

CASE STUDY 9.1

Microsoft Buys Skype in an All-Cash Deal

Key Points

- Skype represents both a defensive acquisition and a significant enhancement to Microsoft's current product offering.
- To realize its cost of capital, Microsoft must realize synergies on a timely basis.
- Simulation of alternative scenarios using financial models helps the analyst assess a range of outcomes and associated risks.
- Internet IPO valuations during the first half of 2011 smacked of another dotcom bubble. Talk

of Facebook's commanding a \$100 billion valuation reverberated around Wall Street. Against this backdrop, Microsoft paid an eye-popping premium for Skype, the leading provider of voice and video calling over the Internet. In hindsight, it looks like Microsoft made a "preemptive" bid, despite the absence of serious alternative bidders, when Internet valuations were inflated.

Founded in 2003, Skype became an overnight sensation by offering for free its Internet-based voice and video calling service. While the firm experienced sustained increases

in usage, its major challenge has been and continues to be converting users of its free PC-to-PC phone services into paying customers. While the Luxembourg-based firm claims to have 663 million total users, most are not active callers. In early 2005, eBay, the online auction behemoth, offered \$2.6 billion for the firm, with a potential payout of additional \$1.5 billion in performance-based incentives. The value eBay saw in acquiring Skype was the potential for integrating Skype technology with its online auctions, enabling those participating in the auction to converse using both video and voice communication. However, this application of the technology was not readily accepted, and Skype could not produce sustained profitability for eBay. By early 2009, an investor group consisting of Silver Lake Partners, the Canadian Pension Plan Investment Board, and venture capital firm Index Ventures acquired a 70% interest in Skype for \$1.92 billion, valuing the firm at \$2.74 billion; eBay retained the remaining 30%.

Shortly after eBay's divestiture of Skype, the Skype founders, who had retained the patent rights to key technologies, sued the investor group for patent infringement. The settlement of the lawsuit in late 2009 resulted in the founders' receiving a 14% stake in the firm. Index Ventures sold its interest in the firm. During the next two years, the remaining investors pushed the firm to focus on

development, shortened product cycles, and forging new partnerships. Skype moved to build out its services in the mobile space and the enterprise space. Skype's staff was increased to about 1,000 in early 2011, 40% above its 2009 yearend level. Between 2009 and 2010, operating performance improved dramatically, with revenue almost tripling to \$860 million and operating profits moving from a loss to a \$424 million profit. In early 2011, the firm announced that it would undertake an IPO in August to raise \$100 million.

Seeking to jumpstart growth, Microsoft had been negotiating a partnership with the investor group that owned Skype in late 2010. When Google showed interest in acquiring Skype, Steve Ballmer, Microsoft's CEO, initiated an unsolicited bid for the firm. Skype investors refused to consider offers less than \$7 billion, because the investor group believed that the IPO would place a value on the entire business of at least that amount. On May 11, 2011, Microsoft announced that it had reached an agreement to acquire Skype for \$8.5 billion in an all-cash deal, the biggest in Microsoft's 36-year history.

Microsoft is betting it can use Internet calling to catch up in mobile and web advertising. The firm was willing to pay what some consider an extravagant price to cover Skype's outstanding debt and to prevent competitors such as Google from acquiring the firm.

In this regard, the acquisition was defensive in nature as well as an attempt to extend the capability to a range of other Microsoft products. Specifically, Microsoft intends to add Skype, which boasts 170 million active users per month who use an average 100 minutes per month, to Microsoft's Outlook e-mail, Xbox game console, Windows mobile phones, and corporate phone software. Microsoft also made it clear that it did not intend to reduce free offerings. Microsoft also justified the high premium paid in part by noting that it expected the stock to appreciate after the IPO and that it would cost more to acquire the firm later. Microsoft is hoping that by integrating Skype into Microsoft products, the firm can hasten the mainstream adoption of video communications. Skype could give Microsoft its first leading consumer Internet service and help promote its other businesses, such as smartphone software, Office productivity programs and Xbox.

Buying Skype gives Microsoft access to popular mobile applications, videoconferencing, and video chatting, which are already included in both Google and Apple devices. Since Skype lets cellphone users make free or cheap calls over the telecommunications carriers' data networks, people could become less reliant on expensive, unlimited voice plans, which in turn could cut into the amount of revenue that wireless carriers are able to bring in from their customers. Of course,

Skype has been available for some time on a number of smartphones, including the iPhone and smartphones powered by the Android operating system. The deal could cool relations between Microsoft and wireless carriers, which would not bode well as the firm works with Nokia in an attempt to gain a foothold in the smartphone industry. Carriers have the final decision in terms of what they choose to sell and market in their stores.

Microsoft is paying 10 times 2010 revenue; Google, with its established track record, trades at about 5 times last year's revenue. If Microsoft is able to realize anticipated synergies with other products, the investment may pay off handsomely. However, the challenges are considerable. Microsoft expects the deal to integrate Skype's voice, video, and messaging tools with Office e-mail and its mobile operating system. The recent deal with Nokia to utilize Microsoft smartphone software on Nokia handsets could support efforts to promote Microsoft's smartphone platform, which currently is well behind Apple's iPhone and Google's Android operating systems. Widespread recognition of Skype's brand name could also help Microsoft to compete with Apple's FaceTime video calling. Moreover, Microsoft could expand its revenues from increasing video conferencing by its business customers.

Table 9.10 provides the assumptions underlying a stand-alone valuation of Skype. The \$6.3 billion

Selected Financial Data: (\$ Millions)

Net Revenue	860	1,161	1,567	2,115	2,856	3,855	5,012	6,265	7,518	8,646	9,510
EBIT	424	522	705	888	1,142	1,435	1,504	2,150	2,416	2,594	2,853
EBIT(1-T)	424	522	705	755	914	1,172	1,353	1,598	1,894	1,947	2,140
Depreciations & Amortization	114	151	157	190	228	270	301	313	301	346	380
Working Capital	-110	0	235	423	571	964	1,504	2,193	2,631	3,026	3,329
Δ Working Capital		110	235	188	148	393	540	689	439	395	303
Capital Spending	31	42	63	95	143	193	251	313	376	432	476
Free Cash Flow to the Firm		521	564	662	851	856	864	908	1,291	1,464	1,742
Present Value (2011-2010)	5,078										
Terminal-Period Cash Flow	1,314										
Terminal Value	1,266										
Total NPV (Enterprise Value)	6,344										
Equity Value	5,543										

Debt Maturity: (12/21/2010)

	Book Value	Weights	Weighted Maturity
2011	38,512	0.05	0.05
2012	38,512	0.05	0.10
2013	67,397	0.09	0.27
2014	452,521	0.61	2.44
2015	144,422	0.19	0.97
Total Debt Outstanding	741,364		
Weighted Avg. Maturity			3.84
Market Value of Debt			801.41

http://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html

* All Skype historical data from Skype SA Form S-1 Registration Statement, United States Securities and Exchange Commission, March 4, 2011.

TABLE 9.11 Skype Valuation Range

	Base Case	Optimistic Case	Col. 2/Col. 1	Pessimistic Case	Col. 4/Col. 1
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5
Enterprise Value	\$6.3	\$9.3	47.6%	\$4.1	(34.9)%
Equity Value	\$5.5	\$8.5	54.6%	\$3.3	(40)%

enterprise (equity plus debt) and \$5.5 billion equity valuations are driven primarily by sustained high revenue-growth rates and continued robust operating margins. By using a 10-year annual forecast period, the terminal value represents a modest one-fifth of the firm's enterprise value. At the end of 2010, Skype, with debt comprising about 22% of total capital, was four times more leveraged than the industry average of 5%. Reflecting this higher volatility, Skype's levered beta of 1.35 compared to 1.06 for the industry average. The firm's weighted average cost of capital assumes Skype has a target debt-to-equity ratio equal to the current industry average and that revenue growth rates and operating profit margins will in time mirror those more typical of maturing software firms. Existing tax loss carryforwards would likely shelter the firm's income from taxes for at least the next several years. While the firm's marginal tax rate is expected to remain in line with that of other large software firms, after-tax operating profits are recalculated using a marginal tax rate of 40%

to estimate cash flows during the terminal period to avoid suggesting that the firm could defer the potential tax liability indefinitely.

If we assume the annual growth rate in net revenue is 10 percentage points higher than assumed in Table 9.10, Skype's enterprise and equity values surge to \$9.3 billion and \$8.5 billion, respectively. In contrast, if we pessimistically assume that revenue grows by 10 percentage points less per year, the enterprise and equity values plummet to \$4.1 billion and \$3.3 billion, respectively. In the more optimistic case, Microsoft would appear to have purchased Skype at a bargain price; however, if revenue grows much more slowly than anticipated, Microsoft would be exceedingly hard-pressed to generate sufficient synergy to earn its cost of capital. Hence, a range of reasonable-growth assumptions suggests that the valuation could vary widely (see Table 9.11).

Entitled "Skype Valuation Model," the Excel model on which Table 9.10 is based is available on the companion website to this book (<http://booksite.elsevier.com/9780123854872>). The reader is

invited to create alternative scenarios by changing key assumptions, including the revenue growth rate, operating margin, and discount rates during the 10-year annual forecast period and the terminal period. The usefulness of such models often is more in identifying the range of potential outcomes than in providing highly accurate estimates.

Discussion Questions

1. What factors might cause Skype's stand-alone valuation net revenue growth to slow and operating profit margin to shrink? Be specific.
2. What challenges would you expect Microsoft to face in

realizing the anticipated synergies? As the manager in charge of integration, what would you do to overcome these challenges?

3. Assuming the stand-alone valuation in Table 9.10 is accurate, what is the implied present value of Microsoft's anticipated synergies required for the firm to earn its cost of capital?
4. The acquisition of Skype could also be viewed as defensive. How would you put a value on the defensive nature of this acquisition?

Answers to these questions are found in the Online Instructor's Manual available to instructors using this book