TALKINGPOINT: M&A in the tech sector

FW moderates an online discussion on M&A in the tech sector between ***Nat Burgess*** *at Corum Group,* ***David R. Yates*** *at Hunton & Williams LLP, and* ***James Klein*** *at Penningtons Solicitors LLP.*

FW: What are some of the major trends you have witnessed in technology M&A over the last year or so? Have any particular deals caught your eye?

Klein: Global technology M&A volume in 2011 increased by around 11 percent. Private equity deal volume growth was strong throughout 2011; the aggregate value of PE backed deals in 2011 grew at nearly twice the rate of corporate deals, with investors being attracted by strong balance sheets and higher growth rates. Since the last quarter of 2011 deal volume in the sector has declined, with the value of disclosed deals falling significantly. During 2011 deal volume increased across the sector except for general software, with the same trend continuing into the first quarter of 2012, although software still has the highest deal volume of any sector. Within software, video technology (especially mobile) and Software-as-a-service (SaaS) deals increased and continued to do so. Social media, e-commerce, information management, cloud computing and IT security also flourished. In the Americas, PE investors were particularly focused on cloud computing/SaaS and healthcare technologies. The second half of 2011 featured a number of substantial deals, such as Hewlett-Packard's purchase of Autonomy Corp PLC for $10bn, Microsoft's acquisition of Skype and Google's all-cash buyout of Motorola for $12.5bn. Google's acquisition of Motorola is evidence of the trend of using M&A to gain control of valuable patents. Indeed, Google completed no less than 21 acquisitions in 2011, in addition to the 27 companies it acquired in 2010. The UK technology sector saw a number of overseas buyers in 2011 – in particular large US technology corporates on the UK acquisition trail like IBM, Google, Cisco, Amazon and Twitter – as well as a number of delistings. The balance sheet of the technology sector remains solid. The top 10 global technology companies have around $300bn in cash and are well positioned to fund M&A activity without the need to call on bank funding.

Burgess: Valuations are up, buyers are hiring corporate development personnel and actively seeking deals, and private equity buyers are more willing to 'lean forward' and credit aggressive EBITDA forecasts toward current valuations. 2012 is reminiscent of 2006, the last big run-up to a tech M&A peak.

Yates: We have seen more and more deals and activity in a number of technology sectors that are becoming further defined, including cloud computing, smart mobility (and particularly mobile payment systems) and 'big data' analytics. Cloud computing, as it has hit the mainstream and is accepted by an increasing number of large and small business and home users, presents unique opportunities for large strategics to round-out or expand their service offerings – many of which were completed in 2011 and now have the foundation in place – and for financials to pursue industry-specific middle market tech players to expand into cloud services in that industry. Meanwhile, the 'big data' analytics sector has seen tremendous activity as better value is being derived by the end-user from the output. So far this year, Dell's acquisition of AppAssure Software is particularly interesting since it is Dell's first software acquisition since it announced its new software group in February. The move highlights Dell's desire to move quickly on the software side with a focus on system management and cloud services.

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FW: What are the drivers of activity in today's market? Are there any segments or regions that seem to be offering a wealth of M&A opportunities?

Burgess: The premium tech M&A deals over the past 12 months have been driven by cross-border dynamics, diversification, and the explosive growth of certain key markets. US companies have billions in cash overseas, where they can put it to work on M&A, rather than repatriating it and facing stiff taxes. All of the major buyers we talk to, from Microsoft on down, are refining their strategies for buying quality companies offshore. In the last four months we have sold a French company to ANSYS, a Korean company to Intel, and have received other offers and indications from US companies looking to put offshore capital to work. Diversification is also a strong driver. Big tech companies are seeking the growth that they can't achieve in their legacy markets. They are placing bets in new areas. The segments that are drawing the most attention are cloud and data centre, mobile, collaboration, and customer engagement.

Yates: Financing and economic considerations are driving much of the activity in the tech sector. The biggest drivers are the low cost of borrowing, cash on hand by top technology companies, available capital of private equity funds and anticipated tax increases in 2013 for income and capital gains/dividends in the US. Interest rates have never been lower, and we have seen the return of 'near' covenant-lite loans for the right deals. However, lenders are requiring more equity which has not been an issue for strategic or financial buyers. As for the coffers of the top 20 US technology companies, they are filled with over $300bn of cash and marketable investments, according to PwC's March 2012 report. Similarly, private equity is sitting on billions of dollars of dry powder yearning to be invested. Finally, US sellers have an undeniable incentive to sell before 2013 to take advantage of lower capital gains/dividends tax rates before the 2013 increase go into effect. In order to achieve this, many of those deals are likely in process already. Even before the US Supreme Court's decision to uphold the Affordable Care Act, the healthcare industry was a key focus in the tech sector. The implications of the Affordable Care Act on the tech sector are undeniable, and will channel more focus and activity on the tech sector to serve and solve issues in the healthcare industry presented by the Affordable Care Act.

Klein: Technology M&A is generally being driven by smart mobility, wireless, cloud computing, social networking, and business intelligence/analytics. A number of our recent, and larger, cross-border deals have been in these sub-sectors. Key 'regions' for M&A opportunities include cloud computing, business intelligence and analytics, e-commerce, social media, information management, managed services, SaaS, IT security, online gaming and internet-and-mobile video technology. Recent deals by the likes of Zynga, such as its purchase of OMGPOP Inc., and Groupon Inc. suggest an evolving mobile commerce strategy towards smaller value deals. PE dealmakers appear to be ready for increased growth in the sector in 2012. They are focused on strategic acquisitions, driven by the opportunity to gain access to new technology and products, particularly within the communication and networking software sectors. The Economist has estimated that PE investors are sitting on $370bn in 'dry powder'. US buyers have been particularly interested in companies in Europe, the Middle East and Africa (EMEA) and although the value of EMEA deals fell in Q1 2012, the number of EMEA deals announced in Q1 2012 has increased. Although the current aggregate value of EMEA deals is down, the trend is towards out-of-region companies buying EMEA companies – three of global top 10 deals in Q1 2012 by dollar value involved US corporate or PE buyers and UK targets. The expectation is that European markets are ready to improve

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through 2012.

FW: What issues need to be considered when assessing business readiness for tech M&A transactions?

Yates: In preparing for any M&A transaction, a party is seeking to put itself in the best position possible. That includes getting its books and records in order and conducting an internal assessment to identify issues, and resolve those issues before going to market, before others do. So beyond the strategic and economic viability assessment, one of the key issues often overlooked is technology compatibility across systems. As outside systems are constantly evolving, keeping your system up-to-date and compatible requires continuous assessments as well as investments in your systems. Succeeding on this front would suggest that a company is proactive and is flexible enough to adapt to different environments which bode well for maximising value.

Klein: Tech companies preparing themselves for sale should have the following characteristics. Enhanced profile in relevant and appropriate markets. Existing partnerships to build compatible platforms and services for acquirers. Earnings predictability and the stability of earnings forecasts. Maturity of operational and financial controls – importantly, PE firms can often invest in more immature companies and help them to reach maturity, which makes them more attractive to corporate buyers. Attractiveness of the competitive position and strength of competitive barriers which the target company has in place. Stability and loyalty of the key customer base and ability of the business to switch to different vendors and suppliers. Ability of the business to extend the customer base over time.

Burgess: Due diligence is tougher than ever. Eurozone regulators are more protectionist than ever, looking for any excuse to avoid losing high quality companies to foreign buyers. There is heavy scrutiny on revenue recognition and long term deferred revenue. Companies interested in selling need good advice to manage these areas, and to present them properly and in a timely fashion.

FW: IP assets are one of the primary motivations for undertaking M&A in the tech sector. How can companies identify and unlock value and protect their IP?

Klein: A key step for companies in unlocking value is to first identify all IP. An internal IP audit to identify what IP a company has or is likely to acquire is recommended. This should identify both IP that is owned by the company and IP which the company uses under licence. Attention is typically focused on registered or registrable IP rights, such as patents, trade marks or designs. In the tech sector, unregistered IP is just as, if not more, important. A full IP audit should identify patents, (including applications), trade marks and trading names, designs (registered and unregistered), copyright, domain names, software, databases and key know-how and trade secrets. Copyright and database rights are commonly given insufficient attention. Copyright can exist in software, software specifications and release notes, operating and technical manuals, marketing literature and website content. Most companies have databases, for example containing information on customers and targets, in which IP rights may well reside. Protection of IP involves having a clear IP strategy. The value of IP may be undermined by infringement by third parties. Companies should proactively monitor and protect their IP. With trade marks it is advisable to subscribe to 'watching services' which identify potentially conflicting marks that are filed by third parties so that the company can take action at any early stage. Watching services are a relatively low cost, but extremely prudent, measure. Taking these steps can help

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demonstrate and unlock value in IP, and will also make an acquisition process much smoother.

Burgess: IP cuts both ways. A company with a strong patent portfolio can help a buyer defend a critical area, but also opens them to significant risk in the M&A process. For example, certain buyers who are under siege from patent trolls will open discussions with an NDA that includes a 'no enforcement' provision for patents. This stalls discussions before they can even get started. We have to choreograph a delicate dance to get the business units interested, while avoiding stalling out in legal. We recently sold two emerging tech companies with over 50 patents in their respective portfolios. The patents drove value, but had to be managed very carefully.

Yates: In tech M&A transactions, nothing is more important than conducting in-depth due diligence on the underlying IP assets. A buyer must ensure that the seller actually owns or has valid rights to the IP assets so that the buyer will enjoy the benefit of those assets going forward. A prudent buyer will ensure that IP assignments have been obtained from all applicable employees and contractors at the outset of their employment or engagement, or address consideration issues if such assignments are entered into afterwards or in connection with the transaction. Also, a buyer must address issues arising from any open-source code that may be present in applicable software coding. A buyer can protect itself in the purchase agreement through representations, warranties and indemnification relating to the IP assets. However, in an ideal situation, the remedies in the purchase agreement should serve as a backstop, and the due diligence should identify issues and determine if the deal should proceed. While most every party believes that their IP is unique and a market changer, a buyer should also conduct a landscape review of the seller's industry and competitors to ensure that the IP assets are in fact as unique and valuable as the parties believe they are. Additionally, a landscape review will provide a buyer with a better idea of possible infringement issues and potential claims. Of course, this is something that a seller should do as well in advance so that it is neither mischaracterising itself to buyers nor surprised by any results that a buyer would discover in its landscape review.

FW: How can companies overcome transactional challenges such as cyber security, privacy and data protection?

Burgess: There are some great consumer-grade file sharing platforms such as Dropbox and Livedrive. They don't belong in the M&A process. We know of at least one process that was compromised when buyer and seller tried to use a consumer platform to manage the data room – it has recently been reported that Dropbox was compromised on a large scale. For ongoing operations, emerging companies need to model their privacy and data protection policies and infrastructures after the practices of the large, entrenched players, or they will create risks that the buyers aren't willing to bear.

Yates: We are seeing significant investment by companies going into security and development and implementation of policies and procedures to maintain privacy and protect client data and other information. The old adage remains true today: an ounce of prevention is the best medicine. Compliance with US and EU privacy laws as well as data breach notification laws – which can vary by State in the US – requires a significant commitment by a company. Failure to maintain material compliance with these laws and regulations is rarely incidental and is often a sign of larger, systematic issues. Not only for sake of the ongoing business of the company but particularly in advance of going to market on a transaction, a company must assess its systems and implement necessary changes as the cost for failure in

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connection with a transaction can literally be multiples of any damages or notification expenses.

Klein: In an M&A transaction documents are often shared between a seller and a purchaser using an electronic data room. It is important for both parties that a reputable data room provider is used, providing clear levels of security and data encryption. Parties should retain control over their documents by limiting access to specified members of the other party's team, including advisers. Parties can also consider restricting the ability of data room users to make copies of the documents. Parties should be aware that in the context of an M&A transaction they must comply with the Data Protection Act 1998 (DPA) for any data sharing. Fines of up to £500,000 can be imposed for serious breaches of the DPA. Often in the M&A context, the prospective purchaser will want information about the target company's employees, including payment information and benefits. The Information Commissioner's Office (ICO) has provided some guidance in its Employment Practices Code to assist employers to comply with the DPA in this scenario. Business-to-consumer businesses should make it clear in their privacy policies that customer information could be shared if the company or its business is acquired, and the seller and purchaser should work together to agree on the best way to communicate completion of the deal to the customer.

FW: Looking ahead, how do you expect tech M&A activity to unfold for the remainder of 2012 and into 2013?

Yates: M&A in the tech sector should remain strong. While it outpaced many sectors over the last few years and many forecasted that the sector was due to slow somewhat this year, the economic (low borrowing costs and available cash) and tax (increased tax rates in 2013) drivers should continue to push deals in the tech sector. Deal volume in the middle market should continue to be strong, but don't expect too many mega-deals in the second half of 2012 as that will keep the overall deal value in check.

Klein: There are tentative but optimistic signs of growth. Continued caution in Europe due to concerns about the stability of the euro may inhibit activity, however the low cost of borrowing and anticipated 2013 capital gains/dividends tax increases for US sellers means that we should see them divest themselves of businesses before 2013. The 'dry powder' being held by PE firms may drive increased technology private equity M&A in 2012/13. Also factor into this anticipated changes to taxation regimes for corporate gains tax in the UK in 2012/13, which may encourage further investment in 2012. Further, expect enhanced information security solutions investment to develop alongside the growth of the social-mobile-cloud. This will involve possibly smaller value deals, rather than 'big-ticket' deals. Cloud computing, social networking, mobile apps and big data will continue to be key targets.

Burgess: 2012 and 2013 will look a lot like the last M&A peak in 2006 and 2007. There will be an accelerating wave of consolidation in the consumer and enterprise markets, but it will peak. It is only a question of when.

Nat Burgess is president of Corum Group. He joined Corum in 1996 and brings a diverse background in technology M&A and law. While with the Enforcement Division of the US Securities and Exchange Commission, Mr Burgess helped identify and build cases against securities fraud schemes. With the Strategic Development Division of Morgan Stanley's M&A group, he worked on cross-border acquisitions

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of US and European companies by Japanese firms, and on financings by large Japanese public companies. Mr Burgess moved to Morgan Stanley's Tokyo office, where he reported directly to the President of Morgan Stanley, Japan Ltd. and focused exclusively on cross-border M&A. He can be contacted on +1 (425) 455 8281 x 206 or by email: nburgess@corumgroup.com.

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