

# US technology M&A insights

Q3 2009 update

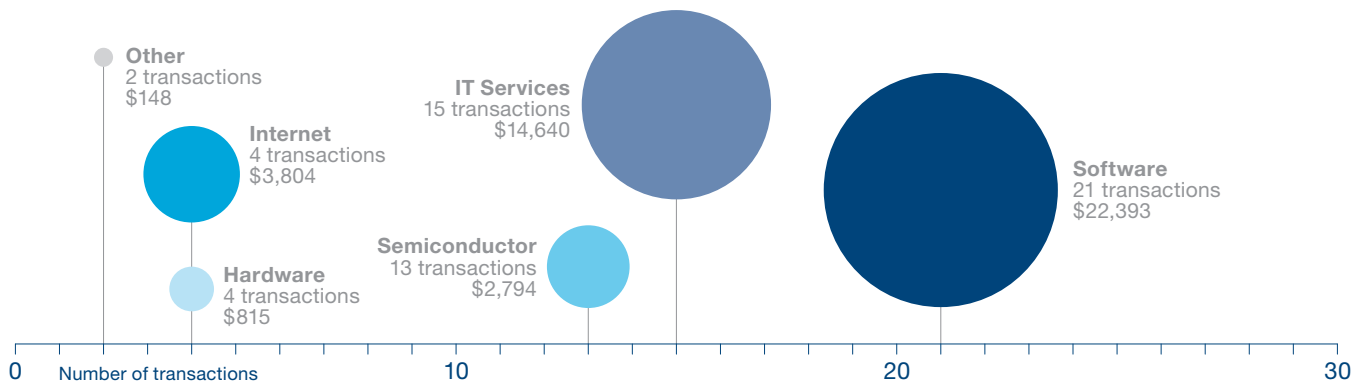
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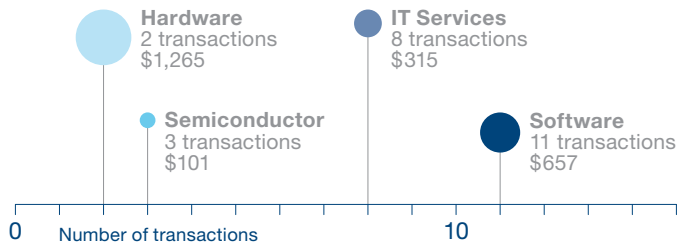
## Number of closed technology deals and deal value by sector, \$US million

Bubble size indicates the total deal volume for the sector.

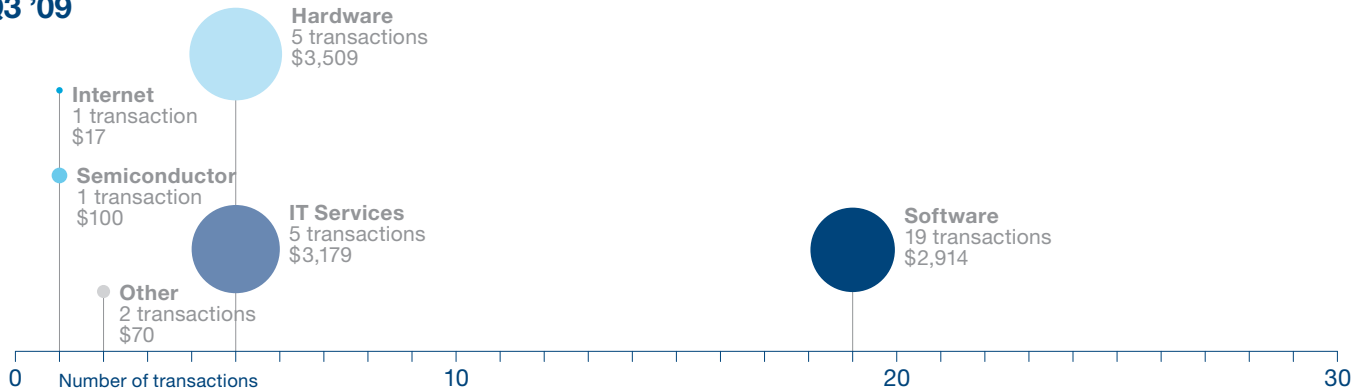
### Q3 '08



### Q2 '09



### Q3 '09



Source: DealLogic

## Billion-dollar deals stage a comeback

Welcome to the third-quarter 2009 update of PricewaterhouseCoopers' US technology M&A insights.

The re-emergence of larger, strategic, transactions—which began to take shape in the second quarter of 2009, continued to gather momentum during the third quarter with the announcement of several billion dollar-plus transactions. It is no coincidence that these deal announcements followed statements by some technology CEOs that they believed the recession had bottomed out and they would see growth in their core businesses soon.

### Key announced transactions

The largest technology companies, with over \$150 billion in cash on their collective balance sheets, are well placed to take advantage of the increasing alignment of buyers and sellers regarding expected valuations. This has partly been facilitated by the extended bull run of most technology stocks. Even the companies that aren't sitting on a war chest of cash are finding the market opportunities too good to pass up and thus accessing thawing debt markets to fuel their growth plans.

During the third quarter, acquisitions were heavily weighted toward the service, hardware, and software targets that allow value-added services to extend an existing portfolio. Among the most notable announced during the third quarter:

- Xerox's acquisition of Affiliated Computer Services for \$6.5 billion;
- Dell's proposed acquisition of Perot Systems for \$3.9 billion; and
- Adobe Systems' proposed acquisition of Omniture for \$1.7 billion (which moves Adobe deeper into Web services).

M&A activity in the quarter got into full swing with the back-to-back announcements of two deals over the \$1 billion mark at the end of July:

- Agilent's planned acquisition of Varian Inc. for \$1.5 billion; and
- IBM's announced \$1.2 billion deal for software data analysis company SPSS.

The Agilent/Varian transaction, like the Oracle-Sun transaction announced in the second quarter, seems destined to take longer to close in light of interest from both US and overseas regulators. This trend toward increased regulatory scrutiny appears to be gathering momentum, and will likely be exacerbated by deals involving a Chinese regulatory review.

In addition to the reawakening of technology giants, the third quarter also saw the early beginnings of the return of private-equity transactions, with Silver Lake taking the lead for a planned consortium acquisition of Skype for \$1.9 billion. EBay has continued to have involvement in Skype, retaining 35% of its former subsidiary. The acquiring consortium utilized a 2:1 debt-to-equity ratio, significantly down from pre-credit crunch leverage and a possible harbinger of the future.

In the Internet arena, the Skype transaction was joined by Amazon's acquisition of Zappos for \$847 million and Intuit's acquisition of Mint for \$170 million as the convergence of the Internet and software as a service (SaaS) continues to be attractive—when the right business model appears.

While software, hardware, and IT service companies joined the fray in the third quarter, players in the semiconductor sector remained conspicuously quiet, although a good deal of semi-conductor activity continues behind the scenes.

North of the border, Canada's technology sector saw continued announced deals for acquisitions of pieces of Nortel, including:

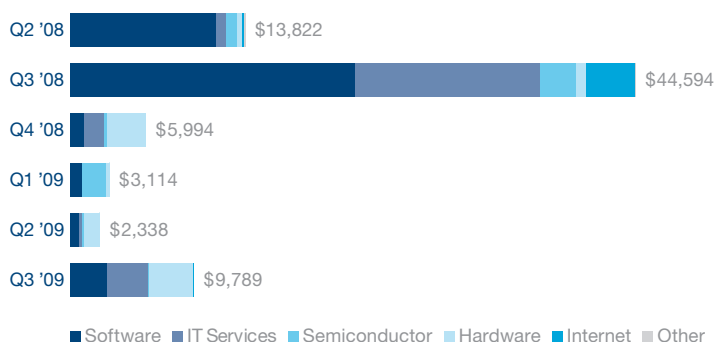
- Ericsson's acquisition of the wireless business for \$1.3 billion; and
- Avaya's acquisition of parts of the communication business for \$915 million.

It seems likely that stalking horses will continue to emerge to take on pieces of the Nortel business, with the Metro Ethernet Networks unit next on the auction block.

We expect to see continued growth in M&A activity across technology, with Semiconductor transactions likely to rejoin the ranks before the year is out. Large IT service company deals may slow, due to a winnowing of likely targets, but we expect more announcements of transformational deals in the hardware and software sectors, particularly storage, networking, and SaaS.

While it is unlikely that the remainder of the year will break any records, the second half of 2009 should significantly outpace the gloomy first two quarters.

### Closed deal value by sector, \$US million



Source: DealLogic

### Key closed transactions

Switching from announced deals to those that have closed in the quarter—technology transactions closing in the third quarter of 2009 were up 420 percent from the preceding quarter, yet were still down 80 percent on the same period a year ago (an outsize quarter in its own right). With the closing of three transactions greater than \$1 billion and two above \$500 million, the third quarter put in a respectable showing compared with the rest of the year to date and boasted an average deal value of \$300 million.

Among the most significant transactions closing during the quarter:

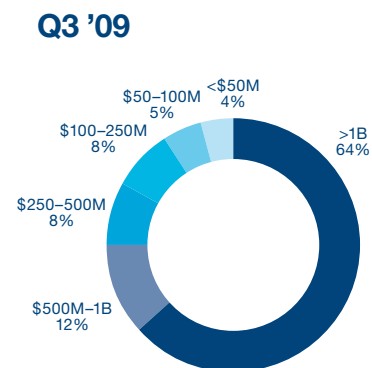
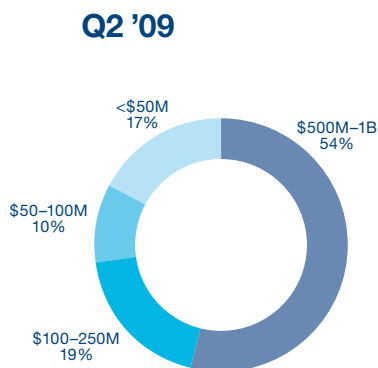
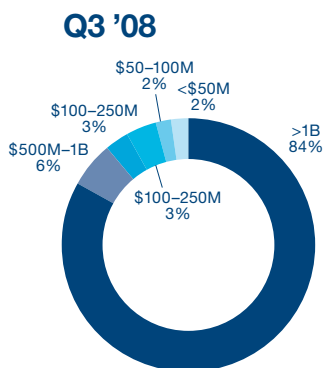
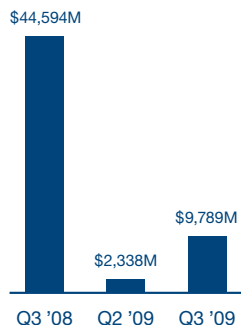
- Fidelity Information Services' acquisition of Metavente for \$2.9 billion, a transaction indicative of the ongoing consolidation of business process outsourcers in the IT space and which partially foreshadowed the Dell and Xerox transactions.
- EMC's acquisition of Data Domain for \$2.2 billion, an all-cash transaction that closed quickly with only US competition authorities involved.
- Intel's acquisition of Wind River Systems for \$1.1 billion.
- General Dynamic's acquisition of Axsys Technologies (a maker of military imaging systems) for \$628 million.
- Safran's acquisition of GE's security division for \$580 million, which strengthens Safran's homeland security offering.

Also of note, VMware's acquisition of Spring Source Global for \$362 million was a reminder that early stage companies with desirable IP continue to have an alternative to the rocky IPO markets.

Finally, continuing the nine month-long trend of famous names being acquired as the downturn bites, Micro Focus acquired Borland Software Corporation, at one stage the second largest software company behind Microsoft, for \$110 million.

## Top closed US deals by value

### Change in total deal value



\$ in millions, except #	Q3 '08		Q2 '09		Q3 '09	
	Number of deals	Total deal value	Number of deals	Total deal value	Number of deals	Total deal value
< \$50M	24	735	16	403	15	345
\$50M to \$100M	11	727	3	234	6	446
\$100M to \$250M	10	1,563	3	436	5	797
\$250M to \$500M	4	1,219	0	-	2	753
\$500M to \$1B	4	2,765	2	1,265	2	1,208
> \$1B	6	37,585	0	-	3	6,240
<b>Total</b>	<b>59</b>	<b>\$44,594</b>	<b>24</b>	<b>\$2,338</b>	<b>33</b>	<b>\$9,789</b>

Source: DealLogic

# New revenue recognition rules can dramatically affect due diligence approach, integration planning, and valuation models: what dealmakers need to know

## Non-comparative historic revenue, more complex post-deal modeling, perhaps lower post-deal deferred revenue haircuts

In technology deals, revenue and the post-deal modeling of revenue have always been extremely complex. In part, this reflected the increasingly widespread use of software accounting rules by technology companies as software became a key, distinguishing component in advanced technology devices, from ultra-sound machines to gigabit routers.

These accounting rules for software resolved numerous longstanding industry issues, such as the ability to give additional zero-marginal cost products to dissatisfied customers at no charge. But the rules had the unintended consequence of providing hardware companies that fell under the software rules accounting results that do not reflect the economics of their transactions. The revised rules are having an enormous impact on the finance and sales departments of virtually all the major technology companies, as they implement these standards and gain the accounting and commercial advantages they offer.

Under the new rules, companies that have revenue contracts with multiple deliverables—which were not all being delivered at the same time—and for which they have been unable to establish fair value of some of the elements under the old rules, will be required to use best estimate of selling price to separate and allocate the revenues related to the elements. The residual method (i.e. deferring the fair value of the undelivered item and allocating the remainder to the delivered item, thereby pushing any discounts in the arrangement to the delivered item) will no longer be permitted and companies will be required to allocate using the relative selling prices of the elements. This “best estimate of selling price” may be new data that finance departments will be gathering for the first time.

For example, companies that sell hardware bundled with a service agreement and historically “carved out” (deferred the fair value) of the service agreement and allocated the remainder to the hardware (the residual method) will now

## Deal impacts

- Companies considering targets prior to the implementation of the new guidance should consider the target’s plan for implementing the changes and assess the integration impact.
- Companies considering targets that have implemented the new guidance should understand the methodologies the target uses to separate and allocate arrangement consideration because the new standards allow wider discretion than the current accounting model. Accordingly, greater scrutiny should be applied to such judgments and estimates during due diligence.
- The immediate deal impact will likely be an increase in revenue in the initial period, since more revenue can be taken up front for deals signed after adoption. Teams will need to consider the quality of earnings impact during the transition period.
- Haircuts on deferred revenue in purchase accounting will likely be lower because there will generally be less deferred revenue due to absence of evidence of fair value of the deliverables.
- There may be faster accretion, and better synergies, from the greater flexibility the new standards provide.

be required to determine their best estimate of selling price for the hardware and allocate revenue between the hardware and service agreement based on relative selling price.

The effect of the revised standards (EITF 08-01 and 09-03) will be far reaching. Companies must now weigh the timing of implementing the changes while they revamp revenue

systems, reforecast results, and revise instructions to sales teams. These complications extend to acquisitions:

- A target's results may have a different timing in the future;
- A target's historic results may not indicate its future results (many companies expect a one-time revenue benefit from the new rules);
- The level of the deferred revenue haircut may be significantly lower; and
- Earn-outs which fall due in the next couple of years could be impacted as the new standards could affect the timing of revenue recognition.

Although the new rules do not change the total recognized revenue, the timing of revenue recognition and how that timing is determined can be very different.

#### Which companies will be affected?

- The rule changes may affect any target company that is not a completely pure software company. Even within certain software companies, subscription or SaaS offerings may be accounted for differently.

#### How will an acquisition target's results change?

- In the year of adoption, companies will generally have higher revenues and profitability, as post-adoption deals will often see more up-front revenue. For instance, the *Wall Street Journal* reported that Apple's revenue would be "much higher" as a result of the change. In due diligence, the impact of the rules on a company's historic and ongoing results should be determined to allow effective modeling.
- The new guidance allows companies wider discretion in determining the best selling price. However, this increased flexibility means that there will be much greater variability amongst companies in determining the appropriate methodology, putting greater importance on benchmarking and due diligence to

#### Numerical example

Assumptions:

- Agreement with a hardware installation service and a 12-month consulting service contract for a \$100,000 combined fee
- Hardware is useful by itself, without the consulting service
- The value of the hardware, installation and service could not be rigorously determined under the former guidance
- The best estimate of selling prices are:
  - hardware deliverable: \$90,000
  - installation service: \$5,000
  - consulting service contract: \$20,000
- Hardware delivered in Q4 2009
- Installation completed in Q4 2009

Analysis	Former accounting	New model
Units of accounting	1	3
Method of allocating the total sale price	N/A – Ratable	Relative selling price
Hardware allocation	\$0	\$78,000
Installation allocation	0	4,000
Consulting service allocation	0	18,000

Timing of recognition	Former accounting	New model
Q4 2009	\$25,000	\$86,500
Q1 2010	25,000	4,500
Q2 2010	25,000	4,500
Q3 2010	25,000	4,500

enable a better picture of how a target's results would look post-acquisition.

- Companies will have a great deal of flexibility in how and when they choose to adopt the new provisions, which will lead to less comparability.

### Impact on deferred revenue haircut

One impact of acquisitions under US GAAP has been a general reduction in deferred revenue at acquisition, which means lower revenues for the acquiring company, post acquisition. This has become a frequent non-GAAP adjustment in many post-acquisition press releases.

Because the new standards generally accelerate revenue recognition, they tend to lead to less deferred revenue, particularly the portion of deferred revenue relating to products with no significant remaining obligations. Since this has historically resulted in significant reductions, buyers should expect lower reductions in remaining deferred revenue balances upon acquisition. Some transactions may even see deferred revenue increase.

### Integration considerations

Acquisition target companies that are yet to implement the new standards (which do not have to be implemented until fiscal years beginning after June 15, 2010—so January 1, 2011 for calendar year end companies) will have to have considerable changes to their revenue process to align with an acquirer who has implemented the new rules—implementation that will need to be completed for the close of the acquisition:

- **Best estimate of selling price:** Companies will need to determine whether a target has a methodology for determining the selling price, whether it varies from their own, and then align and implement policies and processes around determining selling price.
- **Controls and systems:** Targets will need to make changes to their existing IT systems, report parameters and controls to both comply with the new rules and align with parent company policies, as well as any internal control considerations. Systems will need to be updated to accommodate the relative selling price method. Areas not previously considered part of financial reporting for SOX (such as pricing) may be subject to increased scrutiny.
- **Greater flexibility in how sales go-to-market, contract structuring, and pricing:** Companies may be able to relax some of the pricing/discounting policies that were previously constrained by the need to comply with accounting rules. Additionally, companies will have greater flexibility to include certain items in contracts that had previously resulted in full revenue deferrals (e.g. specified upgrades). Accordingly, the go-to-market approach for the target should be reassessed as part of sales integration planning.

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