

Generation Equity Advisors, LLC

2009-2010 Technology M&A Update and Forecast



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Advisors, LLC**

Tech Mergers and Acquisitions to grow in 2010

After a glacially slow start to 2009 in the mergers and acquisitions market, technology companies started buying again in the second half of the year and analysts expect the resurgence in takeover activity to continue in 2010.

Technology M&A activity in the United States hit lows of \$US3.1 billion in the first quarter and \$2.3 billion in the second quarter of this year, as measured by value of closed deals. Those numbers were a far cry from the \$13.8 billion posted in the second quarter of 2008 and the \$44.6 billion in the third quarter of 2008, according to a report by PricewaterhouseCoopers.

But the industry is starting to rebound with \$9.8 billion worth of closed deals in the third quarter of 2009. Future M&A activity is always hard to predict, but the trends are going in the right direction, analysts say.

"If you look at the first two quarters of the year it was almost at decade lows, which is pretty meaningful if you consider what else happened this decade" with the dot-com bubble bursting, says Rob Fisher, leader of PwC's tech M&A services group. "What we saw was basically the deal volumes doubled in Q3 compared to Q2 and actually basically doubled the year to date stats. Given the announcements we've seen over the last few months it's our expectation we will see another doubling."

Billion-dollar deals made a comeback in the third quarter of this year with announcements such as Xerox's \$6.5 billion purchase of Affiliated Computer Services and Dell's planned acquisition of Perot Systems for \$3.9 billion.

Dell's acquisition of Perot closed in the fourth quarter and Xerox-ACS is still pending and so they are not included in the third-quarter figure. Another pending deal that could boost the stats is Oracle's \$7.4 billion purchase of Sun, which is being reviewed by European regulators.

A shortage of M&A activity as well as a slowdown in the IPO market has made it difficult for new technology companies to secure venture capital funding, because investors are wary of putting money into new companies when they haven't received liquidity on prior investments. The venture capital industry will continue to shrink dramatically over the next three to five years, according to the National Venture Capital Association ("NVCA").

But as long as the stock market doesn't crash again, the tech industry should see healthy levels of acquisitions and IPOs in 2010, says an analyst at Dow Jones. "There's been a pretty torrid pace of tech deals in the second half of 2009. Even if the stock market can just bumble along where it is, we think M&A will continue to increase its pace." As the market stabilizes, it's easier to determine a fair price for an acquisition, reported the analyst at Dow Jones.

"2009 was kind of an odd year because the macroeconomic environment was so uncertain," Dow Jones reports. "The uncertainty and instability is always a problem when you think about making big decisions about mergers and acquisitions. A degree of stability next year should definitely help."

Many small start-ups that were nearly ready for an IPO but did not go public because of economic conditions are likely to take the plunge in the first half of 2010.

This in turn will drive further M&A activity as big companies go for takeovers to preempt the IPOs.

One of the next logical questions is which types of tech companies will do the buying in 2010, and what types of companies will they take over.

Facebook, Twitter and LinkedIn are potentially hot properties in the social networking industry. Creating financial value in Facebook and Twitter will be a challenge, however, and therefore the list of companies willing to shell out big bucks for the sites is limited, Armstrong said. Armstrong believes LinkedIn may have more value to potential acquirers because the site is built around a quite significant type of transaction – the hiring of new employees.

In the enterprise market, **Xerox-ACS, Dell-Perot and HP-EDS** are examples of big tech vendors buying IT services firms, part of a trend in which IT vendors are seeking to become one-stop-shopping destinations. Oracle, a software company, is attempting to buy Sun, a hardware company, and HP is trying to become more like Cisco by purchasing switch and router vendor 3Com.

The convergence of historically segregated markets like networking, storage and server technologies, and convergence of hardware with software and services, is likely to trigger further acquisitions, Fisher says. Customers are demanding better pricing and vendor and product consolidation, putting the squeeze on pure-play vendors competing against larger, diversified product and service providers, he says.

Trying to predict unpredictable events like mergers and acquisitions "is a great

way to make yourself look stupid," Armstrong says, noting that analyst forecasts often turn out to be wrong. Many of the big vendors don't have an obvious need for a giant transaction along the lines of Oracle-Sun, so it's hard to say which companies are likely to pull off a blockbuster deal, he said. "Does Cisco need to buy anything now? No. Does HP? No. Does IBM? No. They might be opportunistic and snap up something small, but they all have big, complete portfolios. There's nothing that screams out 'how can they compete without X?'" Armstrong says.

Still, there are interesting cases like Juniper. Many of Juniper's investors would likely be happy if Cisco bought the company, but assuming that doesn't happen perhaps Juniper would bulk up itself by taking over competitors Riverbed, F5 or Blue Coat, he says.

More broadly, interest in healthcare IT and the desire of tech companies to expand market presence in China are factors likely to create more M&A activity. Ultimately, the downturn in 2009 will just be seen as a temporary interruption of a longer-term trend toward industry consolidation through mergers and acquisitions, Fisher says.

"Our perspective is this is basically the continuation of what's been a five-year trend in which the technology industry in general, which is consolidation," he says. "We view that as having been interrupted by the recession. At least in the last two quarters, that consolidation wave has reignited and we're seeing increases in activity and overall deal volumes and values as a result. In a broad sense, we no reason to expect that won't continue."

Gartner Says IT Spending to Rebound in 2010 with 3.3 Percent Growth After Worst Year Ever in 2009

The IT industry is exiting its worst year ever, as worldwide IT spending is on pace to decline 5.2 percent, according to Gartner. When the recovery does settle in, Silicon Valley will no longer be in the driver's seat.

Worldwide enterprise IT spending will struggle more with IT spending dropping 6.9 percent. The IT industry will return to growth with 2010 IT spending forecast to total \$3.3 trillion, a 3.3 percent increase from 2009.

Gartner provided that while IT spending will increase next year, they cautioned IT leaders not to be overly optimistic. "While the IT industry will return to growth in 2010, the market will not recover to 2008 revenue levels before 2012," said Peter Sondergaard, senior vice president at Gartner and global head of Research. "2010 is about balancing the focus on cost, risk, and growth. For more than 50 percent of CIOs the IT budget will be 0 percent or less in growth terms. It will only slowly improve in 2011."

- The *computing hardware* market has struggled more than other segments with worldwide hardware spending forecast to total \$317 billion in 2009, a 16.5 percent decline. In 2010, spending on hardware spending will be flat.
- Worldwide *telecom* spending is on pace to decline 4 percent in 2009 with revenue of nearly \$1.9 trillion. In 2010, *telecom* spending is forecast to grow 3.2 percent.
- Worldwide *IT services* spending is expected to total \$781 billion in 2009, and it is forecast to grow 4.5 percent in 2010.

- Worldwide *software* spending is forecast to decline 2.1 percent in 2009, and the segment is projected to grow 4.8 percent in 2010.

On a regional basis, emerging regions will resume strong growth. "By 2012, the accelerated IT spending and culturally different approach to IT in these economies will directly influence product features, service structures, and the overall IT industry. Silicon Valley will not be in the driver's seat anymore," Gartner's Mr. Sondergaard said.

From a budget perspective, there are three important items that IT leaders must consider in 2010:

A Shift from Capital Expenditure to Operational Expenditure in the IT Budget — Concepts such as cloud services will accelerate this shift. IT costs become scalable and elastic. CIOs need to model the economic impact of IT on the overall financial performance of an organization. For public companies, they must show how IT improves earnings per share (EPS).

Impact of the Increased Age of IT Hardware — With delayed purchases of servers, PCs and printers likely to continue into 2010, organizations must start to assess the impact of increased equipment failure rates, and if current financial write-off periods are still appropriate. Approximately 1 million servers have had their replacement delayed by a year. That is 3 percent of the global installed base. In 2010, it will be at least 2 million. "If replacement cycles do not change, almost 10 percent of the server installed base will be beyond scheduled replacement by 2011," Mr.

Sondergaard of Gartner said. “That will impact enterprise risk. CFOs need to understand this dynamic, and it’s the responsibility of the CIO to convey this in a way the CFO understands.”

IT Must Learn to Build Compelling Business Cases — 2010 marks the year in which IT needs to demonstrate true line of sight to business objectives for every investment decision. IT leaders can no longer look at IT as a percentage of revenue. CIOs must benchmark IT according to business impact.

Gartner’s Mr. Sondergaard said three additional topics that were important in 2009 will continue to dominate IT leaders’ agendas in 2010. These three topics include:

Business Intelligence — Users will continue to expand their investments in this area with the focus moving from “in here” to “out there.”

Virtualization — IT leaders should not just invest in the server and data center environment, but in the entire infrastructure. In 2010, users will create the cornerstone for the cloud infrastructure. They will enable the infrastructure to move from owned to shared.

Social Media — Organizations are starting to scale their efforts in this space. The technologies are improving and organizations realize this is not only about digital natives. It’s about all client segments including the most significant: the population in the next 10 years, the above 60 year old generations.

While those topics are key to IT agendas today, Mr. Sondergaard highlighted three themes that will become important going forward. They include:

Context-Aware Computing — This is the concept of leveraging information about the end user to improve the quality of the interaction. Emerging context-enriched services will use location, presence, social attributes, and other environmental information to anticipate an end user’s immediate needs, offering more sophisticated, situation-aware and usable functions.

Operational Technology (OT) — OT is devices, sensors, and software used to control or monitor physical assets and processes in real-time to maintain system integrity. The rapid growth of OT is increasing the need for a unified view of information covering business process and control systems. OT will become a mainstream focus for all organizations.

Pattern-Based Strategy — This is a new model about implementing a framework to proactively seek, model, and adapt to leading indicators, often termed “weak” signals, that form patterns in the marketplace, and to exploit them for competitive advantage. A Pattern-Based Strategy will allow an organization to not only better understand what’s happening now in terms of demand, but also to detect leading indicators of change, and to identify and quantify risks emerging from new patterns rather than continuing to focus on lagging indicators of performance.

In Technology, transformative deals are the goal and “the battle over the data center and end-to-end services continues to drive the larger players.” Smaller players with intellectual property that can be leveraged will be a fit for large technology companies. Simultaneously, there will be consolidation of smaller and weaker companies, with a particular highlight on semiconductors.

In media and entertainment, strategic buyers are expected to focus on content

and distribution buyouts, as well as opportunities in new media.

On the IPO front, there is expected to be more private equity firms continuing to pursue exiting portfolio companies through IPOs in 2010. That is on the heels

of Q4-2009 being the most active private equity IPO-exit strategy since 2007. The big question, and risk, is of course a double-dip. As long as no significant equity market correction occurs, PwC is looking for IPO activity to gain in 2010.

The 10 Biggest Tech Mergers and Acquisitions of 2009

The top 10 mergers and acquisitions in the network industry in 2009 all cracked the billion-dollar barrier, and involved vendors in hardware, IT services, collaboration, storage, wireless infrastructure and other segments. IT behemoths such as Oracle, Cisco, Dell, HP, EMC and IBM were among the biggest spenders, according to **Network World**.

Here are the top 10 acquisitions from 2009 based on publicly disclosed transaction values, including some deals that are still pending and may not be completed until 2010.

1. Oracle-Sun: \$7.4 billion

It seems a long time ago that Oracle announced its blockbuster deal to purchase the struggling Sun Microsystems, giving the industry's largest database software vendor entry into the server and storage markets. The acquisition, still pending, was announced in April, and may even be blocked because European regulators are contending that combining Oracle's technology with Sun's open source MySQL database would violate competition laws. Oracle-Sun is by no means a done deal, but if it goes through it would give Larry Ellison new ammunition against Microsoft (in the database market) and against big hardware vendors such as IBM, HP and Dell.

2. Xerox-Affiliated Computer Services: \$6.4 billion

In one fell swoop Xerox was able to triple its services revenue from \$3.5 billion to \$10 billion a year with the purchase of business process outsourcer Affiliated Computer Services. The agreement, announced in September, combines 74,000 ACS employees with Xerox's staff of 54,000, which runs the company's longtime photocopier business and various document management technologies and services. Xerox believes ACS will help it penetrate new markets without huge amounts of overlap, saying that only about 20% of the companies' customers are common to both businesses.

3. Dell-Perot Systems: \$3.9 billion

Just days before Xerox's big move, Dell announced an agreement to buy Perot Systems, another major IT services firm founded by Ross Perot. Dell is betting that Perot will help it become a leading services company, and allow it to sell more hardware to existing Perot customers, many of whom are in the healthcare and government industries. Dell's purchase can also be seen as a response to rival HP's \$13.9 billion acquisition the previous year of EDS -- another services company founded by Perot.

4. Cisco-Tandberg: \$3.4 billion

Cisco, already a major player in collaboration products with WebEx and TelePresence, signed an agreement in October to purchase videoconferencing vendor Tandberg, which makes both video devices and network infrastructure products. The acquisition, if completed, could have both a direct and indirect impact on Cisco's bottom line, because expanded use of videoconferencing may increase network traffic, letting Cisco sell more switches and routers.

The deal, announced in October, is still pending. Shareholders initially objected to the acquisition but Cisco now appears to have won enough support to complete the merger.

5. Cisco-Starent Networks: \$2.9 billion

Cisco's multibillion dollar purchase of Starent, announced in October, boosts the vendor's IP-based mobile infrastructure for several types of wireless networks, including LTE and WiMAX. Cisco had already made an investment in WiMAX with the \$330 million purchase of Navini Networks in 2007, and a supply contract with Clearwire in 2009. But LTE is gaining steam as well, with both Verizon and AT&T saying they will use LTE for their 4G networks. Starent's technology has been deployed by more than 100 mobile operators in 45 countries.

6. HP-3Com: \$2.7 billion

HP is launching an assault on Cisco in the data center networking and convergence markets with its purchase of 3Com, a maker of switches, routers and security products. The deal, announced in November, gives HP a core switch, the H3C 12500, to compete against Cisco's Nexus 7000, as well as significant market presence in China. But the acquisition, which is facing a shareholder lawsuit, also suffers from overlap at the low end of the companies' switching lines and in wireless networking.

7. EMC-Data Domain: \$2.1 billion

EMC had to outfox rival NetApp to make this top 10 list, as the storage vendor won a six-week bidding war to purchase Data Domain and gain new technology in the data de-duplication market. De-duplication helps companies save money by reducing data storage needs, which is why both EMC and NetApp believe it will play a major role in the storage market in the coming years. NetApp originally had a \$1.5 billion signed agreement to purchase Data Domain, but EMC swooped in and kept raising the price until the smaller NetApp could no longer afford to stay in the bidding.

8. Emerson-Avocent: \$1.2 billion

Emerson is expanding its IT operations management portfolio with the addition of Avocent, which makes software, hardware and embedded technologies designed to simplify management of complex data centers. Emerson said Avocent's configuration and monitoring technologies are complementary to its own power, energy management and cooling systems, and will thus help customers tackle the growing problem of energy inefficiency. The acquisition, which will also expand Emerson's capabilities in the KVM switching market, is expected to close around Jan. 1, 2010.

9. IBM-SPSS: \$1.2 billion

IBM is spending more than \$1 billion to expand its analytics software capabilities, with SPSS and its predictive analytics tools that help companies mine historical business data to identify future trends. "IBM sees potential applications for SPSS tools in helping financial services companies retain customers, preventing crime and picking the optimal site for a new store or factory," the IDG News Service reported in July when the acquisition was announced. The purchase is just the latest step in IBM's strategy of bolstering its line of business analytics

tools. Previously, Big Blue acquired data discovery technology from Exeros and paid \$5 billion for business intelligence vendor Cognos.

10. Ericsson-Nortel Networks' wireless assets: \$1.13 billion

Ericsson won a bidding war over the wireless assets of bankrupt Nortel Networks, beating out offers from Nokia Siemens Networks, the private equity firm MatlinPatterson and Research in Motion. Specifically, Ericsson won Nortel's CDMA

and LTE wireless networking business, allowing the Swedish company to strengthen its presence in North America. "Nortel customers in North America that will now be supplied by Ericsson include Verizon Wireless, Sprint, U.S. Cellular, Bell Canada, Leap and Telus," Network World reported when the deal was announced in July. Because of the Nortel purchase and other strategic deals, Ericsson will have 14,000 employees and \$5 billion in revenue from North America.

NABE Economists predict GDP growth of 3.2 percent in 2010

Reaffirming last month's call that the Great Recession is over, panelists for the National Assn. for Business Economics ("NABE") have marked up their predictions for economic growth in 2010 and expect performance to exceed its long-term trend. "While the recovery has been jobless so far, that should soon change. Within the next few months, companies should be adding instead of cutting jobs," said NABE President Lynn Reaser. Panelists predict a relatively sluggish consumer upturn but look for a sizable housing rebound, low inflation, and further rise in stock prices. Importantly, panelists are mostly (though not entirely) optimistic that the Federal Reserve's policies will not lead to higher inflation.

At the same time, NABE panelists are "extremely" concerned about high federal deficits over the next five years.

The fourth quarter of 2009 is now slated for a 3.0 percent pace of real GDP growth and 2010 is predicted to experience a gain of 3.2 percent over its four quarters. For the two years combined growth is expected to be one-half of a percentage point above the forecast made in October. Economic growth is projected to slightly exceed its

trend pace-which NABE panelists estimate at 2.7 percent-over the next five quarters.

Real GDP growth should also be enough to recover losses from the recession and return output to an all-time high by the end of 2010, the panelists said.

NABE panelists believe the end of net employment losses is near, with modest declines during the fourth quarter followed by a "bottom" in the first quarter of 2010 and gains thereafter. Still, given the severity of employment losses during the past two years, most panelists (61 percent) do not expect a complete recovery of the previously lost jobs until 2012. Additionally, the unemployment rate is predicted to remain stubbornly high, averaging 9.6 percent in the final quarter of next year. When asked to rank "concerns" over the next five-year period, panelists ranked high unemployment second only to the federal deficit.

The November 2009 NABE Outlook presents the consensus of macroeconomic forecasts made by a panel of 48 professional economic forecasters. The survey, covering the outlook for 2009 and 2010, was taken October 24-November 5, 2009.

Generation Equity Advisors, LLC is an independent M&A advisory firm focused exclusively on the technology and digital media industry sectors.

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