



Reader,

This is the eighth edition of BlueLake Partners’ Newsletter – ***The Perspective from BlueLake***. The Newsletter is published periodically and focuses on and analyzes trends in the sectors we follow: Software, Semiconductors, Enterprise Storage Networking and Communications. We hope you find it informative and thought provoking, and we welcome any suggestions or thoughts you might have on the content. Please feel free to pass it along to others that you think would find it interesting.

Sincerely,

**BlueLake Partners, LLC**

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**Straight to the Point**

- **M&A activity troughed in 2002**
- **The rebound began in 2003:**
  - ✓ Value of deals up over 20%
  - ✓ Number of deals up 11%
  - ✓ Average deal size up 8%
- **Strategic acquisitions resurface**

Only someone who has spent the last three years in a “spider hole” wouldn’t know that strategic acquisitions virtually disappeared during that period due to the downturn in the economy, especially in the technology sector. We are indeed happy to report that it appears strategic acquisitions are back, even in high tech.

***The “Terrible Twos”...2001 and 2002***

First let’s look at the numbers. According to Mergerstat, U.S. and U.S. Cross-Border M&A activity in terms of deal value (based on base equity price offered) peaked in 1999 at \$1.387 trillion (\$144 million per deal) and plummeted over the next three years. The total transaction value for all of 2002 was only \$442 billion, less than a third of the value just three years prior, and the average transaction value had fallen to just under \$60 million.

The number of M&A transactions, also as reported by Mergerstat, crested at 11,123 in 2000 and fell by a third over the next two years with only 7,411 deals completed in 2002.

***Growing out of it***

Lest we start a stampede for an open window, let’s get to the good news: the trend appears to have reversed. For calendar year 2003, the dollar value was up over 20 percent, the average deal size was up 8 percent, and the number of deals increased by over 11 percent, all in comparison with the 12 months of 2002.



### ***Let's not get defensive***

As we all know, acquisitions can be done for a number of valid reasons, but in the technology sector it is often out of strategic necessity to position the buyer for its next-generation product, platform or environment. However, over the past three years when BlueLake has spoken with companies about making an acquisition, the primary criteria were usually revenues, profitability and earnings dilution, legitimate concerns but not necessarily of a compelling strategic nature. The economic downturn had made potential acquirers extremely risk-averse and Scrooge-like with their cash. The principal strategic objective was to survive.

In a tough economic environment, those acquisitions that are made are often defensive or "non-strategic" (in a high tech context) in nature, e.g., cost reduction through economies of scale or geographic expansion. Two recent examples occurred in commercial banking — a slow-growth, mature industry where size matters: Bank of America acquiring FleetBoston for \$47 billion, and the just announced acquisition of Banc One by J.P. Morgan Chase for \$58 billion.

One phenomenon which tends to exacerbate the contraction in deal volume in a stagnant economy is the fact that most major economic metrics seem to move in the same direction at the same time. For example, when the stock market moves up, so does the number of IPO's, the rate of venture capital investing and the level of M&A activity, both in relative price (multiple) and number of transactions. Conversely, when the stock market is down, would-be buyers lower the price they're willing to pay, and the target company often resists being acquired at those prices, even when survival is at stake, rather than be bought "too cheaply."

In addition, acquirers are acutely aware of, and take advantage of, an unfavorable economic environment. Acquirers are quick to "walk" if their price demands are not met and are more willing to wait for a bargain-basement intellectual property asset purchase rather than add headcount. This partially explains why the number of M&A transactions from 2000-2002 decreased by only 33 percent while the value decreased by more than 65 percent.

### ***You can't steer the boat by looking at the wake***

But enough about those things that might have happened over the past several years in a bad economy. They're not very relevant when the Bureau of Economic Analysis revised its estimate and told us that our Gross Domestic Product (GDP) grew at an annual rate of 8.2 percent in the third quarter of 2003, the highest rate of growth in 20 years, and the Conference Board is projecting a 5.9 percent advance in the fourth quarter. Likewise, those tough economy phenomena aren't likely to occur with the Dow trading at its highest level in 22 months and the Nasdaq Composite Index up over 56



percent from the beginning of 2003. Let's talk about M&A activity in that kind of environment.

***Let's do get strategic, again***

In better economic times the strategic acquisition becomes a strategic imperative, critical to maintaining product leadership into the next-generation. Fortunately, an improving economy often provides the potential acquirer with the additional financial wherewithal to address that strategic imperative. Thus, the advancing financial markets become an enabling factor, as companies feel increasingly better about using their higher-priced, and less dilutive, stock to effect an acquisition.

The strategic acquisition in the technology world is where  $1 + 1 > 2$ . A good example is IBM's recent acquisition of Tarian Software, a small electronic records management company with negligible revenue, for a price rumored to be in the \$20 million range. IBM will incorporate the product into its Content Manager offering, with the goal of dramatically improving its competitiveness and increasing the sales of its DB2 Content Manager product suite through its established distribution system.

Other recent deals that have a similar flavor include Network Appliance's acquisition of Spinnaker Networks for \$300 million and McData's acquisitions of Sanera for \$102 million and Nishan for \$85 million. All of the acquired companies were considered startups and had negligible revenue, particularly when compared to their acquisition price. These were also in the fast-moving enterprise storage networking world, where established companies such as EMC Corp., McData Corp. and NetApps have a need to maintain and improve their position in a fiercely competitive market, especially in light of Cisco's entry into the fray.

Although all areas of technology have shown an uptick in merger activity, enterprise storage networking, security software and systems and internet-related companies have evidenced a particularly high level.

A striking example is Symantec Corporation. With its stock price having increased more than 60 percent since April and with \$2 billion in cash on its balance sheet, it has been particularly active with the recently announced acquisitions of On Technology for \$100 million, PowerQuest for \$150 million and SafeWeb for \$26 million. Symantec also spent \$375 million over the summer buying four security companies: Riptech, Recourse Technologies, SecurityFocus and Mountain Wave.

Also in the internet security area, Rainbow Technologies merged with SafeNet for \$457 million. In the internet and services-related area, WebMD acquired Medifax-EDI for \$280 million, Macromedia acquired eHelp for \$65 million, Travelocity acquired World Choice Travel for \$50 million and InfoSpace acquired Moviso for \$25 million.



### ***A much better dynamic***

Whew! That's a lot of money, especially in "post bubble" dollars. However, we are encouraged by this recent spate of activity and see no reason for it not to continue. It seems a far healthier dynamic than has existed for the past three years. While some of these acquisitions on a stand-alone basis appear pricey, they make sense if that's what it takes to remain competitive and maintain or establish industry leadership. If nothing else, the new M&A environment involving the placing of bets on the future rather than trying to survive by hiding in a "spider hole," will be more exciting to watch and execute.

— *Margaret Johns*

**About BlueLake Partners:** BlueLake Partners is a boutique investment bank focused on providing mergers & acquisition advisory services, raising growth equity capital and providing other financial advisory services.

**BlueLake Partners, LLC**  
The Pilot House  
Lewis Wharf  
Boston, MA 02110

Tel: 617-854-3755  
Fax: 617-854-3759  
Email: [Info@bluelakepartners.com](mailto:Info@bluelakepartners.com)  
[www.BlueLakePartners.com](http://www.BlueLakePartners.com)

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