

MARKET SPOTLIGHT

BUCKING THE TREND – SECRETS TO A SUCCESSFUL STRATEGIC ACQUISITION

EMC'S ACQUISITION OF DATA DOMAIN

CORUM

MERGERS & ACQUISITIONS



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EMC²

datadomain

DEAL DYNAMICS			
Buyer:	EMC	Announced:	June 1, 2009
Seller:	Data Domain	Closed:	July 23, 2009
		Deal Dynamics:	Auction
Acquisition Value:	\$2,017,000,000	Premium Paid:	87%
EV/S:	7.4 x	<i>Note: Premium paid from closing price before NetApp bid announcement</i>	
EV/EBITDA:	79.4 x		

M&A DONE WELL DELIVERS BILLIONS TO SHAREHOLDERS

To fatigued investors, bankers and analysts, we offer this cure for the recession hangover: a multi-billion dollar return to EMC investors over the next 5 years, based solely on the success of the Data Domain acquisition.

We are profiling the Data Domain acquisition in this Market Spotlight because it offers three important lessons for tech M&A: first, that the most successful acquisitions are either market-cycle agnostic or counter-cyclical; second, that they are driven by a highly focused investment thesis (which, not trivially, needs to be sound); and third, that execution and integration are the most important ingredients for success.

Our analysis makes sense only if we accept that the Data Domain acquisition was successful. A recent Bain & Co. study revealed that 70% of mergers fail to measure up to the financial forecast on which the transaction was based. CFO Insight research shows that 83% of corporate mergers fail to produce positive value for shareholders and, worse yet, 50% of mergers actually decrease shareholder value. Both studies looked at **a)** whether the merged entity met or exceeded financial targets, and **b)** whether the transaction increased shareholder value.

Our view on the Data Domain transaction, based on our financial analysis and discussions with industry sources, concludes that Data Domain is a runaway success on both counts.

EXCEEDING PLAN

Based on public record of EMC's statements:

- Data Domain revenue was up over 40% in Q3 2009, the quarter when the transaction closed. This was ahead of plan and, in spite of the distraction caused by the deal, EMC also capitalized immediately on synergies, forming a new division around Data Domain and another recent acquisition, Avamar, called Backup and Recovery Systems, or BRS.
- Operating within BRS, Data Domain revenue was up over 50% year over year in Q4 2009, again ahead of the financial plan that drove the acquisition. On its financial earnings call, EMC said, "Throughout the entire company, the segment we expect to grow the fastest will be the BRS group." In the same quarter, the division added 600 new customers, 300 of which were net new to EMC.
- In Q1 2010, Data Domain and Avamar accelerated to over 100% growth and over \$1 billion in revenue on an annualized run-rate basis.
- In Q2 2010, EMC said, "That the acquisition of Data Domain has already shown itself to be one of our best ever" and, combined with Avamar, now exceeds the \$1 billion revenue run rate announced the previous quarter. EMC acquired 350 new Data Domain customers in Q2 alone.

In summary, Data Domain has satisfied the first criteria by, out of the gate, exceeding the financial forecasts that EMC used to model the acquisition and delivering increasingly impressive results quarter after quarter.

DELIVERING A RETURN TO INVESTORS

Data Domain's performance certainly had an influence on EMC's overall stock performance. Comparing EMC to the NASDAQ index, we find EMC outperforming the broad index by 30% from the date of the acquisition announcement to the present.



EMC made an even stronger showing against a field of its peers.



In addition to outperforming the market and its peers subsequent to the Data Domain acquisition, EMC also saw a substantial decrease in the volatility of its stock. From Jan 2, 2008 until the announcement of the acquisition, the standard deviation on a weekly basis of EMC's stock return was 6.25%; from the announcement date to June 28, 2010, the standard deviation of EMC's stock return was 3.59%. Our position is that steady earnings growth from the Data Domain transaction helped to stabilize EMC's stock performance.

Based on our calculations, we do not believe the acquisition is yet accretive. EMC paid five times the company's own enterprise value to sales multiple and ten times its own EBITDA multiple for the acquisition, with the premium comprised of growth and synergies. If Data Domain sustains the growth that it has exhibited in recent quarters, it should become accretive mid-2011. More importantly, we believe the newly formed BRS division could make up as much as 15% of EMC's total revenue in two to three years.

LESSONS LEARNED

Based on our analysis, EMC's acquisition of Data Domain has outperformed initial expectations and will deliver a substantial return to EMC's shareholders – a return measured in billions. As investors we respect those numbers. As M&A professionals, however, we are fascinated by the lessons to be learned from the acquisition.

BUCKING THE TREND

Buy low, sell high: Logic tells us that smart companies should make strategic acquisitions during a downturn in order to multiply their returns during the recovery. The data tells a different story: most acquirers shy away from strategic acquisitions during market troughs. In fact, the number of tech M&A transactions remains relatively constant, but the dollar volume plummets. The following table shows the number of transactions in the first half of each year, starting in 2004. In the first half of 2009, during the heart of the recession, total deal volume fell less than 10%, but deal value fell by about 75%.

Year	Deal Volume	Deal Value
2009	1,400	\$58 bn
2008	1,557	\$228 bn
2007	2,005	\$294 bn
2006	2,019	\$268 bn
2005	1,388	\$162 bn
2004	999	\$111 bn

This drop was not due to a 75% drop in the value of high quality companies. It simply reflects the fact that most transactions in the recession involved distressed targets at bargain basement prices. Quality buyers stayed on the sidelines, and strategic targets waited until they could command a 'normal' valuation.

Recent discussions with corporate development professionals from several leading tech companies reveal the primary driver behind this problem: Acquisitions are tied closely to P&L performance, rather than balance sheet performance. A manager delivering great financial results has support to make acquisitions – and strong results generally occur in market peaks.

Investors and analysts don't expect high returns from acquisitions during a recession but studies have shown that the returns are many times over those of deals completed during boom years. According to Bain and Co, acquisitions done during the recession years of 2001-2002 generated returns in excess of 3x those made in preceding boom years. Excess returns were measured by comparing shareholder returns from peer groups in four weeks prior to acquisition to four weeks after deal completed. Deals done during the recession also provide a diversifying portfolio strategy. Think of it like "corporate-dollar cost averaging" -- when executives buy both during good and bad times, they are able to create better returns than fellow executives who only buy during the good times.

Most of the acquisition activity involves distressed targets selling for low prices. In High Tech, 30% of all deals done are distressed, according to a study conducted by the Cass Business School in London. Value is created for the acquirer of distressed targets in the short-term stock performance, but distressed deals struggle to produce long-term value because "buying cheap" doesn't extend its benefits into longer timeframes. Post-integration strategies prove to be challenging to fully execute, which results in long-term growth suffering.

EMC bucked the trend. They identified an acquisition target that was highly strategic, and they bid aggressively and successfully for it at a time when their peers were paralyzed by recession fears. EMC decoupled their acquisition strategy from current P&L performance, and focused on long-term return on assets. In an economic environment of fear and uncertainty they could have let the deal go to NetApp. They could have, but instead they took action and are now running ahead of their peers.

INVESTMENT THESIS

The second lesson we take away from Data Domain is the importance of a focused investment thesis. EMC is a veteran of this game. When they bought VMware for \$635 million in 2003, it looked like a diversification play. Only later did it become clear that virtualization was going to reshape the IT landscape. VMware's value has now increased 45x to almost \$30 billion. Will Data Domain follow the same path?

Why did EMC want to buy Data Domain? Data Domain was the technology and market leader in deduplication technologies. Like virtualization, deduplication has the potential to reshape the storage landscape. The new generation of multi-core processors are capable of deduping data so that only changed data is backed up. The result is extraordinary compression ratios which in turn makes it cost effective to use live disks rather than tape for data backup – live disk backup being EMC's calling card. Selling deduplication encourages sales of storage hardware.

NetApp had a similar strategy, but insufficient cash to compete with EMC's bid. To the victor go the spoils.

EXECUTION AND INTEGRATION

Finally, we get to the most important point – execution and integration. While preparing this Market Spotlight, I recalled a 1998 panel in Boston. I was the moderator. One of EMC's corporate development professionals was on the panel. I asked the question, "What percentage of the acquisition price do you typically spend on integration?" The answer surprised me and the other panelists. "25 to 50%." "Does that mean," I asked, "that if you spend \$100 million to buy a company, you will plan on spending another \$25 to \$50 million on integration?" Again, the answer was yes, with the caveat that the percentage would be lower, but the dollars still significant, for larger transactions.

More recently, we interviewed a senior member of EMC's corporate development team on a webinar. Our guest insisted that post-merger integration is key to creating successful deals. "Success is based 10-15% on

strategy and 85-90% on execution," he said. "We need patience and valuation discipline, but also a rigorous approach to integration that displays a sense of urgency." He said that success came from immediately leveraging Data Domain's strong leadership for the newly structured organization, and that "persistent concentration on major value drivers behind the deal, and a well-coordinated launch" are all key factors to increase the success rates of new acquisitions.

Let me stop here and say that it is unusual for one, let alone two, corporate development professionals to dwell on integration. Years ago, I negotiated a deal with a VP of Strategy who told me that his job is to hunt bears. "It's like this," he said. "Three friends are on a hunting trip, staying at a cabin in the mountains. One of them steps out in the morning to see the sun rise. A bear charges him. He runs in the front door, through the cabin, out the back door and slams it, trapping the bear inside. To his two friends, who are now stuck inside the house with the bear, he yells 'you guys go ahead and skin that one while I go catch another.'"

EMC takes the opposite approach. They don't buy a company unless they are willing to spend the time and money necessary to fully integrate the company, achieve synergies, relaunch, and win market share. All acquirers can learn from their approach.