

Study on the seagate technology buyout finance essay



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Motivation and structure of the transaction. In early 1999, Seagate was planning on major restructuring proposal with the private equity firm, Silver Lake partners L. P. The plan implied a leveraged buyout of Seagate's disk drive operations, followed by the tax free acquisition of Seagate's remaining assets by VERITAS Software Corporation. The choice for this two step transaction was mainly a result of Seagate's 40 percent ownership of VERITAS's common stock. In the previous year the share price of VERITAS increased significantly and the market value of Seagate's share in VERITAS had come to substantially exceed Seagate's entire market capitalization. The value gap was a result of the perceived tax liability by the market if Seagate were to sell its VERITAS stake and Seagate's core disk drive operations were not fully valued in the market due to increased interest in Internet firms and cheaper data storage providers. The two-step transaction was thus believed by Seagate's management to generate significant wealth gains for its shareholders.

Before making their decision Seagate's has to consider some alternatives to the previously described restructuring in order to address its low stock price. The company could sell the company as a whole, repurchase its own stock or sell off part of the VERITAS stake, or undertake a tax-free spin-off of either the disk drive business or its stake in VERITAS. We address each of these alternatives next.

Seagate could choose to sell itself to other companies that may be interested. A merger or acquisition, in this case, could be either horizontal or vertical. Whereas a horizontal merger or acquisition could be beneficial for Seagate, because of the even higher market in the very competitive disk

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drive market, a vertical merger would be less successful as the company is already vertically integrated. However, it would be ideal for Seagate to be acquired by VERITAS as it holds 40 percent of its shares. But VERITAS was not interested in entering into the disk drive industry as management believed this was too far away from their core software business.

A second alternative for the company is to sell its VERITAS stock or repurchase its own stock partially in the open market, however. However both actions proved to be ineffective. First Seagate's ability to sell off VERITAS shares was limited by a prior agreement made with VERITAS. Even if they could sell off the entire VERITAS stake, it still seems an undesirable outcome since the transactions would be taxable on both the corporate and personal accounts. Second when the company performed a repurchase it had little impact on its stock price.

A tax free spin-off would imply that Seagate spins off one of its business units, the core disk drive business or the VERITAS stake as an entirely new company. However the internal revenue code, as part of the US statutory tax law, requires that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in an actively conducted trade or business for a five-year period. Furthermore it also states that the corporate divisions lacking a business purpose can not be accomplished tax free (IRS, 2003). Clearly the " VERITAS stake" corporation will not satisfy these conditions and thus a tax free spin-off is unlikely. Besides the distribution must be the last resort for solving the business problem. In other words, it must be established that the business problem cannot be solved otherwise. This condition also does not hold since, <https://assignbuster.com/study-on-the-seagate-technology-buyout-finance-essay/>

as we will later see, the proposed two step transaction remains as a valid alternative.

After reviewing these alternatives the proposed two step transaction seems to be baneful, mostly due to its low tax nature. As indicated in the case the stock-for-stock swap qualifies as a reorganization under the Internal Revenue Code, thus avoiding the tax implications as a swap. VERITAS will swap 109, 330, 300 shares for 128, 059, 966 shares previously owned by Seagate, and the tax advantage will be Huge as no personal or corporate taxes have to be paid on the transaction. Furthermore the decrease in total outstanding shares associated with the deal will cause earnings per share to rise, *ceteris paribus*. In total this would be in the benefits of the VERITAS shareholders, enabling the two stage transaction to be pursued on their behalf.

Seagate's shareholders also benefit from the potential restructuring program. First they will receive 109, 330, 300 shares that have experienced a price increase of 200 percent after the half year that followed VERITAS acquisition of Seagate's Network and Storage group. Compared to the 25 percent increase over the same period of its own shares this is a significant difference. Furthermore they will receive an additional amount generated from the sale of Seagate's disk drive manufacturing assets (including \$765m of cash) to the " Suez Acquisition Company". The benefits to be received here, and thus also the potential benefits of Silver lake Partners L. P. are thus for the main part determined by this price, which was not determined yet.

Seagate's employees will also benefit from the two step transaction as their incentive to perform increases significantly when the new " Suez Acquisition Company" is no longer tight to VERITAS performance. Corporate governance <https://assignbuster.com/study-on-the-seagate-technology-buyout-finance-essay/>

is now considerable tighter than in the old situation. A sincere loser of the reorganization is the government that could have gained more in taxes if one of the pre-described alternatives were chosen.

Levering the buyout

There are a number of benefits of leveraged buy outs. Business efficiency improvements, increased interest tax shields, change of management or improved management incentives and higher firm value are the most important possible effects.

In the case Seagate an increase of the stock price was the most important target of the leveraged buyout. Before the leverage buyout Seagate's stock price was more and more tied to VERITAS stock price. The performance of Seagate's main business was a subordinated parameter. The trial to increase the stock price by means of selling VERITAS shares and buy own shares in the open market did not lead to the aimed target. Therefore a leveraged buyout was a possibility to lose the stock price from the performance of VERITAS. Besides of this main purpose to disconnect the stock price development from VERITAS also other positive effects of leveraged buyout could be realized, as the improvement of the market position of Seagate from a strategic and long-term point of view. As a consequence a higher probability to secure a positive stock price development after being on the stock market again can be attained.

Another positive aspect of leveraged buyouts are taxes that can be saved through higher debts and interest that is tax-deductible. Although it should be considered that interest cannot be deducted unlimited because of interest

barrier rules or earnings stripping rules. Therefore the interest only can be deducted to a certain extent, depending on the debt-to-equity ratio. There are specific regulations that differ from country to country. In case of cross-border leveraged buyouts the situation should be analyzed separately. Within the EU there is no different treatment in cross-border situations because of the freedom of establishment and the freedom of capital of the EC Treaty.

A decisive argument of leveraged buyouts is the possibility that enterprises that were poorly managed before their acquisition can undergo valuable corporate reformation when they become private. An important change in the corporate structure is often the modification and replacement of the management staff or improved management incentives. In the Seagate case Silver Lake was convinced about the abilities of the management team. Silver Lake argued that the members of the management team had over ten years of experience in the disk drive industry and underlined that it was an important condition of the deal that the six top managers were taken over. In many articles it is argued differently as a restructuring without modification of management staff is much harder and there is a stronger opposition against many unpleasant but necessary changes. As incentives the management had to convert a portion of their Seagate equity into new equity and also got some deferred compensation. The rejection of unnecessary company sectors as well as the reduction of excessive expenditures also is an important factor for the success of the deal.

In the leveraged buyout market stable and predictable cash flows and significant tangible assets which can be provided as security for bank loans <https://assignbuster.com/study-on-the-seagate-technology-buyout-finance-essay/>

are positive preconditions. These are features that make an enterprise for private equity firms interesting to invest. In the 1980s and early 1990s industrial companies were strongly favored and technology business was avoided. This has changed as the technology sector has become more and more important and in the last years this sector has become increasingly more interesting for Private Equity investments (von Nell-Breuning/2010).

The disk drive industry as part of the technology sector is distanced by heavy price competition, short product life cycles which are often no longer than six months and high expenditures on R&D. These are features that make buyouts very risky. It makes it difficult to predict cash flows, which plays a significant role for the success of a leveraged buyout. Nevertheless Silver Lake was convinced that in general the disk drive industry market development would be extremely positive and that the disk drives would be the key technological component in hardware products.

It also should be taken into account that Seagate had a number of characteristics that were from a positive nature for a leveraged buyout like vertical integration for a better competitive position on the market. But also high R&D while using up cash is a positive aspect to prevent market entry of smaller, less well-capitalized competitors. Another advantage of Seagate was the relatively high equity ratio compared with the technological industry. The equity ratio of Seagate was 26.6 per cent in June 1997, it was 29.6 per cent in June 1998 and in June 1999 the equity ratio constituted 23.9 per cent. The equity ratio of its competitors were lower, f. ex. the competitor Quantum HDD only had an equity ratio from about 13.5 per cent. The average equity

ratio of mature industries is between 20 and 25 per cent depending on the country.

Capital Structure

In order to assess the capital structure of the deal and in essence the amount of debt the Luczo and the buyout team should take it is necessary to estimate the firm value. Two model are being considered for this task. The first one is the relative valuation model. The rationale for relative valuation stems from the notion that the intrinsic value of an asset is difficult to estimate. Its value can be measured by the price the market is willing to pay for its assets, based upon its characteristics. The second model being considered is the DCF model. When comparing relative valuation with DCF, one advantage over DCF is the reflection of market perceptions on the value of the company. Thus, in a perfect market, the perceptions of future prospects are already reflected in the stock price. It requires less information than DCF models and is therefore less prone to estimation errors. In addition, managers are often judged on a relative basis and relative valuation might therefore match their needs and horizons. Markets are assumed to make mistakes when pricing assets across time. DCF valuations detach themselves from market valuations and assess the fundamentals underlying the firm and its growth perspectives. Relative valuation leads to a reasonable estimate when there are many comparable assets that are priced in the market and a common variable can be applied to standardize the prices. Although the case offers some information on competitors we deem the data to be insufficient. Even more, relative valuation works best for investors that usually have relatively short investment horizons as it is rather difficult or impossible for

the market to perceive long-term growth perspectives. In general a private equity investment(PE) spans on a 5 to 7 years' time line meaning the PE investor has a medium to long-term investment horizon. More confidence in reasonable firm value estimation is thus assigned to the DCF valuation. The fundamentals of a company provide a prudent basis for estimations. Assumptions for the estimations are transparent while these are rather not in the case of relative valuation. A DCF valuation can be applied to long-time horizons and is thus more applicable for investors with long-term investment perspectives. In addition, a fundamental approach might work as a catalyst that moves the price in the market towards the real value of the assets.

Silver Lake Partners L. P., as the bidder for the controlling stake of the company is interested in deriving the firm value, meaning the value of the equity stake in association with debt. Cash flows coming from operating activities would therefore need to be estimated. A first step concludes in the calculation of free cash flows to firm (FCFF).

The FCFF is computed based on the following assumption:

The company management provides three different projections for the buyout team: The Base Case, The Upside case and The Downside Case, each differing in EBITA and Revenues values. Capital expenditures and Depreciation are to remain the same in all three cases. The values used are provided in the operating performance projections table of Seagate. The working capital(WC) is mentioned in the case as being historically equal to 0 for the industry so the change in WC is to be ignored. According to this values the FCFF can be computed.

After total cash flow is calculated, it is brought back to NPV using the company's weighted average cost of capital (WACC). The WACC, which is defined by the relative cost of the company's debt and equity is also viewed as the 'required rate of return' for the company and its investors to compensate them for the inherent risks of ownership and realization risk for projected cash flows. The value for the risk free rate and the market risk premium have been set as given by Damodaran(2010) as 3.20% and 2.05% respectively. The beta of the company is supplied by the case as 1.2. Thus we come to the value of 6% for the WACC. Based on the values of the FCFF and WACC computed we can now assess the present value of the firm in the years to come. By summing up these values for the required time horizon we get to the firm values for the three cases

Figure 1 Firm value analysis

As it can be noticed the firm values for the cases register important differences. The Upside case stands out. Comparable to this the Downside Case has a much smaller difference. In order to better account for the possibility of worse than expected, but more importantly, for better than expected performance in the company we consider that the average of the three values should be used as the firm value and as the price the buyout team should pay meaning US\$2.224 billion.

We have determined a purchase price of \$2.22 billion that Silver Lake & Partners will pay to acquire the operations of Seagate. This will be a leveraged buyout that includes two different equity sources and two different debt sources. Our proposed capital structure will consist of 79% percent

equity and 21% percent debt. This structure was chosen based on the BBB three-year median rates as referenced in the case (Exhibit 11). The EBIT Interest Coverage ratio set the median value over 1997 to 1999 of 3.9x. In order to get the highest value for the firm when deciding to sell it, the PE firm will try to maintain its rating or even to improve it so it makes sense to consider the BBB value as appropriate. Even more lower rating will also mean higher interest rates for its debt. Using this value and the EBIT values provided for the case we can compute the amount of interest that the firm can afford to pay every year. It can be noticed in Exhibit 1 that the lowest value for EBIT is predicted in year 2000 so it makes sense to consider this value as a benchmark as the following years the performance is expected to improve. Starting from amount of interest that the firm can afford to pay every year we calculated the value of debt that the firm has to take in order to be required to pay that amount of interest. This adds up to US\$468.31 meaning 21% of the price recommended for the deal. By comparing this result with the values provided in Exhibit 11 from the case it can be noticed that the firm will remain under BBB rating. The remaining 79% is to be provided by the buyout team in form of equity. It should also be considered that Silver Lake Partners L. P. will receive US\$765 million by acquiring Seagate, funds that can be used as equity for the deal.

Figure 2 level of debt analysis

In order to better assess the impact of the three scenarios on the capital structure of the deal we also used the values computed under The Base Case, The Upside Case and The Downside Case. Again it can be noticed that the better performance predictions stand out. This is based on the possibility <https://assignbuster.com/study-on-the-seagate-technology-buyout-finance-essay/>

that in the latter years of the investment the firm will perform over the expectations even though 2000 is perceived as the same in all cases.