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Directors who shy away from acquisitions may cost shareholders dearly in lost opportunities

After seeing the result of several recent studies, corporate directors can hardly be blamed if they lack enthusiasm for proposing or approving acquisitions. According to one study, 58 percent of mergers destroyed shareholder value, profitability of companies involved in mergers declined an average of 10 percent, and fully 75 percent of mergers fell short of meeting the strategic goals that inspired them (*Directorship*, November 1999).

The flip side of these numbers is, of course, that some acquisitions do work out well and increase shareholder value. Directors who shy away from acquisitions because of the negative assessments of M&A activities may be doing their companies a great disservice.

As an investment banker specializing in mergers and acquisitions, I'd like to come to the defense of M&A by pointing out four common motivations for making strategic acquisitions and citing examples in which all four were employed to increase shareholder value.

Adapting a company's core technology for use in a different market. Because Wall Street regards the defense industry as mature, it punishes companies in that field by giving them low relative values. Many defense contractors have tried to make their technology useful in commercial markets, with little success. The problem is that the mindset and the culture of a defense contractor are often very different from what is needed to make and sell commercial products.

One way for a defense company to be successful in commercial markets is to create a completely separate division to make products using its technology. Another is

to acquire a company that can apply the buyer's technology to commercial markets.

An example of a company that successfully used the latter strategy is ViaSat Inc. of Carlsbad, California. Until 1999, ViaSat's business was making advanced digital satellite telecommunications and other networking and signal processing equipment, mainly for defense markets.

ViaSat's technology was generally acknowledged to be very good, and for some time management had been seeking to penetrate the rapidly expanding commercial marketplace for that technology. The company went to considerable expense to achieve this objective but with only modest success. Wall Street just yawned, and ViaSat's stock stagnated at around \$10 a share. At that price, the company was valued at about \$85 million (market value of stock plus debt).

So ViaSat decided to take an alternate route. Early in 2000, the company acquired the satellite networks business of Scientific-Atlanta for \$65 million in stock. The acquisition, ViaSat said in a press release, "substantially increases ViaSat's global resources and customer base."

The announcement electrified the stock market. Investors bid up the share price sharply. Six months after the acquisition, and after ViaSat issued 2.3 million shares in the transaction, its stock was selling for better than \$50 a share, giving the company a value of \$520 million—six times what it was worth in 1999.

Acquiring new technology for existing markets. Broadcom Corp., based in Irvine, California, provides an excellent example of how this can be done.

Broadcom did well after going public in April 1998. By the end of 1998, the company's revenues had grown to \$203 million, up 450 percent from 1997, and the stock rose 125 percent to \$30.19 from the closing price of \$13.40 on the first day of trading (after adjustment for stock splits). All of this progress was achieved with the company's basic products, integrated circuits for cable modems and digital set-top boxes. But Broadcom wanted to grow even faster, so in January 1999 it launched a highly ambitious acquisition program.

Broadcom's initial acquisition was Maverick Networks, a company that was only two years old and had not yet shipped any products. But Broadcom management pointed out that Maverick would enable it to penetrate the market for corporate enterprise switches, a rapidly growing field. The price for Maverick was 864,200 shares of Broadcom stock worth \$104 million.

Three months later, Broadcom bought Epigram, which uses telephone wiring to move data at high speeds between such devices as cable and satellite set-top boxes, home PCs and DVD players. In this acquisition, which cost Broadcom \$316 million in stock, the company was seen by an industry observer "covering both of the bases, wanting to be a sort of one-stop-shop chip manufacturer."

Soon afterward, Broadcom bought HotHaus Technologies, Inc., developer of software that runs on Broadcom chips and enables the transmission of digital voice, fax and data over broadband networks. This acquisition, made for \$280 million in stock, furthered Broadcom's plans to use high-speed networks to deliver voice over the Internet.

Broadcom's acquisition spree continued unabated through the rest of 1999 and into 2000. At this writing—September 2000—Broadcom has bought 13 companies, all for stock; the number of shares issued for these purchases was about 29 million (on an unadjusted basis) with a market value of \$5 billion.

And how has all this benefited Broadcom's stockholders? At the end of 1998, before the acquisition program was initiated, the company's stock was selling for \$120.75, or \$30.19, adjusted for splits. By mid-September 2000, its stock was trading at about \$230—7.5 times what it was going for just 21 months earlier. So don't tell Broadcom or its shareholders that acquisitions don't increase shareholder value.

"Compaq's stock would have fared much worse had the company not acquired those assets...."

Adding more products to move through existing sales channels. In the late 1990s, Stryker Corporation, along with many other makers of medical products, was feeling intense pricing pressure from both the private and public sectors. Stryker believed that only market leaders would succeed in this environment, so it decided to make a bold move.

In August 1998 Stryker announced that it would acquire Howmedica, the orthopedic division of Pfizer Inc., for \$1.9 billion in cash. Stryker's management felt this would make a good fit because Howmedica's products complemented its own line of orthopedic, surgical and medical products.

At the time the merger plans were announced, Stryker was the fifth largest manufacturer of orthopedic implants, and Howmedica was the third largest; the two companies' sales totaled about \$1.8 billion in 1997. But Howmedica's product lines didn't represent a complete overlap. In addition to implants, Howmedica also made bone cement, trauma products for internal and external fracture fixation, implantable devices used in oral, facial and skull surgery, and specialty instruments.

As it turned out, the enthusiasm expressed by Stryker management over acquiring Howmedica wasn't shared by Stryker shareholders. In the weeks immediately following the announcement of the deal, Stryker's stock declined from \$41.75 to as low as \$31.44, apparently because of concern over Stryker's assumption of \$1.65 billion of debt to finance the acquisition.

By the end of 1998, though, Stryker's stock had regained all of its lost ground, and one year after disclosure of the plan to acquire Howmedica, the stock was selling for more than \$60 a share. The stock was split 2 for 1 in May 2000, and in mid-September 2000 it was selling for about \$45 a share, more than double the split-adjusted \$20 it was going for in the wake of the merger announcement.

Making an acquisition to add more sales channels. Compaq Computer, which once held the largest share of the domestic market for personal computers, lost this dominant position to Dell. Compaq sold its products primarily through dealers and distributors, whereas Dell sold directly to end-users. Dell enjoyed lower operating costs because it didn't have to carry as much product in inventory.

For several years Compaq tried to emulate Dell, but with

Acquisitions—Continued on page 6

Acquisitions—Continued from page 5

little success. Selling direct requires extensive computer tracking systems, different assembly and inventory techniques, and other knowhow that Compaq lacked.

Finally, Compaq decided that rather than trying to build the complex front-end and back-end systems needed for direct selling, it would acquire these capabilities. Thus, on January 4, 2000, management announced that it would acquire distribution facilities and related assets from Inacom, a PC distributor, for \$370 million in cash.

Just one month earlier, Compaq had come up with a new product line called iPAQ. Consisting of a pocket PC and several related devices, the iPAQ line became an immediate best seller.

The success of the iPAQ products makes it difficult to measure the value contributed by the Inacom acquisition. But it's noteworthy that the powerful downdraft that swept through the market last spring barely affected Compaq's stock. At the beginning of March, it was selling for about \$26; the low for March–April was \$24.50, and by May 1 the stock had recovered to \$29.75.

One indication that the Inacom acquisition had a very positive effect came in July, when Compaq announced that it was then selling 40 percent of its products direct in North America and 25 percent worldwide; by the end of the year, management said, those rates should increase to 60 percent in North America and 40 percent worldwide. Still, Compaq's

stock was hovering at the \$30 level by late summer 2000, even though its commercial computer group had returned to profitability in the second quarter of the year.

It's reasonable to conclude from this performance that Compaq's stock would have fared much worse had the company *not* acquired those assets of Inacom. Many investors might have lost confidence in the company's ability to grow if it hadn't done something to sharply increase the percentage of products sold directly to computer users rather than through dealers.

Eventually, Compaq's bottom-line performance will determine whether the \$370 million Inacom acquisition was worthwhile. But at present, it's difficult to argue that the acquisition wasn't in the best interests of shareholders.

There are, of course, many valid reasons other than those I've cited for going down the acquisition trail. All of the four cases I've described are intended to achieve growth strategically, as opposed to increasing size just by combining two or more companies without giving much thought to possible synergy.

What it comes down to is that acquisitions that are made for the right reasons and are carefully planned and executed have a far greater chance of success than some studies would indicate. Certainly, there is an element of risk in almost all acquisitions. But growth can rarely be achieved without risk-taking. To be overly cautious of acquisitions is to deny shareholders a tried and proven means of increasing the value of their stock. **D**

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