M&A Seminar Series, Session Six

Director/Executive/VC View Summary

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Panelists

Ray Lane, General Partner, Kleiner Perkins Caufield & Byers

Edward W. (Ned) Barnholt, Former Chairman, President and Chief Executive Officer, Agilent Technologies.

H. Raymond Bingham, former Executive Chairman, President and Chief Executive Officer, Cadence Design Systems Inc.

Moderator:

David W. Healy, Co-Chair M&A Group, Fenwick & West LLP

M&A vs. internal development or licensing

- In deciding whether the best alternative for growth is acquisition, internal development or partnering/inbound licensing, some factors that drive the decision are: if you need absolute control (*e.g.*, to ensure product interoperability) or have (or can, within the relevant market window, hire) people with the requisite skills, internal development may be best, but if not and speed to market is critical, then inbound licensing or acquiring a target with the right product or technology may be best, if obtainable on reasonable terms and without acquiring excess baggage.

- The right mix between internal development and growth through acquisition depends on the acquiror's technology, its services skill set and its market position. For example, SAP and IBM have leading market shares and understand customers and will help them to do more as partners, whereas other companies generally view themselves more as technology suppliers so they tend to lead more with technology and less with a service model. These strengths should, and do, drive companies' M&A and partnering strategy. In general, a technology-centric company may be willing to acquire a company with technology that will take considerable time and R&D effort to integrate, whereas a services-centric company like IBM or SAP may prefer a product that can be more easily integrated for rapid customer benefit. For example, SAP recently acquired Virsa in part because Virsa's products are written in the native language that SAP's products use, so Virsa's products could be integrated rapidly. Conversely, during the 1990s, some large enterprise software companies, like Oracle during that period, felt that enterprise software was inherently difficult to integrate with their existing code, so they were reluctant to grow by acquisition.

- In the electronic design automation software space, the market leaders have the skills to integrate acquired products into a single, integrated, full-solution offering, market momentum is in part dependent on efficacy of a company's overall design flow, and the most innovative technology is often developed by start ups as a single solution tool. For those reasons, the leading EDA vendors have often acquired companies with tools that are similar but technically superior to a buyer's existing tools rather than relying solely on internal development. For example, Cadence saw at one point in the past that it needed to upgrade its technology to remain competitive. If that required that Cadence replace existing with acquired tools, that was viewed as an acceptable outcome in achieving the overall goal of creating enterprise-wide applications with integrated solutions that could be sold at the CEO/Division president "value" level rather than the engineering manager "technical" level. This required a series of acquisitions with a roadmap and a migration path that was credible to customers.

- At Agilent there was a sense that the company had the engineering horsepower to successfully complete any R&D project internally. However, in many cases the best course was to do an acquisition as a "gap filler" to fill in a product line quickly where time to market was critical. Agilent's acquisition of OSI was a good example. Agilent could have internally developed products similar to OSI's 3G wireless, optical, broadband Internet Protocol technology. But by buying OSI, Agilent immediately jumped to the number one position in that market segment, which was an important strategic win for Agilent at the time. The downside of an acquisition approach, however, is that you "spend" the acquisition price all at once, so if market conditions suddenly deteriorate, the return on investment on the acquisition will take longer than projected, whereas when growing by internal development, you can change technical directions to meet changing market conditions before exhausting your entire R&D budget.

- SAP has a similar acquisition strategy, which is stated as using "fill-in" acquisitions to add to its broad solution offering by gaining specific technologies and capabilities that meet the needs of its customers, within industries or across industries, while maintaining SAP's successful organic growth track record. The recent acquisition by SAP of Virsa is a good example of this approach.

- Oracle's recent string of acquisitions is a good example of a M&A strategy that makes sense in a maturing market. When you have an established footprint (and a strong balance sheet), time to market becomes the most critical element in growth, so acquisitions at the right price point that accelerate time to market over what internal development would allow will always make sense. The increasing complexity of ERP products has made the risk of customer attrition in an M&A scenario decline, which has reduced concerns about product integration to the point that the amount of M&A in that market segment has rapidly increased.

- Another acquisition strategy is to use a company's strong market position in one market to fund its acquisition of a company in an adjacent market, thereby improving its revenue growth rate and increasing its total addressable market. If the valuation and market position of a target in an adjoining space is right, it makes for an easy decision to acquire that target rather than relying on internal growth. KLA Tencor's acquisition of ADE Corporation is a good example of that—it allowed KLA Tencor to expand from its base market to acquire a strong position in the bare-wafer market.

- Another way to approach the make vs. buy decision is to assume that due to rapidly changing market conditions you will need to replace your existing product offerings with innovative new products at a more rapid rate than internal development would allow. The M&A strategy of Quest Software, for example, has been driven by this type of approach and it has worked according to plan. But this strategy is not for the timid, as the strategic vision may have to take precedence over the desire to keep valuation metrics within a conservative range. In fact, Quest's approach is consistent with what many believe to be the only prudent course for small public companies in the enterprise space, where acquiring companies that offer fundamental innovation may be the only path to becoming a market leader with continuously innovative technology, which is critical to long term viability.

- The make vs. buy decision for a private acquirer is generally similar to that faced by a prospective public acquirer, except that acquisitions are generally more difficult due to the inability to offer freely tradable stock and, where one venture backed private company seeks to acquire another, the possible need to dovetail the preferred stock preferences of two sets of venture investors. Margin sensitivity or lack of sufficient cash may also make inbound licensing a less attractive alternative for a private company, due to the potential licensor's demands for a significant cash payment up front or in the form of royalties. Reasons for private acquisitions can include the reasons noted above (including leveraging a technology lead in one market segment to finance the acquisition of other products or key technologies), or reasons such as acquiring a sales channel (such as Virsa's acquisition of PwC's SAFE internal controls compliance software, which enabled Virsa to add PwC as a sales channel partner), and acquisitions to position to become the leading player in an emerging market niche (such as Elance's acquisition of its main competitor, Cascadeworks, in the services procurement management space to add a number of important customers).

Impact of macro industry trends on M&A and partnering strategy

- Trends in software and IT have significant implications for M&A and partnering in those market segments. It was recently reported that the top 15 enterprise software companies generate 84% of the revenues in the industry, the top three generate 75% of the profit and the top company generates 57% of the profit. Enterprise customers are increasingly looking for one vendor to provide a complete, integrated solution (even if there is a delay in adding functionality), and are often unwilling to buy unproven, single point tools from start up vendors. So further consolidation is inevitable to bring the industry down to a rational number of competitors.

- The enterprise software industry now has the largest "no man's land" in history. The top 25 companies are leaders with continuous innovation. There are thousands of startups, a fraction of which are doing fundamental innovation, and a couple of hundred attacking the current paradigm. That leaves 5,000 companies competing against big companies or startups. The 5,000 or so companies in the vulnerable no man's land are fearful they won't be able to innovate, and spend time changing their business models, searching out new channels. Only a few of those will get acquired, with 90 to 95 percent of investments going to the bigger companies innovating continuously and small startups with private equity investments.

- As a result, the only viable approach for medium-sized public companies in this market segment may be to either agree to be acquired in the near term, or to grow by acquisition of other companies that have technology representing fundamental innovation that holds the promise of moving the combined company into the optimal market leader/continuous innovation position. Conversely, from the viewpoint of the dominant players in the enterprise software space, like Oracle, defensive acquisitions to lock in a leading market position may now make more sense than internal development because valuations are attractive due to the factors noted above, time to market remains critical and, as noted above, the risk of customer attrition has declined due to the increasing complexity of ERP products.

- Where there is a general slowing of a market segment as a whole, that may require segment participants to seek M&A, divestiture or partnering strategies, or other business model changes, that may lead to revenue growth.

  › For example, Enterprise software companies are well advised, either through internal development or acquisition, to change their business models and product offerings to adapt to the new "Web 2.0" software landscape (*i.e.*, to have products that serve individual needs, are capable of viral adoption, enable contextually personalized information, reduce or eliminate the need for data entry or training, deliver instantaneous value, utilize community and social relationships and have a minimal IT footprint).

  › As a further example, the EDA market continues to search for new strategies for overall revenue growth. Lack of revenue growth can lead to intense margin pressure as EDA vendors compete for relatively static R&D budget dollars. So EDA vendors have searched for means of expanding the overall size of the EDA market. One (non-M&A) approach is to "partner" with customers by pricing EDA products according to the yield improvements they drive, but public vendors who have tried that often are tempted to lock in near term, certain revenues to meet analyst expectations rather than wait for the uncertain, but possibly higher, pay off from a yield improvement pricing formula. A second approach is for EDA companies to expand into selling IP components such as those historically offered by Artisan and Virage, but no EDA company has yet been able to optimize the business model for an IP components offering. EDA companies are also exploring acquisitions that may help them expand revenues in the design for manufacture (DFM) space. Another approach is for EDA companies to add a substantial services component to their overall revenue mix. For example, Cadence expanded its services offerings through acquisitions of technology and design personnel from customers in exchange for long term product and services contracts. Ultimately, though, as noted below, the outsourced EDA services model has been less than optimal due to margin pressure and overall decline in demand for outsourced design services from venture-backed semiconductor startups.

- Adverse industry developments may slow the pace of acquisitions in a particular market segment. For example, Agilent became less willing to look at acquisitions in the telecom space as it became clear that there was a tremendous amount of excess capacity in telecom and a slowdown in adoption of new telecom technology. Telecom revenues fell off so dramatically that there could be no assurance of any particular level of return on investment could be expected on acquisitions in the telecom space.

- Competitive developments or industry cycles that reduce the profitability of a particular market segment may drive divestitures in that market segment, as was the case with Agilent, as discussed below.

Evaluating spin-offs and divestitures

- Divesting to improve focus

  › In evaluating whether to spin off Agilent from HP, a key question was whether HP wanted to grow by leveraging its internal expertise in telecom, medical products and other areas to help grow its computer business, as IBM has done so successfully, or by focusing on consumer branded products. HP chose the second path, so the spin off of those businesses to form Agilent made sense, and was supported by Agilent management. The spin off also made sense because the value of the test and measurement business was not reflected in HP's stock price.

  › The "diversity" in the Agilent technology skill set was viewed as an asset, not a distraction, at the time of its IPO. However, changes in market conditions led to increased margin pressure in several lines of business that led Agilent to spin off lines of business.

  › Specifically, the advent of multi-hospital purchasing organizations and the emergence of complete hospital equipment providers like GE began to exert considerable downward pressure on equipment margins in the medical products industry. This led Agilent to realize that it would either have to invest heavily in its Healthcare Solutions Group (HSG) to offer a broader range of solutions, or sell the HSG to a company with a complementary business and the resources to make such investments. These factors, and Agilent's desire to focus on the high-growth communications and life sciences markets, led Agilent in 2001 to sell HSG to Philips Medical Systems for $1.7 billion in cash. As it turned out, this cash gave Agilent the ability to weather a later slowdown in several of its lines of business.

  › Similarly, margin pressures resulting from semiconductor industry cycles induced Agilent to spin off its Semiconductor Products Group to form Avago. Interestingly, KKR and Silver Lake Partners, well known private equity players, won the deal over potential strategic buyers.

  › Divestitures are often driven by a desire to "unlock" the value of a business unit that is not reflected in the stock price of a company with multiple lines of business. For example, at one point Cadence considered spinning out its Design Services Group as Tality via an IPO. Tality's 50% revenue growth and "path to profitability" suggested that the IPO might be attractively valued relative to Cadence, which had a much lower revenue growth rate. As with any spin out, justifications included that Tality could generate more business stand alone than as part of Cadence, the spin would let each company focus on its core competencies, that Tality could create a lower cost infrastructure more suited to the lower margin EDA services business, the prospect of an IPO would give Tality an edge in recruiting top talent, and the IPO proceeds would enable strategic acquisitions. In the end, the IPO was cancelled because of low service margins and a decline in demand from start ups whose desire to produce working chips to fuel their own IPOs faded as the IPO market window closed. There was also a sense that major electronics firms viewed product design as a core competency that they were more reluctant to outsource than was expected. So if you are considering a spin out, be sure you understand the spin out company's customers and value add.

Evaluating acquisitions: views on minimal EPS dilution, low valuation, strategic fit, cultural fit, minimal product and employee overlap, and minimal deal risks.

  › For Cadence, the M&A guidelines were generally that a deal must make financial sense, there must be a cultural fit, and the deal must fit the strategic roadmap and thus bring value to customers. For international deals, it is also critical to "know what you don't know" in terms of differences in culture, financial practices, labor laws, corporate governance and controls, and so forth. Generally, Cadence only did deals that met all of these metrics. Earnouts pose additional hurdles in terms of ensuring a cultural fit, as they can lead to resentment.

- At Agilent, the key factors in evaluating an acquisition were confirming that the deal made both financial and operational sense and was a good strategic fit. Agilent generally required that any acquisition be accretive within a year and generate about 20% return on invested capital within two years. Agilent had many opportunities to do deals that made strategic and operational sense, but did not make financial sense. For example, there were deals where potential targets with no revenues sought valuations in the hundreds of millions of dollars, or companies with $80M in revenues wanted valuations above $1B, and so forth. There is a price limit above which deals cease to make financial sense regardless of strategic benefit.

- Sometimes a deal will make sense, despite concerns about product overlap or cultural fit, if it is a defensive move designed to lock in a market leading position and customer attrition can be avoided.

Evaluating selling a company

- When to sell

  - Buyers can persuade target CEOs to sell by convincing them that the buyer offers a platform, resources and a channel that would allow them to bring their technology to market faster than they could achieve stand alone and that the buyer would give them sufficient control over execution of their strategy.

  - When a target is in a rapid revenue growth phase, it can be difficult to persuade the target CEO and Board to sell. Earnouts can help bridge the valuation gaps that may otherwise preclude a deal.

  - Where a deal makes great strategic sense, a strong acquirer can put a preemptive offer on the table that can overcome target concerns about "leaving money on the table" by selling too soon.

- Valuation tactics

  - It is critical to keep future M&A valuation drivers in mind when operating a company that may be acquired. For example, Virsa was attractive to SAP due to (i) having a product written in the native language of SAP's products; (ii) an OEM deal with SAP that was on terms that made it attractive for SAP's sales force to re-sell the Virsa product; and (iii) having ported the Virsa product over to the Oracle platform, such that there were multiple potential acquirors. These factors helped induce SAP to make a preemptive offer for Virsa. Similarly, extensive business synergies led BMC to make a preemptive bid for Marimba.

  - Often, target founders need to take some liquidity risk (*i.e.*, take illiquid stock) or take some valuation risk (*i.e.*, agree to contingent earnout payments) to get a deal done and to maximize valuation. From an acquiror's viewpoint, it's often a bad signal if a target wants all the upside, but is unwilling to share any of the downside risk. Where a target is controlled by the founders and they are willing to accept stock due to the tax deferral benefit and look to future appreciation in the buyer's stock, an acquirer may pay more. Similarly, if a target is willing to accept a lower base valuation, the buyer may be willing to agree to an uncapped earnout formula and still view that as a financial win-win. Keep in mind that any high quality acquiror will walk from deals that make no financial sense, even if they make strategic sense.

  - Where buyers do agree to an earnout to bridge a valuation gap (as was the case with Cadence's acquisition of SPC), it should be structured to create an alignment of strategic and financial goals and the post-closing role of the target's CEO needs to be carefully defined. Both parties should consider, preferably pre-closing, a means of addressing the tensions that often result from earnout-incented target engineers working closely with acquiror engineers who do not benefit from the earnout.

  - Market leaders often obtain a higher valuation on their revenue stream than others, so if an acquisition will make the buyer a leader in a market segment, as was the case with Agilent's acquisition of OSI, the deal may justify a higher valuation.

- Hostile Deals
  - Since enterprise software is now so complex and so integrated into the enterprise that it is hard for customers to change ERP suites, buying an enterprise software company like Peoplesoft is more akin to buying an annuity stream. This makes ERP companies attractive to hostile acquirors (as well as private equity plays).
  - Sometimes hostile bids create opportunities for other bidders to prevail as a friendly "white knight". For example, in a defensive move, Cadence thwarted Mentor's hostile bid for Quickturn by acquiring Quickturn in a friendly deal.

Partnering tactics: systems integrators, solution provider partners, OEMs, etc.

- Sometimes, complex, win-win deals can be struck with customers that involve both partnering and asset acquisition elements. For example, Cadence acquired three separate business units from IBM, and gave IBM the ability to influence Cadence's roadmap, and the parties agreed to engage in joint development of next generation EDA tools, and in exchange IBM agreed to standardize on Cadence tools rather than use IBM's internal EDA tools, which gave IBM a time to market and cost advantage. Similarly, to expand into a new analog space in which Agilent had a key RF simulation product but Cadence had much of the infrastructure needed to use that product, Cadence acquired some designers from Agilent and Agilent entered into a long term supply contract with Cadence. Cadence's acquisition of technology from Unisys in exchange for a long term design services contract with Unisys is a further example.

- As noted above, Virsa's OEM deal with SAP was a good example of how partnering with a potential acquirer can lead to an attractive M&A deal. The OEM deal involved an attractive revenue split that highly incentivized SAP's sales force to sell Virsa's product, to the point that SAP began selling the product in high volumes, which made SAP realize the upside involved in acquiring Virsa. No other buyer could pay what SAP offered, because the synergies were maximized for SAP, so they were naturally the most incentivized buyer.

VC and Board member value add in M&A and partnering process

- The role of an outside board member in the public company context is to be a coach and mentor, focus on governance, exercise good judgment, and provide support without meddling with management.

- VC directors can often use their high level executive contacts to help broker go to market OEM deals and to make "market check" calls to confirm that targets have maximized their M&A deal values.

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Speaker	
Dave Healy	Thanks for coming to our sixth M&A breakfast briefing session. We have a very distinguished panel today. Ray Lane, is a general partner of Kleiner Perkins, a preeminent venture capital firm. Ray was formerly a top executive at Oracle where he brought it from $1 to 10 billion in sales, a modest accomplishment. I first met Ray on Cadence's board of directors where Ray Bingham served as well. Ray has a number of portfolio companies including Elance, Animatrics, Virsa, which was just sold to SAP, Visible Path, Pod Show and Spike Software. Ray is also the vice chair of Special Olympics International. Ned Barnholt is a former chair and President and CEO of Agilent, including at the time it spun off from HP. Ned and Ray are both on the board of KLA Tencor, a semiconductor company. Ned is also on the board of Ebay and Adobe. Ray Bingham, former Executive Chairman, President and CEO and before that CFO of Cadence and former EVP at Red Lion Hotels. Ray is currently on the board of Oracle and KLA Tencor, Flextronics, Freescale and UPEK, among others. He's involved some venture activities of his own. **M&A VS. INTERNAL DEVELOPMENT OR LICENSING** Why don't we first talk about whether a company, large or small, should do internal development or grow by acquisition. What are the pros and cons of each approach, when is each appropriate and so forth. Ray Lane, you've said that that depends on the technology of the company, the skill set of the company and how services oriented they are, and you've compared Oracle with Sun, SAP and HP in that regard. Could you go through that with us and explain how you view that.
Ray Lane	David, you're right. I think it depends a lot of factors and some of those are, I think, industry factors, market factors and somewhat uncontrollable by the company. Some of them are internal factors and what makes most economic sense and I think some are quite personal since the senior management has certain opinions about what should be done and what would benefit the company long term or in the short term and how acquisitive the company wants to be. As David mentioned, let's discuss Oracle. Ray Bingham can certainly comment on Oracle, as Ray and I are seeing Oracle in very different times. I remember in the 90's Larry basically saying many times in public "write code not checks" and we were not an acquisitive company in the 90's although we did do twenty-two acquisitions. It surprised us all when one day we added them up. We thought we were not acquisitive and we believed in not acquiring companies and found that we had bought twenty-two, albeit the two largest were $100 million acquisitions that were really not acquisitions ofcompanies—they were acquisitions of products, like our acquisition of Digital's Rdb database. So it was really something we did quite well and we were really buying the maintenance streams.

	Contrast that to the Oracle today which is very acquisitive and I think it's largely market factors that do that. So what could change leadership in a company to that extreme from having a view that "we would just never do that because we believe in writing the code, trusting our developers to totally develop and integrate the complexity of our business because that's going to protect us more"? When we competed against Informix, Informix basically used this acquisition strategy against us in the mid 90's where they had bought three or four different database companies and we thought it was, if not impossible, pretty near impossible to integrate all of those technologies together — object storage, relational storage, different types of graphical storage. They were going to combine them into one multi-function database and we basically declared to the market it was impossible. In fact, it never happened. That's very different than what's going on today at Oracle where you have an opportunity to basically freeze market share for a period of time by acquiring the number three or number four, depending on how you look at it, or number two I think at the time they actually wrote the check PeopleSoft had actually grown to a number two position, and so you are buying number two and you buy number four in the market and you pretty much wrap it up and make it – you've made the market bi-poplar and now you focus one competitor and Oracle does that very well. You have one competitor to focus on. So I think the view on M&A can change over time and there's a good example where market dynamics, internal performance, organic growth or lack of it – changed the opinion vastly in the leadership of Oracle who now say the best strategy is to consolidate the industry and be a dominant player that has equal market share in the United States with SAP and about half the market share or a little more than half the market share world wide. That's a pretty drastic change and it is based on the conditions of the market and the economic analysis done at that particular time.
Dave Healy	Thanks. Ray Bingham there's a nice EE Times article that said that "the Cadence Ray has made through multiple acquisitions has no sacred cows" and it was noted that you had chosen to acquire companies, like SPC, Simplex and CADMOS, where they had a product or a tool that you had already developed internally so you kind of voted, even though you'd done the internal development, to acquire a company with a replacement product – how did you think about that?
Ray Bingham	When you think about acquisitions as a generic topic I think you have to be very clear about where you are as a company, what your market looks like and what it is exactly you are considering acquiring. The kind of story that Ray just recounted in the Oracle case happened in the context of a very high growth market and that serves both its own opportunities and constraints when you look at that. In the case of Cadence and the time during which we were making the kinds of acquisitions which Dave described we had a different kind of a problem. We had a problem where Cadence was taking a radical change of strategy from a company that had embarked on turning its software company into a services company and turning back into a declared goal of regaining technology leadership in the very fast changing semiconductor design world. In order to do that we had to move very very quickly and that meant not only that we didn't really have the time to develop the technologies that might have competed at the next geometry of Moore's law, we had to find those new companies who were already getting the attention of customers that already had a level of credibility in the eyes of the most advanced designers so we could leap frog competitors. That kind of an acquisition strategy brings its own kind of problems and they are not dissimilar from the ones that an Oracle looks at either when they were acquiring products, as Ray described, or today when they are acquiring market positions that they can push through their very significant channel with the brand and the capital that they have behind that. We were doing more in Cadence what Oracle is doing today in their space. Cadence has the most significant channels, they have customer attention, they have customer access but we needed those core technologies that could be integrated into our offerings for what designers would be doing in the next generation of chip development. Now, as Dave hinted, that comes with its own special problems — we had product development ongoing that had to be changed, and in fact, in many ways the strategic direction and therefore the culture of the company had to be bent pretty dramatically. In order to do that, it required that you change leadership in many cases and in our particular case our strategy was to bring in these new technologies and in effect put the leaders of those technology companies in charge of the product areas and the offerings that we needed in order to be successful in delivering products that would regain technology leadership in the chip design world. It raises a whole range of cultural problems that you have to think about any time you do acquisitions, but for where we were at the time and the market we were trying to serve, product development was not an option — acquisition was what we really had to do in order to regain both revenue and technology leadership in the market place.

Dave Healy	Thanks Ray. Ned you were quoted before Agilent's IPO as saying having all these technologies under one roof gives us more opportunity than if we were single dimensional, which sounds like you view internal development as the key, and you had the enormous R&D fire power of some of the best of breed from HP at your disposal. All that said you did go do some acquisitions — OSI, RedSwitch, Rapid IO, Silicon Genetics and so forth. How did you think about the trade off between internal development verses acquisition?
Ned Barnholt	I think as both Rays have said, a lot depends on your market, what's happening in your market as well as what's happening inside your company. In our case when we separated from HP in 1999, if you remember back that far, those were pretty heady days for the industry. Growth was the number one word, and keeping up the pace of growth was really the top priority. So we took a look at what were some of the markets that we wanted to be in looking forward and what was our position in those markets and if we didn't feel that we had a strong enough position then we would look at acquisitions as a way to accelerate our time to market or to strengthen a position or build a position in a market that was important to us. So, for example, back in 1999 optics was big, so we went out and acquired a couple of optical technology companies — we bought the optical R&D lab of Telecom Italia — it was a great deal and we had some of the best optical technology in the world but unfortunately the market didn't develop, but it was a case of acquiring technology to buy a market position and also acquiring talented people. The case of OSI, that was an interesting one. OSI is a network management software company. We had decided that we wanted to take our test measurement expertise and apply it to managing telecom networks, and as we looked at that we realized that there were a few key pieces that we were missing, particularly software called a manager of managers that allows you to link element management managers from different parts of the network. We had a program under development at Agilent that was going to take another three years to get to market. We felt that we couldn't afford to wait three years so we looked out in the market place and found OSI had something similar to what we needed and we acquired the company. So again I think that's the example of using acquisitions to accelerate your own strategy and build a position. When I think about acquisitions I think it's important to understand what your own strategy is. Most of the acquisitions that I can look back on at HP and Agilent that failed were because our strategy wasn't clear or because our strategy was changing and so I think it's very important to be really clear, particularly in a larger company, what it is you're trying to accomplish and then look at what role acquisitions can play that help you achieve your strategic objective. Don't fall into the trap of looking at acquisitions for the sake of acquisitions. They've got to support your strategic goal and be something that's going to help strengthen the company one way or another. So we looked at mostly gap filling acquisitions — these were acquisitions that brought technology, people, and market positions to the company. We didn't look at a lot of big, consolidating acquisitions but I think that is something that the industry will probably look at at some point in time, much like the enterprise software business has. I think as an industry matures and you're looking at how to accelerate growth and consolidate the position, you're either a consolidator or you get consolidated and I think in the case of Oracle, certainly that was their position to be a consolidator and I think certainly that will be the case in a lot of the industries that Agilent is in. Certainly, the HP/Compaq merger would be in that category as well. So it all starts with your market position and what your strategy is and from there you decide what role acquisitions should play.
Dave Healy	Thanks. Ray Lane, do you want to tell the story about the Virsa acquisition and how SAP viewed that acquisition? Why did that make sense for them in fitting with their M&A strategies, internal development verses acquisition and so forth?

Ray Lane	The Virsa acquisition by SAP is pretty straight forward. I don't think there's a lot of lessons learned there, but I'll tell the story quickly. I would, before doing that, add something to what Ned just said. That is, in a maturing industry like enterprise software and others we've seen you have to decide whether your going to be a consolidator or consolidatee, I guess it's what you would call it. The biggest category in either one of those are those companies that don't get acquired and that is the category you don't want to be in and in the enterprise software business there is a very large category of those players right now, we could come back to that if you would like to. Virsa was a seven year old company although it had spent most of its existence as consulting company. They started out as Price Waterhouse auditors and started focusing on compliance in business processes prior to compliance being cool. After Sarbanes Oxley was enacted, many software companies converted their business strategy from supply chain management or CRM to compliance—it was just funny to watch this happen. They were in the business in 1997 as consultants and after they had a number of very large clients they decided to write in code what they knew and to do it by writing it in the same language that SAP had written its products in, JAVA. So they could actually sell a product to a customer that would then run in real time in the SAP management system without SAP even knowing it. It would be like SAP wrote the code, in fact better than SAP, because SAP did write their own code and, in SAP's own words, they believed their product is one of the worst in the market. It just wasn't doing the job. Oracle and SAP developed monitoring and reporting systems for compliance based on Sarbanes Oxley and that's kind of the state of the market right now. You go to Oracle, they have a product called ICM or you go to SAP, and they have a product called MIC, and both of those products are basically reporting on compliance after the fact. The Virsa product, by contrast, enables real time compliance, so it basically stops the keyboard—so any time an employee is violating a policy that is known to the system, writing two checks to the same vendor on the same day of the same amount or violating a known rule (say Sarbanes Oxley or Rule 144) in some way, the program stops the process in real time, so it's a very popular product. When we invested a year and a half ago they had about forty clients, we talked to SAP about them reselling the product, they looked at it said this is a much better product than we have; we now have about four hundred customers a year and a half later. It has been an incredible success. Everybody asks, why did SAP do a reseller arrangement instead of just buy you? It was a great question. I think we've meant more to SAP as a partner, because SAP is trying to demonstrate that it can work with small companies — it doesn't have a very good reputation of being able to work with small companies and partnerships. So we were the poster child for SAP for a year in cooperation, being out there and the sales force was just on fire in terms of selling this product. Our hope was that they'd wait another year before they would figure out that they'd be better off buying us because we were going to grow so fast, but SAP made a preemptive bid and said we just need to have this inside SAP, it makes so much sense, we now know our sales force loves it and we know our customers love it (in fact, except for probably a dozen, all of Virsa's customers are large SAP customers). Virsa has an Oracle product as well but SAP decided it would take it off the market with a preemptive bid and since the founders owned a lot of the company it made sense to them.
Dave Healy	Could we talk about whether it makes sense to use your strong market position in one space to jump into another space. Ray Bingham and Ned do you want to talk about KLA Tencor's ADE acquisition?
Ray Bingham	Well as board members we are prohibited from commenting on the company's business but let me mention a point first of all. Any company with a well established brand, a big channel and the capital to operate it has an opportunity to buy a company as a means of moving into adjacent markets under some conditions and leverage those channels into that adjacent market. That said, my experience and my opinion is that anyone who attempts that has to be very very clear that the channel they are leveraging into that adjacent market place is a relevant market for their channel to operate in. We sold a lot of software at Cadence into the semiconductor industry and so there was a notion that we could sell lots of things into the semiconductor industry and moving down stream into equipment, for example, might have been an alternative or moving onto the plant floor and out of the design shop where we were selling our things. There was a presumption that that might be okay – but in fact those are completely different markets within the same customers and our sales people didn't know their sales people, their buying practices were completely alien to ours and all attempts to cross that chasm, even within the same semiconductor industry, have proven to be foolish. In the case of KLA's acquisition of ADE, I think we are talking about something where the ability to leverage the channel to the same customers, the same buying patterns, and the same buying practices were well qualified and it was and has been in my view a very legitimate and attractive leveraging of existing channels.

Ned Barnholt	I think looking at the adjacencies is one of the ways companies like an Agilent, or like a KLA, or like many companies in the valley, grow. To the extent that there are small companies out there, or mid-size companies, that offer some unique capabilities, that's something we'd always be interested in. I'll give you another example. We decided back in the 1999 time frame that we wanted to take our lead in optical test and move into optical components. Some of the acquisitions we made were to get into the component business, but, much as Ray has said, when you start getting into optical components, particularly optical components that are going to be used inside of the telephone network, the requirements are a lot different than those for test and measurement equipment. We didn't have the skill sets, we didn't have the knowledge, we didn't even have the channel to be able to address a lot of those. So I think it's important when you look at adjacencies that you really understand exactly what's common and what's different and that when you structure within your organization you focus on those things you must do differently and not just assume that everything will be the same
Dave Healy	Ray Lane, do you want to talk about Quest Software and why you think their M&A strategy has been so effective over time?
Ray Lane	Let me provide a little bit of context on Quest Software. Quest Software is a $500 million, will be a $600 million, dollar software company this year growing at 20% with 21% pre-tax margins. You don't see enterprise software companies like that a lot anymore, other than SAP, Oracle or Microsoft. About a year ago, year and a half ago, I was asked by the CEOs of the software industry to come and address them as a group. They get together a couple of time a year to talk about industry wide issues. I was a charter member of that group. They are now debating the problem they have in a slow growing industry and what they can do about it as a group without getting into each others' strategies. The predominant discussion was about business models — you would find in the enterprise software industry today the predominant discussion is about business models. How quickly do we move to a service company and ASP model to provide software as a service. Salesforce.com has basically grabbed the high ground in terms of demonstrating that you can build a company that way and create growth. It occurred to me that that was not the primary concern in enterprise software business. That is not what they should be thinking about — they should be thinking about how to stimulate innovation again to re-create growth. There is a lot of white space in the enterprise software business. You cannot create growth by offering a different business model of the same product Oracle has—that game is over. When I see a business plan that says we're going to offer a CRM system but we're going to do it online or we're going to offer supply chain management system but we're going to do it as an ASP, I know that's not viable. Oracle is going to figure that out like in no time at all and customers will want to buy that from Oracle or buy it from SAP. But, there are things that Oracle and SAP are not going to do. They are spending most of their R&D on what I call continuous innovation. They are extending the relational database market, extending the enterprise application market. So after figuring all of this out I realized that what I had figured out was right under my own nose, and I didn't even connect the two because I was watching but not connecting the empirical evidence. Vinnie Smith at Quest offers products that Oracle or Microsoft or other database companies should be offering as a tail to their products. So if you buy Oracle's database product, you can buy a lot of add-on products to make Oracle run faster, run better, get better statistics, develop the application faster. All of these are what I call after-market products. They've done that for a long time in the Oracle space. But now, as Oracle matures, Oracle is starting to offer such add-on products as part of the base price. That will ruin a company like Quest. So they've designed they think a clever and aggressive M&A strategy. So we will frequently look at opportunities to buy small companies. They'll be $3, $5 million dollar revenue companies, which I do not consider a revenue company at all but basically they've created some customer traction and they've got some revenue, that can be taken out for $60 million to $100 million. Well, as a board member, you look at those figures and you just choke on those prices, but if you believe you can take that product and put it through the distribution channels that you already have, using the infrastructure you already have and that you can go to the customers you already have with something very innovative, then you can create big businesses out of it. Let's say about five of those acquisitions in the last five years have turned into major product lines. And they are basically replacing the old revenue streams, over say a five year period, that were going to go away anyway, because Oracle is going to offer the after-market products for the base price, as I mentioned.

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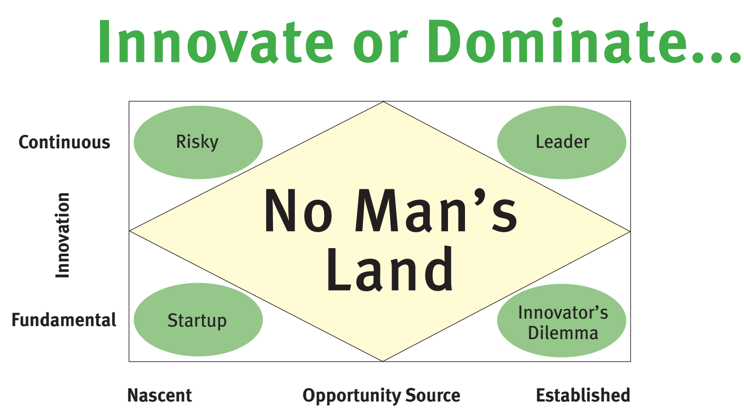
<tr><td></td><td>You know, when I left Oracle the product overlap with Quest was about a million and a half dollars. A million and a half dollars of revenue at Oracle doesn't get anybody's attention. Now the product overlap is about $100 million dollars. Well that's significant to Quest. But they are now making a market in Microsoft SQL Server and making a market in other databases. So it's a very clever M&A strategy and I would recommend it to a lot of mid-sized software companies that are maybe $300, $400, $500 million software companies. If they cannot do the innovation from within, then they should go the opposite direction and basically figure out how you're best of breed expertise can be acquiring companies, assimilating companies and doing that well. And it's not just that they don't write their own code, but they've developed an expertise that can assimilate these acquisitions fast and integrate them into their own product line.</td></tr>
<tr><td>Dave Healy</td><td>IMPACT OF MACRO INDUSTRY TRENDS ON M&A STRATEGY

Thanks Ray. Ray let's stay with you for a few more minutes. Why don't you talk about just what impacts the macro industry trends have on M&A and partnering strategy as it impacts enterprise software business and refer to your chart on what are the implications of where you think the enterprise industry is on what companies should do.</td></tr>
<tr><td>Ray Lane</td><td>



The above chart represents where I think the enterprise software industry is going. Basically this chart looks at the size of the company and the opportunity source. So small vs. big companies on one axis and on the other axis, the type of innovation that they do. I think Oracle does continuous innovation. 10G is very innovative to Oracle; they think it is very innovative but it does not challenge the relational database market. Someone else might be a small company that may be doing fundamental innovations and say that relational databases are over, they've had their day, it's not a good way to store information any longer because technology has moved ahead in thirty years and so there is a new way to do it. So they will basically challenge that. So in this corner you've got start-ups that are doing fundamental innovative things that are challenging the current paradigm. Up here you've got the existing players that will continue to engage in massive R&D — 10,000, 15,000 engineers that are continuing to pour large R&D budgets into making their products better and better. And so in the industry now we've got this kind of "innovate or dominate" kind of bipolarism. So we've got maybe fifteen companies up here in the top right of the chart. There's fifteen companies in the enterprise software business that own 85% of the revenues. Three companies own 75% of the profits in the business. So you think it's quite consolidated. Then, there are probably a couple hundred start-ups that truly have a chance to break through with a fundamental innovation out of the 5,000 that are out there or whatever number you think there are out there. That leaves this as a very unconsolidated industry but they are all sitting in here in the no man's land in the middle. So they are deciding today, or they are just following what they have done in the past, to compete against the industry leaders and that's why you hear in the press that the enterprise software business is over, it's done.</td></tr>
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	Because most of them are trying to compete with the big guys up here and they can't do it. They don't have the R&D budgets to do it. So if you're selling an application server or a set of tools and you're trying to compete against Microsoft and Oracle—forget it, they'll win. Or you're trying to basically change the world down here; that's also very difficult to do. Instead, you've got to forget what you've done, what made you, what brought you here, what made you successful, and compete with some new start-ups that are led by some thirty year olds that don't remember the old way. These start ups are basically using new technology methods to create their product. Now when these guys try to drop down here and do fundamental innovation, of course, they think it's fundamental innovation, but the further you get down here the more they're stuck with innovator's dilemma. So they're not going to cannibalize their current businesses. They're not going to create. Oracle probably has twelve or fifteen thousand engineers of which there's a small group that may think about break-away technologies while everybody else is doing kind of continuous innovation—it's their job. Basically, using the R&D budget to make their products better. What's Oracle 12 going to be? And then the little guys are doing what I described before. This is very risky, if you're going to take continuous innovation trying to replicate what Oracle and Microsoft and SAP do, then it is just a question of time. So for Virsa, even though our competitors like Microsoft and SAP acknowledged that Virsa was the best product on the market – and even though we have four hundred Fortune 1000 companies and a 40% market share — it's still a question of time before Oracle and SAP are going to say, we are ERP players, we must provide compliance software to our customers. SAP decided to buy the best product on the market. Oracle is still developing its own. Oracle and Microsoft and SAP do, then it is just a question of time. So for Virsa, even though our competitors like Microsoft and SAP acknowledged that Virsa was the best product on the market—and even though we have four hundred Fortune 1000 companies and a 40% market share—it's still a question of time before Oracle and SAP are going to say, we are ERP players, we must provide compliance software to our customers. SAP decided to buy the best product on the market. Oracle is still developing its own. So it leaves what I call a huge no-man's land and this is where you've got to make the decision about acquisitions. Be acquired or go acquire. If you are a company like Quest in here, you need to go acquire the start ups offering fundamental innovation. Go figure out the best companies to buy, buy them and try to convert them to big revenue streams in the future. If you're somebody else you may decide to do it a different way. But you can't just simply sit here in no man's land competing with Oracle or competing with the startups—that's death and you'll get squeezed out. At the same time, what's working on this space is Open Source Software (it's basically under-pricing existing offerings—why would you buy an App server from BEA when you can buy it from JBoss), outsourcing (just get rid of the IT you know and let somebody else manage it) and software as a service. Should I make a decision to buy the Oracle CRM System that used to be Seibel because it is best of breed in the market and pay a million dollars for the license and take a year to install it? Or do I want to get Salesforce.com and start entering data on day two at $100 a user or do I want to get SugarCRM at half the cost of Salesforce. This could eat away at this big middle. This middle is going to be gone in five years. There will still be a few players, but it will be cut way, way down in size and so we will see this industry restructured. It is going to be a hostile restructuring of this industry, I believe.
Dave Heay	Ray, that presentation should end with "and, by the way, have a nice day". Ray Bingham, a former EDA CEO's infamous quote was that EDA companies were all "eating from the same dog bowl", perhaps indicating that they were just eroding each other's margins. Can you comment on various strategies EDA companies have used including by M&A to grow the size of the EDA market and improve the revenues or change their business model and so forth in their quest to overcome that.
Ray Bingham	Sure, let me start and just comment very quickly on Ray's chart and his comments. Remember that chart. It's really an outstanding description not just of Enterprise Software but really the entire tech market today. If you look at any market segment, what you see is an oligopoly structure, where a very few companies have all the market cap, all the revenue, all the profits and then there's this very long list depending on the size of the industry and the number of players of companies that are stuck in that no-man's land. I read recently that there are more than a thousand public tech companies with market caps under $500 million. A thousand public companies. Those are the companies that once were on the left hand side of that chart but that wandered, with very good technologies and very good people, past the "sell by" date in terms of aligning themselves with someone else and into that no-man's land and the clock is ticking on their ability to survive. That's Economics 101. That's the world we live in today in a maturing technology sector.

	Now as it relates to any of those industries including EDA and the "dog food bowl", the famous quote by Joe Costello was about the limited growth prospects that appeared to be available in the EDA industry. It's a problem that is common to many markets. If I look at the high growth tech leaders from the bubble era, and think about even the big guys that have market power — Intel, Cisco, Applied Materials, KLA — these are big powerful companies, whose stocks have not moved in six years, whose revenues have grown modestly and are trying to figure out how to get out of this box that they live in. In the EDA industry, which is a relatively small industry, we were faced with that continuously and there were and are things that have been modestly successful in breaking out of that path. If I put them in two buckets, one of them is to create more market leverage and access to a larger share of the chip development dollar, in our particular case by changing the business model, and the other one was to explore accessing adjacencies which we touched on a moment ago. The business model side, given the amount of innovation and the number of small very interesting innovative start-up companies that continuously come into that marketplace, in my view held the most promise for that industry. What does a business model change look like in that particular case? Well, one of the failed experiments was to apply design technology to the outsourcing of design. Turn a software company into a services company. It didn't work for a whole long list of reasons that remind me of the unexpected; the things that you don't know when you go into an unexplored space like moving into an adjacency. One of the more successful strategies that we found and something that did actually move the needle was to find a way to become relevant at the enterprise level in addition to selling the technologies that you offer at the engineering level. So traditionally for most tool companies, whether it's Enterprise Software or Technical Software, the point of sale happens at the engineer or departmental engineer level. If you can assemble enough critical mass, enough brand and capital but also enough of a solution to be able to tell your story in a board room and have a CEO say, "Oh yeah, I get it, this can change my business," then you have an opportunity to create more leverage and obtain a much larger piece of a slow growing market. Now what I'm describing isn't expanding necessarily the size of the market. Though it may. It's a market share play. But what it does is re-brand you as someone that is relevant at the enterprise level, and that can change the outcome of the business equation and potentially give you more visibility and access to an eventual adjacency.
Dave Healy	Thanks Ray. Ned, in the businesses you've been in there have been a lot of interesting up and down trends. You've talked about medical products, semiconductors and of course you lived through the telecom industry shake-out. So can you talk about how in those three industries the trends have impacted your thinking in terms of whether you could do acquisitions, how to grow and so forth.
Ned Barnholt	Maybe I can give a couple of examples. When we separated from HP, we had a fairly large medical devices company. It was about a billion and a half dollars at the time, but this was an interesting market. It was clearly consolidating. Not only were suppliers consolidating but customers were consolidating. All these hospitals were getting together. There would be one buyer for maybe a dozen or more hospitals all looking at their medical equipment and frankly they didn't want to spend much money because all the hospitals were under pressure — that's why they were buying and pooling their purchasing power — so there was a tremendous amount of pressure on margins. At the same time, companies like General Electric, Siemens, and others were buying up pieces of the industry so that they could go into hospitals and offer CAT scans, X-ray, MRI, ultrasounds, and patient monitoring equipment as one big turn-key package. And oh by the way they would finance it and oh by the way they would service it in a package deal. So this was an interesting play against somebody like us who basically only competed in two narrow segments—we competed in ultrasound and patient monitoring. What was happening is from a customer's perspective, our products became free, because GE would package the ultrasound as part of an overall deal and it would look like it was free and we were trying to go in and sell it. So this was a tough choice for us. We either had to go out and acquire ourselves an X-ray, CAT scan, MRI company and look like a GE and Siemens or we would divest businesses and focus on other areas. We decided to divest businesses because at the time we could have spent a couple billion dollars probably to acquire those technologies but at the end of the day we would be one of three or four companies that would offer these kind of integrated solutions in a market that was still under tremendous FDA pressure, margin pressures etc. and we decided to use the money to focus on life sciences and telecom. It turned out that was a very fortunate decision because we were paid $1.7 billion for the business just about the time the telecom market tanked and that cash came in real handy to the company. But the flip side of that was Telecom — we talked before about the OSI acquisition. We did acquire a number of companies.

	We made about twenty-five acquisitions over the first two, two and a half years after splitting from HP and most of them were in telecom and Life Sciences. Most of them were relatively small other than OSI but there's an interesting example there. When we look at acquisitions we try to get the acquisition to be accretive within a year and to generate about 20% return on invested capital within two years. Now you can imagine with valuations back in those times, that was very difficult to do and we generally stretched that to almost double those numbers for acquisitions we made during the peak. But the problem is when the market died, particularly the telecom market died, the time to get that return on investment went out a long time. So this put a lot of pressure on us — we had to rethink our model. In actual fact we stopped making acquisitions in the optical area and the telecom area because we felt it was going to be many, many years for that industry to come back and we would not be able to achieve even close to our goal for the return on these acquisitions. So anyway the market conditions can change, and that'll change M&A outcomes, so you need to go back and look at those acquisitions and decide if they were still right for the company. In several cases we later divested. In the case of OSI, and some of the optical businesses, we actually kept them, integrated them in but rescaled them to what we believed was going to be a lower level of return going forward.
Dave Healy	**EVALUATING SPIN-OFFS AND DIVESTITURES** Ned, let's stay with you for a little bit longer. The spinoff from HP was one of the largest divestitures ever, probably. And, as well, you've seen the movie of divesting some of your assets in the Agilent context. So you've been on both sides of divestitures. What generic comments would you make on how to think about spinoffs and divestitures, when is it right, when is it wrong, what are the drivers there?
Ned Barnholt	The HP divestiture of Agilent is an interesting one to reflect on. A lot of people think that HP spun off the measurement business because HP got too big. It really didn't have anything to do with size. It had more to do with complexity. The fact is, in a large company you can have multiple business models at work and those business models can compete for strategy, for resources and for the way you run the company. A classic example is the person who ran our personal computer business at the time would come into staff meetings and say, "Gee, I can't afford to pay engineering salaries that we're paying at HP to compete with Dell. I can't afford to invest in central research and oh, by the way, I can't afford a pension program because Dell doesn't have one." And I'm sitting there saying, "Time out, I want to spend more for engineering, I want more in central research, I want to have the best benefit programs on the planet for our engineers, so we can attract the best engineers." So these competing views ultimately lead to a vanilla solution, unless you have some way to separate them, either within the company, or to separate the company. Now some companies deal with that by actually having very autonomous businesses where they have totally different salary structures, benefit plans, and everything. We decided not to go that route at HP and felt that the right way to deal with this was to separate the company. But I think that even when you looked at HP, the question there at the time was, "Well, what does HP want to be when it grows up?" Does it want to be an enterprise computing company? Did it want to be more of a consumer marketing company? It was clear as HP changed to a consumer marketing focus, that we didn't fit that model. So that was the reason we spun off. The other reason was we were not valued as part of the HP portfolio. HP was a computer and imaging company. There was virtually no shareholder value for the measurement side and it was a way to unleash some value for HP shareholders by creating a separate company for us. And it also allowed both companies to focus on our businesses with our business model, our set of customers, and whatever we needed to do to be successful. So I think that situation actually continued, even most recently with the spinoff of the Agilent component business. As you know that was recently spun off. We had started to look at that before I retired last year, but the fact is it was a very different business. It was something that really confused Wall Street. A big portion of our stock valuation was due to the component business even though it was only 20% of the company. We weren't getting valued for our leading position in measurement and as a result we felt that both organizations would be stronger by identifying with the markets that they were in. So after I left, the component business was split off. So a lot of this is based on the complexity of the company, the business models you have, what's your strategy going forward, and some recognition of shareholder value, because, I think, as you get into large companies, what I see is that large companies almost by their nature become multi-business and very complex and every once in awhile you have to step back and look at whether all the pieces fit and whether you're getting truly valued for all the pieces that you have in the company. That leads to opportunities, whether it's for private equity, for strategic deals or IPOs, to spin off independent businesses.

Dave Healy	OK. Thanks Ned. Ray Bingham do you want tell the story of the proposed Tality spinoff, and why it seemed to make sense at the time, and why it didn't make sense in retrospect?
Ray Bingham	What Dave is referring to, is something that I mentioned earlier, the radical change of strategy at Cadence from a company that had turned very sharply in the early 90's to a services strategy focused on a design outsourcing strategy and a later change of course in 1999 when it became clear that that wasn't going to be a successful strategy to develop the company. At that time about a third of our headcount were design engineers that were in business of outsourcing the design of chips and boards for the electronics industry; it was a division that was growing very very rapidly but at least in my view was unlikely to ever make money. Kind of like a lot of other things in the bubble times, and that was 1999 wasn't it. In any event, certainly the people running that business for us felt like there was every likelihood that these outsourcing strategies could be successful in technology software as they have been in enterprise software. I felt like the very best way to liberate value inside of Cadence and to be a purer play on both sides of that fence, the outsourcing side and the design technology software side, was to separate the two and spin Tality out. We strapped on the very best investment banker, the very best advisors, and I attracted an outstanding board for that company and took it to market. Regrettably we took it to market in the fall of 2000 as the market began to really crack, 17 of 19 days that we were in the market place were harsh down days and we ended up with a transaction but not one that was feasible or sustainable for the company as an independent company. Right idea, but the timing missed by a few months in order to establish something that might have been sustainable and might be given that team a chance to demonstrate what they could do because of a severe wind shear in the market place.
Dave Healy	Ray was there also a customer demand element to that in terms of whether the revenues were sustainable if Tality had spun off?
Ray Bingham	Well sure, part of the bubble cracking was that in large part the customer base for this outsourcing model consisted of chip start ups that were working as a first order objective not so much time to money, but rather time to IPO. When the IPO market went away about 45% of Tality's customer base for this outsourcing activity went away.
Dave Healy	**EVALUATING ACQUISITIONS: PRICE, FIT, OVERLAPS AND RISKS** Okay, let's turn to how you evaluate and think about an acquisition that is on the table. There are metrics like accretion/dilution, fairness of valuation, strategic fit, cultural fit, employee overlap, product overlap and deal risks. Ray Lane, do you want to comment on kind of what rules of thumb you think about, on both the buy and the sell side, in terms of when the deal makes sense and when it doesn't make sense.
Ray Lane	There are generic rules of thumb, I don't know that they are ever followed because it's so specific to the company; the example I gave was Quest. It's very specific to them in achieving the results that they want to achieve. All the standard metrics you mentioned are certainly looked at, what kind of dilution you are going to get and how will the analysts look it and all those are important, but the real focus needs to be on the long term. What kind of synergy does the acquisition bring, both short term and long term, but more important in the long term? Is it going to build a sustaining business that makes sense for you as the acquirer. That really is the dominant factor that you look at. While Ray Bingham may disagree with this being on the Oracle board, I don't think you can make financial sense short term of Oracle's acquisitions of PeopleSoft and Seibel, but long term those deals made a whole lot of sense because they restructured the industry. It basically cements a position in the industry that was somewhat volatile before it got done so it just stops the jockeying that was going on and probably a lot of the acquisitions that would have occurred anyway in the industry that may not have been on the Oracle balance sheet, but long term you cannot question the fact that this large business, this large application business, now has two players in it and no one else really counts unless you want to come down to Salesforce.com level and everything and look at a different business model, but I think Salesforce.com has a lot to prove before they can start saying they are challenging the ERP business. Certainly there was a lot of press about the Oracle/PeopleSoft deal, but you can't question what that did in terms of cementing a position against SAP because SAP was dominating the applications business against other players, had 3X or 4X the share of any other player, and so this basically gave SAP a single competitor. It made a lot more sense to explain in both the short term and the long term. It took a lot of cash off the balance sheet but Oracle's generating cash. You mentioned before would you use cash from one business to buy another business? Very few tech businesses, I'll stick to what I know best, software business, have two platinum records; the list is Microsoft and I can't think of the second, so it's very hard to create that second platinum record; I did not consider the ERP applications business as a platinum record.

	It was not a successful, profitable business. An now it's profitable because of acquisitions. I think it remains to be seen whether this is going to be an organically growing business that will supply more cash to the company. But did they use the cash generated from a superior market position to buy? Yes. Microsoft has seven or eight different businesses and have used the profit stream from two great products, their operating systems and their office suites, to basically be acquisitive and I think that's a smart strategy.
Dave Healy	Ned, what were your rules of thumb in evaluating acquisitions? You mentioned a couple of metrics a few minutes ago, but how did you think about acquisitions in terms of the formulas you use or the metrics you used and do strategic goals always win out over price?
Ned Barnholt	Simplistically, I think of three basic questions when I think about acquisitions. One, is what's the strategic fit, two is what's the operational fit, and three is the financial fit. Strategic fit gets back to the comments that Ray just made. How is this going to strengthen you long term position, what are the synergies, what are you going to be getting out of this and as I mentioned earlier a lot of it depends on the stability and clarity of your own strategy. If your strategy is clear and not changing around then you can think about how an acquisition can strengthen your position, accelerate time to market, deliver some synergies that you would like. The operational fit is really more a question of how difficult is it to realize those synergies — are there are geographical issues, are there cultural issues, are there issues of merging platforms, merging sales forces, what are the issues that you have to deal with that could derail the acquisition. Those are important to think about because I can think of a number of examples of consolidations where the combining companies spent the next three years merging a platform only to watch a competitor pass them by. I think you have to be careful as you think about these things, and focus on what are the investments you're going to have make internally to realize the synergies and the return on the investment you seek; unless you're prepared to make those investments and keep a leadership position in the market, you are probably not going to get the synergies you want. The third is the financial fit and frankly that's kind of the order that I think about them. To me, far and away the most important decision is the strategic fit and as Ray says depending on how important that is that may change the financial goals that you set for the acquisition. If the strategic fit is clear, if the operational fit is clear, then you come down to how do we make it work financially. We look at the usual metrics, accretion, dilution, return on the invested capital and we have some rules of thumb as I noted earlier but those rules thumb vary depending on how strongly we feel about the first two items. One point I would make though—it's important to think of acquisitions relative to a do-nothing strategy because sometimes acquisitions are defensive and if you did nothing you may find yourself in a worse position. So you just can't assume the competitors are going to be standing still, you got to think about what if somebody else buys the company, what if something else changes in the business and then look at the acquisition relative to the do-nothing strategy.
Ray Lane	Can I just add something to what Ned said — I can't think of an acquisition that I'm aware of, either I'm involved or not involved in, that didn't start out with the idea that this is a good idea long term, this makes a lot of sense and this is a strategic fit. I think we all start out with the thought that this is going to make a lot of sense and then they fail on the second dimension that Ned mentioned, which is the operational fit – because most acquisitions are delegated to middle management to figure out. Some companies do brilliant jobs of acquiring and they use different styles to do it. I can't validate this, but I've heard the rumor over and over again of how Charles Wong at CA used to do acquisitions. He made sure it would fit their portfolio, and he wanted to make sure it would be integrated quickly, so basically he would take the list of employees that were incoming, organize them alphabetically and then cross off every other name. It was a unique way of acquiring a company but it got integrated fast and there wasn't any opportunity for middle management to look at someone across the aisle and say "well there are now two VP's of whatever, how's this going to work?" So how does it get integrated? I think HP did a nice job of integrating—certainly they were doing it in a fish bowl—but did a nice of integrating Compaq, a very large, complex company. Certain banks like Chase Manhattan have always done a great job of acquiring and integrating, but you need a top down direction for getting these acquisitions done. Allowing them to be delegated to the functional aspects of the company, trying to figure out how two look alike functions are going to come together is very difficult to do — it's a formula for disaster. The CEO and other top management leaders have to be involved after the fact more so than before the fact.

Ned Barnholt	I forgot to mention one thing. You know it's possible to have really good strategic fit, really good operational fit and still fail on the financial, don't get me wrong. A good example of that is we were looking — I mentioned optical companies — the latest thing is life science companies – there's a whole bunch of life science companies out there, many of you may be aware of them, that have virtually no revenue and want a billion dollars for the company. At some point in time, a board is going choke, a management team is going to choke and say this just doesn't make sense. So you have to be careful you don't get so in love with the strategic fit and the operational fit that you can't make good business decisions.
Dave Healy	Ray Bingham, you have done an excellent job of putting a lot of rigor into Cadence's M&A process and you definitely had some rules you wanted people to abide by—how flexible were those rules for you and what were those rules and what was your thinking on that, both domestically and internationally.
Ray Bingham	Let me start with acquisitions – mergers and acquisitions are not generic things. We've all said that over and over again in our various comments today. It depends on who you are, where you are, where you sit, what your focus is on, what you're trying to accomplish with the acquisition. The rules that have been discussed also tend to align, there needs to be a financial fit, there needs to be a strategic fit and though the words haven't been used heretofore I'll mention, there needs to be cultural fit. I think this is particularly true when you are talking about bringing in a capability that simply does not exist in your company and probably doesn't exist in very many other places. Here I'm talking about critical technology – thought leaders or critical technology that if you lose those key people you have lost the entire market value – the entire purchase price of what you bought and probably more because you lost time in going down that avenue. I think this ties very nicely into the comments that Ray was just making about top down involvement, in fact top down commitment, as you integrate these activities into the company. Strategically it is very difficult to align the entire company and as the company gets larger it is even more difficult and as you get down into those layers of execution there will be a lot of subplots working through – often, not even with bad motive, but subplots because it's his job or my job, it's his department or my department or altogether too frequently mergers will fail because it's his product or my product and they both very nicely snap into the strategy as I understand it. There are a lot of personalities that go into applying these rules or these guidelines, as we discussed them, that have to be very carefully thought through. Now if you look around the industry to see who has done this well, the first thing that comes to my mind is Cisco. Cisco as they ramped the company were famous for being able to acquire very quickly, not particularly lose the people, which is critical to the technology they were trying to acquire, and to continue ramping Cisco at what seemed to be endless heights of revenue growth from the early 90's to 2000. The cookie cutter approach, the ridged inflexible acquisition approach that they brought to bringing teams in and integrating them into Cisco's way of doing things, worked pretty well for that kind of an acquisition. These tended to be small groups of people; they were technologies that were on tremendous growth cycles and the real integration of channel and culture, in my view, didn't really matter all that much. Where you're trying to blend people, competing for jobs, competing for sockets within the internal product development team of the company, then you can create very difficult problems. The involvement of the CEO to make sure that ties were broken, that decisions were made about product offerings is indispensable to making sure that you don't confuse your own troops internally and your customers externally as to what it is you're bringing to market.
Dave Healy	**EVALUATING SELLING A COMPANY—WHEN TO SELL** Let's turn to when to sell. Ray Lane you've seen the Marimba story where the stock price went up then it went down and the stock lay dormant for a long time. There was a lot of consolidation in the industry and concern about being the last player left standing. You've seen that movie and you've seen the Virsa movie where it was like a rocket ship upward and an argument can be made that it is too early to sell. How does an entrepreneur know when to sell the company?

Ray Lane	I think that's a great thing about being an entrepreneur is that you can—if you own enough of the company—you can decide. Most entrepreneurs I see that are coming through a couple of financing rounds are basically down to five or ten percent of the company, often closer to five than 10 percent. The decision will be taken by a group, by the board, and no entrepreneur is going to make the decision themselves but they can be quite influential obviously with the amount of ownership they have in the company. So it becomes more of a personal decision. Most really good entrepreneurs want to build long term, sustaining companies, they're trying to change something, they're trying to challenge the current ways of doing things. They want to see something happen, want the customers to respond to it, want the market to change –the financial outcome is a secondary issue. If you can see an inevitability, that you're building something that you're in the upper left hand side of this chart, so you're now a start up trying to do something that eventually the big dominant players will get around to, then you have more of financial decision model. Is it best to take it off the table today? Yes, you probably would have done a little better in three or four years but you assumed all that risk. If you decide well you know I'm going to turn down this offer—say you are Virsa—I'm going to turn down this very good preemptive offer that has a pretty good result for all the shareholders and everybody would be happy with this—we'd be happier with more so let's go ahead and take the risk. Then SAP goes and they buy somebody else. Well, now our closest partner has bought a competitor and all of the sudden the economics change for us so we're not in a great negotiating position, but of course the first thing I do is call Larry Ellison and say do you want to talk, yeah absolutely we're interested in looking and Oracle brought a team in. But Virsa had more value to SAP because it was worth more to SAP customers. If you look at all those things the inevitability in Virsa's case was clear—this is something that ERP companies have to do, they have to be best of breed in compliance because their customers expect them to; in fact their customers may demand it and say we need it and we won't even pay for it. It has to be a fundamental part of your ERP integration. We think that was the way the movie was going to play out for compliance solutions and that to go first would probably generate the most value for shareholders rather than going third although going second could be okay because Oracle can afford to pay for acceleration especially now that SAP has bought somebody. Who's going to buy the third one though? There aren't many choices, you don't want to be third, so you don't want to end up in that no man's land. Trying to make that decision I think has a lot to do with what's going on in the market, what your inevitability is, what are you trying to change fundamentally. We weren't at Virsa trying to change the world, we were simply trying to do what large businesses should have been doing all along, which is to ensure compliance with their own policies. SOX put a spot light on that and we have a pretty favorable cost pay back because we don't have to spend the money on auditors and — doing it manually every quarter — it's all automated. Another case as you mentioned, Marimba, I think the board was — and the management team was — somewhat confused about what we should do and when. We saw other start ups pass us right by and we were somewhat frustrated by that, we changed the business and focused less on client management – desk top management — and more on server management because the Internet changed that perspective and we just couldn't get it right and said maybe we ought to look at being acquired, maybe we are now the best we can be, so we decided, I think a couple of years too late, to be acquired and we did get it successfully acquired. It was a time when acquisitions were not the first thought. We were coming out of a successful IPO and in a successful market and everybody was geared to say grow, grow, grow and for a couple of years we weren't growing and we were managing to just break even. It took us a couple of years to kind of get our head around that. Our inevitability there was to be part of something bigger because we weren't creating anything big.
Ned Barnholt	Looking at a number of companies that we have acquired over the years there seems to be a stage companies get to where they need to make significant investments. Whether it's in channel, whether it's in building their own support organization, whether it's building a manufacturing organization, but generally they come to a point, a decision point, where they need capital. They need to make some significant investments to expand and grow and that's usually the time that they start considering the alternative of being acquired; most of the companies that we've acquired get to that stage.
Dave Healy	We are out of time, please join me in thanking our very distinguished panel.