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Avaya: How an $8 Billion Tech Buyout Went Wrong

Telephony company bought by TPG and Silver Lake in 2007 is weighing chapter 11 bankruptcy filing

As sales fell, Avaya began to buckle under the weight of a multibillion-dollar debt load. *PHOTO: KRIS TRIPPLAAR/SIPA USA/ASSOCIATED PRESS*

By **MATT JARZEMSKY** and **MARIE BEAUDETTE**
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At a 2007 meeting to discuss a potential buyout of Avaya Inc., some employees of private-equity firm TPG expressed concerns that the company was at risk of becoming technologically outmoded, a "buggy-whip business," as one put it.

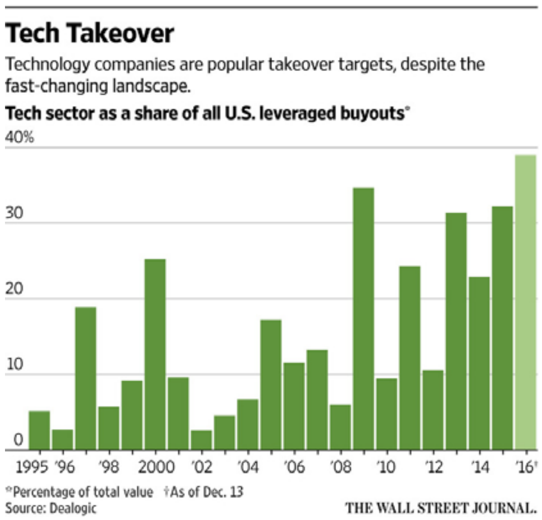
To them, Avaya's business of installing and managing corporate phone systems appeared vulnerable to the same forces that were making landlines scarce in households across the U.S., according to people familiar with the meeting.

But their concerns, not unusual in deal deliberations, didn't prevent TPG from partnering with Silver Lake on a roughly $8 billion deal to take Avaya private. The firms were betting that Avaya's sales of corporate telecommunications gear would chug along while they cut costs and teed up a profitable exit.

Instead, the ensuing financial crisis decimated corporate spending. And when companies started buying again, Avaya faced stiff competition from rivals Cisco Systems Inc., Microsoft Corp. and, later, from Internet-based phone services.

As sales fell, Avaya began to buckle under the weight of a multibillion-dollar debt load the buyout firms layered on and pension obligations largely dating back to the company's time as a unit of AT&T.

Now Silver Lake and TPG stand to lose most of the more than $2 billion they invested in the buyout and two related acquisitions. Avaya is weighing a chapter 11 bankruptcy filing to slash its $6 billion debt load.



The Santa Clara, Calif., company, which has more than 11,000 employees, is in talks with creditors including Blackstone Group LP's credit arm to sell its call-center software unit to Clayton Dubilier & Rice LLC, according to people familiar with the discussions. Avaya plans to reorganize around its corporate networking and communications business, which has moved away from hardware into software and services, they said.

Avaya illustrates the potential pitfalls of buying big, established tech companies at a time of near-constant innovation. Private-equity firms often use borrowed money, or leverage, to buy a company with the hopes of juicing their gains on an eventual sale of an investment. But if economic conditions worsen or the competitive landscape changes, the buyout debt can become difficult to manage.

A number of companies taken private in the buyout boom that preceded the financial crisis later ended up in bankruptcy.

Avaya was once part of AT&T's technology division, whose Bell Laboratories research center pioneered development of the laser and other innovations. AT&T spun out the business in 1996 as part of Lucent Technologies Inc., which in turn spun out Avaya in 2000.

When TPG and Silver Lake arrived, the company was doing steady business selling telephone equipment that supported office workers' phone extensions, voice mail, call-forwarding and other features.

The buyout firms expected that Avaya's stable cash flow would give them time to wring costs out of the business and grow its call-center software unit, according to people familiar with the matter.

But in its 2009 fiscal year, Avaya's revenue fell about 20% as the financial crisis drove companies to cut spending. It also had started paying interest on the roughly $5 billion in debt issued to fund the buyout, which cost it $377 million in 2008 and $409 million in 2009.

The company posted a loss of $847 million in 2009. At the time of the deal, Avaya had projected it would earn $418 million that year, according to a regulatory filing.

Over the next several years, rivals nibbled away at Avaya's sales. Cisco lured customers who were already buying its computer networking gear by pitching phones that route calls over the internet. Microsoft offered calling tools to customers of its Windows and Office software.

TPG and Silver Lake put up additional money to help fund Avaya's purchase of $915 million worth of Nortel Networks Corp. assets out of bankruptcy in 2009 and Israeli videoconferencing company Radvision in 2012.

The acquisitions were meant to help Avaya adapt to the times but didn't always go smoothly.

Global Response, which operates call centers for Toyota Motor Corp. and Urban Outfitters Inc., switched to Cisco from Nortel, then owned by Avaya, when it upgraded some of its equipment in 2012.

Stephen Shooster, Global Response's co-chief executive, said Avaya declined to offer a discount that Global Response executives expected for that type of upgrade. He also worried that Avaya might stop supporting one of its two brands after the acquisition.

Avaya adapted by introducing software and services for call-center management and corporate calling delivered over the internet. Software and services now account for more than 75% of total revenue, and margins have expanded since the buyout.

Avaya hasn't posted an annual profit since the buyout, but that could change once the company pares its debt. This year, the company is expected to generate between $926 million and $936 million in adjusted earnings before interest, taxes, depreciation and amortization, a measure of profitability that excludes debt costs. In 2007, Avaya's adjusted Ebidta was $832 million. The company paid $452 million in interest in 2015.

But it also must reckon with a pension plan depleted after years of ultralow interest rates. As of Dec. 31, 2015, Avaya's U.S. pension plans had obligations of $3.15 billion and assets of $2.21 billion, according to retiree communications reviewed by The Wall Street Journal—a gap of nearly $1 billion.

The pension plans have more than 15,000 beneficiaries.

Companies that file for chapter 11 protection sometimes seek to terminate their pension plans, putting them in the hands of the Pension Benefit Guaranty Corp., the U.S. pension insurer. For plans terminated in 2016, the PBGC caps annual payouts at $60,136.

The company is in confidential talks with the PBGC, according to people familiar with the matter. Still, the plans could emerge from the process unscathed.

A group of Avaya retirees backed by the National Retiree Legislative Network, a coalition of retiree groups that represents U.S. pensioners, is banding together to fight to protect the pensions in bankruptcy. The group's leader, Vern Larson, said he has been overwhelmed with calls from worried retirees.

"We're not going to go away," Mr. Larson said.

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