues such as the replacement of directors.

\(^{13}\) Robert Monks, shareholder activist and investor. See Acknowledgements for short biography.
The disparity in the tools available for shareholder leverage is evident in the relative costs of activism. In the US, activist investors need to spend millions of dollars on a proxy contest, whereas in Britain, a pension fund can simply approach a company’s board and management, who prefer a consultative rather than confrontational approach. This is because British companies realize that pension funds and major investors have the ability to call special meetings if they can assemble a block of shareholders representing 10% or more of the company’s stock.

The issue of acquiescing to the wishes of majority shareholders can in itself be problematic due to considerations of cumulative voting rights. For example, currently, if the majority of shareholders vote against a director, the director must submit his resignation to the Nominating Committee, who will then decide whether or not to accept the resignation. Some institutional investors would prefer to amend company bylaws so that there is an outright rejection of a nomination if a majority of shareholders are against the nomination.

The Corporate Library has actively advocated removing directors who do not secure a majority of votes. An often cited example of a board clearly ignoring the wishes of shareholders is the board of Blockbuster, Inc. Here, shareholders removed the CEO from the board, only to have the board add another seat and reappoint the CEO as a board member. Here, the board cited “continuity” as a reason for adding the seat; however, “continuity” was precisely what shareholders did not want. Such incidents further strengthen the momentum in support of majority voting, and more legislation is
likely to be passed at the state level mandating that boards respect majority shareholder wishes\textsuperscript{14}.

However, this diminishes the rights of minority voters — after all, if someone owns 10\% of a company, could we not argue that he should have one board seat in a 10-person board? In short, even though reform is needed to allow shareholders more say in nominating and electing directors, regulators need to balance the rights of all shareholders versus the need to protect the rights of minority shareholders.

### 3.6.2 Independence of Directors

In this area, regulation has largely been restricted to issues of financial interdependence. For example, under the 60K test, if a director receives more than $60,000 per year in compensation for activities beyond his directorship, he may be in violation of the law. Also, if a director has a financial interest in a particular board decision, he should recuse himself from deliberations.

Outside financial independence, our interviewees generally agreed the definition of independence was in itself challenging, and it is consequently difficult to distinguish

\textsuperscript{14} Nell Minow further believes that, ideally, protections afforded by business judgment rule should not be extended to board members who occupy seats despite a majority of ‘no’ votes. After all, the ‘no’ votes already indicate a lack of faith in the business judgment of the director. Furthermore, insurance companies should not insure these directors, which would be likely in any case if the business judgment rule could not be applied.
between suitable and unsuitable levels of business relationships among directors and between directors and other companies, such as suppliers or customers. Drawing too firm a line is unrealistic in many industries, since many are clustered in the same geographical area, and executives from competing and complementary companies would naturally know one another.

Determining the appropriateness of “chummy” relationships built through extra-professional networks is even more difficult, since many board members are introduced through informal networks from memberships in social and other clubs. Furthermore, even if board members do not know one another well before joining a board, relationships between board members and the CEO develop and strengthen over time as a normal part of group dynamics, causing potential conflicts in areas such as performance evaluations. Because of the nature of these inter-relationships, restrictions will continue to be self-imposed through internal codes of conduct.

Recently, regulators have nevertheless tried to enhance board independence, although the concept of independent director is narrowly defined to be a director who is not also an executive of the company. For example, the Sarbanes-Oxley Act specifies that the Audit Committee must comprise independent directors. NASDAQ and NYSE have also adopted volitional standards on having majority independence in Nominating and Compensation Committees.

Court rulings have also encouraged more independence by citing “social atmosphere” as a factor that may disqualify a director from being considered
independent in certain committees. In Oracle v Derivative Litigation, the Vice Chancellor of the Court of Chancery of Delaware ruled in May 2003 that Joseph Grundfest, a director of Oracle Corp. and professor at Stanford Law School was not independent enough to serve on a special litigation committee (SLC) primarily because he would be investigating board members who were also connected to Stanford, i.e. a fellow Stanford professor, a major Stanford donor, and Larry Ellison, the CEO of Oracle Corp., who had made millions of dollars in donations to Stanford through a personal foundation and large donations indirectly through Oracle.

Here, the Vice Chancellor stated,

"The question of independence turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind. That is, the independence test ultimately focuses on impartiality and objectivity"

After citing the various ties of the investigated board directors to Stanford, the Vice Chancellor then wrote,

15 The board of directors is allowed by law to respond to stockholder derivative suits by appointing a special litigation committee (SLC) of independent directors to conduct an investigation of the suit's allegations. During the investigation, the derivative suit is stayed. Taking into consideration SLC's findings, the court decides whether to dismiss the suit or return control to the plaintiffs.

16 Oracle v. Derivative Litigation, opinion by Strine, Vice Chancellor, (Court of Chancery of the State of Delaware) May 2003, p. 2
“Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. Homo sapiens is not merely homo economicus. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.

Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume -- absent some proof of the point -- that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk."

It is important to note here that the test for independence was more stringent here because of the “extraordinary importance and difficulty” of the SLC’s responsibility. The SLC had been given the task of determining whether the derivative

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suit proceeding against their fellow directors for insider trading should proceed. This is significantly different from simply preventing a director from endorsing an action in the normal course of business, and would currently not apply to the Audit, Nominating or Compensation Committees.

The Corporate Library believes that although independence does intuitively matter, there needs to be a distinction between resume independence, as discussed above, and actual independence. The Corporate Library’s empirical studies on the relationship between independence and various measures of performance such as stockholder returns have shown no correlation. This is because there is no disclosure that can indicate a director’s willingness to say no to the CEO. Furthermore, since the CEO has a high degree of control over the flow of information, tenure of the directors and the agenda of board meetings, a complete stranger would automatically become less willing to dissent upon joining a board.

3.6.3 Board Leadership

The main issue here is the separation of the Chairman and CEO role. Here, most authorities are divided, although the issue has been discussed by the NYSE, but not adopted. There are also few internal company policies on the separation of Chairman and CEO roles, with most companies believing that the decision should be made on a case by case basis taking into account the particular circumstances and context of each decision.

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18 Oracle v. Derivative Litigation, p. 51
The Corporate Library has also carried out studies on the separation of roles and its effect on stock performance. Consistent with the views of company management, there was no correlation between the two, supporting the view that a strict rule on the separation of roles would indeed be counter-productive since it removes flexibility with no discernible benefit in return. Again, conceptually it may make sense to separate roles, but in reality, whether it is beneficial to separate Chairman and CEO roles depends on the underlying independence of the Chairman.

**3.6.4 Board Performance & Evaluation**

Board and CEO performance and evaluation remains a contentious issue as CEO pay packages continue to rise, sometimes despite poor company performance. Both shareholder activists such as Robert Monks and proxy analysts such as The Corporate Library agrees that, when it comes to independence, actual independence can only be indicated by post-fact observations. A disconnect between performance and pay is seen to be a strong indicator of a lack of board independence and weak directors in the Compensation Committee. Similarly, one can conclude that an Audit Committee is underperforming by looking at tangible indicators such as the accuracy of filings and the need for restatements.

These indicators of performance are more objective measures of performance than board self-evaluations, which have been heavily influenced by the board's group dynamics. Not surprisingly, in the area of board self-evaluations, the exchanges do not require companies to have annual performance feedback. However, self-evaluations are recommended as a best practice.
Currently, proxies require the inclusion of performance graphs and details on executive compensation. However, scant attention is actually paid to these disclosure items, and companies do not typically take compensation reports seriously. Many companies produce boiler-plate reports to meet minimum requirements of disclosure, with little effort invested in providing robust and useful information.

The SEC is just beginning to consider regulations on a number of proposals on improving rules on compensation packages. On the legislative front, Congressman Barney Frank, the US House Representative for the 4th District of Massachusetts, has proposed legislation that CEO compensation packages be submitted for shareholder approval. The Corporate Library agrees with the logic of this proposal, since shareholders have the least conflict of interest when determining CEO compensation, compared to CEOs and company boards.

3.6.5 Disclosure & Information Management

Simply put, the more disclosure, the better. Typical mechanisms for disclosure are the required filings such as the 8-K, 10-Q and 10-K. However, there is scope for improved timeliness. Recent SEC rules passed in September 2005 require accelerated filing of 10-K within 60 days after fiscal year end, instead of 75 days. Under this rule, 10-Q filings are to be filed within 35 instead of 40 days.

On the issue of disclosure to institutional shareholders, there has been considerable debate over the merits of Regulation FD (Fair Disclosure). Detractors claim that Regulation FD has had a chilling effect on the ability of companies to provide useful
information, and the ability of institutional investors to meet with company management to raise specific concerns on performance. The regulation has had the effect of preventing company management from constructively discussing management and business issues with institutional investors, since managers run the risk of violating Regulation FD by doing so.

Within corporations, there has been more pressure on management to report information to the board of directors on a more timely and professional basis. There is a growing trend towards formalization of board presentations by creating books, incorporating memos from legal counsel and financial staff. In addition, board members are now more likely to demand that presentations be received well in advance of board meetings, complete with backup and supporting material.  

There is also greater information flow between the board and corporate staff beyond employee directors. Furthermore, executive sessions of independent directors, although not required, are strongly recommended by NASDAQ and the NYSE.

3.6.6 Education & Ethics

Underlying the need for stronger protection of shareholder rights are concerns regarding the ethics of directors and managers. Here, there needs to be a two-pronged “carrot and stick” approach – regulations, penalties and shareholder threats help to

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19 Megan Gates, Member, Mintz, Levin, Cohn, Ferris, Glovsky & Poppeo. See Acknowledgements for short biography.
enforce ethical behaviour, but education is required to enhance the attractiveness and intrinsic value of ethical behaviour respectful of shareholder interests.

This is because, despite increased activism, change has been impeded by conflicts of interest and agency problems. For example, company pension plans and trustees would prefer not to antagonize other companies and potential clients by actively campaigning against management. There is always the possibility of commercial reprisals. As discussed at the beginning this leaves public pension funds as the only player with both the concentration and clout to affect management. However, public pension funds are typically headed by executives who are less familiar with the commercial sector. Consequently, even though there is growing activism among public pension funds, CalPERS and several other Council of Institutional Investors members (e.g. the pension plans of North Carolina, AFL-CIO, teachers’ unions, Louisiana, Wisconsin and New York City and New York State) are the only ones with a high degree of prominence.

Given these continuing difficulties in enforcing ethical behavior and respect for fiduciary duties to shareholders, institutions such as leading business schools have an important role to play in educating future managers on the duties. There has indeed been an increased emphasis on leadership and ethics within the curricula of management education programs nationwide. The effectiveness of these initiatives remains to be seen.
3.7 Conclusions

This brief study conducted by interviewing some of the thought leaders in Corporate Governance issues related to institutional investors leads us to the following conclusions and predictions:

- Post-Enron, investor activism is on the rise. Many pension firms have joined the movement and we see Hedge funds as a new class of rising activist. We also see valuable role played by Carl Icahn, a self-made billionaire investor and self-appointed guardian of corporate governance. But, still activism remains on the sidelines and to enter the mainstream, support from academia (e.g. Harvard University), investment bankers, private equity firms and insurance companies (D&O liability insurance) is desired.

- The influence of investor activism, though slow in pace, has been instrumental in affecting major changes in corporate governance such as the evolution of staggered boards from classified boards, electing independent directors and executive compensation.

- While performance evaluation of CEO and board members is considered a positive trend, there is a lack of visibility of evaluation metrics, and the ability to influence change by outside investors is very limited. In the UK, institutional investors can indirectly negotiate with the management to affect changes through 10% of votes. In the US, some changes can be affected through best practices but lack of regulatory support makes it impossible for institutional investors to bring about change.
• Even recent attempts to provide remedial solutions to agency problems through Independent director status provide only “resume independence”. According to Nell Minow executive compensation provides the only measurable metric to evaluate board independence.

• Regulation FD and lack of comprehensive disclosure has compromised the quality of information to shareholders, particularly institutional investors, resulting in increased information asymmetry between shareholders and management. Proposed regulations for disclosing executive compensation are a positive step. According to Robert Monks, citing a model from Singapore’s exchange, the more information disclosed is better. We concur with this view.

• We see the future of shareholder activism growing and the increasing role private equity firms and venture capital will play a role in the seeding of good corporate governance guidelines during the birth of a firm.
Chapter 4 Tech Buyout Analysis and Trends

4.1 Overview

The private equity industry is poised for significant growth over the next decade as a result of global entrepreneurial environment, where venture capital is essential to bring market driven innovation and increased globalization of established businesses, where buyouts offer the key to unlocking the creative potential that is otherwise lost.

The overall merger and acquisition market has risen to $1 trillion and competition between strategic corporate buyers and private equity buyers has intensified. Private equity M&A transactions rose sharply by 45% from $136.5 billion in 2004 to $198 billion in 2005, accounting for approximately 15% of the global M&A volume.

One of the striking features of 2005 is the brisk growth in buyouts of technology companies as a result of continued consolidation in the technology sector. In 2005, tech buyouts constituted $47 billion (24%) of the total worldwide buyout volume of $198 billion. Similarly, in 2005, the capital inflows in private equity, particularly buyout funds, rose approximately 270% from $64 billion in 2004 to $164 billion. This trend is largely motivated by institutional investors (equity investors) such as pension funds, endowments, corporations, who are desperate to show an 8% return in 5% percent world. According to Journal, altogether buyout managers have about $1 trillion in capital available to them. The total funds raised by the private equity industry in 2005 was
approximately $250 billion of which $164 billion was raised by buyouts funds, $65 billion was raised by venture capital funds, $12 billion was raised by fund of funds, and $9 billion by mezzanine funds.

4.1.1 M&A Trends

Aggressive competition between corporate buyers and financial buyers is creating unprecedented growth in mergers and acquisitions transactions. According to Dealogic, the total volume of global M&A transactions is approximately $2.9 trillion, a 38% increase since 2004. Many financial economists suggest even greater activity. Analysis of M&A transactions from 2000-2005 and industry reports provide evidence about factors influencing this latest boom as listed below:

1. *Open debt market* – According to the Federal Reserve opinion survey on Bank lending practices in October 2005, the percentage of banks loosening their credit standards is at the highest level in 10 years. Bank debt multiples have risen steadily from average 3.7 times EBITDA in 2001 to 4.3 times in 2005, a level that hasn’t been seen since 1999 according to S&P report, which compared average debt multiples and highly leveraged loans. The default rates continue to decline and the current default rate of 2% is the lowest level in a decade. Finally, purchase price multiples are at 10 year high. Although it varies from industry to industry, middle market purchase prices range from 6-7 times EBITDA and sometimes as high as 10 or 11. The average multiple is up from 5.9 times EBITDA in 2001 to 8.5 times EBITDA in 2005.
2. *Increased competition* – Since the dotcom bubble burst, many corporations have taken excess out of their operations as a result are experiencing earnings growth and generating substantial revenue from operations. Since continued organic growth with optimized cost structure is challenging, these corporations are looking at ways to bolt-on acquisitions for continued growth. This additional demand is a key catalyst for the dramatic rise in purchase prices and higher EBITDA multiples for transactions. Corporate buyers are not only driving costs but are impacting the strategies private equity firms use to raise funds, structure transactions and win deals. Private equity firms are using more equity and less leverage. With interest rates still near historic lows, return on equity compared to debt is more valuable and private equity firms are putting between 25%-50% of purchase price.

3. *Capital Structure* – Corporations today have many financing alternatives and the resulting capital structure is akin to layers of capital outlays. A typical transaction starts with a senior secured loan, followed by junior debt, after that a mezzanine strip and finally equity is at the bottom of the financing structure. The popular way of financing mergers and acquisitions is cash-flow and asset based facilities. Asset based financing is attractive for middle market manufacturers who are faced with high energy and transportation costs and cash flow financing is unattractive or may not be a option. These companies find asset-based lending attractive as it offers flexibility in long haul especially when market turns and they face risk of cash-flow covenant violation. Additionally, “second-lien” have become popular mechanism to take control of corporation, especially in distressed private equity and hedge fund M&A transactions. These investors use
second-lien as a strategy to get control in event of default and prior to bankruptcy these investors buy securities at a significant discount from senior note holders, who often have majority ownership of the company.

4. *Industry dispersion* – M&A transactions continue to be strong in traditional industry segments or geographies, but are rapidly proliferating across other industries including energy and financial services. Telecom was the most active sector in 2005. According to Dealogic, both European and Asian-Pacific M&A volume increased by approximately 45% representing a broad distribution of transactions globally. In addition to rapid expansion, M&A transactions are completed in much less than time than in past. For example, large investors such as distressed private equity firm and hedge funds simply buy the firm at discount and take the company private rather than arranging financing with partners to arrange sale of the company. Another factor that is accelerating the closing of deals is staple financing. Since, competition is so fierce today, investment banks representing sellers, instead of waiting to find out who was going to own the company, arrange financing to a certain level to close the deal faster. Since, in staple financing lenders have already run the deal a sponsor can focus on deal evaluation and bidding strategies.

The rise and speed in M&A transactions combined with fundamental changes in transactions suggest further growth in M&A volume over next 5 years. The technology sector (information technology, telecom, digital entertainment, consumer electronics) will experience further consolidation as emerging growth companies (venture backed) and slow growth companies sell to better positioned competitors. The escalating energy
and transportation costs and the recent passage of new bankruptcy laws that further reduce the time for restructuring would drive companies into distress. Private equity investors and corporate buyers taking advantage high capital inflows and low interest rates will aggressively pursue transactions. Similarly, hedge funds - with higher liquidity, agility, and risk-tolerance - will continue to be active acquirers. Finally, both asset-based lenders and distressed private equity investors using “second-lien” with comfortable credit facilities will play an active role in turnaround of distressed companies.

4.1.2 Sarbanes Oxley & Going-Private Trends

After the passage of Sarbanes Oxley (SOX) act of 2002, increasing number of companies have opted to go-private. It is widely speculated that since SOX adds significant costs to public companies, they may be motivated to go-private. SOX came into existence as a result of large corporate scandals involving Enron, Worldcom, Tyco, Arthur Anderson, and others. Under the law, all publicly traded companies are required to submit annual reports of internal accounting controls to the Securities and Exchange Commission. The act has potential to improve transparent disclosure and corporate governance. The benefits come at significant costs as public companies have to spend millions to comply with the new regulation. According to a study conducted by the law firm Foley and Lardner, the compliance costs were higher for small companies and as much as $15 million for a company with $1 billion in revenues. A large portion of compliance costs is paid as fees to outside auditors.

Many industry experts investigating this trend remain sceptical. According to Buyout article (April 3, 2006), S&P chief economist David Wyss suggest that SOX has
played relatively minor role in recent wave of privatization and the trend is transitional, at best. He adds that although the legislation makes it harder to be a public company, once companies learn to operate in new environment. Similarly, a leading private equity firm partner confirmed the trend, suggesting that if companies were going private because of SOX, then, they would have something else to worry about. The private equity firms face serious challenges in taking public companies private and it is very time consuming and prone to shareholder lawsuits. Some transactions take more than year and procedural requirements sometimes force many deals to fall through.

Engel, Hayes, and Wang [2004], examining this trend suggest that SOX has affected firms’ decision to go-private. The authors provide evidence on the effect of SOX on firms that are close to public/private margin; that is firms for which the net benefits of being public are relatively small. The study examined 353 firms that filed schedule 13E-C with the SEC between January 1998 and January 2004 using three questions, First, to what extend was SOX associated with an increase in the number of firms electing to go private? Second did the factors associated with firms’ decisions to go private change around the passage of SOX? Third, did the determinants of going-private announcement returns change around the passage of SOX? They point that by applying standard economic reasoning, firms maximize their value to go private in response to SOX only if the costs imposed by SOX exceed the benefits offered by SOX to shareholders. The authors analyze and provide evidence to support the following 3 findings:
1. The quarterly frequency of going private increased modestly after the passage of SOX.

2. The abnormal returns associated with the passage of SOX were positively related to firm size and share turnover. Firms with large insider ownership (illiquid positions) with limited need for external financing realized very small benefits from being public are more likely to go-private.

3. Smaller firms experienced higher going-private announcement returns in the post-SOX period compared to pre-SOX period and this effect was especially pronounced for firms with high inside ownership.

To further evaluate the hypothesis, we interviewed Steve Bochner, who is partner at Wilson Sonsini Goodrich and Rosati and member of SEC’s Advisory Committee on Small Public companies. Steve recommended that SOX-lite was being considered by the SEC and at the writing of this report; an exposure draft for SOX-lite was released in March 2006 and due for vote on April 23, 2006. Some in the committee recommend that unless a special internal control framework is developed for smaller companies, the SEC should:

- provide exemptive relief from SOX 404 requirements to microcap companies with less than $125 million in annual revenue and to smallcap companies with less than $10 million in annual product revenue that have

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20 The Sarbanes-Oxley Act and Firms Going-Private Decision [May 6, 2004], Ellen Engel, Rachel M. Hayes, and Xue Wang
specified enhanced corporate governance controls, including a requirement to maintain effective internal controls;

- provide exemptive relief from external auditor involvement in the SOX 404 process to the following companies, subject to their compliance with the same corporate governance standards:
  - Smallcap companies with less than $250 million in annual revenues but greater than $10 million in annual product revenue; and
  - Microcap companies with between $125 and $250 million in annual revenue; and
4.2 Post bubble Buyout Analysis

4.2.1 Fund raised 2000-2005

4.2.1.1 Capital Commitments

The Figure 4-1 shows the capital commitments in the private equity industry. At the peak of the dot-com, the buyout industry experienced highest growth since the LBO wave of 1980s. During this period the capital inflows into venture capital were as high as 69% compared to that in the buyout industry. After the bubble burst there was widespread speculation that the buyout industry was dead.

![Private Equity Fund Commitments (2000-2005)
Source: Thomson Financial](image)

Figure 4-1: Capital commitments (2000-2005)

The passage of Sarbanes-Oxley Act of 2002 and lack of public market liquidity fuelled a buoyant merger and acquisition era. In 2005, the M&A volume reached $2.6 trillion and buyout led transactions accounted for 15% of total volume. This is also reflected in the rising capital inflows in the buyout funds. In 2005, the buyout funds raised $193 billion, the same level as venture capital did at the peak of the dot-com.
4.2.1.2 Funds Raised

The figure Figure 4-2 shows the new funds raised since the dot-com burst. Since, 2000 the number of funds has dropped by 1/3 as number of under performing funds were shutdown and number of venture firms stopped raising funds. On the contrary, the new funds raised in the buyout industry have remained consistent since 2000 and LP’s continued to invest more capital in buyout as compared to venture capital.

![Private Equity Funds (2000-2005)](source: Thomson Financial)

Figure 4-2: New funds raised (2000-2005)

4.2.1.3 Fund Performance (2005)

The Figure 4-3 shows the private equity performance in 2005.

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 Year</th>
<th>3 Year</th>
<th>5 Year</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture Capital</td>
<td>4.30%</td>
<td>-1.30%</td>
<td>-6.10%</td>
<td>25.50%</td>
</tr>
<tr>
<td>Large Buyout</td>
<td>16.3%</td>
<td>9.5%</td>
<td>1%</td>
<td>10.9%</td>
</tr>
<tr>
<td>Mezzanine</td>
<td>8.5%</td>
<td>3.7%</td>
<td>1.8%</td>
<td>6.9%</td>
</tr>
<tr>
<td>All Private Equity</td>
<td>13.8%</td>
<td>5.5%</td>
<td>-0.4%</td>
<td>12.6%</td>
</tr>
</tbody>
</table>

Figure 4-3: PE industry performance (Source: Thomson Financial)
4.2.2 Transactions 2000-2005

4.2.2.1 US Buyout Dealflow by Sector

The Figure 4-4 is analysis of the domestic US buyout transactions. These include buyout transactions across all active sectors namely (a) Financials (b) High Technology (c) Media Entertainment (d) Real Estate and (e) Telecommunications. The deal flow data includes announced M&A deals where a financial sponsor, such as a Buyout fund or a
Hedge fund or a distressed fund, is involved and transaction value is $25 million or greater. The deal flow analysis of buyout transaction excludes withdrawn M&A transactions.

As shown in our analysis, since 2000, the US buyout transactions in technology oriented industries are on rise. The real-estate transactions are relatively flat and financial sector saw increased transactions in 2001 and subsequently the number of transactions has remained relatively flat. Summary of past 5 year trends:

- Telecom sector consolidation
- Media and Internet convergence
- Tech Sector growth rate has surpassed 2000.
4.2.2.2 Global Buyout Deal flow by Sector

The Figure 4-5 is analysis of the worldwide buyout transactions. These include buyout transactions across all active sectors namely (a) Financials (b) High Technology (c) Media Entertainment (d) Real Estate and (e) Telecommunications. The deal flow data includes announced M&A deals where a financial sponsor, such as a Buyout fund or a Hedge fund or a distressed fund, is involved and transaction value is $25 million or
greater. The deal flow analysis of buyout transaction excludes withdrawn M&A transactions.

As shown in our analysis, since 2000, the world wide buyout transactions in technology oriented industries are on rise. The world wide trends follow the same trends as in US as listed below:

- Telecom sector consolidation
- Media and Internet convergence
- Tech Sector growth rate has surpassed 2000.

4.2.2.3 Global Tech buyout transaction trends

The Figure 4-6 is analysis of worldwide buyout and domestic US buyout transactions. These include buyout transactions across all sectors namely (a) Consumer products (b) Energy and Power (c) Financials (d) High Technology (e) Industrials (f) Government Agencies (g) Healthcare (h) Materials (i) Media Entertainment (j) Real Estate (k) Retail (l) Consumer staples and (m) Telecommunications. The deal flow data includes announced M&A deals where a financial sponsor, such as a Buyout fund or a Hedge fund or a distressed fund, is involved and transaction value is $25 million or greater. The deal flow analysis of buyout transaction excludes withdrawn M&A transactions.
The Figure 4-7 is analysis of worldwide tech buyout. These include buyout transactions across all sectors namely (a) High technology (b) Media Entertainment and (c) Telecommunications. It breaks down transactions by acquisition techniques (Distressed, Go-Private, LBO, MPO, Spinoff), which are common techniques used by a sponsor to buyout a company. The deal flow data includes announced M&A deals where a financial sponsor, such as a Buyout fund or a Hedge fund or a distressed fund, is involved and transaction value is $25 million or greater. The deal flow analysis of buyout transaction excludes withdrawn M&A transactions.
The Figure 4-8 provides a detailed analysis of all domestic US tech buyout. These include buyout transactions across all sectors namely (a) High technology (b) Media Entertainment and (c) Telecommunications. It breaks down transactions by acquisition
techniques (Distressed, Go-Private, LBO, MPO, Spinoff), which are common techniques used by a sponsor to buyout a company. The deal flow data includes US targets only and announced M&A deals where a financial sponsor, such as a Buyout fund or a Hedge fund or a distressed fund, is involved and the transaction value is $25 million or greater. The deal flow analysis of buyout transaction excludes withdrawn M&A transactions.

<table>
<thead>
<tr>
<th>US TECHBUYOUT-DEALTYPE BREAKDOWN</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<td></td>
<td></td>
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<tr>
<td>Deals</td>
<td>8</td>
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<td>35</td>
<td>29</td>
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<tr>
<td>Deal Value (billions)</td>
<td>$1.2</td>
<td>$4</td>
<td>$6.5</td>
<td>$21</td>
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<td>$20</td>
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<tr>
<td>Net Proceeds (billions)</td>
<td>$1.2</td>
<td>$4</td>
<td>$6.5</td>
<td>$21</td>
<td>$18</td>
<td>$20</td>
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<tr>
<td><strong>Going Private</strong></td>
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<td></td>
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<tr>
<td>Deals</td>
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<td>5</td>
<td>11</td>
<td>18</td>
<td>11</td>
<td>17</td>
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<tr>
<td>Deal Value (billions)</td>
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<td><strong>Leveraged Buyout (LBO)</strong></td>
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<tr>
<td>Deals</td>
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<td>Net Proceeds (billions)</td>
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<td><strong>Management Buyout (MBO)</strong></td>
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<tr>
<td>Deals</td>
<td>7</td>
<td>2</td>
<td>6</td>
<td>8</td>
<td>2</td>
<td>3</td>
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<tr>
<td>Deal Value (billions)</td>
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<td>$0.3</td>
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<td>Net Proceeds (billions)</td>
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<td>$1.4</td>
<td>$1.3</td>
<td>$0.3</td>
<td>$4</td>
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<tr>
<td><strong>Spinoff</strong></td>
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<tr>
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<td>$11</td>
<td>$2</td>
<td>$5.7</td>
<td>$8</td>
<td>$42</td>
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</table>

Figure 4-8: Analysis of US Tech buyout transactions 2000-2005

(Source: Thomson Financial)
4.2.2.4 2005 Tech buyout highlights

**Top 5 Deals of 2005**

The Figure 4-9 provides a detailed analysis of all top 5 tech buyout deals in US. Silver Lake led the largest deal in 2005 with the acquisition of Sun Guard, a leading provider of disaster recovery solutions. KKR acquired Agilent, the semiconductor test division of Hewlett Packard, for $2.7 billion. All transactions were club deals involving one or more mega-funds.

<table>
<thead>
<tr>
<th>Company</th>
<th>SPONSOR</th>
<th>Deal type</th>
<th>sector</th>
<th>value ($B)</th>
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<tbody>
<tr>
<td>SunGuard</td>
<td>Silver Lake Partners</td>
<td>Public-to-Private</td>
<td>Software</td>
<td>$11.3</td>
</tr>
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<td>Agilent</td>
<td>KKR</td>
<td>Public-to-Private</td>
<td>Semiconductor</td>
<td>$2.7</td>
</tr>
<tr>
<td>Verizon (Hawaii)</td>
<td>Carlyle Group</td>
<td>Public-to-Private</td>
<td>Telecom</td>
<td>$2.1</td>
</tr>
<tr>
<td>Insight Comm.</td>
<td>Carlyle Group</td>
<td>Public-to-Private</td>
<td>Telecom</td>
<td>$2.1</td>
</tr>
<tr>
<td>Telecordia</td>
<td>Warburg Pincus</td>
<td>LBO</td>
<td>Services</td>
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</tbody>
</table>

Figure 4-9: Top 5 deals in 2005 (Source: Thomson Financial)
**Tech buyout transactions by market (2005)**

The Figure 4-10 gives a breakdown of tech buyout transactions by markets. The mid-market sector continues to be active in 2005. It is worth noting that the mega-deals increased sharply to 14.

<table>
<thead>
<tr>
<th>Market</th>
<th>DEALS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>49</td>
</tr>
<tr>
<td>Middle</td>
<td>69</td>
</tr>
<tr>
<td>Large</td>
<td>3</td>
</tr>
<tr>
<td>Mega</td>
<td>14</td>
</tr>
</tbody>
</table>

Figure 4-10: 2005 Buyout transactions by market (Source Thomson Financial)

**4.3 Industry Dynamics**

**4.3.1 Emerging competitive landscape in Buyout Industry**

The buyout industry went through a radical transformation in the nineties and most buyouts were sponsored by either a strategic corporate buyer or a traditional buyout fund or a distressed fund. The buyout deals in the 1990's, however, were very different from those in the 1980's. There were fewer transactions, more intense competition and less leveraged capital structure. The industry return remained sharply low and buyout transactions were addressed through innovative financing and multiple capital layers -senior debt, subordinated debt, mezzanine financing, and equity. The buyout funds focussed on more established companies and firms continued to be generalist – financial experts with very little or no operating experience.
Since the bubble burst in 2000 a large pool of younger rather than well established firms have become potential buyout targets. Many companies are in technology related industry and face financial difficulties or growth challenges. Buyout firms are involved in unlocking the entrepreneurial spirit from rigid corporate structures in these technology companies. Similarly, large established technology companies face consolidation challenges. This necessitated buyout firms to shift their core strategy from financial focus to operational/strategic focus. These firms need to understand technology sufficiently to access the investment and monitor it. Existing buyout firms are recruiting executives with strong operating experience to the team. Mega-funds and Venture buyouts have emerged to exploit these opportunities and are competing with traditional buyout funds.

Many large and established firms face high risks of bankruptcy as a result of dramatic rise in energy and transportation costs. Hedge funds are emerging to compete with traditional & distressed private equity firms in this space. The Figure 4-11 shows the emerging competition in the buyout industry.
4.3.1.1 Mega funds

Big Buyouts – In 2005, top tier private equity firms raised over $10 billion, which have been a significant contributing factor to M&A volume. These firms can complete with corporations for virtually any size of transactions. Furthermore, many of these private equity firms are teaming up to pursue large buyouts, giving them access to diversified experience and allow them to spread risk, a recent phenomenon also commonly referred as club deals. Analyzing private equity transactions in 2005, 9 of the 10 biggest transactions were announced in 2005.
4.3.1.2 Hedge Funds

Historically, hedge funds are well known as short-term investors today are looking for returns across broad investment opportunities and locking up money for longer periods of times. They often act as lead lender in a leveraged buyout and are buying equity at auctions when a member of a private consortium, who is not able to find a bidder, are looking to exit their position. Hedge funds have a competitive advantage over other buyers since they can provide their own acquisition financing. They are becoming a formidable competitor to private equity firms, putting more pressure on pricing and auctions process as a whole.

4.3.1.3 Venture Buyout Funds

Venture buyout (term coined by Garnett Helfrich Capital also referred to as VBO) is a combination of VC and traditional buyout investing -- adds a twist to the private-equity game by aiming to acquire and rejuvenate promising business units trapped inside other organizations. These businesses may (or may not) be profitable or cash flow positive, may be in need of new technology and products to expand the existing offering, and may be "broken and orphaned" within the parent organization. However, these spinout businesses must possess the potential to be turned into great operating companies that can grow revenue and profits dramatically in the coming years as standalone entities.
Venture buyout firms look for entrepreneurial leadership that wants to operate their business in a freestanding manner with all the benefits and rewards of management ownership and operational control. In many cases, they are willing to back existing management in the financing of a management buyout of their business from the parent company.

4.4 Leadership Challenges in Buyout Industry

The buyout industry is experiencing unprecedented capital inflows as evidenced by record multi-billion dollar funds raised in 2005. The scale and scope of transactions are so large that buyout firms can virtually acquire any company across the globe. Secondly, the shift from financial focus to strategic and operation focus is forcing these firms to hire operating partners. These trends pose new leadership challenges in the buyout industry as discussed below.

4.4.1 Fund Raising

Buyout firms continue to raise bigger funds. Although, there has been rise in takeover premium in recent past years in the buyout industry, the decision to raise bigger fund is driven by firm strategy rather than market conditions. The size of the fund is determined by the target investment portfolio i.e. a large fund will pursue larger deals and smaller fund will pursue smaller deals. The size of the fund can be source of advantage or disadvantage both for limited partners (LP) and general partners (GP).
GP's with top quartile performance build long lasting relationship with LP's. This enables them to increase capital allocation and thus realize higher management fees (approximately 2% of committed capital) upon fund closing. The key disadvantages of raising a larger fund are that the deal sourcing is constrained to bigger deals and thus a restricted opportunity set to build an investment portfolio. The GP has many advantages in raising bigger funds. First, by raising mega-funds they can pursue mega-deals with little or no-competition. Second they can cross-fertilize ideas across the firm and absorb losses from dead deals. The additional scale allows GP’s to achieve better diversification and mindshare with industry players (lawyers, bankers) and Wall Street. Lastly, in tech buyouts since both risks and uncertainties are higher a larger fund may be able to absorb increased costs.

LP invest in buyout funds directly or through a fund of funds. Big institutional investors (state pension, foundations) partner with advisors during the investment process. LPs compete to invest in top quartile funds and the motivation to allocate capital amongst fewer GP’s and as a result commit more money is based on both past performance and relationships. The key benefit of investing larger pool of capital amongst few GP’s is so they don’t need to have huge number of relationships. On the contrary, there are many reasons that it could be disadvantages. First, mega-deals and increasing club deals that involve mega-funds may reduce the overall investment opportunities. Secondly, in event that an LP has invested across multiple participants in a club deal, it can be considered effectively as doubling down and loss of diversification.
According to Buyouts article (April 8, 2006), Calpers is overhauling its Alternate Investment Management (AIM) program. It plans to reduce the number of private equity relationship such that core portfolio will consist of 20-30 existing private equity firm relationship and plans to sell to the secondary market all of its non-core relationships and underperforming assets. Calpers is also considering handing over its private equity management to established advisors and third party advisors. This decision if passed by the Calpers investment committee would have significant impact on fund raising practice.

4.4.2 Compensation and Succession

The buyout industry uses a 2/20 rule for compensation, where 2% is management fees and 20% is the carried interest. The base compensation, which includes employee (partners, associates, and administrative) staff salaries and operations are funded from management fees. The most important component of compensation is the carried interest, which is distributed to partners and in certain cases also shared with associates. To sustain long term growth the buyout firms need to institutionalize, attract operating partners, determine ways to recruit and develop future leaders, and manage partner succession effectively.

To attract operating partners and develop future leaders, firms need to elect partners. This has an economic impact to current partners and firms need to balance costs of hiring new partners and the added benefits they bring to the firm. Firms need to consider the dilutive effects and uneven distribution of carried interest. Some firms, especially multi-strategy funds, have multiple tiers of partnership each with a fund-specific allocation of carried interests. Other firms use equal distribution and fund-wide
allocation of carried interest, fostering a team-based approach. The other important
decision is the issue of a vesting schedule of carried interest (a) whether it is deal-by-deal
or fund-wide? (b) what is the vesting period and schedule (straight-line or accelerated)?.

Many firms today face succession planning and partner retirement challenges.
Related to it are issues (a) what is the new management structure? (b) how to share value
with a retiring partner? (c) what is the transition strategy for retiring partners? As
founders retire, some firms are following corporate like management style with a CEO as
leader, while others are pursuing a management committee approach. This process of
adopting new management structure and choosing new leaders is pretty fluid in the
buyout industry; some have recruited top business leaders (Lou Gerstner - Chairman of
Carlyle Group) with operational expertise to lead this transition. As founders or
significant partners retire, firms face challenges in remaining a on-going concern. One
common approach is to compensate outgoing partners for value created and maintain a
significant economic incentive for those partners who remain. Many firms have
developed a value-sharing mechanism that payout carried interest after retirement. One
common approach is a two-fund tail to compensate the retiring partner.

4.4.3 Structure and Controls

Buyout firms were founded by entrepreneurs and today are encountering growth
challenges. In part, the entrepreneurial mind-set is reflected by multiple hats that
partners have to wear – deal-sourcing, fund raising, and portfolio management. It is also
reflected in part by the industry compensation structure, where significant portion of
compensation is linked to the performance of the fund.
As these firms have evolved the firms hired staff to do the work that founders didn’t like and these people are more risk-averse. Similarly, as number of partners grew, firms have developed more formal processes for making important decisions such as capital commitments and staffing. To support decision-making, firms are imposing structure to support increasing information flows. The administrative costs also sharply increase as firms transact complex deals, especially in technology industry. The added costs include (a) accounting (b) information technology infrastructure (c) compensation management. As deal-velocity increases and firms start sub-optimizing decisions the performance of a fund with additional structure suffers. Thus firms must impose an increased structure under certain conditions as listed below:

- Financial performance suffers as a result of poor decision making process
- Large pool of investment professionals – need better information flows
- Increase in assets under management by large number of partners
- HR and performance management to grow talent
- Launch multi-fund strategy (late-stage, distressed, hedge-fund, etc.)
Chapter 5 Comparative Study of Tech Buyout Funds

5.1 Overview

A comparative study of tech buyout funds is described in this chapter. First, we define a methodology to classify private equity firms and identify unique characteristics of a tech buyout firm and select three unique firms as a sample for comparative study. Second, we present our analysis of these 3 firms. We conclude by giving overview of the three tech buyout firms and review a tech buyout transaction (Seagate successful re-transformation) using the “Delta model”.

5.2 Comparative Study

5.2.1 Methodology

As discussed in the previous chapter, in 2005 alone $193 billion was raised in 306 funds. The change in industry dynamics and increased capital inflows, particularly in technology buyout transactions needs a closer examination.
Industry Focus and Expertise

The above chart provides a methodology to classify different private equity firms based on investment size and industry focus. On one dimension, firms that pursue financial focussed strategy tend to be generalist; most traditional buyout firms fit this classification. On the other dimension, firms that pursue smaller investments and act as specialists – providing industry connections, strategy guidance and operating expertise - to build a business; most venture capitalist fit this classification. Whereas, if we combine the two dimensions namely, strong financial engineering with industry focus and strong expertise, then we have tech buyout firms that tend to focus in a particular sector like the VC's or a general buyout firm that are transforming into a tech buyout firm by recruiting operating partners. The chart indicates that these characteristics are exhibited by following firms:
- **Mega buyout firms:** These firms have both scale advantage and specialization. They tend to focus on large established technology firms. Many generalist buyout firms are recruiting operating partners to pursue tech buyouts.

- **Venture buyouts firms:** These firms are using the venture model to buyout. They tend to focus on entrepreneurial buyout opportunities with growth problems.

- **Hybrid (Multi-Strategy) firms:** It includes existing firms that have both a venture and buyout funds. A large number of firms in this category tend to be focussed in mid-market transactions.

We analysed a large number of firms that fit above criteria and short-listed one firm per category. We chose Silver Lake Partners, a technology focused private equity firm, in the mega-fund category, especially for its role in industry's largest technology transaction (SunGuard transaction worth $11 billion). We selected, Garnett and Helfrich for their pioneering concept of venture buyout. And finally, we selected Morgenthaler in the hybrid fund category.
5.2.2 Analysis

The table below summarizes our analysis of the three leading tech buyout firms.

<table>
<thead>
<tr>
<th></th>
<th>Silverlake</th>
<th>Garnett/Helfrich</th>
<th>morgenthaler</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founded</td>
<td>1998</td>
<td>2003</td>
<td>1968</td>
</tr>
<tr>
<td>Investment Focus</td>
<td>Buyout</td>
<td>Buyout</td>
<td>Venture/Buyout</td>
</tr>
<tr>
<td>Investment Stage</td>
<td>Large, Mega</td>
<td>Mid market</td>
<td>Early, Late Stage/Mid-market</td>
</tr>
<tr>
<td>Industry Focus</td>
<td>High Tech</td>
<td>High Tech</td>
<td>All industries</td>
</tr>
<tr>
<td>Core Competency</td>
<td>Mega buyout</td>
<td>Venture buyout</td>
<td>Hybrid (VC+Buyout)</td>
</tr>
<tr>
<td>Funds Raised</td>
<td>2</td>
<td>1</td>
<td>11</td>
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<td>Cap under Mgmt</td>
<td>$6 Billion</td>
<td>$350 Million</td>
<td>$2.5 Billion</td>
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<td>2</td>
<td>235</td>
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</tr>
<tr>
<td>LBO</td>
<td>Yes</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>MBO</td>
<td>Yes</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Go-Private</td>
<td>No</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Carve-outs</td>
<td>Yes</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Spin-offs</td>
<td>Yes</td>
<td></td>
<td>No</td>
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<tr>
<td>Recapitalization</td>
<td>No</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Acquisition Finance</td>
<td>Yes</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Buyout Investment Strategy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>$100-10k mil.</td>
<td>$50-250 million</td>
<td>$50-250 million</td>
</tr>
<tr>
<td>Cash flow Status</td>
<td>CF+ or BE</td>
<td>CF BE or slight +/-</td>
<td>CF BE or +</td>
</tr>
<tr>
<td>Equity Financing</td>
<td>$100-500 mil.</td>
<td>Up to $50 million</td>
<td>Up to $50 million</td>
</tr>
<tr>
<td>Leverage(Debt)</td>
<td>Yes</td>
<td></td>
<td>Yes</td>
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<td>Recent Deals</td>
<td>Wyse</td>
<td></td>
<td>Comm-works</td>
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<tr>
<td>LBO</td>
<td>-</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>MBO</td>
<td>-</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Go-Private</td>
<td>SunGuard</td>
<td></td>
<td>Comm-works</td>
</tr>
<tr>
<td>Carve out</td>
<td>Instinet Group</td>
<td>Ingres, Blade Network</td>
<td>-</td>
</tr>
</tbody>
</table>

Figure 5-2: Analysis of top 3 tech buyout firms
5.3 Silver Lake Partner Overview

*Source: Silver Lake Partner’s website*

The PE firm Silver Lake Partners concentrates on investing in prime US and global technology firms. They partner with leading management teams who invest capital and expertise to expand their market leadership.

Silver Lake invests in companies with a successful, established business model and sustainable competitive advantages; the firms they choose are also well positioned to grow revenue and profits. Silver Lake seeks firms who are leaders in their industry niches, with expert management teams, and proprietary technology and business processes.

When considering a firm in which to invest, Silver Lake first meets with management teams to ascertain their operational goals and assesses their ability to meet their goals. Its managers then design a transaction structure geared for identifying and securing investment prospects. Their guiding principle: a transaction structure should aim to expand and enhance the firm’s ability to successfully compete within the high-stakes global technology market.

Traditional PE firms have not focused heavily in technology investments; in fact most have focused on identifying investment structures such as buyouts or mergers rather than on a specific sector such as technology. To date, PE firms generally have avoided technology companies for various reasons, possibly due to the technology bust of the 2001 and the uncertainties in the sector.
Silver Lake, however, views the technology industry as a sound investment because it has recently reached a level of maturity yet has much room for growth. It seeks to invest in relatively “young” companies that are emerging market leaders, and in mature companies developing a leading edge in key sectors.

The firm’s primary aim is to add value to their portfolio companies by investing large sums — on average — $100-$500 million in firms that possess enterprise values of up to $10 billion and more. Silver Lake does not limit itself to one type of transaction but instead pursues many types of investment structures, spanning the ownership spectrum from ownership and control to minority investment:

- Leveraged buyouts and going-private transactions
- Spin-offs and carve-outs from larger companies
- Restructurings and recapitalizations
- Structured minority investments and strategic stakes
- Acquisition finance

### 5.3.1 Funds Raised

<table>
<thead>
<tr>
<th>Fund</th>
<th>Size($M) (Stage)</th>
<th>Vintage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silver Lake Partners (unspecified)</td>
<td>0 (Buyout)</td>
<td>1998</td>
</tr>
<tr>
<td>Silver Lake Partners, L.P.</td>
<td>$2312 (Buyout)</td>
<td>1999</td>
</tr>
<tr>
<td>Silver Lake Partners Cayman, L.P.</td>
<td>$64 (Buyout)</td>
<td>2000</td>
</tr>
<tr>
<td>Silver Lake Partners II, L.P.</td>
<td>$3600 (Buyout)</td>
<td>2004</td>
</tr>
</tbody>
</table>

**Figure 5-3: Silver Lake Partner Funds**
5.3.2 Seagate Transformation

Seagate, based in Scotts Valley, Santa Cruz, California is one of the leading supplier of hard disc drives that are used in wide-range of Enterprise, Desktop, Mobile Computing and Consumer Electronics applications. Seagate is well known for delivering award-winning products, customer support and reliability to meet the world's growing demand for information storage.

On November 22, 2000, Silver Lake Partners, a lead investor in a go-private club deal including Seagate management, leading private equity firms (Texas Pacific Group, Chase Capital Partners) and Venture capitalist firms (Integral Capital partners and August Capital) acquired Seagate for $2.2 billion. Veritas Software Corporation, now acquired by Symantec Corporation was part of the buyout through divesting of Seagate's 33% stake worth of $18 billion through share buyback. Silver Lake invested $345 of the total $1.1 billion equity financing and raised approximately $1.3 billion high yield debt from Chase Capital Partners and Goldman Sachs. As part of the go-private transaction a new holding company SAC (Seagate Technology holding company) was formed and Silver Lake appointed Ed Zander, former COO of Sun Microsystems well known as a strategy expert with strong operating expertise, as the Chairman and CEO of SAC.

Seagate is considered as one of the most successful tech buyout in the post bubble burst times. The above figure describes Seagate Corporations corporate restructuring using Delta Model and Growth matrix. As shown in the figure, before restructuring Seagate Corporation had four divisions pursuing a low-cost and differentiated strategy.
The OEM business was cash-cow as major computer manufacturers such as Dell, Sun and HP integrated their hard drives in computer products. The Enterprise storage division was a growth business with good operating margin. The tape division became a victim of cannibalization as customers migrated to RAID and operated centralized data backup/recovery.

![Seagate Before Restructuring](image1)

![Seagate After Restructuring](image2)

Figure 5-4: Delta model of Seagate Transformation
After going private, Seagate was transformed from a low-cost hard disk drive manufacturer to solutions’ company. As shown in the figure, after restructuring, the company offered horizontal breadth of products for each customer segment (personal, network, consumer electronics, etc.). The enterprise storage division was restructured to address the growing need of rack-servers and modern data centers. In fiscal year ending June 2002, Seagate’s net income was $449 million and EBITDA was $967 million. The company completed $1 billion IPO in December 2002. The company became a market leader with 28.3% market share and attained superior technological forefront as a result of the buyout.

5.4 Garnett and Helfrich Overview

Source: Garnett & Helfrich Capital’s website

Garnett & Helfrich Capital fund (GHC), initiated in March 2004, was the first fund to focus on investing primarily in emerging venture buyouts of mid-cap technology spinouts. The fund began with $250.2 million in capital from institutional investors and educational endowments and has expanded to $350.4 million to date. It invests in technology firms and business units’ buyouts in enterprise software, communications, networking, semiconductors, data processing, and the Internet (content and infrastructure). GHC looks for high visibility firms with a record of technological excellence, a strong customer base, and annual revenue of $40 million to $200 million. However, the firms they select need not be profitable or have positive cash flow and they may require new technology and investment to expand. These spinouts must have the potential to expand significantly without the help of their parent companies. This requires savvy entrepreneurs who are able to operate their business in a highly
competitive environment while enjoying the risks and benefits of ownership including ultimate control.

Since the mid-1990s, many stagnant business units of large conglomerates have been acquired by larger and smaller firms alike and turned into major, successful technology firms. GHC looks for such opportunities and has helped managers finance buyouts of business units from conglomerates and turn them into world leaders. Their ultimate aim is to rejuvenate lagging business units with potential by infusing them with capital, management expertise and business networks. In some cases, company founders and CEOs eventually want to buy back their “children” when they are better functioning. GHC looks for such buyback opportunities, often called "venture buyouts".

Unlike traditional buyout, GHC uses a partnership model in deal sourcing. They work closely with the management to propose and develop a carve-out or buyout target. In case of Wyse, Terry met customers around the world during the deal sourcing stage. GHC typically invests 50 cents on a dollar worth of first year cash flow in equity financing. They develop a 1 yr transition plan targeting new growth within 1 year and demonstrating both top-line and bottom-line results. In terms of company buyouts, GHC buys companies with $20 to $100 million in annual revenues that appear to be undervalued and have potential of 5-10x; firms with this amount of annual revenue have likely cleared initial acquisition problems as well.
5.4.1 Funds Raised

<table>
<thead>
<tr>
<th>Fund</th>
<th>Size ($M) (Stage)</th>
<th>Vintage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Garnett &amp; Helfrich – Unspecified fund</td>
<td>0 (Buyout)</td>
<td>2003</td>
</tr>
<tr>
<td>Garnett &amp; Helfrich, L.P.</td>
<td>$350 (Buyout)</td>
<td>2004</td>
</tr>
</tbody>
</table>

Figure 5-5: Garnett & Helfrich Capital Funds

5.4.2 Investment Profile & Selected Transactions

**WYSE Technologies**

Wyse is the world's leading provider of thin-client computing solutions. Wyse was founded in 1981 and became a leading supplier of terminals for mainframe and minicomputers. In 1995, Wyse introduced Windows based computer. Wyse offers hardware, software, and services that shift computing complexity to the network, freeing IT departments from unnecessary support and maintenance functions, empowering users to be more productive in their jobs, and protecting and improving access to critical information and business applications. Wyse operates in all major enterprise markets around the world and sells over $175 million of software and hardware systems each year. Today, Wyse counts over 40 percent of the Fortune 100 as customers and is the worldwide leader in thin-clients with 35 percent market share according to analyst firm IDC.

On April 11, 2005, GHC acquired a controlling equity stake in Wyse Technology, a market leading thin-client vendor, San Jose, Calif.-based Wyse Technology, for $35 million. Garnett & Helfrich Capital purchased a controlling stake in Wyse from the Koos Group located in Taiwan, who will retain an ownership position in the company. Garnett
& Helfrich Capital and the Koos Group will work together to bolster Wyse’s software business and support the company’s movement into underserved Asian markets.

**INGRES Corporation**

Ingres Corp is the world’s leading provider of business open source relational databases for companies of all sizes. Ingres Corp’s mission is to supply the market with the best database technology at a price point that enables customers, both large and small, and partners to reduce their Total Cost of Ownership. Based in Redwood City, California, Ingres Corp is a young and dynamic company.

On November 7, 2005, Garnett & Helfrich Capital announced carve-out of Ingres Corporation from Computer Associates (CA). GHC will own majority shares in Ingres and CA has an ownership stake in Ingres and right to appoint a member to its Board of Directors. CA also intends to work with Ingres on product development, industry partnerships and marketing activities.

As an independent entity, Ingres is focused exclusively on the development dynamics and business opportunities associated with the open source market. The divestiture will also enable CA to focus on its core strategic markets, which include systems and security management for the enterprise.
5.5 Morgenthaler Overview

Source: Morgenthaler’ website

Morgenthaler, founded in 1968, is a leading venture capital and buyout firm. It is considered a pioneer in private equity industry and the founder David Morgenthaler, who took a leadership role in establishing legitimacy and potential of then nascent venture capital industry, became the president of National Venture Capital Association in 1979.

Morgenthaler is a hybrid also commonly known as multi-strategy fund with approximately $2.5 billion under management, including $450 million in our current fund (capitalized in October of 2005). The firm invests in early stage and late-stage in high technology sectors such as semiconductor, information technology, life-sciences and other high technology areas. The firm also focussed on traditional leveraged or management buyouts. It invests in profitable, stand-alone middle-market companies, and divisions or subsidiaries of larger corporations. It focuses on advanced manufacturing and business and industrial services.
5.5.1 Funds Raised

Morgenthaler raised its first institutional round in 1980 and has raised 8 funds. Morgenthaler balanced stage funds is both a venture capital and buyout funds. The venture capital fund invests in both early stage and late stage investments in information technology and life-sciences. Whereas, the buyout fund invests in all industries.

<table>
<thead>
<tr>
<th>Fund</th>
<th>Size ($M) (Stage)</th>
<th>Vintage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chester Associates (Morgenthaler)</td>
<td>80 (Expansion)</td>
<td>1980</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners</td>
<td>$20 (Balanced Stage)</td>
<td>1981</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners II, L.P.</td>
<td>$70 (Late Stage)</td>
<td>1985</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners III, L.P.</td>
<td>$68 (Balanced Stage)</td>
<td>1989</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners IV, L.P.</td>
<td>$136 (Early Stage)</td>
<td>1995</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners V, L.P.</td>
<td>$303 (Balanced Stage)</td>
<td>1998</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners VI, L.P.</td>
<td>$570 (Late Stage)</td>
<td>2000</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners VII, L.P.</td>
<td>$868 (Early Stage)</td>
<td>2001</td>
</tr>
<tr>
<td>Morgenthaler Venture Partners VIII, L.P.</td>
<td>$450 (Balanced Stage)</td>
<td>2005</td>
</tr>
</tbody>
</table>

Figure 5-6: Morgenthaler Funds
5.5.2 Investment Profile and Selected Transactions

Morgenthaler raised its first institutional round in 1980 and has invested in over 235 companies in past 26 years. As a hybrid fund, investments range from early stage to buyouts. The following table summarizes the portfolio breakdown by stage.

<table>
<thead>
<tr>
<th>Stage</th>
<th># of Investments</th>
<th>Invested Capital ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Startup/Seed</td>
<td>49</td>
<td>$73</td>
</tr>
<tr>
<td>Early Stage</td>
<td>79</td>
<td>$255</td>
</tr>
<tr>
<td>Late Stage</td>
<td>88</td>
<td>$354</td>
</tr>
<tr>
<td>Expansion</td>
<td>130</td>
<td>$584</td>
</tr>
<tr>
<td>Buyout</td>
<td>35</td>
<td>$175</td>
</tr>
</tbody>
</table>

*Figure 5-7: Morgenthaler portfolio by market*
Chapter 6 Conclusions

The unsurprising trend from the analysis is that the buyout industry is experiencing large capital inflows and unprecedented growth, especially in the technology-oriented industries such as high technology, media and telecom. This is supported by the fact that the top 5 multi-billion transactions of 2005 (shown in Figure 4-9) were technology companies and Silver Lake Partners executed the largest buyout transaction in the past 5 years, acquiring SunGuard for $11.3 billion. The analysis also concludes that the scale and scope of these tech buyout transactions, especially go-private and carve-outs transactions, have been rising since 2000 and the top quartile buyout funds continue to perform better and are raising bigger funds.

The general conclusion from the analysis of tech buyout firms, trends and transactions is that firms need to complement the creative financial techniques with strategy focus and strong operating expertise in order to succeed. The buyout firms are becoming institutionalized with new management structure and by recruiting operating partners. Similarly, venture buyout firms are combining venture practices with traditional buyout suggests that operating expertise is essential and a source of differentiation.

The role of operating partners is greatly exemplified in the deal sourcing stage as firms spend more time in deal sourcing stage than in the financing stage. In this phase, they develop a winning strategy and a detailed post-financing operating plan. In section 2.4.5 (Figure 2-3), I propose use of BCG growth matrix and Delta model to develop a
corporate restructuring strategy in the deal sourcing stage. Analysis of Silver Lake Partner’s acquisition and restructuring of Seagate with a successful $1 billion IPO in 2002 supports the fact that buyouts with operational focus have superior returns. The key success factors observed in tech buyout are similar to that in a venture capital industry. Therefore, in general it would be considered as acceptable hypothesis that most tech buyouts driven by strong strategy and operation focus have been justified by the enhancement of shareholder values.

The enactment of the Sarbanes-Oxley act in 2002 and wide acceptance of the executive compensation reforms and role of the compensation committee on corporate boards suggests the important role played by shareholder activists, especially hedge funds and private equity activists. The evidence of going-private and passage of Sarbanes-Oxley act is inconclusive. However, academic research supports the conclusions that private equity led restructuring and improved corporate governance are justified a positive market valuation.

Finally, the buoyant mergers and acquisitions market is attracting many formidable competitors. Traditional buyout firms face increased competition from mega-funds, venture buyouts and hedge-funds. Corporate buyers are driving purchase multiples and bank multiples have risen as a result of wide open debt market. Private equity sponsors are investing 25-50% equity and less leverage. In distressed buyouts and hedge fund transactions, “second-lien” have become a popular mechanism to take corporate control. In conclusion, the buyout industry is in a period of rapid and irreversible transformation.
Chapter 7 Interview List

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Partner: Wilson Sonsini Goodrich & Rosati
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Co-chair: NASDAQ Listing and Hearing Review Council

MEGAN GATES

Member: Mintz, Levin, Cohn, Ferris, Glovsky and Popeo P.C

DAVID HELFRICH

General Partner: Garnett & Helfrich Capital L.P.
Board Member: Ingres Software
Chairman: Blade Network Technologies

DREW LANZA

General Partner: Morgenthaler Ventures, L.P.
Board Member: Ultradots, Overture Networks, Unity Semiconductors
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*Co-ordinator:* AFL-CIO (Shareholder Initiatives)

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