Seagate Technology Buyout Case Analysis

The recent high-tech rout has been horrific--for companies ranging from Internet start-ups to old-line component makers. Among those dragged down is Seagate Technology. Divergent fortunes of Seagate and Veritas, which became intertwined in October 1998, when Seagate sold its software unit to Veritas and in return received about 35 percent of the company. Despite being the dominant supplier of disk drives, Seagate struggled to maintain profits in a competitive market. Veritas, on the other hand, flourished as the growth of the Internet bolstered demand for its software, which manages data storage and backup tasks across networks.

With Veritas's market valuation at about $55 billion and Seagate's at $13 billion, Seagate is valued at less than its stake in Veritas is worth. Seagate had been seeking a way to realize the value of its assets but is unable to distribute the Veritas stake to its own shareholders without setting off a substantial tax liability for them. And despite Seagate's market leadership in disk drives, no buyer has emerged for that business.

Veritas makes software that is used to manage the disk-drive operations at big companies. Because that part of the technology world has been a Wall Street darling in recent months, Veritas shares have roared up nearly six-fold since the fall. As a result, the value of the shares held by Seagate have an indicated value of $18 billion, more than Seagate's $15 billion market capitalization.

The most striking aspect in this case is the fact that the market does not seem to value Seagate’s disc drive business and its leading position in the industry (21.1% market share). Instead, the market sees Seagate’s primary value in the Veritas stake it owns, rather than in the products and the future potential Seagate holds as the market leader in disc drives.

Due to undervalued stock of Seagate, the company should go for leverage buyout option. A large stake of VERITAS Software Corporation's stocks is owned by Seagate Technology, because of which its stock price has increased multi-fold, however, the share price of Seagate Technology hardly changed for a long time. As a result, Seagate should opt for two fold transaction, i.e. the first is to sell out all of the company's disk drive manufacturing assets including $ 765 million of cash to the acquirer “Silver Lake”.

On the other hand, the most crucial thing for Seagate Technology is to take care of the large stake of VERITAS Software Corporation's stocks. Therefore, it is essential for Seagate Technology to go for a separate transaction in order to evade paying large amount of taxes. The transaction of shares among VERITAS and Seagate is taken into account as reorganization of asset, while not applying any corporate taxes. Thus, by using two-fold transaction, Seagate Technology will be able to liquidate its undervalued shares as well as its stake in VERITAS. So, in my opinion Seagate Technology is definitely a winner in this scenario, as the business could successfully accomplish its objective. On the other hand, VERITAS as well as Silver Lake cannot be considered as losers because they can also take advantage of the assets resulted from the transaction (they bought from Seagate Technology) and generate more profit from it.

The Leverage Buyout (LBO) in addition to those benefits, Seagate Technology has a benefit over other disk drive firms and that makes this leverage buyout an attractive strategy. Since, the vertically integrated management can provide a firm an effective competitive edge, which would allow it to be less impacted by the slump of the economy/market and for avoiding expensive supply chain trouble. Taking Seagate's disk-drive operations private, meanwhile, helps buffer the company from the pressures associated with being a public company in one of the tech world's most cutthroat markets. One of Seagate's biggest competitors, the disk-drive operations of International Business Machines Corp. (14% market share), has some of the benefits of a private company, because its results are folded into the much larger results of IBM. The newly private Seagate could be a more aggressive competitor, because it could cut prices and pare its balance sheet without having to worry about Wall Street reactions.

Seagate Disk Drive business Valuation

Assuming that the level of working capital at the end of the 1999 tax year is $1,773 million and the future years' working capital of 26% of projected revenues and 34% as corporate tax rates, Free Cash Flows from year 2000 to 2006 are projected below-

	Year Ending June 30,						
	2000	2001	2002	2003	2004	2005	2006
Base Case ($ million)							
Revenues	$6,619	$7,417	$8,564	$9,504	$10,416	$11,359	$12,350
Gross Margin	1,264	1,409	1,696	2,043	2,312	2,624	3,026
EBITA	141	189	316	449	499	614	724
Taxes	47.94	64.26	107.44	152.66	169.66	208.76	246.16
Depreciation	625	626	642	666	708	726	729
Working Capital	1720.94	1928.42	2226.64	2471.04	2708.16	2953.34	3211
Change In Working Capital	-52.06	207.48	298.22	244.4	237.12	245.18	257.66
Capital Expenditures	627	690	720	795	700	725	750
FCF	**143.12**	**-146.74**	**-167.66**	**-77.06**	**100.22**	**161.06**	**199.18**

Upside case

	Year Ending June 30,						
	2000	2001	2002	2003	2004	2005	2006
Upside Case ($ million)							
Revenues	$6,619	$8,185	$10,146	$11,283	$12,626	$13,961	$15,404
EBITA	141	365	689	783	867	1,000	1,167
FCF	**143.12**	**-230.26**	**-133.12**	**92.16**	**231.04**	**313.9**	**374.04**

Downside case

	Year Ending June 30,						
	2000	2001	2002	2003	2004	2005	2006
Downside Case ($ million)							
Revenues	$6,619	$7,393	$7,797	$8,310	$8,801	$9,369	$9,759
EBITA	141	189	322	363	378	403	407
FCF	**143.12**	**.-140.5**	**29.48**	**.22.8**	**129.82**	**119.3**	**146.22**

Using the comparables mentioned in case EXHIBIT-3 the return on assets was calculated to be 11.48% while asset beta for disk drive business is 0.74.

	Quantum HDD	Western Digital	Maxtor
Re	11.6	10.2	13
Rd	10.44	10.44	10.44
Equity Share (million $)	733.075	669.706	1315.95
Debt (million $)	115	544	150
Ra	11.44	10.29	12.73
Average			11.48666667

Now the two approach are used to estimate the value of the disk drive business of Seagate.

1) Enterprise Valuation

The targeted Debt-Value ratio is 80%. The expected Free Cash Flow At the end of year 2006 based on weightage is $229.64 million dollar.

Case	FCF Value	Weight	Value
Base	199.18	0.5	99.59
Downside	146.22	0.25	36.555
Upside	374	0.25	93.5
			229.645

The Return on Equity for Seagate with Equity share being $14597 million is 15.18%. Assuming that the riskiness of the tax shield provided by interest payments for the comparables is as risky as the real assets in the disk drive industry WACC is calculated to be 10.32 %.

Assuming Seagate will grow at 3% per annum after 2006, the terminal value can be calculate using Perpetuity Growth Model. Terminal value turns out to be $1.94 billion.

Based on this method the company is valued at $2.22 billion + $1.94 billion = $4.16 Billion.

2) **Adjusted Present Value method**

Additional 1 billion dollars of debt will be issued for the LBO. Also, the free cash flows will be used to pay down this additional debt as quickly as possible.

The debt and tax shield at the end of year 2006 is found as

	2000	2001	2002	2003	2004	2005	2006
Debt	1704	1904	2104	2254	1954	1854	1754
IE = (Debt * Rd)	116	130	144	154	133	127	120
Corporate tax	40	44	49	52	45	43	41
PV of TS	36	36	36	34	27	23	20
Total TS	212						

The terminal value of Tax Shield comes out to be $1.03 Billion.

Thus from this method the Seagate is valued at $2.16 Billion (Value till 2006) + $0.96 Billion (Terminal Value) + $0.21 Billion (Tax Shield for known years) + $1.03 Billion (terminal value for Tax Shield) = $4.36 Billion.

Both the methods value Seagate at slightly different magnitude because of the assumptions. The capital structure used while evaluation in both method varied. Adjusting the capital structure will reconcile the magnitude. Moreover the in EV method the capital structure is fixed whereas in APV method the debt varies across years.

In a leveraged buyout, the equity investors are expected to pay off outstanding principal according to a specific timetable. The owners know that the firm's debt–equity ratio will fall and can forecast the dollar amount of debt needed to finance future operations. Under these circumstances, the adjusted present value (APV) approach is more practical than the weighted average cost of capital (WACC) approach because the capital structure is changing.

Recommendation

Disk Drive industry is a volatile market which proportionally affects the cash flows. Seagate already holds large amount of debt i.e. $704 million as compared to $110 million (Quantum) and $236 million (WD) of the competitors. Moreover vertical integration will require the company to incur higher R&D and capital expenses. Seagate holds high level of tangible assets as collateral i.e. $7072 million.

Historically Seagate has done well and remained competitive with products in both high end and low end markets. The more conservative capital structure with low debt ratio is proposed. The structure should be chosen based on BBB three-year rates as referred in the case EXHIBIT-11. The range of BBB rating for total debt is between 17 percent and 47 percent. The debt should not exceed 47 percent if Seagate wants to continue with or better their BBB rating. If BB rating would be downgraded to BB or worse, Seagate would be paying higher interest rates for their debt obligations.

Followed by the LBO is Veritas acquisition of remaining assets wherein each share of Seagate stock outstanding exchanged for Veritas stock and cash on a 1:0.85 exchange ratio.

109M Veritas shares + Cash flow from disk drive sales + $ 765 million in cash

This avoids tax implications because it qualifies for reorganization under section 368(a) of internal revenue code.

Thus it produces benefit for both Veritas and Seagate as number of Veritas shares in the market will decrease i.e. higher earnings per share.

Seagate shareholders will receive 109 million of Veritas shares which have experienced a price increase in the six months following Veritas' acquisition of Seagate's Network and Storage Management group. This is multiple times the increase of 25 percent that Seagate's shares recognized in the same time frame.

Seagate shareholders would get about $77.50 a share for each share of Seagate common stock, consisting of 0.467 Veritas share and approximately $5 in cash based on closing prices. The price represents about a 24 percent premium to closing price for Seagate of $62.75. Seagate shares have traded as low as $25.125 the last 52 weeks.

Veritas shares, which closed down $12.4375, at $142.50 on the NASDAQ, traded as high as $160.375 after hours. Seagate, off $4.50 at the close of trading, moved as high as $76 after hours.

Considering the analysis I have come to the conclusion that two-stage buyout best suits all parties involved.

Sources

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- www.nytimes.com
- www.wsj.com