



# The Wainhouse Research Bulletin

ONLINE NEWS AND VIEWS ON VISUAL COLLABORATION AND RICH MEDIA

## *SPECIAL EDITION*

# POLYCOM ACQUIRES PICTURETEL

### **Polycom Acquires PictureTel**

Polycom has announced its intentions to acquire PictureTel Corporation for \$362 million in cash and stock. The deal, which is expected to be completed in the second half of this year pending regulatory filings, will create a videoconferencing behemoth with a 68.8% group systems unit market share, and 32% desktop unit market share.

The deal will be executed by swapping \$3.11 in cash and 0.1177 shares of Polycom stock for each share of PictureTel, or \$176 million in cash and 6.7 million Polycom shares total. Using Thursday's closing prices, the deal values PictureTel shares at \$6.37, which represents a 29% premium, though PictureTel stock has experienced a recent run-up on buy-out rumors. The deal also includes \$50M in convertible loans from Polycom to PictureTel effective immediately to bolster its balance sheet and alleviate customer concerns about PictureTel's viability, although Polycom expects the full amount to remain intact until closure.

Polycom intends to "maintain full R&D spending" behind PictureTel's iPower series of PC-centric videoconferencing systems and PictureTel's iPower development center in Andover, MA, though PictureTel's conferencing services business (NOC) will probably be sold as Polycom has "no intentions to compete with its channels". Lew Jaffe, PictureTel's President, and Dalton Edgecomb, CFO, will stay on for 6 months after the closing while

Norman Gaut, Chairman and CEO, will be available as a consultant to help assure a smooth transition.

#### *Here's What I Think*

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(I'm writing this from a passenger terminal lounge at Narita Airport outside Tokyo. I've just downloaded my email and read the news, and I'm feeling trapped by the 13 hour time difference - it is 2am in Boston - that no current generation real-time conferencing technology will let me overcome. I have no-one to talk to!!!)

Well, the shoe has finally dropped, ending all the rumors and sending the chat board mavens onto new subjects. Polycom has acquired PictureTel. No one should be surprised by this turn of events.

However, whenever the number one vendor in any industry acquires the number two vendor, it's big news. Big News, no matter what industry we're talking about.

When viewed in historical perspective, I believe this event may be seen as the watershed event, transforming the conferencing industry. Up until now, that is, for the past 16 years or so, we've been living in the BPE, the Before-Polycom-Era. By my reckoning, PictureTel was founded in 17 BPE. There were many significant events in the BPE, including the adoption of H.323 (1996 = 5 BPE), the rise of desktop videoconferencing (7-4 BPE), the first ISDN-compatible set-top videoconferencing

system, SwiftSite, (3 PBE), and the Intel-PictureTel alliance (2 BPE).

I suspect history will show that the turning point that signaled the end of the BPE and that introduced PPE, was the acquisition of Accord Networks by Polycom, an event which I predicted would signal the onset of a domino effect in the conferencing industry.

So, now, we're entering a new era, the PPE, the post-PictureTel era. The controversy in the industry today isn't really around ISDN vs. IP conferencing – most of the endpoint products support both network protocols anyway; the controversy in the end user systems space is really about appliances vs. PC-centric machines. The prototypical appliance is the Polycom ViewStation, while the prototypical PC-centric machine is the iPower product line of PictureTel. Each type of conferencing system has its strengths and weaknesses (details are outside the scope of this opinion piece), and now Polycom owns both sides of the ledger (as does VCON). This puts the Polycom sales team in a major driver's seat – with the ability to present the customer with an unbiased approach to product selection and the ability to satisfy a customer's range of needs – from easy-to-use appliances to conference room systems with comprehensive collaboration capabilities.

I expect it will be 1 PPE before Polycom has the new organization fully re-aligned, rationalized and perhaps early 2 PPE before the channel partners are sorted out. The product issues are another story. There isn't any reason why all the products can't move forward as they are; I actually see little overlap in the present situation. However, there are certainly some synergies in the R&D and product development space to be gained. Polycom can add some great PictureTel technology to the ViewStation product line, especially in the audio area. By 2 or 3 PPE we should see a great and unified management system with enhanced features and supporting both the appliance and PC-Centric product lines. The merger also presents a chance to join forces on algorithm development and on IP technology to take the conferencing product line to the next level. By 4 or 5 PPE, most of you won't remember the BPE at all!!!

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By my calculations, the combined PictureTel + Polycom entity had over 61% of the group systems dollars and over 68% of the group system units in Q1/2001. The next largest player, TANDBERG, had just over 19% and 12% respectively. So there's no question that this acquisition creates a dominant player and reduces the competition in the industry, something that usually leads to higher prices and lower customer satisfaction. Somehow or other though, I don't expect this to happen here - perhaps because Polycom has always been aggressive on price, and perhaps because TANDBERG, though now in a distant second place, is a tough competitor with a formidable product line. In addition, Sony is only days away from announcing its next-generation room system, hoping that the combination with its new set-top will strengthen the company's appeal to enterprise conferencing professionals.

But make no mistake, if you're in the TANDBERG or Sony seat, you have to be (or ought to be) concerned. Here's a scenario I can imagine.... This scenario is only in my imagination, mind you....

PictureTel hires an investment banking firm to explore options, including putting the entire company up for sale. It first skinnies itself down by unloading MultiLink, Starlight, and shuffles off parts of 1414c to FVC in an alliance. The remaining pieces look pretty clean. The banker approaches Sony, TANDBERG, and Polycom to buy PictureTel. Each of the three has to analyze not just what the implications would be if it acquired PictureTel, but also what the implications would be if one of the other competitors were to buy PictureTel. (This is a twist on a classical logic problem known as 'the prisoners dilemma,' also outside the scope of this piece.)

- a. Sony decides that Sony is too far along in its development of the PCS 6000 and the e-conference architecture, that it is committed to an appliance product strategy, and that the headaches of a PictureTel acquisition are too much trouble. Acquisitions aren't part of the plan anyway. And Sony isn't concerned about the competition.
- b. TANDBERG makes a very serious effort to understand the PictureTel situation and concludes that while the product line is

interesting, and the audio/video technology is valuable, the price of PictureTel is too high, the management challenges are too great, the turnaround effort is too formidable, and the sales and channel strength that PictureTel would bring to the TANDBERG party are too limited and declining. While TANDBERG doesn't really want to see the PictureTel assets fall into the Polycom camp, TANDBERG also hopes that a PictureTel acquisition might actually prove to be Polycom's undoing. TANDBERG hopes that it's interest in the deal will at least drive up the price that Polycom has to pay.

- c. Polycom thinks Sony won't buy this deal, and knows it can always outbid TANDBERG, so Polycom isn't worried about losing control of the situation. Polycom decides it would rather own the PictureTel assets than let them fall into Norwegian hands. The deal is done.

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The value of the transaction, based on Polycom's closing stock price, is approximately \$362 million, or \$6.42 per share. I can't comment on the structure of the deal (an acquisition, not a merger), but the price seems not very high, and only a small (and perhaps disappointing) premium over the trading price of PictureTel shares when the deal was announced. PictureTel did around \$50 million last quarter, or a run rate of \$200 million, so this deal is just over 1.5x current sales, which is in line with other recent acquisitions. The fact that the price wasn't higher, however, I believe reflects two factors – there weren't very many suitors, and there is a tacit acknowledgement that selling PC-Centric solutions for conferencing and collaboration still requires missionary zeal and the market for such products may not explode this year.

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It's hard to imagine this situation won't affect the fate and fortune of some of the other players, notably VCON, VTEL, and Zydacron. While TANDBERG is much smaller than the new Polycom, these players are much smaller than TANDBERG, and each holds lots of interesting technology. Lots of possibilities exist, but I'm not going to start any rumors. But, I have to believe, if your VCON, VTEL, or Zydacron, it's starting to feel mighty cold out there.

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Think back to 1996-1997. PictureTel was doing almost \$500 million a year in revenues, and VideoServer was king of the hill in the multipoint bridging business. Both seemed unstoppable. Who would have imagined that PictureTel would shrink to half its size, VideoServer to 1/4th and both would be eclipsed by competitors that weren't even on the scene five years ago. Now think forward five years. Will history repeat itself?

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I've said this before. The really hard part of the deal happens after the paperwork is signed. It's all in the execution, it's all in the way management can bring together the product development teams and the sales/marketing teams into a unified whole. Some cost savings can certainly be attained, but the real benefits will accrue if the new Polycom can help grow the market by raising awareness and by introducing ever better products.

The king is dead. Long live the king.

And by the way, I don't have any idea if this deal will get any anti-trust scrutiny from the US federal government.

*What Andy Thinks*

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Polycom has squarely dropped the second shoe, the first being their acquisition of Accord earlier this year. The implications are multi-faceted, so I'll poke at this from a few different angles.

On the surface, Polycom gains quite a bit from this deal. My very biased opinion is Polycom gets the best audio technology in the business (14khz audio will be a great addition to the ViewStation), the best speaker locating technology (Limelight), the best microphone technology (Power Mic), some great video work, and the best information sharing – which is actually combination of T.120, X VGA capture and compression, and a user interface that integrates it with an open PC very well.

(There is an interesting side note here as well: the inventor behind many of PictureTel's audio achievements joined Polycom awhile ago – but obviously could not take his PictureTel audio

patents with him. If the deal goes through, they are united once again, so I'd watch for even more audio innovations, which also has implications on Polycom's ambitious VoIP conference phone plans.)

The iPower platform in turn gets a truly committed MCU (Accord), which iPower really needs, and perhaps an integrated MCU as well. iPower may also get some reduced pricing pressure since the ViewStation can fight the pricing battles – more on this later. But probably most importantly, iPower gets a viable, profitable powerhouse company behind it, so the argument against buying iPower because PictureTel may be perceived as weak goes away. Properly executed, Polycom ends up with a best-of-breed product line covering both the appliance and PC-centric spaces, so the customer is free to choose the best fit for their application without competitive distractions. Sounds like a clear winner for all involved.

Or is it? I have two concerns over this deal.

The first is distribution: selling a PC-centric system, by design, is just not the same as selling an appliance – the PC-centric system requires more pre and post sales support, and needs a distribution channel that is assured they will be rewarded for putting the extra time into selling and supporting an iPower system. PictureTel's successful iPower resellers know how to nurture customers; throwing the iPower systems into mass ViewStation-like distribution will mean they will get undercut – and thus not be able to afford to sell the product. I think Polycom needs to treat the iPower systems as a different product line with its own set of dealer support requirements. This doesn't mean the same dealer can't carry both, it does mean that to carry iPower a reseller needs to demonstrate they have made the investment to staff and support it correctly. In my mind appliances = resellers & distribution, PC-centric = VARs, each of which have different business model requirements.

My second concern is our little videoconferencing industry is getting a little lonely at the top. I think both Polycom and TANDBERG have rightly achieved "IBM" status: no one will be fired for choosing either of them as vendors. I believe the set-top appliance space has enough viable players to remain healthy and competitive – and Polycom has a

demonstrated history of being price aggressive – so I'm not worried about any price bloat there. The PC-centric space, however, may have less pricing pressure now that iPower doesn't need to compete head-on with ViewStation, and doesn't face competition from a major player.

Is TANDBERG the odd man out? I don't think so. TANDBERG has a rock solid, innovative product line that competes well, and has a reputation for an excellent distribution channel. I believe a major factor of iPower going forward will be customer support, per my distribution point above: Will PictureTel's existing customers continue to get the support they are used to post acquisition? Will PC-centric customers get the support they need to be successful? How well will Polycom's ongoing distribution model provide these support needs? I think TANDBERG understands this.

In closing, I think Polycom got one heck of a deal. Hats off (again) to Bob Haggerty and Mike Kourey for making this deal happen - and quickly. Actually, I believe they may have gotten too good of a deal: my back-of-the-envelope calculations lead me to believe the PictureTel deal was a steal compared to the Accord deal, which was a great deal in its own right. Yes, I know Accord was nicely profitable and PictureTel isn't, but take a look at the premiums and judge for yourself:

	ACCD	PCTL
Qtr prior to deal	q3 2000	q1 2001
Qtr sales annualized \$M	\$43.50	\$198.40
Qtr net income annualized \$M	\$2.21	-\$30.08
Cash on hand \$M	\$57.00	\$42.70
Value of deal \$M	\$339.00	\$362.00
Deal - cash \$M	\$282.00	\$319.30
(deal-cash) / sales	6.48	1.61
(deal-cash) / income	127.72	-10.62

In any case, this deal represents a great investment for Polycom, and profoundly changes the landscape of the videoconferencing industry from now on.

Got something to say or add? Need to vent? Click here:

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