M&A Seminar Series–Session Eight: CEO View: Top Ten Business Points Summary

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OVERVIEW

1. Maximize valuation by building a great company (not just a great product) that is the leader in its market segment. You can become a market leader by buying companies to fill out your product suite, increase average sales per customer and improve your go-to market strategy (*e.g.*, Cadence; Opsware; Clarify; Mercury Interactive) or by using M&A to expand into new markets (ATI; Opsware). The best deals help the buyer to start selling "business value" to customers' senior executives rather than "technology value" to their R&D or IT groups (Mercury Interactive). Shedding weak businesses (*e.g.*, Loudcloud's web hosting business) or product lines (e.g., ATI's low margin graphics boards) to focus on core strengths is critical.

2. CEOs (and Boards) must evaluate strategic alternatives as a way to expedite the maximization of shareholder value. In deciding whether to remain stand-alone, ask: Are we #1 in our market? Is our market large and growing? Will our market remain stand-alone? If yes, more value is generally created stand alone. However, if it becomes clear that you cannot become the No. 1 player in your market segment (*e.g.*, *Clarify vs. Siebel*), or that the market will change (*e.g.*, via consolidation, increased competition, or declining demand) in such a way that the upside is or may be adversely impacted (Loudcloud; Opsware), perhaps it is time to sell. In this regard, CEOs must ask tough questions about the strength of the team, the strength of the company's product mix and the impact of new trends and should not assume "perfect execution". If you receive a cash bid that is clearly better than any risk-adjusted, projected stand alone value (Clarify/Mercury Interactive/ Opsware), the board should maximize value for stockholders. It is imperative to "get big or get bought", because customers prefer to buy from the market leader.

3. Generally, it is best to maximize M&A valuation through a competitive deal process and by maintaining an ability to remain independent and thus having an ability to walk from the deal (Opsware; Clarify; Mercury; ATI). Sometimes, however, a thorough market check is not advisable, such as where a leak about the deal might upset a target's competitive situation or where there is only a small number of viable bidders (ATI). Often, strategic partner discussions will lead to M&A or make it easier to do a rapid market check (Opsware).

4. Macroeconomic factors should inform your assessment of your own valuation. Valuation is relative to that of peers and targets, and "markets can remain irrational longer than you can remain solvent", so don't wait for a market rebound to do a deal. Many deals are done for strategic reasons (ATI/AMD, ArtX/ATI, Opsware/HP; Mercury/ HP), while others are done for defensive reasons (SGI/ Alias Wavefront). Sometimes, the price is such that a target should accept the deal even though the business synergies are less compelling (Clarify/ Nortel).

5. Key negotiating tips for targets are: have a disciplined negotiating approach and stick to it; be truthful and consistent in your statements; focus on what is motivating the buyer (*e.g.*, why the deal will help the buyer more effectively deal with its customer base); and maintain deal momentum (which may mean passing on slow moving bidders). Sometimes, you can maintain negotiating momentum by creating a valuation model and limiting discussion only to the assumptions. The target team must know more about the markets, competition, and its potential revenue upside than the buyer's negotiating team.

6. Targets that are comparing alternate deals that each provides for an earnout or the receipt of stock merger consideration should evaluate the long range success of each buyer, and the timing to liquidity, especially for target employees subject to continued vesting.

7. The deals that tend to be the most successful have good strategic fit, minimal product overlap, a good cultural fit and a price that is fair to both parties (so critical target team members are retained). In addition to these factors, the parties must focus on issues that will impact deal certainty. Cultural fit (including management style and work ethic) is often hard for a target to determine in advance. Companies with a more open communications style can more effectively overcome cultural differences. As to strategic fit, acquiring a top brand that has no synergy with the buyer's core business is less likely to be effective than a deal that leverages the buyer's technology, products and brand to enable it to grow out of its core business. If a deal is critical to a buyer's strategic objectives and will result in substantial top line synergies, it may make sense for the buyer to pay at the high end of the valuation range.

8. Avoid a "NIH" attitude—the best growth strategy is to combine a strong R&D program with a robust M&A strategy to maintain market leading products (Clarify). An effective M&A strategy requires an environment where risk taking is respected, not penalized.

9. Buyers with a robust marketing and sales channel (Oracle; Cadence) can bring target products to market quickly, which can help drive revenue synergies and ROI and is a selling point to target CEOs who want their technologies to achieve market acceptance.

10. Executives need to focus up front on integrating acquired companies. Emotions and broad public statements (*e.g.*, "no layoffs") should be avoided as they are counter-productive and fast execution is critical. They key to successful integration is giving someone (optimally the target CEO) substantial authority to drive integration decisions, retaining key target employees, and motivating the target team members to focus on achieving the buyer's (not the target's prior) business objectives. Often, it is better to be crisp and decisive than to be "fair" or "right" in making integration decisions. Implement cost synergy plans (often involving layoffs) quickly, then set expectations and create alignment within the company. It is difficult to integrate a major acquisition and achieve strategic synergies (*e.g.*, create new, combined products) when the buyer has weakness in its core business (SGI/Cray; AMD/ATI).

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M&A Seminar Series, Session Eight

CEO View: Summary of Panelist Interviews

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PANELISTS:

- **Ben Horowitz.** Ben was the co-founder and former President and Chief Executive Officer of Opsware, a leading data center automation software company that was sold in 2007 to HP for $1.68B. Post acquisition, Ben served as VP and GM of HP's Business Technology Optimization software unit. Under Ben's leadership, Opsware completed its IPO in early 2001, despite an unfavorable investment climate for Internet companies, bolstered its product offerings with multiple acquisitions, and combined with HP in a deal that reflected a substantial premium. Prior to Opsware, Ben served as Vice President and General Manager of the E-Commerce Platform division of America Online and as a vice president at Netscape Communications. Ben holds a B.A. in computer science from Columbia University and an M.S. in computer science from the University of California, Los Angeles.

- **Dave Orton.** Dave was the former President and Chief Executive Officer of ATI Technologies, a leader in the design and manufacture of innovative 3D graphics and digital media silicon solutions that was sold in 2006 to AMD for $5.4B. Post acquisition, Dave became Executive Vice President of AMD's Visual and Media Businesses. Under Dave's leadership, ATI completed several acquisitions, achieved key customer wins and was acquired by AMD at a substantial premium. Dave also served as the former President and CEO of ArtX, which he sold to ATI in 2000 for $400M. Prior to ArtX, Dave served as Senior VP and GM, Visual Computing, and Senior VP and GM, Scalable Systems, at SGI. He also worked in the graphics and semiconductor industry at GE and Bell Labs. He holds several patents in the graphics and computer architecture areas. Dave earned a B.S. in Mathematics and Economics at Wake Forest University and a M.S. in Electrical Engineering from Duke University.

- **Tony Zingale.** Tony was the former Chief Executive Officer and President of Mercury Interactive, a leading IT management software and services company that was sold in 2006 to HP for $4.5B. Tony was also president and CEO of Clarify, a public traded company that was a leader in the CRM market until it was acquired for $2.1B by Nortel in 2000, after which Tony served as president of Nortel's eBusiness Solutions Group. Prior to Clarify, Tony served in various senior executive capacities, including as SVP of Worldwide Marketing at EDA provider Cadence Design Systems, where Tony played a key role in guiding Cadence's M&A strategy. Tony began his career at Intel in 1980 as a product marketing manager of X86 microprocessors. Tony holds a B.S. degree in electrical and computer engineering and a B.A. degree in business administration from the University of Cincinnati.

MODERATOR AND SUMMARY AUTHOR:

- **Dave Healy.** Dave Healy is a partner and Co-Chair of the M&A Group at Fenwick & West LLP. Dave has negotiated over a hundred acquisitions, including the sale of Opsware to HP, the sale of ArtX to ATI and numerous acquisitions for Cadence.

BUILDING STANDALONE COMPANY VALUE

It is best to build your company as an independent company that is a great place to work and that has a product or products that companies desire to buy now. If you can build a company that is the No. 1 player in its market segment, and it is a good market segment to be in, you have built a company that is a far more valuable stand-alone than as part of a larger entity and one that is more valuable than one built for the purpose of being sold. (If you are only the No. 2 player in the segment, you will be far less profitable.) Acquirors (especially large acquirors) ideally desire to buy an entire company, not just people, technology or products alone.

TIPS FOR GROWING STANDALONE VALUATION

Growing Clarify

It was clear to Clarify's management that that the key to success in the CRM space was growing revenue rapidly. This required making changes to the executive team, the board and the strategy (towards being a front office automation solution that unified all applications that touched the customer). The Clarify team focused on driving up average sales price and correspondingly driving revenue. The keys to success included intense focus and brutal execution – ultimately, the competitive battle was won and lost in the field and in perception, in marketing, momentum, evaluations and the sales process. Clarify also made some low cost acquisitions to fill out its product suite. As a result of all of these efforts, Clarify became the No. 2 player in the CRM space behind Siebel, its stock rose from $4 to $50 and its quarterly revenues rose from $20M to $100M. Clarify's ASPs were at the highest point, its balance sheet was strong and its executive retention was excellent.

Growing Mercury Interactive

In 2002, the question for Mercury was how to grow from $400M to $2B in revenues, what was the ideal "go to market" strategy and how to create a wider and deeper portfolio of products. Clearly, becoming a multiple product company is difficult. One major change Mercury made was to expand its message to a higher business value level, by changing its "value proposition" to focus on BTO (business technology optimization), which embeds quality into IT-enabled processes, so as to optimize quality, performance and compliance. This concept really gained traction and drove both sales and valuation. Mercury also grew by acquiring Kintana, an IT governance company. The acquisition of Kintana completed Mercury's BTO portfolio and story. Given the Kintana acquisition, by the end of 2004 Mercury had all assets it needed to compete in BTO. Competitors included HP and others, but Mercury's solution was the most robust. Mercury exited 2004 with $685M in revenues, Q4 revenue of $200M and 30% compounded growth.

Growing ATI

Through the 1990s ATI grew organically to $1B. In the late 90s through 2006 ATI added acquisitions to its growth strategy. First and foremost, ATI acquired ArtX, which included a number of experienced executives (including Dave Orton) and an experienced and talented R&D team. ATI was able to leverage this acquisition, including by using ArtX' relationships with Nintendo, to expand the ATI/Nintendo relationship. ATI was constantly acquiring other small companies as well, usually about 1 per year, normally in the $5M-$25M range. ATI acquired workstation, digital TV tuner and software companies. Most of these deals were "buy" vs. "build" decisions, on a small scale, and were as much about acquiring talent as IP and products. They were normally in new locations so ATI could expand where it drew its talent pool from. Many of these deals had technology synergies as well. ATI did a number of deals (its "string of pearls") that helped it grow its consumer business. One in particular enabled ATI to enter India with a strong software presence. ATI also evaluated larger strategic deals, other than the AMD deal, that offered the possibility of improving ATI's competitive position relative to NVIDIA and Intel. Throughout this time, however, ATI concentrated on building a strong, stand alone business with a strong cash position such that ATI had no compelling need to be acquired. By the time AMD acquired ATI, ATI's annual revenues had grown to $2.2B.

Growing Opsware

Opsware (then known at Loudcloud) sold off its web hosting business to EDS when it became clear that the hosting business was quickly evaporating due to customer concerns about the balance sheets of smaller web hosting companies. This gave Opsware the cash to transform itself into an enterprise software business. After that, Opsware successfully acquired a number

of companies. From 2003 through 2007, Opsware acquired asset management systems provider Tangram Enterprise Solutions, network device configuration management vendor Rendition Networks, CreekPath, a storage automation company, and iConclude, a provider of process automation software. In general, these deals were successful and the integration went well. Those acquisitions, in addition to successful internal R&D, Opsware's growth in revenue to $100M in its last full fiscal year and its rapid projected revenue growth rate, made potential buyers realize that data center automation was an important business segment they should enter.

M&A (plus R&D) as a Growth Strategy

Cadence

In the 1980s, M&A was not as fundamental and accepted a growth strategy in the technology sector and in some quarters it was viewed as an admission of weakness rather than as a sign of strength. Cadence, led by its CEO Joe Costello, was a pioneer in the use of acquisition as a growth strategy during the period from 1988 to 1998.

M&A was not just an afterthought in the Cadence growth strategy--it was a fundamental cornerstone of its growth strategy. The question for Cadence was how to become a market leader in EDA. Cadence's strategy was to grow by having both the best products that were internally developed and also by buying other companies with the best products. After the ECAD/SDA merger to form Cadence in 1988, the biggest EDA vendors were Mentor and Cadence. Unlike the enterprise software space, where having a product solution that was "close enough" (e.g., to approximate the performance of an application) was generally acceptable, in EDA, the software tools either were able to solve the tough design problems, or not, so technical product excellence was a key to becoming and maintaining traction as a market leader.

Cadence's key early realization was that it was not good enough just to grow organically, but rather it had to foster both organic growth and buy companies with the top products simultaneously. That was the winning strategy that yielded the strongest overall product portfolio, which would in turn lead Cadence to become a market leader in EDA. So Cadence's strategy was to leverage the strength of the company by doing the "right" M&A deals, doing those deals better than anyone else and being acquisitive for all the right strategic reasons. The entire Cadence team bought into, and fostered, this strategy.

SGI

In October 1990 SGI had about 2200 employees and a number of strong engineering managers. It was doing well stand alone. Nevertheless, SGI made a number of acquisitions in its search for growth, and each acquisition had a different outcome.

In 1992, SGI acquired MIPS. Ultimately, there were many synergies realized from the MIPS merger, as it enabled SGI to develop its own MIPS processor and expand its product line. This resulted in a transformational change in the company.

In the 1994/1995 timeframe, SGI acquired Alias (which sold high end CAD software), but that transaction ultimately was not as transformational as the MIPS deal, in part because SGI and Alias had little technology overlap, so Alias was kept as an independent business unit which was never leveraged, so no significant strategic synergies were created.

In 1997, SGI acquired CRAY, a super computer company, mainly to acquire CRAY's high end technology / IP and strong customer relationships. This was indicative of a decision by SGI to attempt to grow by acquisition rather than by leveraging SGI's core strengths and business model (high volume/profitable/value added). Ultimately, the deal interrupted SGI's R&D flow and it was very difficult to integrate CRAY. Further, the deal timing was unfortunate because there was margin pressure on SGI's core business as the graphics capabilities of cheaper PCs continued to improve. The lesson learned is that it is difficult to integrate a major acquisition when the buyer has weakness in its core business. The CRAY acquisition also demonstrated how critical it is to make the rapid, decisive moves (in terms of rationalizing teams, platforms, architectures and headcount) required to realize the cost synergies that are used to justify making an acquisition. A buyer must have a strategic view of what synergies are desired from a deal and let that drive the integration plan and then use that plan to set expectations properly and create alignment within the company.

Star Technologies

Star Tech, an imaging company in Virginia, acquired GE's internal graphics business unit in hopes that it could use that business to scale imaging beyond just medical imaging. Star Tech received good value for this acquisition; for modest consideration it obtained a full 50-person R&D team as well as capital equipment. Ultimately, Star Tech did not attempt to integrate the graphics and imaging businesses, or to tightly integrate the two teams (which were 400 miles apart). As a result, there were few synergies created between the two business units to create leverage.

M&A That Leverages Existing Brands vs. That Uses a "House of Brands" Approach

The SGI/Alias and Star Tech/GE graphics unit are examples of a "House of Brands" approach to M&A. That is, you buy the best brand available and add it under your corporate umbrella, even though that brand/product/technology is unlinked to your core business—like Proctor & Gamble might do for example. The opposite, preferable approach is to do deals that leverage your technology, products and brand to grow out of your core business. (Though not M&A related, Apple is a good example of offering various products that leverage its brand and technology through tight integration between the iPod and the Mac, thereby creating push/pull demand synergies.) Had the Star Tech/GE graphics teams been better integrated, for example, the GE unit's core technology and Star's core medical imaging technology might have been combined to create a better medical imaging solution, which could then have then sold to GE as a customer.

DECIDING WHEN TO SELL

Loudcloud/Opsware

The ongoing question that a company must ask itself is: "are we stronger stand-alone or in combination with another company." It's an easy question to pose, but a much more difficult one to answer. The litmus test for being stand-alone for Opsware was several-fold:

- Are we #1 in our market?
- Is our market large and growing?
- Will our market remain stand-alone or will it combine with another market?

If it becomes clear that you cannot become the No. 1 player in your market segment, or the market changes in such a way that the upside is adversely impacted, or worse yet, your company ceases to be a relevant and compelling player in its space (and there is no compelling alternative in a new space), then that might be a sign that you should consider being acquired.

Sometimes a good market can quickly become a bad market. Demand can be suddenly adversely impacted, resulting in the need for an immediate sale. For example, Opsware started in 1999 as Loudcloud, a web hosting company. Though Loudcloud had a large accumulated deficit, it had a great customer base, was rapidly growing and was able to consummate its $150M IPO in the down market of March 2001. However, as web hosting companies began to fail due in large part to the falling rate of demand growth, customers suddenly felt it was too risky to continue using smaller web hosting companies, such as Loudcloud, so all the demand began concentrating in large service providers with substantial balance sheets, like EDS and IBM. It was challenging to come to grips with this sudden change in the market and figure out next steps. It became clear to Loudcloud management that if it did not sell off its web hosting business quickly (and before its cash ran out), there would be no one left standing to buy that business at an attractive valuation. So, in August 2002, Loudcloud sold off its web hosting business to EDS for $63.5M, EDS agreed to pay an additional $52M for the company's automated server life-cycle management software and Loudcloud changed its name to Opsware.

By early 2007, however, Opsware started to think about whether it would be better off being acquired rather than remaining independent. Factors favoring remaining independent included the strength of the team, an exciting value proposition and high confidence in Opsware's ability to achieve its revenue plan.

The big question, however, was whether the Opsware data center automation products would remain as a market segment that was distinct from the systems management products offered by BMC, HP and others. Eventually, Opsware concluded that those two markets would converge and that BMC and HP would eventually acquire a data center automation software solution. So, to compete with them, Opsware would either have

to add systems management products to its offering, which would have taken several years of internal R&D, or acquire that technology. Either approach involved substantial time and risk to Opsware's stockholders. So, the possibility of considering acquisition offers suddenly gained urgency by 2007.

When debating whether to remain independent or be acquired, the CEO needs to ask some tough questions about the strength of the team, the strength of the company's product mix and the impact of new trends. For example, as virtualization technology became more heavily used in the data room environment, Opsware evaluated how that would change Opsware's business and how Opsware's product offering would have to change. As noted, there also was concern that market consolidation would increase the level of competition Opsware faced.

Clarify

Clarify faced a similar moment when it became clear that it should consider being acquired. Although it had grown rapidly and was succeeding by many measures and its products were the best CRM products in the industry (remember, the best technology does not always win), Siebel was able to invest a higher percentage of its revenue dollars in building up its sales force (50% to Clarify's 40%), so Siebel eventually had twice as many sales people and a more robust channel reach. Clarify's Board realized that Siebel was pulling away at such a rate that Clarify could never catch it, so the discussion turned to "you can be a nice No. 2 player, or consider strategic alternatives", which Clarify did. Even though there were other possible bidders with whom a deal might have had a better strategic fit, when Clarify received a $2.1B bid from Nortel, which represented 8.5 X its current year revenue, since at the time Nortel's currency was strong and Clarify stockholders would be able to achieve liquidity with little risk, the board felt compelled to accept that deal. The board has to maximize value first for the stockholders, then for employees, then for customers, in that order.

Mercury (Cashing Out Now vs. Upside After Perfect Execution)

Mercury's board faced a choice: it could either agree to sell out to HP for $52/share in cash, which was a fair price, or it could seek to stay independent and try to drive the stock price to above $55 within 6-8 quarters, though that would require perfect execution and no unexpected difficulties or economic downturns. HP would be a great company for Mercury's employees and the development of Mercury's product and Mercury would be transformational to HP in terms of helping HP become a more robust software company. Furthermore, $52/share in cash compared favorably to $55/share with the higher risk. Also, HP's CEO, Marc Hurd, is impressive —he does what he says, is thorough, direct and sincere. Given those factors, the attractive valuation and the marginal risk-adjusted benefit of remaining independent, it was clear that the board mandate should be to accept HP's offer. There were other potential deals that might have had a better strategic fit, but the HP offer to Mercury had the most compelling economics.

Valuations in the Current Economic Environment

Macroeconomic factors should inform your assessment of your own valuation. For example, if you are going into a huge market upswing, then selling at current market multiples may be too low a valuation, whereas if you are about to enter a recession, then a lower valuation can look very attractive. $1.6B (Opsware's valuation in selling to HP) for $100M in Opsware trailing annual revenues may seem expensive given current market valuations, but in fact Opsware met its revenue plan within HP.

You must be honest about what your company offers and what it should be worth. Also, realize that sometimes you just have to get the best value you can given the circumstances. Remember that your stock is only worth something when you sell it. In this market, some companies will not survive and may have to sell out at fire sale prices or be liquidated.

Remember, that there is no "correct" value of your stock—sometimes companies will trade at a 20X earnings multiple over many years, then at a 10X earnings multiple thereafter. Stock valuations are much more arbitrary than what anyone would care to admit.

From a M&A perspective, stock values merely represent a monetary system. The primary thing to consider is relative value, not absolute stock values among companies. If both your stock and the target's stock have gone down, but remain in the same ratio to each other, then that has no valuation implications. Thus, it makes sense to reject the idea that a buyer should shy away

from strategic acquisitions simply because the trading price of its stock has declined. Further, using cash for making acquisitions in the current environment may be too risky given the tight credit markets. Thus, using a buyer's stock to make acquisitions can still make sense.

If an acquisition offers significant strategic value, then it might be sensible to pay a good value, or even a premium for it, even in this environment.

Given current economic conditions, however, it is particularly critical, once you complete a deal, that you quickly and efficiently make the changes necessary to realize cost synergies and that probably means cutting deeper than you might think.

DRIVING VALUATION THROUGH COMPETITIVE BIDDING AND/OR HAVING THE ABILITY TO WALK

Opsware

One smart move Opsware made from 2002 to 2006 was to meet with, and develop relations with, a number of large strategic partners, who also, of course, could have been potential acquirors of Opsware. This let Opsware and these other companies understand each other and what was possible. It was clear during that period, though, that there was no readily apparent reason for these large companies to acquire Opsware.

Then, in early 2007, that changed, in part because Opsware had achieved over $100M in annual revenue and also because Blade Logic was about to go public, so it became clear that the data center automation market was about to take off as a market segment. Correspondingly, the larger players all decided they needed to intimately understand and enter this business. So, suddenly many different companies began approaching Opsware at once – this was a key moment in Opsware's history. Since Opsware had ongoing business discussions with top executives at all the major players, it was easy to quickly do a market check and when it did so, there was substantial interest from many companies. The Opsware/HP tender offer documents disclose ten unnamed parties contacted in the course of Opsware's market check, aside from HP.

Because of this dynamic, there then became a clear choice presented for these larger players between acquiring Blade Logic or Opsware. If Blade Logic had been acquired by a larger player, it would have changed the market dynamic for Opsware in terms of its ability to remain No. 1 in its market segment. The future became unclear. So that too was a compelling reason to consider a merger.

Opsware's management team went through all the various valuation scenarios. With board direction, Opsware ultimately agreed that it would have to consider selling the company if it could obtain $14/share, as a decision not to do so would create substantial risk to its investors and employees.

Opsware then did a market check, contacting all the large players and informed them that it would consider selling at $14 or more per share.

Several companies had expressed interest below $14, so this was an ambitious price target. Ultimately, Opsware settled on close to $14 as its walk away number. At least two players emerged that seemed to have the ability to buy Opsware at north of $13, HP and one other company.

Two elements were critical in driving valuation:

First, despite Opsware's concerns, it was confident in its ability to remain an independent company and its board supported that notion, so it was clear that Opsware was willing to walk away from all buyers if necessary.

Second, and perhaps more important, the existence of a competing bid drove valuation. The fact that Opsware had at least two viable bids let Opsware have the confidence to negotiate hard and be willing to walk away if need be.

A company does not necessarily need a banker to generate competing bids. In fact, using a banker to conduct an auction or implying that the "company is for sale" that can sometimes feed the perception that the company can't remain a viable independent company and that can hurt valuation. Sometimes, you can drive a stronger sense of competition without a banker. However, bankers can definitely add value as an intermediary and they have deep connections with buyer business development executives. Ultimately, the message that should be conveyed during a market check is, "we are not for sale unless buyers step up with the right deal and valuation".

Clarify

One of the best ways to drive deal value once a decision to sell is made is to create a bidding war. However, in Clarify's case, selling out to a competitor seemed too risky and selling out to the various large enterprise software vendors ultimately proved difficult. One large ERP vendor was interested, but it was in trouble and had flat revenues. Clarify was in the process of negotiating a term sheet with that ERP vendor, when a far superior bid was made by Nortel, which was obviously not in the ERP space.

ArtX

ArtX was a graphics technology company that designed the graphics pipeline for the Nintendo Game Cube. It became clear that for ArtX to succeed as a standalone company it needed to build a business beyond Nintendo so it moved into the graphics Northbridge business. To realize this model, ArtX decided to license the "south bridge" (SB) technology instead of building its own SB. In addition, in order to sell products on the Intel platform, ArtX needed a front side bus license and pursued a strategic partner for this and a sales channel. ArtX started discussions with a number of companies with this in mind and recognized that each of those companies was a potential acquirer. In the fall of 1999 ArtX had four potential acquirors, including ATI. Because of this competitive bidding, ArtX ultimately did the deal with ATI for $350M with a $50M earnout.

ATI

ATI drove valuation by having a viable independent business with a significant cash and $2.4B in revenue, so it did not need to do a deal at all, much less at a fire sale price. ATI's strength and position as an independent company gave ATI's management the confidence to create a price floor. ATI was able to approach the AMD negotiations with a walk away price in mind - if ATI could not consummate the deal done above $20 per share, it would walk. ATI did the AMD deal for the compelling strategic vision (graphics and microprocessor integration) it represented. Since most of the rationale was an aligned strategic vision, it didn't make sense for ATI to shop the deal to other buyers, as the strategic vision of the AMD/ATI deal was unique. The combination drove value due to the strategic synergies.

M&A NEGOTIATING TIPS AND TACTICS

Effective negotiating can help drive deal value for target companies:

First, be highly disciplined in your negotiating approach. Sometimes, buyers are not as detailed as targets, as by definition the deal is more material to the target. If target management scripts out all statements to be made during the negotiations and diligence meetings and takes detailed notes on all discussions to ensure consistency, that can help. Make sure that you are perceived as strong, don't admit weakness that will be used as an excuse to push down valuation and don't accept concerns raised by buyers as real when you know they are not (remember, that as the target CEO, you know more about your own business than any buyer). Be truthful and consistent in whatever you say—false or inconsistent positions jeopardize both your negotiating position and the deal itself. Remember that the buyer is interpreting every statement target management makes, e.g., as to the legitimacy of the buyer's concerns about diligence issues (or the lack thereof), or as to whether there is a competing bid or not. Remember that in negotiations, details matter and impact perception. The basics of negotiating training can help. Understand why the buyer made certain statements and took certain positions. Understand the buyer's motivations. Negotiating is not about what motivates you, it's about what motivates the other party. Do the deal from other party's perspective, not your perspective. Why do they want to spend so much to acquire you? If the buyer believes it must get into your market segment and buy the No. 1 player in that segment, then don't do anything that might change the buyer's perception.

Second, don't let the "demons" (surprising issues that come up in every deal) get to you, don't panic and don't get over emotional.

Third, stick to your negotiating principles, strategy and approach. For example, be sure you and your negotiating team are in harmony and don't agree to 11th hour changes.

Fourth, maintain your deal momentum, especially if you've effectively framed and executed your negotiating strategy.

Fifth, understand that every point is a potential trade, so it is playing with fire to back off what enabled you to get to the current deal value and terms. For example, if you believe in your revenue projections, don't react to the buyer's questions about those projections and offer concessions as if those projections were not supportable, as that invites a valuation reduction.

Sixth, don't get hung up on issues that are not critical to the deal. For example, when the Loudcloud business was sold to EDS, EDS refused to assume Loudcloud's lease, which represented a $30M liability. But EDS didn't want that asset and it made no sense for them to take it (and if Loudcloud did not close the asset sale, bankruptcy loomed). So, it is critical for a target to focus on first principles--such as getting the deal done--and drop demands for non-critical terms.

Finally, only deal with parties that are willing to move fast on your deal and elevate it to "hot" status within their organizations. Sometimes an older, more traditional company just can't move fast enough to be a viable bidder.

M&A "PRINCIPLES" FOR A SUCCESSFUL DEAL

Cadence had four M&A principles:

1. **Strategic Fit**. Is the deal strategic to your overall business strategy and does it amplify and increase your ability to succeed at that strategy? It is critical to harmonize the product line without alienating major customers. This is the most important principle by far, as if this principle is not met, then you should not do the deal. Cadence's Valid acquisition, for example, was both strategic and tactical. As a result of the deal, Cadence achieved No. 1 market share in EDA overnight. Being the market leader has many first and second order benefits. Being big is its own strategy. Buyers want to buy from larger players, especially in a down economy. Potential targets want to merge with the number one player. The ability to retain and attract employees is enhanced. No. 1 players have greater access to the press and lead the industry.

- The ATI/AMD deal is a good example of strategic fit. ATI did not need to be acquired, but was open to a major business combination that had a good strategic fit and delivered powerful synergies. In that regard, from 2000 through 2005 ATI considered merging with one of its major competitors, but such acquisitions have a high degree of risk, including that such a deal might be blocked, or divestitures might be required, due to antitrust concerns, or that such a deal might bust and one side may seek to paint the other party's willingness to merge (or to "be acquired") as a competitive weakness, which in turn might impair that party's ability to achieve design wins. Also, mergers with a competitor often involve substantial redundancy and require significant layoffs to achieve cost synergies, which is not an attractive prospect. The ATI-AMD deal, which was announced in July 2006, had many technology synergies. It was clear that graphics would increasingly be integrated into the microprocessor/ x86 architecture, mobile devices and digital TVs. The companies were very complementary, had little overlap and the deal was a true case of 1+1=3. The developments required could not be done in a partnership context; a merger was required. Strategically, the deal was compelling. In retrospect, the AMD/ATI integration has not gone as well as hoped, in large part because AMD's core microprocessor business has not been as healthy as desired. AMD sold off the ATI DTV and handheld businesses, instituted layoffs and has not built up a consumer business. Nevertheless, the strategy of the deal is still sound and, as a mostly cash deal, clearly it was a good outcome for ATI shareholders. It is harder to say if the deal was good for ATI employees as a whole; in part that is a question of how ATI would have done had it remained independent. 2006 and 2007 could have been tough years for ATI standalone, as its handheld and digital TV business units saw revenue decline, while its PC business did well competing with NVIDIA. It's hard to predict where ATI would be stand-alone, whereas ATI ended up selling to AMD for $21 per share. Again, that's a great result from an ATI stockholder viewpoint and ATI analysts praised the deal and the deal value.

2. **Product Overlap**. If strategic fit is strong, then you move on to looking at the other M&A principles, the first of which is to determine whether there is excessive product overlap in the deal. If there is overlap, it is critical to quickly decide, prior to closing, which product will be

retained and which will be shut down or transitioned out. These product choice decisions are emotional, almost "religious", decisions that are rarely based on fact. The Cadence/Valid deal provided a good example, perhaps of what not to do. Initially, Cadence announced that it would transition all Valid customers to the competing Cadence product. However, the Valid sales team did not buy into this decision and essentially fomented a revolt from Valid customers. So Cadence relented and agreed to support both products for a transitional period. The lessons learned are: (i) insist that your entire company be committed to effecting these product transitions (whether they agree with them or not); (ii) engage in extensive target customer diligence to determine the best product transition strategy; and (iii) product transition announcement and implementation must be crisp and clean. The problem, of course, is that it is hard to do customer diligence in mid-deal, as the target is worried about customer reaction especially if the deal fails to close. But the best deals have little or no product overlap—the HP/Mercury, AMD/ATI, ECAD/SDA and Cadence/Gateway deals were examples of those. In addition to product overlap, you need to look at other aspects of operational fit, including evaluating employee overlap, harmonizing sales/distribution/OEM channels and managing integration issues.

3. **Economics**. The deal valuation and economic deal terms must be fair for both parties. The buyer must feel that the price was fair given the strategic opportunity presented. The target's go-forward team must feel that the price was fair and close to its requested valuation, as that is the key to retaining the target's key technologists, which is critical, especially in software deals.

4. **Cultural Fit**. Cultural fit is important at several levels. It requires that both buyer and seller teams be bought into the same strategy, have the same set of goals and the same work ethic. Culture also includes matters such as communication style, risk appetite, compensation philosophy, whether those who take risk are appreciated or "shot", how employees work together, hiring philosophy and the cultural issues that derive from different locations. Generally, cultural fit is closer where you are merging two Silicon Valley companies, as the work ethic here is so strong and perhaps stronger than in the Midwest or in Europe. Cultural fit includes combining teams without losing the benefit of each culture and right-sizing the company without adversely impacting employee morale. Cultural fit impacts the combined companies' ability to achieve its strategic goals.

- Cultural fit played an important role in both the ArtX/ATI deal and the ATI/AMD deal. For example, ATI's culture was more about making decisions at the top, and tightly managing risk. As a result, ATI did not move as quickly to rationalize ArtX' team or the two companies' chipsets or architectures. Ironically, despite the location differences (Silicon Valley and Toronto), the cultural fit between ArtX and ATI was probably closer than the fit between ATI and AMD. Fortunately, the ArtX team had some strong positive influence on the ATI culture and helped to improve the cultural fit. Cultural differences between ATI and AMD included how decision making was made. For example, since AMD was primarily in one business, the functional areas of manufacturing, finance and legal tended to drive many decisions, whereas at ATI decisions were more business unit driven. Those differences made it more challenging to combine the two companies than initially planned.

- When doing a public-public deal it is hard to do the sort of "reverse diligence" that helps you learn about the culture of the other party. One reason is that, due to the need to keep the discussions confidential and minimize the risk of pre-disclosure, each company has to keep its deal team very small, often to no more than 5 people. As a result, often neither party can obtain a clear sense of the dynamics of how the other party operates.

MAXIMIZING M&A ROI BY REALIZING CHANNEL SYNERGY

A key to successful M&A is channel synergy--ensuring the ability to rapidly start marketing and selling the target's products through the buyer's channel using the buyer's sales force. For example, the day after Gateway was acquired, Cadence's sales team was selling Gateway products in the field. Gateway revenue doubled within two quarters so there was a rapid return on investment. So speed to synergistic revenue was Cadence's key enabling strategy. If you can do that, the deal will work; if you can't, it won't. Obviously, it helps if the sales forces of the buyer and seller already call on the same customer base. In EDA, that is largely the case, which is why there was generally a great deal of revenue synergy in EDA

deals. But in the Nortel/Clarify deal, for example, that was not the case, as their respective product offerings were sold into different parts of the enterprise—the buyers for telecom equipment had no budget or need for Clarify products and the Nortel brand name had no meaning in the CRM market segment channel, so there was little sales synergy. The HP/Mercury and HP/Opsware deals had substantial channel synergies, as HP is able to sell software effectively anywhere within the enterprise environment and has a large sales force and there is substantial leverage associated with the HP brand. HP's software offering, with Mercury, Opsware and Peregrine products now included, is now very broad. HP's sales force can always get any meeting in the enterprise space. Every CIO will take a meeting with HP due to HP's vast product portfolio.

INTEGRATION

Achieving successful integration is a harder task than first appears. Delegating to an integration team that is not given great authority can be a mistake. If the target CEO can stay in charge, that can bring value and quick decision making. Integration issues should be reviewed monthly at a senior management level. Integration involves thousands of small decisions--many trivial--and if not decided at all or correctly, synergies can be put at risk. Sometimes, without guidance from the target team, the buyer may not be as capable of making some of the integration decisions. In any case, someone with substantial authority should have the power to drive the integration decisions.

When target management joins the buyer's team, it should remember to focus on achieving the goals that a buyer has in making the acquisition, not the target's former stand alone goals. For example, the target team should focus hard on exceeding the projections used to value the deal and on bringing their knowledge and skill sets to the table. By contrast, targets that stay focused on their stand alone goals often fail to fully integrate.

In Opsware's case, it had good processes for a software company and the Opsware team did a great job importing that knowledge into HP. For example, Ben Horowitz ran HP's software unit, Opsware's sales executive, Mark Cranney, now runs HP's software sales for the Americas and Opsware's support executive now runs HP's software support team. Likewise, the Mercury business unit was transformational for HP, as it helped HP expand its software business. Both deals demonstrate the criticality of retaining the target's team members to better preserve the institutional memory as to the target's business. Keep in mind, as the target, that you want to be able to utilize the resources of the buyer to help sell the target's technology. For example, HP had 4000 sales personnel vs. Opsware's 70. So the target is better off if it is successfully integrated.

LEADERSHIP AND M&A

An important factor in a company's ability to effect an M&A strategy is the strength of its executive leadership and the creation of an environment where the risk taking that M&A (and other bold management action) necessarily involves is respected, as opposed to penalized if it is not successful. Cadence's CEO, Joe Costello, for example, was great in both respects. He was not just great at strategy and competitive positioning, but also at understanding the technology and the business, as do other great CEOs such as John Chambers and Larry Ellison. During his tenure, Costello produced many great executives and there was an environment that allowed the taking of risk. Cadence tried things and if they failed, the team learned from that and moved on. Many companies today do not tolerate a risk taking culture and that has its downside in terms of both M&A and executive retention.

CRISIS MANAGEMENT IN THE M&A CONTEXT

Mercury is an excellent example of managing through a crisis to a successful outcome. In 2005, option backdating and other accounting irregularities led to Mercury becoming delisted and missing revenue targets. Nevertheless, customers remained loyal and the Mercury executive team stayed together and was determined to help the company recover. While Mercury's stock traded on the pink sheets, it received offers at a 50% premium to its depressed stock price. These offers were declined, but relationships with potential buyers were maintained. In 2006, Mercury strongly rebounded, grew revenues at the rate of 35% quarter over quarter and had a strong fourth quarter. For 2006, Mercury had $1B in revenues, $1.2B in bookings and margins above 25%. Mercury was generating cash and its stock was trading at $40 on the pink sheets, a new precedent. It took 9 months to restate Mercury's financials. All potential buyers made clear that they wanted Mercury to complete the restatement before an acquisition was made, so as to eliminate litigation

and regulatory issues and provide comfort that there were no other accounting issues lurking. Ultimately, Mercury had acquisition interest from HP and two other major enterprise players. A third major enterprise player refused to participate in the bidding process. Ultimately, HP offered $52 in cash. HP publicly stated that HP had reviewed Mercury's stock option reporting and concluded that there were no hidden liabilities or earnings adjustments that were not already known.

EARNOUTS

When looking at a stock deal involving an earnout, the target team has to focus not on the closing deal value, but on the value of all the merger consideration assuming the earnout is achieved, including the effect of the increased value of the buyer's stock in the future when the stock vests, especially where the target team can help to materially increase the value of the buyer's stock. For example, ArtX was able to help drive up the trading price of ATI's stock to the point where the ArtX team members did very well.

RETENTION AND VESTING ACCELERATION

The best way to increase return on investment from an acquisition is to retain the target's key employees. This includes not only R&D, sales and marketing employees, but also those with customer relationships and other key institutional knowledge. Retaining talent may require some stretching in terms of compensation, organizational change and other factors.

It is critical that the target CEO play a major role in the acquirer organization, as that will help the CEO have the seniority to rationalize the integration of the target and buyer teams, it will help the buyer more effectively make many of the detailed integration decisions and the target CEO is often best positioned to encourage the target's team to stay on board post-acquisition. For example, for these reasons it was helpful that ATI appointed Dave Orton as President of ATI after it acquired ArtX. A large portion of the ArtX' team remains at ATI seven years after closing and that team has helped ATI win Nintendo business, design ATI's R300 chip and develop new technologies. Likewise, as a leader in the software organization at HP, Ben Horowitz was able to ensure that the Opsware team was best positioned to improve HP's software business.

Ability to retain target employees is enhanced if employees' option vesting is not accelerated as a result of the merger. Thus, if the target has pre-agreed to acceleration, and employees refuse to waive acceleration, valuation, and even the ability to do the deal, can be adversely impacted. For example, a deal cannot easily be structured as an earnout if it is impossible, due to acceleration, to incentivize retention to perform the earnout milestones.

MANAGING YOUR TEAM, BOARD AND BANKERS

The target's CEO should minimize the number of executives who are aware of deal negotiations so they are not distracted from the task of keeping the company successful on its path as an independent company. As to dealing with the board on M&A matters, it is important to err on the side of over-informing the board members; never let the board be surprised with good or bad news. When considering a merger, set a strong deliberations record with multiple board meetings, perhaps even two or three meetings a week. As to dealing with bankers, remember that the target's executives can do extensive preparation to learn key facts about the deal, the buyer and the business case that can help the bankers be more effective in negotiations and in driving value.

**Questions about the panel can be addressed to Dave Healy, 650.335.7266, dhealy@fenwick.com.*

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Moderator and Summary Author:

Dave Healy. Dave Healy is a partner and Co-Chair of the M&A Group at Fenwick & West LLP. Dave has negotiated over a hundred acquisitions, including the sale of Opsware to HP, the sale of ArtX to ATI and numerous acquisitions for Cadence.

Distinguished Panelists:

Tony Zingale. Tony was the former Chief Executive Officer and President of Mercury Interactive, a leading IT management software and services company that was sold in 2006 to HP for $4.5B. Tony was also president and CEO of Clarify, a public traded company that was a leader in the CRM market until it was acquired for $2.1B by Nortel in 2000, after which Tony served as president of Nortel's eBusiness Solutions Group. Prior to Clarify, Tony served in various senior executive capacities, including as SVP of Worldwide Marketing at EDA provider Cadence Design Systems, where Tony played a key role in guiding Cadence's M&A strategy. Tony began his career at Intel in 1980 as a product marketing manager of X86 microprocessors. Tony holds a B.S. degree in electrical and computer engineering and a B.A. degree in business administration from the University of Cincinnati.

Ben Horowitz. Ben was the co-founder and former President and Chief Executive Officer of Opsware, a leading data center automation software company that was sold in 2007 to HP for $1.68B. Post acquisition, Ben served as VP and GM of HP's Business Technology Optimization software unit. Under Ben's leadership, Opsware completed its IPO in early 2001, despite an unfavorable investment climate for Internet companies, bolstered its product offerings with multiple acquisitions, and combined with HP in a deal that reflected a substantial premium. Prior to Opsware, Ben served as Vice President and General Manager of the E-Commerce Platform division of America Online and as a vice president at Netscape Communications. Ben holds a B.A. in computer science from Columbia University and an M.S. in computer science from the University of California, Los Angeles.

Dave Orton. Dave was the former President and Chief Executive Officer of ATI Technologies, a leader in the design and manufacture of innovative 3D graphics and digital media silicon solutions that was sold in 2006 to AMD for $5.4B. Post acquisition, Dave became Executive Vice President of AMD's Visual and Media Businesses. Under Dave's leadership, ATI completed several acquisitions, achieved key customer wins and was acquired by AMD at a substantial premium. Dave also served as the former President and CEO of ArtX, which he sold to ATI in 2000 for $400M. Prior to ArtX, Dave served as Senior VP and GM, Visual Computing, and Senior VP and GM, Scalable Systems, at SGI. He also worked in the graphics and semiconductor industry at GE and Bell Labs. He holds several patents in the graphics and computer architecture areas. Dave earned a B.S. in Mathematics and Economics at Wake Forest University and a M.S. in Electrical Engineering from Duke University.

Panel Discussion

Dave Healy: Introduction

I'm Dave Healy, co-chair of the M&A group here at Fenwick. We have an amazing panel of great guys here who've done many deals and are here today to regale you with their experiences. Ben Horowitz, on my immediate left, sold Opsware to HP and Loudcloud to EDS, and was an officer of Netscape. Tony Zingale sold both Clarify and Mercury Interactive and spent many years at Cadence planning out its EDA acquisition strategy. Dave Orton sold ATI to AMD as well as ArtX to ATI, so he was both the buyer and the seller relative to ATI, and he also presided over a number of deals on the buy side at ATI. So he's seen deals from every perspective. That is what's so interesting about this panel. The panelists have seen deals from both sides, and done deals that are large and small, complex and less complex, and have experience ranging from the start-up to the public side, and done deals that are extremely successful as well as those from which there were lessons to be learned. So with that, let's move ahead. Note that Tab 1 in your booklets is a summary of my prior interviews with the speakers here which has some but not a complete overlap of the topics we'll discuss here today. You can follow along there if you wish.

Building Standalone Company Value

Ben, why don't you start us off in terms of talking about building standalone company value as an independent mindset, and we'll take it from there.

Ben Horowitz: Right. An acquirer tends to look at a target company or whatever asset it is acquiring solely from an economic standpoint. An acquiror tends not to view an acquired technology as being particularly valuable. Generally, such assets go for five or ten million dollars. Where you buy a product, that's more valuable, or if you buy a business, that tends to be the thing that is by far the most valuable to acquire. If you're building a business, you can't envision it in combination with something else, because it's got to stand on its own. So as you go about building your company, you're generally going to get a much better economic outcome if you look to build a standalone business and then if you get acquired – you get acquired. But you're building all of the things that you need both from a business standpoint and from a cultural standpoint to stand alone. Also, if you look at it more philosophically, you know that people buy companies because they are very valuable and so the acquisition is really the by-product of creating value. But if you start by focusing on getting acquired, then you are focusing on exactly the wrong thing. You are focusing on the by-product instead of the product. It's not unlike the employee who comes to you and says, "What do I have to do to get promoted?" I always say, "Well, how about you sell some software, build a good product or do something else that creates value, and then we'll think about promoting you". And you know, it is just like that with a business. So you really have to focus on how you are adding value to the world and then the acquisition comes. You know if it comes, it comes, but you

are not going to maneuver, or it's dangerous to try to maneuver, your way into an acquisition from the outset.

Dave Healy: Tips for Growing Standalone Valuation

-Growing Clarify

Tony, why don't you talk about growing Clarify and your strategic approach in doing that.

Tony Zingale: Sure. But first, a few comments to add on to what Ben said. I think when you're the leader, who is responsible for doing all of the things that Ben described and making sure that the management team is wholly focused on building that kind of value as a standalone entity, which includes focusing on the product line and the whole go-to-market strategy in order to truly build the standalone nature of the business, and I like the way Ben characterized that—it's beyond the product or the technology, it's the business that really drives the value that the company ultimately achieves, you have to keep your eye (as the leader and therefore as the Board) on what are the possible outcomes once value is achieved, and throughout the process, on what the landscape looks like. The investment bankers of the world are very well skilled at coming in and providing what we all call the universe charts where they show you all the planets and moons and this is how everybody's moving and this is where you're at. You know, you're always the worst positioned company, by the way, when they come in and describe that to you. You think you're doing extremely well but on the charts all of a sudden you look like Venus and everybody else is Saturn and Jupiter. But it's important that you as the CEO (but, as we discuss later, not your head of marketing or head of sales, for example, as they have to focus on building the value that the business ultimately creates) keep an eye on the possible outcomes so that you are not surprised or caught off-guard when that conversation about strategic alternatives, which is code for M&A, comes about in your company's lifecycle. With respect to Clarify, it's everything Ben said. When I left Cadence, I was fortunate to exit the electronic design automation business, which is the most technical industry I have ever been in. When I joined Clarify, which was a customer relationship management company, in 1997-1998 our competitors were Siebel Systems, Vantive and Scopus. I knew that Clarify had gone through its IPO with its entrepreneurial founder, Dave Stamm, still at the helm. Dave was a great technologist and entrepreneur who I actually had the chance to work with at Intel and Daisy. So I knew what I was getting into when I joined Clarify, but at the same time it became very clear that Clarify needed to expand its portfolio of products and re-position itself in the marketplace in a way that was unique vis-a-vis everybody having the same thing to offer the customer. Customers were very willing to purchase CRM products at that time, having made all of the investments in ERP software. Y2K was just around the corner. If you harken back to 1997/1998, it was all about the customer and touching the customer. The Internet was kind of a dream at that time, although all the venture guys in the industry were shelling out hundred of millions of dollars to non-companies and non-entities. But CRM companies were real, so market demand was not a problem. The challenge was building value, as Ben described, and value had to be

derived from increasing the average sale to every customer, which means more products. Automating the process of customer service was Clarify's strength. Automating the process of sales automation was Siebel's strength. We all moved towards one another in the marketplace to offer sales, marketing and service in an integrated, and what we called "front office" suite of automation tools. ERP software was more like the "back office", it never saw the customer, never touched the customer. So, we made hay with "touch the customer" as a category and we called it the Front Office and we integrated products internally where necessary. We bought small technology offerings from companies that were undervalued and we built out the suite and we spent so much energy on our go-to-market strategy since Siebel was a company that was spending over 50 cents on every revenue dollar in sales and marketing at the time. We had to compete in a way that positioned our unique value but at the same time be present as much as possible so the real claim to fame at Clarify is that it worked. We created a category along with all the other vendors, I don't mean to say we did it on our own. Everybody got smart on CRM and Front Office and all the touch points including the Internet, although the Internet piece was actually BS—no one had an Internet offering at that time—but you had to have it in the slides and we all marketed that, and we all sold that. Clarify had the best technology. One of the lessons learned is, and I'm sure many of you in the audience know, the best technology doesn't always win. Case in point, Clarify–Siebel, case in point, Intel–Motorola. Back in the personal computer days Intel did not have the best microprocessor. Motorola did. Intel won, $40 billion later, thank you very much. So that was the lesson at Clarify. We grew revenues tremendously by selling a Front Office suite, increasing ASPs and taking advantage of the high growth nature of the marketplace and delivered real value to our customers in the form of real product.

Dave Healy: -Growing Mercury Interactive

Tony, why don't you keep going and talk about Mercury Interactive and how that growth plan worked out.

Tony Zingale: Mercury was a little different. We'll talk more about it throughout the day, but in terms of the create value part of the equation, Clarify was broken when I showed up and we had one product that had done extremely well. Great relationships with customers. Mercury was a company, in 2002 when I joined the board and then in 2004 when I went inside as chief operating officer initially, then ultimately CEO which we'll talk more about later, that was growing extremely well. It dominated its category in terms of automating quality assurance. It had world-class products, which were the leading products in the industry. It did an incredible job at automating the process to ensure high quality applications and the performance of those applications in a pre-production and then also in a production fashion. It dominated the space. It was a four or five hundred million dollar company growing extremely well at the time, but it recognized that it would never double its size. When I went on the board there, I asked the then CEO at the time, Amnon Landan, where does the next 500 million dollars come from? I don't think it comes from test automation. Where does it come from? How will you get from $400 million, $500 million to a billion

dollars? And also, how do you get out from underneath selling to the QA director inside the organization? How do you really sell higher up in the organization, which is the classic thing to tell the sales force, to sell higher. Well the only way the sales force can sell higher is if there is a connection from the technology to the business value, where the executives really reside. So, Mercury did two things really well. First of all, it started filling out its portfolio, adding a piece called business availability or systems management, if you will, at the application level, and doing some acquisitions and then integrating those products with the test automation products. But most importantly, it created a category called business technology optimization, which, fast forward, HP in fact uses today. In fact, after HP acquired Opsware, Ben ran HP's Business Optimization Group. The BTO products were integrated such that it connected all the value that Mercury products delivered on top of the applications directly to the business. So, we created the BTO category, filled in with acquisitions both the business availability functionality and the IT governance functionality by the acquisition of Kintana, which was a company that I also sat on the board of as well. And we were able to go to market in a very unique fashion, much the same way Clarify did and sell a full suite of products. We began increasing our average selling price, doing multi-million dollar deals with customers, and calling on CIOs for the first time. This is back in 2004. Having elevated our message in a sense, from 2004 to 2006 we doubled the size of the company's revenue stream. Doubling a $400 to $500 million company's size is very challenging when you are selling to IT as probably many of you are dealing with today. Selling to IT, where budgets are going down not up. It's what I called "the advanced course of selling". You have to convince customers to spend money to save money. It's very challenging to do that in this kind of environment in particular. But at Mercury, it was the same kind of playbook. Go to a higher level value proposition, fill in the correct product offerings either by building them or buying them, and then really work hard on the go-to-market strategy to in fact effect the business value delivery in the channel.

Dave Healy: Thanks Tony.

-Growing ATI

Dave, tell us the story about ATI before you got there and after you got there and how you built that and also the competitive environment you faced and how you viewed growth relative to those competitors.

Dave Orton: In 1999, I joined a startup called ArtX. Dave Healy was working with us as counsel at the time. In the late '90s there were about forty-seven graphics companies, but by 2001 the number of graphics companies had decreased from forty-seven to four. So, it was an interesting time being a startup graphics company. But, we had one key value add. We had the Nintendo contract. We were developing the GameCube core graphics engine for that. So, how do you build value with that rather than just staying private and collecting royalty checks? And so, what we focused on was our core strength at the time which was really a graphics technology team–72 guys–and recognize that in order to become a company, we

had to develop some strategic relationships. So we started looking at companies that had Intel licenses so we could sell them the front side bus. We looked at companies that had southbridge chips, one of the two basic chips on the motherboard of a computer along with a northbridge chip, because we needed to connect to that. We were just a northbridge company. In doing that, we ended up coming across ATI, which at the time was looking at expanding beyond the GPU business, the core graphics processor business. So ATI approached us and we ended up merging with ATI in 2000. What we brought to them was a northbridge technology, so that ATI could actually go beyond the graphics GPU business, and the Nintendo business, which allowed them to be able to seriously say that they were getting into consumer electronics and were not just a PC company. Because at the time, in '98, '99, ATI was out there saying the PC business is pretty flat. Everybody was telling them that—all the analysts were saying the PC business was going to go down and thus that the graphics business would decline as well. So ATI was in a scramble to try to go beyond what we call GPUs, which is about a $3 or $4 billion dollar business. So, when I got to ATI, it was an interesting awakening. Even though I was coming from being CEO of a 72-person company, I actually became president of ATI, a $1 billion dollar company, after the merger. And, as President, I reported to the CEO, K.Y. Ho. K.Y. moved everything under me immediately. I wasn't quite sure why at first, but I found out pretty quickly. In the first revenue meeting, four weeks into our first quarter, coming from SGI, I asked the normal questions about revenue, bookings, pipeline, billings and backlog. When they told me, I looked up and said "Who signed up for this quarter?" It was the quarter from hell. So we ended up pre-announcing and the stock went down. We lost the economic value of the merger right away, because the stock basically dropped in half and then to a third of the merger price. But we had a core at ATI, a core business. It was a billion dollar business. Again, when you looked underneath the covers of that billion dollars, about $400 million dollars of that was reselling memory, because we were in the graphics chip and graphics board business. Well, the graphics board business is selling memory, sometimes at a negative margin. And so, effectively in the first year, we stepped back and said," Look, we're in the graphics core business, the graphics GPU business, so let's focus on that. Let's get strong at our core and let's start to partner or get out of the areas where we don't add value". And so here we were, a company competing with, not NVIDIA at the board level, at the chip level we were, but at the board level, we were competing with twenty-seven Taiwanese, Hong Kong and Chinese board companies. We weren't going to win that business. We were going to lose, so we decided to get out of it. So, that's what we did. In the first year, we moved $400 million dollars out of the business into our partner channel, but that allowed us to focus on our core strengths, and ask how to become world class again at developing GPUs. At the same, we actually wanted to get in three new businesses. So here we are, out of cash, billion dollars of revenue, no debt on the books, but out of cash. Our situation was that we had $70 million of cash, but our accounts payable were significantly higher than our accounts receivable so net, net, we were out of cash. But we were sitting on a lot of inventory. So a combination of working through that, and really getting the engine going, we actually again became, in 2002, the number one GPU company in the world. At the same time, we grew three new businesses internally, including two consumer electronics businesses. This goes back to the make-buy question. We decided in that case to "make" these new products. We decided internally that we were going to leverage our graphics core

and get into the handheld business. And you say, "How do you do that?" Well, if you look at being in the GPU business on the notebook side, and you want a low powered notebook, what's the natural evolution of taking a graphics engine that's low power? It would go into a certain level of handsets. So it was a media co-processor for handsets. We were in the GPU business in the multimedia space. I don't know how many of you are familiar with "all in wonders", but it has basically brought TV to the PC, so what's a natural extension of TV on the PC? HDTV. So we took that graphics core and extended it and created a $250 million dollar TV business and a $350 million dollar handheld business. And then we looked at the graphics core and said these are barriers that other people would have to develop to get into what we had at the core of the company. And we said let's get into the chipset business because it's graphics core and we actually partnered; even as a billion dollar company, we partnered on the southbridge side and got into the chipset business. We grew a $600 million dollar chipset business. So we did all that, during a time when the economy, during 2000 to 2002, was pretty tough and we were out of cash, but we focused on our core and then took baby steps to get into these new businesses and by 2005, we were about $2.4 billion dollars in revenues. Our core business grew from about $700 million to almost $1.6 billion and we had three other businesses that were natural extensions of our core business. And at that point, we had won the Nintendo second round and the Xbox 360 GPU business. So, that's how we focused on creating value. We focused on our core strength, we exited the businesses we weren't good at and focused on those that we were good at. We were different from other businesses in a sense, because the PC market is quite consolidated. When you look at a sales force at a Silicon Graphics or maybe some of the software businesses where you really call on the customer, how many customers are out there building PCs effectively? Ten notebook, and five desktop, manufactures. It's a pretty small business. So the sales side of our business was quite different than the classic, I'll call it 25% SG&A company. We ran an 8% SG&A company. Eight percent sales, marketing and G&A. That was our business model. So, very different. So, that was ATI.

Dave Healy: Until you got to that last point about 8% SG&A, Dave, I was going to say that, after all that good work building value at ATI, 2005 would have been a good time for you to have asked ATI for a bonus.

Growing Opsware

Ben, tell us about Opsware and how you grew that by M&A and internal development.

Ben Horowitz: So Opsware, we actually didn't start as Opsware–we started as Loudcloud. The original business was to be the EDS of the Internet and a funny thing happened on our way to being the EDS of the Internet, which is that all of the new companies who were going to be our customers, back in the last big crash, started to go out of business. So it was going to be very, very difficult for us to do that. And, long story short, we ended up selling that services component of our business to EDS, so EDS would be the EDS of the Internet. Now that transition is a really good story which we don't have time for now, but the thing to keep in

mind about it, or the thing that was very unusual, is we were a public company when we did it. We sold 100% of the revenue that we had to EDS and then we became a software company. Still public, still with the same security, only with no revenue. And so it really was a very high wire act of a deal, but in retrospect, it looks really good. At the time, the stock went to 35 cents, and I got some angry phone calls. But that was that part. Then we started to build the software company. So that was in 2002. And in building the software company, and one of the things that we'll get into, is OK, how do you think about when you should be standalone versus when it's time to sell. And that's a question I get quite often. And what I used to always to tell the employees, which I really believe myself, through the lens of the company being acquired, there's really two things you need to be standalone. Number one is, you've got to be in a big and growing market. There's got to be a big market opportunity for you standalone. And then the second is you have to be number one, because there are no profits for number two in the technology space. That's just the way it is. It's sad, it's frustrating. You've got a really good product and you're almost number one, but, if you're number two, that's just not generally a very good position. So the things that cause you to want to be acquired are: One, the market either isn't as big as you thought or changes, kind of like when WordPerfect changed to the office suite, right? Word processing was the market and then it wasn't the market. So, at that point, you have to look at acquisition. Or two, the market is just smaller than you thought. The other reason you ought to consider not being standalone is, if you're going to be number two, then it's possible that in combination with somebody else, you can be number one. And so what I always used to tell the employees is, "Look, as long as the market is big and growing and as long as we're number one, we're going to be standalone, because we're going to be more valuable as a standalone." Now if you look at the history of companies that were in that position and sold, those are generally the stories of companies that sold too early. And so, that's how we viewed it.

Now through the lens of the acquirer, they're looking at it as, OK, is this going to be more powerful combined than by itself. And that tends to happen when the market changes, i.e., when you go from a standalone product to a suite. So as we built up Opsware, we were always very focused on this. And we started out as a server automation company. And what we were hearing from customers is like great it's good that you're automating how we manage our servers, but guess what, in the data center there's more than just servers, and if you add a server, you've got to update the load balancer and if you want to provision a server, you've got to add storage to the SAN and these kinds of things. And so our M&A strategy actually unfolded that way too. So we ended up acquiring a networking company and a storage company and we were changing the market that we were in, and expanding it and broadening our product line to go attack it. And that's how the company developed. And that's how we built up the value, and we ended up being the number one company in data center automation.

The turning point for us, though, and we'll get into this more later, was that data center automation was no longer going to be the category, instead it became, as Tony said, business technology optimization, in which the question became "How do you optimize all of IT, of which the automation of the data center configuration was a component, but not the whole thing?" And then we had the big decision of are we going to go blow up to that size

and go do it, or are we going to combine with somebody who has those other components? So that's kind of the story of how we built that.

Dave Healy: -M&A (plus R&D) as a Growth Strategy

-Cadence

So Tony, let's go back to the exciting times of the nineties at Cadence, when you were the marketing executive there who was strategizing about all their M&A. You've talked about how Cadence's approach was a combination of M&A plus internal R&D that ended up being such a powerful, synergistic growth strategy. Why don't you talk about that.

Tony Zingale: I have the benefit of seeing it on both sides and being at Cadence, which for ten years was a fairly active, in fact very aggressive, acquirer of technology. And it kind of harkens back to what Ben said. It has to do with the market. I mean you have to start with the strategy and the market. And in the electronic design automation business, as I said to Dave Healy during the interviews, "The software tool that's being used in a particular part of the design process either does or doesn't do the job, meaning close enough, which might work in the enterprise software space, with all due respect to the enterprise software guys, doesn't cut it. It either lays out the chip or it doesn't. And when it goes into manufacturing, it either yields in silicon or it doesn't." And so, there's no gray in EDA. Of course, some might disagree with me a little bit, but there's no gray. It's pretty black and white. And in that regard, technology was king in the EDA market. And having a very innovative, technology leading development team was fundamental to any, even to this day, electronic design automation company's brand and reputation with its customer base in the marketplace. Early in the eighties, and as the strategy began to unfold, and as Cadence was born out of a merger ironically between a company called ECAD and a company called SDA to create Cadence, it became very clear in the leader's mind, a gentleman by the name of Joe Costello, who deserves all the credit for fashioning the strategy that was executed upon, that to be successful, to be the number one player in the marketplace, the company had to do both extremely well. First, develop world class EDA technology and products and second, acquire leading EDA technologies in the marketplace, and in fact, become the de facto IPO market, if you will, for EDA technology companies that hadn't yet built a business, as Ben described, but really had a great product that solved the analog design problem or the logic simulation or logic synthesis problem. And so Cadence became very adept, and in fact, in my opinion, led the way, on its M&A process and it became the model that all other companies began to follow, at least in that space, and probably even further beyond that. I'm not clear on when Cisco got the title of being the world's best acquirer, but I put Cadence's skills against it any day of the week. But we became very adept at, and we'll talk later about the formula, the very simple formula, we used to assess companies' strategies, products, people and then the economics around getting these deals done in a very high volume and with a high rate of return. And for us, we focused culturally inside the company. I mean, think about it. You tell your R&D group, we're going to go acquire our next generation product offering. What's the

first thing the R&D group feels like? Oh, there is no confidence in us to develop the next thing. So, it was a careful balancing act, keeping the Cadence R&D teams very busy, very challenged, but at the same time, very involved, and in fact, giving them a no vote, if you will, in any acquired technology that was done externally.

Also note that, unlike in the hardware business, in the software business it is very expensive to build a great marketing and sales channel because there are so many clients. And Cadence had a machine from a marketing and sales point of view. So any acquired technology could be put into that channel and quickly taken to market in a way that a standalone entity could never duplicate, or maybe it could but only over a long period of time with lots of investment. So part of the attraction for these small companies was having access to the Cadence channel, which was a means of enabling their product to become the number one offering in the space. And so we used that vehicle as leverage in the space. But it all starts with the leadership of the company saying, day in and day out, that M&A is in our DNA, it's part of our culture. I can remember sitting in meeting after meeting when some market opportunity would emerge and Joe would say, "Well, either we can build it or find who's out there that has that today. Let's go have that dialog today. Let's go make it happen today without any second thought." Too many times M&A, at least back in that era, was considered as a failure on the part of the company. You know, we messed up; we don't have it; we're getting our ass kicked; let's go acquire somebody; that will solve the problem. Quite the contrary, at Cadence, it was always positive as to how could we extend our lead further in the marketplace, how could we satisfy that customer need better, how can we put our competitors on the defensive? It became so much so that, today, back in those banker meetings that I described earlier with the universe charts, you're always worrying, as the CEO, whether it is bad for you if two other companies get together. If I'm the CEO at Mercury, I think it is bad if EMC gets acquired by HP. It's bad for me. So you got to be thinking about what's not only positive for you, but what would be negative for you if two other companies merged. So the subtle point at Cadence, beyond the execution of acquiring great technologies to build and take to market in its high powered channel, was the DNA from the company's leadership that this is who we were. We were going to be great at both.

Dave Healy: Thanks Tony.

-M&A (plus R&D) as a Growth Strategy

-SGI

Dave, SGI was sort of a Hollywood superstar in the nineties when it started down the M&A path. How did that work out in terms of building value in your view?

Dave Orton: I saw it from a different perspective at SGI than at ATI, because at ATI, being the CEO, back to Tony's point, you have to set the tone from an M&A standpoint. And our strategy at ATI was much more of a "string of pearls" model of really looking at how do we go beyond the PC

market and into consumer electronics and what can we make and what companies do we acquire to do that in a few particular segments of consumer electronics. By contrast, at SGI, I was running a $220,000 ASP business vs. a $22 ASP business at ATI. So that was quite a difference. At SGI, I think the first strategy, in general, was to "make" rather than "buy". And then it was, how do we transform, not so much how do we build on what we have, but how do we transform ourselves to continue to grow? And a key merger, the first one that I was exposed to, was in '92 and that was MIPS. And the MIPS merger, as I saw it from where I sat as a GM, transformed the company from being a high-end, low-end graphics company, basically a computer company with two platforms, a high and a low, to being a multi-platform graphics and multi-platform server company. So we went from two divisions to, after the merger, six divisions, and we created a very broad range of products from low, medium to high on the graphics platform/workstation side, and then we really moved into not just being a technical server company, but now started to think about selling into the enterprise. I say think about selling into the enterprise because we actually never quite made it to the enterprise side. But we were very strong in the technical server side. And then the sixth pillar at the time was recognizing the need and the strength of our software development capability in the company. And again, I saw it from a general manager's view, not from the CEO's view or the broader vision. But then, as we evolved as a company, at the time we were talking about reasons for M&A. And I think about the make/buy tradeoffs and I think of offensive and defensive reasons.

The second large merger that we did was actually what I view as a defensive merger. It was defensive and it was something that I used, in my discussion with Dave, of describing the difference between creating a house of brands versus a branded house. We acquired Alias and Wavefront. And that move was, from where I saw it, defensive because the concern was that Microsoft was buying SoftImage, that Microsoft was moving the entire software world to develop under a Windows environment, the DX graphics environment, instead of OpenGL. And for SGI to continue to add value and survive as much as anything, we needed to have the Unix world live and have an environment live, a software environment and application world live, beyond Microsoft. And so it was very much, again as I saw it, a defensive move because we weren't a software application company–we acquired one. And post acquisition we left it as an island. And so that's why I call it a house of brands, Proctor & Gamble type approach. OK, I'm in toothpaste and I'm in toilet paper. We were in platforms and applications. That's the same distance. The mindset and mentality of being in those two businesses is just different. So we left it very much standalone. And ultimately it was spun back out and it's still standalone.

And then the third very large merger that SGI embarked upon was in some ways a combination of being a defensive move (back to the question of what if my competitor acquired this) and, though I hate to say it, an ego driven move, which can be very damaging. That was the Cray acquisition. Here's the mantle of entering the supercomputer world. Now, how does SGI create the brand of being really a supercomputer company? Well, we really were. We just didn't have the mantle of having the fastest in the world. But from an economic standpoint and from a customer-based standpoint, we were there. We just didn't have that trophy. But in order to obtain that trophy, you actually had to shift business

models, and I think that was the failure of that merger was it was a different business than the business we were in. And we didn't integrate it effectively, or quickly enough. And that was the Cray acquisition. And it happened in a time where the business, and our market, was actually getting fairly unstable, and it was also hard from that standpoint as well.

So those are the three mergers I saw at SGI. Each had very different motivations. The deals were really not strategically webbed together in an overarching vision for the company, I think, but each was still valuable to the company.

Dave Healy: OK, thanks Dave.

Deciding When To Sell

-Loudcloud/Opsware

Ben, why don't you use Loudcloud and Opsware as examples of how you know when it's time to sell.

Ben Horowitz: Yeah, it's a hard thing to know. And it's funny, a lot of acquisitions occur due to ego. I think all M&A is highly emotional and gets entangled with the personal motivations of the guys running the company. So you have to be very careful about how you manage your emotions in these kinds of situations because it's off the charts in terms of what you go through. And you kind of have to put the demons aside and say, "OK how do I analyze this and how do I make the right decision?" Loudcloud and Opsware were totally different situations. With Opsware, we were the belle of the ball. With Loudcloud, we certainly were not. In the Loudcloud days, we were the number one company in our category, but the category was going off the cliff. Exodus, which was right next to us, had recently gone bankrupt, coming down from a $50 billion market cap. So that will scare you for sure.

But it was very clear with Loudcloud that we needed to do something because the market that we were in had somewhat disappeared. We were in the market for what amounted to web hosting. Now we'd call it cloud computing—we were essentially the first cloud computing company. The market for our segment started out very large–large enough for us to go public. Then it ended up shrinking to close to zero, at least for cloud computing services from semi-viable companies, and anybody with less than a billion dollar balance sheet was definitely semi-viable at that point. Exodus had run through $800 million in a year and gone bankrupt. So if $800 million was clearly not enough, it was obvious that $100 million was not going to do it. So, we knew we had to do something different because we were in a bad market. And one of my favorite sayings of Andy Radcliffe, who was our venture capital partner at the time, was that, "We always invest in two things, the size of the opportunity and the quality of the team. And a bad market always beats a good team." I said "OK, so why do you care about the team at all?" What he said to me was "Well, in rare cases a great team can navigate a company from a bad market to a better one." That really stuck

with me at the time because we were in a bad market and we were going to go down. There was no question. So as we were looking at our situation with Loudcloud, we asked how do we get out of this market? At that time some people, at least in the company, were advocating that we get bigger, or buy out other companies to add size, or cut costs, and similar changes. But ultimately as we went through that exercise, it always came back to the realization that we were in a bad market. And you can't cost cut your way to success. So we came up with the idea of selling the operational part of the business and keeping the intellectual property. It was really myself, in conjunction with John O'Farrell, who's actually here today, that came up with the idea. I will talk later about how John and I worked together, because a key to both transactions was the combination of his skill set and how good he was and the relationship between him and me, which enabled us to do some things that you really shouldn't have been able to do. But what we realized together was that we had something to sell—that is, Loudcloud was the number one brand in managed services and, for all of our woes and even with our beaten down stock price, we still had a great reputation, the best technology and the best cachet. And so what John and I talked about was, if we could get rid of the managed services part of the business and keep the intellectual property, keep Opsware, which was the software we used to run Loudcloud at that time, then, while it might not be great, at least it would leave us with a chance of success. Otherwise, we were looking at nothing. That was our, rather desperate, thinking at the time.

So, we thought about, OK, in what context is Loudcloud valuable? Who is it going to be valuable to? I started to study the companies in the space and one of the things I first thought was that basically no one was viable, and all the companies in the space were heading for bankruptcy, so there really was not a viable buyer out there. But on second thought I realized that both IBM and EDS remained viable. So, I started reading the 10-K and the 10-Q of both companies and trying to understand their strategy. The realization that I needed to analyze the situation from these potential buyers' perspectives came from the training that John had given me over the years, which was that you should never look at a deal through your own perspective. You always have to look at it through the other company's perspective, because your perspective is really not instructive to what the buyer wants. So you can't be self-centered in these things. So we looked at it from that perspective, and I convinced myself that IBM should be interested in us and that EDS almost had to buy us, because EDS' operational approach at that time was pretty ancient and they needed something more, especially given that EDS' balance sheet was not nearly as good IBM's. EDS needed a real technological advantage, which we could provide, and we really had a modern approach to doing things. So it really looked like a combination with EDS would be a good idea. Now, interestingly, as we went through the process, we called IBM, and they were like boom, yeah let's meet, we want to talk to you, let's go. And there were actually some other companies interested as well, but EDS couldn't have been less interested. But then one day John comes into my office and says, "We just have to let EDS go, we just have to focus on other possible buyers, because EDS won't even take a meeting with us." But I said, "Let's draw the org chart at EDS one more time John, because if this deal doesn't happen, we're going to go bankrupt and I'll have to lay everybody off." So we draw up the EDS org chart and we go through it and we say, OK who's the EDS executive we can

call? We realized that there was one guy whose job was going rise or fall on whether we did a deal, so we decided to call him up. When we called him, we were in the airport somewhere going to see IBM. Sure enough, the EDS executive said, you know what, I will talk to you guys. And long story short, EDS ended up being the only company that ended up bidding for Loudcloud at the end, so had we not persistently pursued EDS, we would never have sold Loudcloud, and we would have gone bankrupt. But it just goes to show that you really have to understand how the potential acquirers might look at your company. And it turned out that for EDS, Loudcloud was still very valuable. So, even though Loudcloud wasn't valuable standalone, it was valuable in EDS' hands. The fact that we had other interested parties gave EDS a sense that there was scarcity to the Loudcloud asset. There was only one Loudcloud and if EDS wanted it, EDS had to step up. Without going through all the details and the three months of not sleeping that I went through, that's what led to the acquisition of Loudcloud. We found the company that needed us the most and then we created a competitive process and got to what, in retrospect, was a really good outcome for the business. We sold Loudcloud to EDS for $63 million, but more importantly, EDS took on the $20 million a quarter cash burn that we had and as part of the deal we were able to retain Opsware, our software (even though there was no software business at the time) and continue operations.

Then, fast forward to Opsware. Opsware did much, much better as a business than Loudcloud did, and was a good, profitable and very fast growing business. We really had no intention of selling Opsware and we certainly didn't feel like we needed to sell it. So we were in a much, much better position than was the case with Loudcloud. And, I'll tell you, the number one thing that you want to go into a M&A discussion with is a standalone option. If you can keep running and growing the company and get a good outcome, if you do end up selling, you're going to get by far the best deal. And that was thankfully the position we were in with Opsware. And through the course of Opsware's history, we received acquisition offers from time to time. People would call us up and say, "Hey we'd really like to buy you guys." And we would run the test. Are we in a big and growing market? Are we the number one player? And it always came out "yes" and so we would just say "no thank you". But the reason we ended up selling is that a few things changed in the market. One is we had gotten a lot more momentum. We were on our way to $150 million revenue a year, which was when enterprise software companies become significant. They're not just little guys at that point; they're on their way to being big guys. And then our primary competitor, Blade Logic, had filed for an IPO. So those two things got everybody's attention, so to speak. And so what ended up happening is that we started receiving a lot of acquisition overtures. And as we talked to these potential bidders we said, gee maybe this time something is different and the market is probably changing. And as we looked at it and had further discussions with the companies, what we found was there was a seriousness to the companies that had complementary software, i.e., software for network systems management and software to monitor and test performance and do the other things that you need to do in a data center. There was no question that those companies were going to enter the market either by buying us or by buying our competitor. There were eleven companies in this situation that were interested in us. If you look at our proxy, we disclose there that eleven companies had a strong enough interest to consider making an offer for Opsware. So we knew it was going

to happen.

So then we had to look at, "OK, what is our standalone opportunity, and then what's likely to happen if they buy a competitor, how will the market change? How will that affect us?" Also of some, but lesser, concern at that time (in 2007) was the state of the economy–what just happened with those hedge funds and why are they blowing up? So we had to consider all of those factors. We went through a very long process thinking about all these changing circumstances. Our initial reaction was that it was not a good idea to sell the company at this point, particularly given the initial offers we received. Initially, the potential bidders were offering us about $10-$11 a share, which was a little over a billion dollars. Given our stock was trading at between $7 and $8, that represented a good premium and you couldn't really ask for more, at least with a straight face. But we thought that our standalone opportunity and our ability to out-execute our competitors was pretty strong.

And as we had the discussion with the Board, one of the questions that they asked was, well what price would you sell it at? Is there a price where you just couldn't get there standalone, where you're way more valuable to the acquirer than you think you can create on your own? And we went back and we looked at that and we talked about it amongst ourselves a lot and the number that we came up with was $15 a share, which seemed too high to achieve if you're trading at seven dollars. Fifteen dollars, nobody's going to pay that. But we felt that, look, if somebody offered $15 a share, there's no way we should not sell. As a public company, we would be shirking our fiduciary responsibility to shareholders and the employees if we did not sell at that price. Nobody would think that was smart. So we went back to the Board and said, "Yes we agree we'd have to sell at $15." But at that time, various companies were calling us and offering $10 or $11. So, I called up those companies and said, "Look, we've talked to the Board and we would not consider selling the company for less than $14 a share." And why I said $14 and not $15 was really because somewhere in our minds, we thought if we said $15, that would be basically like telling them to just go away. And we don't really want to tell them to just go away because that wasn't our feeling. So we thought what's the highest number that still made sense to sell the company, but wasn't telling them to just go away. That was $14. And so we told everybody $14, and everybody said "No thank you." And that was kind of it. And then about two and a half months passed and one of the potential acquirers called back and said, we've thought about this, we've looked at the landscape and we're interested in bidding $14 a share. And so, at that point, we looked at the whole thing again, and we said, we ought to talk to these guys. And we called all the other companies that had expressed interest before and said, look, somebody's kind of met our price and so we're going into process and that's how it started.

Dave Healy: And it was a very relaxed situation, as I recall!

<u>Deciding When To Sell</u>

-<u>Clarify</u>

Tony, you described Clarify having a real "aha!" moment at a board meeting in terms of realizing it was time to sell.

Tony Zingale: Just a couple of piggyback comments on what Ben had to say. You can describe being number one in your market a la Jack Welsh and all of that, but the cliché I like to use is "get big or get bought". And the reason is, it has to do with being number one. It has to do with leverage because, particularly in a tough environment, and regardless of whether you're selling to hundreds of clients or just a handful of clients, as Dave Orton was saying earlier about the PC market, customers like to buy from as few vendors as possible, unless you have something breakthrough that's a step function in terms of its capabilities and value delivered. And so big matters. And particularly in the enterprise software space, the higher up you get in the food chain, the more that leverage really comes to fruition. So as a CEO, you sit there and you think about if I'm number two or three, what are the steps I need to take to become super relevant, and relevant means becoming the leader. Or the other thing I like to say is you have to be great at something. If you're not number one, you have to be great at something, so that your sales channel or your management team can walk in and say "Although we're not the leading supplier in this space, in this subset of this space, we're the best here." And that's actually the cornerstone of many number two and number three companies in lots of different spaces. In the car rental business, for example, Avis gets a lot of recognition for being number two and actually uses that in their branding accordingly. And they use price or availability or whatever it might be in that regard.

The other comment I'd like to piggyback on is the ego comment. Both companies for which I was successful in transacting a great outcome for the shareholders in fact probably wouldn't have gone through the transactions with their founders and former CEOs in places, certainly not at the valuations that we sold at. And I think we have some current cases, i.e. Yahoo, which was splattered through the front pages, where, with all due respect to Mr. Yang and Yahoo, founders just think their companies are worth more, bottom line, they just do. Because it's emotional. They just think it's worth more. But it's not. You have to strip out the emotion in the analysis and move forward, with all due respect to founders. But sometimes, founders do sell their companies at a maximum valuation and that's great. I think you could also go back to the PeopleSoft situation with Oracle, the long proxy contest, whatever. Although the founders were no longer running the company, they persuaded the board to vote down every term sheet that Oracle put forward. And the poor CEO at the time, Craig Conway, got caught in the middle of that. And so again, ego plays a big, big, big role in the equation.

Clarify, as I said to you earlier, was a very broken company when I got there at the end of '97. But we grew very nicely. And, long story short, I got to the point, where, as the CEO, I was looking forward to board meetings, which is odd, because, as a CEO, you rarely look forward to board meetings. For anyone that is a CEO, or is thinking about becoming a CEO, Tony Z's words of wisdom are that less is better when you're running a board meeting. You think you have to have a hundred slides going through every metric in the world. Don't do it, even though you might want to do it. Don't do it, because then you'll have to present it forever in

the board meeting and measure each and every one of those metrics. I happened to go into one board meeting during the summer of 1999 at Clarify at a time when I felt I had fixed most of what was wrong with the company. The stock was trading at an all-time high. The company was valued at over a billion dollars. We had several thousand employees and hundreds of customers. We had filled out the management team, we were executing extremely well. In a very short amount of time, in the span of about a year and a half, we had taken advantage, as Ben said, of a great market opportunity and we had a great offering in the marketplace. I walked into the board meeting and I'm presenting all the slides and, again, less is better. And we always presented a slide called relative market share, which is very important to look at. Relative meaning you and the two or three other leaders in the space. The rest are interesting, but the key is how you are doing relative to the two or three leaders that probably make up 80% of the market, in terms of market share. And at that time, the market leaders were Siebel Systems, Vantive and Clarify. I had asked Joe Costello, the CEO at Cadence, to join my board at Clarify a year prior to that. I was ripping through the slides, but Joe said, "Hold on Tony, can you go back a slide?" And the slide showed that while Clarify was growing up and to the right on a pretty nice ramp, Siebel was actually growing vertically. We were getting killed. We were doing great, but in fact the leader was pulling away at a rate that would show that we would never catch them.

So, as we discussed here this morning, the conversation quickly centered around do you want to be a great number two or do you want to seek out alternatives that can close that gap. And for us, the problem was channel. Siebel had invested a tremendous amount of their revenue dollars in sales and marketing. They had more feet on the street; they had more partnerships. Anderson Consulting was selling the Siebel products like they were theirs. And we just couldn't compete. Long story short, we went and visited all of the ERP companies that were in dire need of a revenue boost from a growth point of view at that time. We visited SAP and Oracle and PeopleSoft at that time. And we began the conversations. PeopleSoft was very interested in acquiring the company. Unfortunately, their stock was very depressed, having done a management change. Craig Conway was on board. He wanted to do the deal. We'll talk more about this later with respect to valuation, but all of the upside for the Clarify shareholders would be in the upside of PeopleSoft stock, so we said, "no thank you." We then began deeper dialogues with a variety of parties, in much the same way as Ben described. Out of left field, literally, comes Nortel Networks. At the time Nortel was growing very well, selling all of the pipes that all of the business software transacted through. Their feeling was that, hardware sales had 10 or 15 percent margins but software sales had 80-85 percent margins. If we combine the two together, we'll have a better margin story. We can drive more value to the bottom line. It looked great on the slides, but it absolutely failed in terms of execution because the two channels were very diverse. Nortel sales people called on people buying hardware and pipes and networks and enterprise sales people called on people buying enterprise software solutions in the IT organization, or in this case, sales and marketing people in the customer services ranks. There was no synergy whatsoever. But, Nortel offered us almost ten times our current year revenues, a $2.1 billion dollar valuation on revenues of $280 million. It comes down to maximizing shareholder value. In comparison, the PeopleSoft offer was basically at market. So, it was a pretty straightforward decision to sell the company to Nortel given the high

valuation. So, we did that deal. I had to commute to Canada for a year, which was tough. But in the end, ego and strategy aside, it's real clear what the CEO's objective, and, for that matter, what the board of directors' objective, is when evaluating an opportunity to sell the company. Don't be confused, particularly when you are a public company, it is all about maximizing shareholder value–bottom line. That is goal one, two, three, four, and five—maximizing shareholder value is what you are there to do. Of course, you should help employees and customers along the way, but, first and foremost, the goal is to maximize value. So when you receive an offer like the one we received from Nortel, it was just a very straightforward decision, even though the alternative deal offered more synergies. Because, again, your goal is to maximize value to shareholders, particularly when you are a public entity

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Dave Healy: Deciding When to Sell

-Mercury (Cashing Out Now vs. Upside After Perfect Execution)

Tony, keep going on that line in terms of describing when you decided to sell Mercury and comparing the upside of doing so with the risk of remaining standalone.

Tony Zingale: As to the Mercury story, I won't bore you with the details. Maybe some of you have read about it. We were one of the first companies to go through the infamous stock option scandal scenarios in the Valley, along with 200 other companies, but we just happen to play ours out on the front pages of the newspapers. I was brought in to Mercury to take the company to a billion dollars. That was the agreement with the then CEO and I went inside the company and we were growing nicely and six months later, I was to become CEO, in the classic orderly transition between the COO and CEO, and the CEO would become the executive chairman. Amnon Landon had run the company for 10-12 years. He had done a phenomenal job, as I said earlier, growing the product base, growing the customer base and building a Nasdaq one hundred powerhouse. That was beyond reproach. Unfortunately, Mercury ran into some troubles and six months later, we formed a special committee of the board, and excused the CEO, CFO and chief legal counsel. I became CEO in a very different manner than expected, a battlefield promotion. The trading price of our stock fell and we were delisted. You never want to go through that, begging the Nasdaq stock exchange for more time, and so forth. We had to deal with the scandal and then take subsequent corrective action, which was the restatement of ten years' of earnings. All that effort distracted the executives from running the business. That was almost as daunting as dating all the potential acquirors and running the business as if it were going to be a standalone entity forever. So we had the perfect storm. Still, Mercury's product line and people were highly valued and highly in demand even before the option scandal came about and we were having lots of discussions with all of the obvious players in advance of the restatement issue arising. And then, of course, we had to clean up the mess at the company. We were able to do all of that in nine months. And I remember going to board meeting after board meeting,

as I am sure my colleagues here did as well.

It is a very tough balancing act, being the CEO of a company and seeking to achieve maximum shareholder value as a standalone entity but as a CEO, that is what you are paid to do. At the same time, you are also paid to evaluate strategic alternatives as a way to expedite the maximization of shareholder value. And I had a split board at the time. Many of the long term members thought Mercury should stay standalone and that it could still achieve great things—egos affected their view very much, as I described earlier. A newer group of board members were more focused on maximizing shareholder value.

The way I like to describe maintaining standalone presence in the marketplace is, and we've all presented slides that say, "If the market continues to grow and if our product line continues to expand, and if the sales force continues to execute at the rate they are currently executing upon, we can achieve this value." I call that perfect execution. And, with all due respect, it's hard to perfectly execute in any market when there are unknowns. For example, as Ben described earlier, in 2007 there were issues with the credit markets and hedge fund failures, and then 9/11 happened. Who knows what's going to happen in the future.

So you've got to present your standalone case in a way that's balanced, but at the same time, built on a realistic scenario. At Mercury we had a number of potential bidders, all as laid out in our proxy, and in the end HP was the best suitor in terms of maximizing value for the company. We obtained a 30 percent premium, sold the company for over $5 billion dollars. HP was the largest tech company in the world, so it was a great home for our employees and a super home for our customers and HP had a strategy, as we will talk about later, that fit perfectly in terms of product overlap and synergy.

So, from the darkest day of my life, November 2, 2005, until November of 2006, there was a tremendous turnaround that no one person is responsible for. It takes a group to make something like that happen. But the takeaway is that when you are presenting the strategic alternatives to your board, remember the three key analytical points that you should "get big or get bought", that the egos in the room might affect the board's ability to objectively evaluate the alternatives and that the standalone case usually requires perfection to be achieved.

Dave Healy: Thanks Tony.

<u>Valuations in the Current Economic Environment</u>

The economic environment has changed substantially and that raises questions about how to think about valuations in the current environment. Ben, can you comment on that?

Ben Horowitz: The first really hard lesson I learned as CEO was watching the Nasdaq market drop substantially (from 5,000 to 1,400) from 1999, when we founded Loudcloud, through to

today–so much for buy and hold. The most important thing to understand about valuations in general is how arbitrary they are. If you look at the history of the stock market, there have been 20-year periods where high-growth companies have traded at about ten times cash flow. There have been other 20-year periods where they've traded at 40 times cash flow. And so, is 10 right or is 40 right as a cash flow multiple? The answer is that they are both right. So, you can't assume that things are going back to being properly valued, meaning highly valued, even though that is how you'd like to think about it when you run a company.

There are a lot of factors that go into market valuations. For example, it's interesting that the high water mark of market valuations largely coincided with the popularization of investing. When I was a kid, few people owned stocks, but now, just like in the 1920's, everybody owns stock, so that has pushed up valuations. So, if smaller investors were to pull out of the market in droves then valuations would probably drop.

So, you must keep in mind that if a bust is big enough, it can change valuations generally, not just for two years, but for 20 years. So, for high tech companies, you have to assume that there will be wide swings in valuation, and you can't get emotional about valuation. We see this all the time in the M&A world. Stock prices will drop and people won't want to buy companies because their stock price is down. But everybody else's stock price is down too, so valuation is all relative. The same thing happens when stock prices are high—for example people at some point thought Google's stock prices were far too high (say when they were at a several billion dollar market cap), which may have put off potential acquirors of Google in the early days. Those people may have thought that, in the abstract, "Wow, that's so expensive." But at the time, those same companies' stock prices were all really high too because multiples were just high. So you can't look at valuation in absolute terms, you have to look at it in relative terms. And you may or you may not get the opportunity to sell your company when multiples are high. So, you just have to deal with and live with the fact that market valuations are arbitrary and they can remain arbitrary for long periods. "Markets can remain irrational longer than you can remain solvent." That's one of my favorite John Maynard Keynes lines, so keep that in mind.

Dave Healy: Thanks Ben. Dave, you had some thoughts as well on using a depressed currency to buy other companies.

Dave Orton: I completely agree with Ben on this question of relative versus absolute stock price. Because in the end, you're trying to create strategic value through M&A. And so your horizon has to be outside of what and where you are today and so I think relative value is the most important. Effectively your stock represents a barter currency, so you have to look at its valuation relative to that of your peer's or that of companies that you want to acquire. The question you should ask about a stock deal is, what percentage do I have to give up to buy this company, and then where can we go with the combined company. So I think today is actually a great time to be acquiring. Buyers and sellers in a sense have to think about deals strategically in terms of whether deal synergies drive long term shareholder value. So,

strategic fit is extremely important, and made all the more so by the fact that in the current market it will be hard for target stockholders in a stock deal to cash out quickly. I am very much a believer in that. You have to push ego aside when you look at a deal's strategic fit.

Dave Healy: Quickly Achieving Cost Synergies

Dave, please comment on the importance of quickly achieving cost synergies.

Dave Orton: It is easy to talk about creating cost synergies, but it is sometimes harder to execute crisply enough to quickly achieve them. That's another reason why, in merger negotiations, it is so critical to look at strategic fit. You must look at the parties' pre-deal expectations of where you are going to create synergies in the market and in terms of expense savings in different parts of the company. But the key is whether you move quickly post-deal to achieve those synergies. That can only happen if the parties are truly aligned on that point pre-closing. A good example where this didn't happen, and synergies were not quickly realized, was Cray's merger with Silicon Graphics. In that deal, there was an opportunity to create synergies between two companies. But the alignment within the company, and even with the executives of the acquired company and our CEO, were completely out of whack. There were three very different perspectives on what we wanted to achieve from a synergy standpoint. A complicating factor was that SGI's CEO had committed not to make any layoffs, even though the two companies had significant overlap, and even though it was obvious that the only way to achieve those synergies was to effect layoffs. "Cost synergies" is just a polite term for layoffs, let's face it. But SGI never executed on that opportunity to achieve cost synergies in that deal and thus that opportunity was lost. And so I think that you have to move fast if you want to capture synergies. You have to really move almost the day you announce; you have to plot that out or you've missed the opportunity.

ATI/AMD Deal Synergies

I think the ATI/AMD deal offered the prospect of substantial deal synergies and that the strategic fit was excellent. We had two great technology companies that were in very different businesses, sold through different channels and were building different technologies. So the synergies in the deal were really around what I'll call infrastructure.

There was not a lot of room for AMD to cut ATI's expenses generally, in particular because our sales, marketing and commission expenses were already fairly low and efficient (40 sales guys generating $2.4 billion in sales) and our sales guys and AMD's called on different customers. This is obviously a very different compensation model than applies in the enterprise software space where commissions are much higher.

But I think the opportunity in the AMD/ATI deal was to achieve what I call strategic synergies. How do you realize the benefit of combining the two companies to realize where you want to go. And where we wanted to go was to create a new line of products. Not to keep

both companies standalone, but to develop something new. But AMD's core microprocessor business has not been healthy enough to allow the companies to realize those hoped for product and technology synergies to this point. But the strategic value of the AMD/ATI combination remains overpowering. So, as with any merger, the key is not to let yourself be distracted with trying to "batten down the hatches". Instead, stay focused on realizing the vision of the rationale for the merger. That has been the primary challenge in the AMD/ATI deal.

But what I've learned from many mergers is that executives need to focus up front on integrating the companies. Emotions and broad statements should be avoided as they are counter-productive and very fast execution is critical.

Dave Healy: Importance of Coordination Among Negotiating Team Members, Staying on Message and Using Bankers

-Opsware

Ben, why don't you comment on the importance of coordination among the negotiating team members, using bankers and staying on message during negotiations.

Ben Horowitz: I think the benefit of using bankers varies a little for each company and based on how you'd intend to use the bank. Also the need for a banker depends to some extent on your internal capabilities. In our case, given Opsware had me as the CEO and John O'Farrell, as EVP Business Development, and given that John was one of the world's great experts on how to structure and negotiate M&A deals, we probably had less of a need than you might have if you didn't have those capabilities inside the company. When bankers would come to advise on the market landscape, I never found that particularly insightful because I had been building the company for eight years and was one of the two or three leading experts in the world on that market and all the surrounding markets, and I knew our market better than anybody. It was in my nervous system. I could feel when the market went down. It was as if I'd "catch a cold" when customers stopped buying the software. That's how wired in I was after all those years of building the company. And then we had John who had negotiated our various acquisitions as well as our EDS deal, which as I noted nobody could believe, and a prepaid $30 million OEM distribution deal with Cisco, so we really had the capability of doing big deals. But probably the most important asset we had, on the M&A side, was the relationship between John and me. When you mix together someone who is a great expert in the market with someone who is a great expert in how to structure and negotiate deals, and they are in complete sync, that was a big advantage, and I think it was that combination of skill sets that allowed us to get what is generally regarded, in retrospect, as top end value. I knew more about what the acquiring companies needed than anybody. I understood it full out, in eight dimensions and in full color. And John knew exactly the right way to communicate that and orchestrate it in a multi-way negotiation. And he and I understood each other so well, that I could trust him to discuss anything on strategy and he could trust

me to do anything in the negotiation at any point. We were each so well schooled in the other's skill set that we were pretty interchangeable and that gave us a huge advantage.

Now, all that said, being a public company doing a large M&A transaction, you have to have a bank involved. There is no way around that, and we had Goldman Sachs involved and they are really good. Jon Woodruff of Goldman is an outstanding M&A guy. But the key to our M&A deal, as Dave Healy who was there will tell you, was the relationship between John O'Farrell and me. We're the ones who orchestrated it, because we knew it better than anybody else. As we went through the deal, it was actually very interesting how it played out.

We constructed the deal and the premise of the deal and our negotiating strategy. You have to have some principle, some thesis, behind the deal. Why would each particular buyer want to buy you? The entire negotiation is built on this premise, and everything we said and everything that occurred was based on it. And so it was very important that we knew more about the markets, competition, and our potential revenue upside than anyone else. By potential revenue upside I mean how much Opsware software could you eventually sell. That was a question in everybody's mind, but nobody knew it like we knew it. As we negotiated, we were very careful in all the messaging that we were sending to establish that position and establish that value.

M&A Negotiating Tips and Tactics

- Price Negotiations; Willingness to Walk from the Deal; Effect of Diligence Issues on Price–Opsware

Now, funny story. Not that funny if you were there. But one of the things that happened in that negotiation, which may actually have adversely affected our valuation, is that an accounting issue came up in diligence due to a weird circumstance. One of the parties who was looking to acquire us (not HP) noticed that three of our customer deals were accounted for in a different way than that potential bidder had accounted for their similar customer deals, but we had the same auditor, Ernst & Young. But, nonetheless, the other potential bidder escalated the question of which methodology should have been used to account for such customer deals to Ernst & Young's national office. As a result, EY called us up and they said that they might need us to restate revenue because we don't think the way that our EY auditor accounted for those customer deals was correct. This, at a time when we had all the negotiators at the table, with prices on the table. And so, when your auditor says that to you and you're public, you have to actually disclose that to the potential bidders. And so it was a horribly messy situation, but we were determined to fix it, even if that required us to call up our customers and ask them to amend our contracts to conform to the manner in which we had accounted for them, so that Ernst & Young could agree that no restatement was required. But in the meantime, as I said, we had to disclose to the bidders that we had this issue.

So prior to us telling that to HP, HP was at $14.25 a share. And once they heard about the

accounting issue, they came back and said, "We'll offer you $13.75 a share". Now at the time, that's still a lot of money, right? Like it's over a billion and a half dollars. You know, there's a lot of things going on. It's a huge transaction, and we are in the board meeting trying to decide what to do. It's funny because Dave Healy, who was our counsel on the deal with HP, asked me, during the interview preparing for this seminar, "Ben, you know, I need to ask you a question." And he said it very politely and I am not sure exactly what he said, but, you know, I've been a CEO so I know polite talk and what people are really meaning because people tend to talk to CEOs politely. And what Dave was really asking me was "weren't you behaving irrationally by insisting that we'd rather walk from the deal than agree to take a penny less than $14.25 per share? Did you know that negotiating approach was going to work? Was it necessary to take that hard a position when you might have gotten the bankers to give a fairness opinion at a lower valuation?" Dave didn't actually say any of that to me, but that's what he meant. But our willingness to walk rather than accept a reduced price turned out to be an effective approach. How'd it work?

The truth of it was, John and I had actually discussed the whole thing before we went into the meeting with the board. And as I said, John and I were in perfect sync. John and I agreed, and told the Board, that "We can't take $13.75 per share. It will jeopardize the deal." The reason that was true was that the whole deal was based upon several pillars of value.

One was that we were number one in our space and we were darn well willing to run standalone. We had absolutely established that we did not need to do this transaction. We will keep running standalone and we will outcompete all the potential bidders in the marketplace, as we had been doing. Number two was that this is a competitive process, and the reason we are at this price is because there are other guys who'll do the deal.

And the third point was–our accounting was clean.

You have to remember that in a negotiation, information is very asymmetric. The only way that the acquirer knows what you're doing is through the prism of the things that you tell the acquirer. And the most powerful thing that you ever tell the buyer is the price you are willing to accept, as that reveals your own view of your company's true value. I was trained on all this by John by the way. I didn't come up with this on my own. But communication about the price you want is geared by its nature to convey a tremendous amount of information. So if I had said "yes" to a price reduction, that would have shaken the foundation of everything we based the deal on. For example, maybe we'd have agreed on the lower price, but maybe the negotiation process would have gotten a lot longer, or the scope of due diligence would have changed radically, and so forth. But, if they had been paying attention, which I know they were because they had a very good team, they would have been spooked if we had agreed to their proposed price reduction. So, when the board asked me "Are you willing to walk if you don't get $14.25 per share Ben? Are you sure you would not agree to take $13.75?" I said "Hell yes, I'm sure. Because everything I've learned, and everything I know about this transaction and everything that we've worked on over the last four months in putting it together, says it has to be $14.25." And so that's how you have to think about valuation. The question is not whether you would take less. Wasn't $14.05 a lot of money?

Does it make a difference to me personally whether it's $14.25 or $13.75? No. Did any shareholder really care? Maybe not. But that's not the point. When you are at that point in the negotiations, the board can't help you, because you, as the CEO, have all the data so you really have to make the decision. Absolutely.

Dave Healy: Ok, I take it all back Ben!

Driving Valuation through Competitive Bidding

-Clarify; Using Bankers; Revenue Synergies

Ok, Tony, just briefly on Clarify. Did you end up doing a full market check process? How did you think about shopping Clarify?

Tony Zingale: Because Clarify was public we had to go through a market check process and Chuck Corey of Morgan Stanley helped us do that. I also had the benefit of working with John Woodruff at Goldman Sachs on the Mercury deal. Both guys are world class and very helpful. I'd say a few things differently than Ben said. I agree that everyone is very focused on price in these deal negotiations. It is extremely important in the process and even $.50 cents becomes huge. I will tell you that as an acquirer at Cadence, we probably overpaid often because in the end; whenever you run into a roadblock, you go back to strategy. Why are you here in the first place? Fifty cents here, a dollar there; yes, it's meaningful. How is the deal going to be perceived? How will it affect your currency as an acquiring company. Did you overpay? Did you do your homework? The target is not worth what you paid. I've heard all those comments. But what is critical is to go back to the fundamentals. Why are you having the acquisition conversations in the first place? What's the strategic value? Costs synergies are interesting but they never happen as predicted in the banker book. What does require more scrutiny is the strength of the top line synergies. If HP acquires Mercury or Opsware or SGI acquires Cray, what will the forward-looking revenue stream look like? That is the key issue, period, end of story. Does it grow? Is it the same as if the target were a standalone entity? If it's just the same, the deal is probably not worth doing.

-Roles of the CEO and Bankers in the Market Check Process

Back to the use of bankers. I've spoken on this publicly before. I think it's a myth that bankers do the deal. They don't. The CEO has to do the deal and cement the partnership. My partner at Mercury happened to be David Murphy, who is back at HP right now and who is world class in handling issues like, as Ben said, being the lens that the buyer sees your company and product line through and ensuring that your accounting is clean—those type of things. The bankers have a very definite role though, not only in doing the market check, but also in feeding you information on what the other side is thinking. That's important, because the buyer's executives are not telling you what they are thinking, where their concerns really lie or what their strategy is. The bankers have long-standing relationships and, with all due

respect to them, the next deal they'll represent the company that's buying you. Right? So relationships are key and paramount to them. So that's really important. You've got to be willing to define those roles and responsibilities and who's doing what. My role at both Clarify and Mercury was to get multiple buyers involved, and I was good at it. In fact, after closing the guys at Goldman Sachs gave me a book called, "The Art of Dating." It seems obvious that if you get a bidding war going, the price goes up. There is no question about it. How do you do it? First of all, it's kind of what Ben said earlier—you got to have a business, not just a product, something that's valuable, something that's strategic. You got to have the ability to explain to they buyer how the deal will help them more effectively deal with their customer base. If you have Opsware, if you have Mercury, if you have Clarify, here's what you can do with it with your product line and your channel. Sometimes you have to lead the buyer. In fact, most times, you have to lead the buyer to the answer. Here's why the top line goes up with the Mercury product line as part of the HP software portfolio. That sort of story, if credible, helps you as the target drive value for you in the negotiations. You will walk out of the showroom at some point during the process. You have to. And then you have to get back on the phone. As the target's CEO, that was my role. Whether your counterpart is Mark Hurd at HP, or John Roth at Nortel, or Craig Conway of PeopleSoft, or Joe Tucci at EMC, or Chuck Phillips at Oracle, you just have to get back on the phone. You have to work that process, which is a little different than the process and the playbook that your other executives and/or the banker are running. That's why, you know, roles and responsibilities—who's doing what to whom—are extremely important as you go through it. No one person does the deal. With all due respect to every CEO and every banker and every lawyer, no one person does it. It takes a team of people that are clear on what you are seeking, whether you are going to do the deal, how to drive up the value, what your negotiating strategy is, are you willing to walk, etc. Like Ben was willing to walk, as he explained, we at Mercury were also willing to walk, there was no question about it. But we had three or four companies in there with term sheets and cash deals in and around $4.5 to $5 billion dollars, so we were probably going to do a deal at some point.

But getting the market check from the bankers is really important. While, as Ben said, they usually don't know much about your strategy, they do know how to get a deal done and how to get it across the finish line. And once you are engaged with them, chances are you going to do a deal. You're going to sell your company—more times than not. So just be careful as to when you bring them on, particularly the Morgan or Goldman guys or George Boutros at Credit Suisse. They are going to sell your company. So just be clear on why they are there. You know, the luncheons and the phone calls at night at home are nice, but at the end of the day, they are there to get the deal done. That's how they get paid.

Ben Horowitz: I'd add to that, as a public company, the point at which you bring in the bankers is the point that you will often see rumors about the deal leak into the public market, so you have to be careful about that.

Tony Zingale: I don't care how tight the NDA is, it's going to leak. Sometimes you want it to leak, by the way. But anticipating leaks is critical.

Dave Healy: Driving Valuation through a Market Check and/or Having the Ability to Walk

-ArtX/ATI; Strategic Partnering to Stimulate Interest; Assessing Value in Stock Deals

Dave, why don't you talk about how you were able to get great valuations for ArtX and ATI despite not having multiple bids, based primarily on the strategic value of those deals and having such strong, standalone companies that you were willing to walk away if you didn't get the right value.

Dave Orton: Okay. Obviously the ArtX and ATI deals were very different.

Again ArtX had 72 people and we did a $400 million dollar deal. And again, $400 million was, I call it, relative, because it was prior to the Internet bust. In today's world, there is no way I would see ArtX selling for $400 million dollars. The opportunity we had was, that we had a very strong team and we had a technology development contract, as I mentioned earlier, with Nintendo. And as I went out and looked at partner strategies, any time you go out and you have partner strategy discussions, you recognize that that's potentially a buyer. And particularly when you're a small private company, you have to do that. But our goal was to become a public company, and so we weren't so much in a hurry as much as we recognized that the market was consolidating and that there would only be a couple of key players left at the end in the graphics world. So, I ended up talking with three or four public companies at the time. One of them wanted to effectively do a reverse merger, where we would take over a public company. That proposal shocked me and sent up a red flag, indicating that something about the other party was problematic, so we did not proceed down that path. We ended up with two viable alternatives, both of which were equity deals. One was about a third of the value of the other one, and this is where you get into the question of which equity deal will deliver greater value over the long term. And so do you take the lower value deal, which may have more upside, or do you take the one that has higher value up front. In a stock for stock merger with a private target, typically the stock received by your employees will continue to vest after the merger over a long period of time. So, then, in that case, which shareholders are you representing? In that case, we actually didn't have VCs. It was an unusual startup in that sense. So we had this interesting debate about whether to take a $300 to $400 million dollar deal, or to take a $150 million dollar deal that may represent a greater opportunity for stock appreciation. You say, "Well that's an easy one, take the $300 to $400 million dollar deal." But again, we had to wait two years or more to realize the upside deal value because of the vesting. And so, that was the challenge we had, figuring out who's going to win in the marketplace two years out. And we picked one, which was ATI. And it turned out that many people in the company, two years later, said we picked wrong. And I actually went back and did quite a bit of analysis, and figured out that it was basically a wash. But at the end, when you're a private company, I think you do

get hung up on the dollar number, and in many cases, you have to look through that, through some time horizon when your stock has vested and your team will realize the full merger value. I think in reality, even though we were acquired for $400 million, and you might think that's a lot, in the end, the ArtX acquisition delivered a great deal of value for ATI, and the ArtX team ended up driving a lot of the success that ATI later enjoyed.

-ATI/AMD; Sometimes Stay Independent Alternative, Not Market Check, Drives Value

The ATI/AMD merger, which I agree was an acquisition not a merger, was interesting. ATI was in the process, through various small acquisitions, which we called our "string of pearls", of building out a line of consumer products. And ATI was not actually looking to be acquired. I'm listening to the discussion about using bidding to help drive up deal value, but in ATI's case, a bidding war would have been a disaster. We were in a very competitive position where there were two players, NVIDIA and ATI. And if the market or our competitor found that we were actually considering being acquired, it would have immediately damaged our position in the market. The PC market is so volatile that we couldn't bear the risk of leaks that a bidding war would entail. The second reason we didn't do a market check was, when you get up to about $5.4 million dollars in deal value, there aren't many companies that would spend that kind of money. And the third reason is that, I think when you're in the PC business, many people don't want to enter that market. We looked at our value and thought it would primarily be PC companies that would acquire us. And so the reality was, the only potential buyers were Intel and AMD. ATI and NVIDIA were about the same valuation at that point. So there were few alternatives as to potential bidders. So I think for us, it wasn't so much the bidding war that allowed us to set up a valuation floor, it was more our view of the available strategic alternatives. And one of those key strategic alternatives was staying independent, and feeling confident that doing so was clearly a viable alternative for us. So I think for us, right from day one, we stuck to that point of leverage. We do have a strategic alternative, which was to implement our "string our pearls" acquisition strategy and stay standalone. So we created a hard floor in our mind, whether it was emotional or practical, you never know. But we did create one, and just stuck to it, and it worked with AMD. The discussions and negotiations took almost 8 months. So, it was not a fast two or three month deal, it took eight months.

Dave Healy: -ATI/AMD; Valuation Issues; Managing Leaks

By the way, Dave, when you sell a company there is often some huge issue that comes up that raises questions about valuation. In the case of the sale of ATI, Intel was a customer, right? And so you're selling in a circumstance where your major customer might be upset about your being acquired by AMD, Intel's competitor. How did that fact impact negotiations or the valuation?

Dave Orton: So it was interesting, that whole dynamic was tricky. We evaluated the deal and looked at it versus a scenario where AMD might acquire NVIDIA and if they did, would that be more damaging to us, versus us being acquired by AMD. Of our $600 million dollar chip set business, $450 million of that was on the Intel platform. So we knew that, from the day we announced, we would lose $450 million of revenue or at least that it would wind down quickly. So how do you work that into the valuation discussion? And so there were a lot of issues to think through in determining valuation. I think in the end, though, back to the banker discussion we have had here earlier, as I noted, I think bankers are often the source of leaks, often simply because they'll go work the other side to find information out. But as they do so, their relationships are with a greater number of people than just the strategic team working the deal. And so all of a sudden, those people find out, and their staff finds out, and thus there are leaks. So once you bring the bankers in, you must be really careful on the leaks.

Tony Zingale: And remember, everybody tells "just" one person. So I'm going to tell "just" you, but it's alright, don't tell anybody else. That's how leaks happen.

Dave Orton: It's the pyramid scheme of rumors. But back to Dave's question as to the potential loss of Intel revenues post-deal, we had to work through that. At the end of the day we did and it was baked into the valuation model we created. The model laid out the revenue synergies we were expecting, net of the impact on the Intel revenues, based on a clear set of assumptions. So anytime you create these kinds of models, and you start to work through these models, you end up discussing and being very explicit about your assumptions. Both sides can talk through the basic assumptions because that would help us align to our view of where we were going to go. If you disagreed, let's get back to the assumptions. Don't argue over the number, argue over the assumptions. And we did. And I think that helped keep the deal moving forward effectively.

Dave Healy: M&A "Principles" for a Successful Deal–Cadence

Good. Tony, why don't you talk about Cadence's secret sauce for its M&A strategy.

Tony Zingale: I'll be just real quick because I know we're running out of time and it's in the summary of this session that Dave prepared that's in your booklets, but what we probably didn't realize until after we'd done 15 or 16 deals, and we went back and looked at it, was that deals that stayed true to certain principles tended to be the most successful, but no methodology is perfect. We did 15-16 deals in the 10 or 12 years I was there and Cadence continued to go on and do a lot of deals afterwards. And you know, a large percentage of them were very successful. But we had four M&A principles and I'll describe each one.

-Strategic Fit

First and most important is strategic fit. And all of us have talked about that over and over again here today. Whether it relates to the price or to which target you pursue, or, whether it makes sense for you as a standalone entity to become part of something bigger, the question is, is the deal strategic to the acquirer, and is it strategic for you as the company that's going to be acquired? I agree with Dave Orton. There is no such thing as a "merger", every deal is really an "acquisition". So be clear on that as it is especially important in terms of product direction.

-Product Overlap

The second principle is, is there product overlap? It seems simplistic and obvious. You want to acquire an entity, or a product line, because you don't have it, and it's fundamental to your expansion in the market place, or to being competitive, or to addressing a market opportunity or transition. But where there's product overlap, at least in our experience at Cadence, and it's been my experience ever since, there's usually strong feelings on all sides (internally and in the customer base), so there is often a challenge with killing a product line. And if you wait to kill it afterwards, it's very challenging. It's religious. It's emotional. There are warring factions inside the company. For example, when Cadence acquired Valid Logic we initially decided to keep in place only the Cadence products and phase out the Valid products. But customers objected so we flip-flopped after the fact, and it cost us a bunch of time and energy along the way. But the cleanest mergers, the more successful ones, in terms of achieving the strategic objectives that you set out originally, are ones where there's zero product overlap. Where you put two things together, and 1 plus 1 equals 4 or 5, then you're able to go to market in a much more effective way.

-Mutually Fair Economic Terms

The next principle is, is there a good economic deal in both directions? Many times, you as the acquirer feel like, yeah, I got a good deal when I acquired that entity, I squeezed every last dollar out of them, and I squeezed out the cost synergies, and I got their leader out of there and we took control. But it's got to be a good deal in both directions. Particularly in software companies, where the principal asset being acquired is the people, the target employee/shareholders (whether the target is private or public) have to feel like the deal was a fair economic exchange for them and that they achieved some liquidity.

-Cultural Fit

The next principle is, is there a good cultural fit going forward? Geography can play a role in cultural fit. Cadence acquired companies all over the U.S. and around the world, and it's often better to acquire locally here in Silicon Valley because people typically have the same cultural dynamic and the same geographic dynamic. But many times, it's just not possible to achieve the primary objective, which is, is it strategic? You've got to work through those issues in advance, in terms of, is it a good culture fit? Many times, you know, it won't be. And

then you got to go back to the strategy. Hey, the development team is in Korea, is that going to work for us? Is that really going to achieve the strategic value we thought we would obtain from this deal?

But as I said earlier, when we're talking about valuation and the fixation on price, or whatever the main negotiating point in the deal might be, there will always be objections. You'll walk out of the showroom several times. The way to get around it, other than pounding the table or telling the banker that we're walking away, is to go back to the strategy, either as the acquirer or as the entity being acquired. Why are you doing this deal in the first place? And is the price, or the lockup agreement, or who gets to run the operation post merger, or whatever the issue was, really the point that you should blow up the deal for? If you go back to the strategy, you'll find it provides a meaningful guidepost to resolving whichever situation you find yourself in.

So those principles, strategic fit, product overlap, good cultural fit, and a good economic deal in both directions, were the simple formula we used, which Joe Costello came up with, that I ripped off and have used everywhere I possibly could over and over and over, and it has worked very well for me.

Dave Healy: - AMD/ATI; Strategic and Cultural Fit

Dave, do you want to just supplement Tony's comments about strategic fit and cultural fit with your own experience?

Dave Orton: Yeah, it's interesting, as Tony noted. I went back and looked at both what we were thinking internally at ATI as we went through the strategic analysis of whether we should merge with AMD. I actually went last night and looked at the PowerPoint slides. As I said, the principles that Tony just laid out really are the key to a successful deal. But there was one more key M&A principle that I would add for you all to consider, which is probably more typical in public- public than public-private deals, which is the amount of legal risk associated with the deal. Specifically, what is the chance, due to HSR problems, litigation challenging the deal, or similar legal issues, that the deal can't go through? In the case of the AMD/ATI deal, we worked through those risks relating to certainty of closure.

As to the timing of addressing the M&A principles that we've discussed, strategic fit, product overlap and economics can all be worked through during the course of negotiations and diligence. Deal certainty risks, to some extent you can work through in advance, but unfortunately you don't really know until you announce. That's one. The other one that's really difficult to parse out in advance is cultural fit. Often that is because, at least as the target, you only have a very small window of visibility into the buyer's culture. When we merged ArtX, a Silicon Valley company, with ATI, a Canadian company, we thought the geographic differences would make for cultural differences, but in fact, both companies had very similar, high-tech, Silicon Valley-type, cultures. You would have thought that the

cultures of ATI and AMD were also similar, given both were high tech companies with operations here in Silicon Valley. But in reality, the cultures are quite different. While AMD is on paper a Silicon Valley company, the entire management decision team is in Austin, Texas, and so AMD is really an Austin company. And Silicon Valley and Austin, even though they're both high tech, are different culturally. And Austin and Toronto are different culturally as well. So I think, at a cultural level, what I realized is that the underpinnings of how decisions are made and how organizations are structured are driven both by the people and the businesses they're in and ATI and AMD are actually in different businesses. ATI was in a portfolio of businesses and AMD was in only one business. So AMD's structure and culture was driven out of almost the silo of being a semiconductor company that was focused on one competitor in one business, whereas ATI was a business unit company, and so our cultures were and are still different. And the integration is still going on. So you have to figure out how to parse out the cultural differences and flush those out early to help keep the people part of it working, particularly when you take two large companies and put them together.

Dave Healy: Integration

We'll have just one more topic and then call it a day. Ben, why don't you talk about post-merger integration, what you've learned about integrating two companies, and how that plays against retention.

Ben Horowitz: OK, but let me just quickly pick up on what Dave Orton was saying about cultural fit, because I think it's interesting that the way Dave and Tony described the cultural differences were slightly different, and I think there's a really important reason for that, which people should understand. Cultural differences are primarily an operations communications problem. So, if the combined company ends up treating somebody one way in Austin, a different way in Boston, and a different way in California, that's an issue. But if you have a company that's great at communicating—and you can obviously see that Tony is an expert communicator—then you can overcome such differences much more easily than if communications is not your forte. So if you're good at dealing with communications issues, you can be more ambitious with cultural differences, and if not, they can cause you more problems. So you just have to know who you are when you do these kinds of things. The other thing that I found out that was really radically different is that it's much easier for a little company to make acquisitions than for a big company to make acquisitions successfully when it comes to the integration part. And the reason is that when you're a little company, let's say, you're five people, the team's view is that "it's all for one and one for all." And the reason for that is everybody knows that if I'm an executive vice president of a five person company, and if fails, it doesn't mean anything. You get nothing. So you don't worry about being the executive vice president, you worry about the company succeeding. It is possible to grow to even a thousand or more people and still maintain that "all for one and one for all" mentality. At some point, though, it changes. When you have 300,000 employees, it's not "all for one and one for all" any more. It is a very complex organism, with systemic

incentives that, when pieced together, give you the result you're looking for. And so, in that kind of environment, when you introduce a new company, the chances of the body "rejecting the transplant" are much higher. So you have to be much more careful in how you effect the integration of the two companies. You have to keep that in mind. It's just reality and there's no way around it, you must deal with it. At HP in particular, enterprise software was actually a relatively new thing that they were getting really competent at starting at the time of the Mercury acquisition and the Peregrine acquisition before that. You also have to be aware that the enterprise software business is by its nature an integrated business. You can't pull sales apart from development, because the sales methodology has just as great an intellectual property component as the actual intellectual property developed by the R&D team. The two go together. You can't take a hardware salesman and have him go sell Mercury software. So if you look at HP's original enterprise software acquisition strategy, that's where it was not as effective at first. HP bought a lot of little companies, with a lot of products, and plugged them into their sales force, but their sales force was lost. Opsware benefitted from the fact that HP had acquired Mercury before us. HP executives said to us that we were lucky that we were second. There were two reasons for that. One is that Mercury was a super-competent software company—they had probably the best enterprise software engineering team in the industry, period, flat out. They had the best engineering managers that I've ever seen, for sure. They also had a really good world-wide enterprise sales capability. But in dealing with the HP/Mercury integration, HP made what I would call some errors of control. That is, they failed to identify who was in control, the Mercury guys, the Peregrine guys, or the HP guys, and they tried to mesh the three companies' cultures together. With the benefit of hindsight, I would say that it's better to be crisp than right, and better to decide than to be fair in these things. It's better to kill some employees early, in the first week, rather than leave it unclear who will survive and be in control. So, there were many compromises, and issues that hadn't been decided, when HP acquired Opsware. But HP knew that was not optimal, and so the really smart thing that HP did, which I think worked out very well for HP after they bought us, was they said, "Ben, we're just going to put you in charge of the software unit and you deal with it."

Having one person in charge was a good thing. Previously, there were multiple, very influential people. That put me in the position of being able to decide on one direction, which actually turned out to be helpful for both the Mercury and the Peregrine teams. The other benefit to my being on the top of the organization was that it enabled me to more effectively integrate the Opsware business and team, because I could see the whole HP software company, and I knew where the leverage was, for example in the sales force and in support. Then I was able to say, "Okay, here's where the organization is weak, here's where we can put a super-competent person from the Opsware team in charge. Here's how we can change the story of HP software to be completely integrated with the Opsware story, and have one story and organization that puts them all together." So I think that, in summary, at a large company, which is the hard case, you really have to be very decisive and it's very beneficial to put an executive from the acquired company as high as you can in the combined organization, because that's how you're going to derive the most value. Now, interestingly, the Mercury team is squarely in charge, which is very, very helpful; it's not totally fair, but you're never going to get fair. But you can get clear. So you always want to

favor clear over fair. Even if it's wrong, it's better if it's clear… it's better to be crisp, than right, in these integrations.

Dave Healy: Words to live by! Anyway, guys, thanks so much. Please join me in congratulating our fantastic panel.

Questions about these issues can be addressed to:
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