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## **SECTOR ANALYSIS: PALMSOURCE CALLS IN EXPERT TO CALCULATE COMPANY'S VALUE**

What is a company worth? In practical terms, the answer is what someone is willing to pay for it. And that price is not easily discernible from an examination of its finances.

**Table 1: PalmSource Financials (2001 to 2005)**

Company	Period	Revenues (\$m)	Net income (\$m)
PalmSource Inc	2001	26.25	-84.02
	2002	44.95	-51.25
	2003	73.41	-21.76
	2004	73.12	-15.25
	2005	71.91	19.48

Source: ComputerWire Tech Finance

Consider the example of PalmSource Inc, whose finances are detailed in the above table. Revenue grew strongly until 2003 and then began to falter. While it steadily reduced losses and broke into profitability in 2005, this was clearly a company going nowhere.

The difficulties were predictable. As the software arm of Palm, the company had prospered on the growth of the PDA market. When this started to shrink, growth became difficult. The company quoted analysts at Canalis as calculating that the PDA market in the United States declined by 21% to 3.8 million units in 2004.

At the same time as this decline, the smart-phone market was booming. ARC Group expects the number of smart-phones to increase from 27 million in 2004 to 125 million phones by 2009. This is obviously where PalmSource wanted to head. To help it move in this direction, it paid \$22.3m for Linux developer China MobileSoft Ltd at the end of 2004.

The intention was to replace the kernel in PalmSource with Linux. But the move to smart-phones and Linux would take time. Moreover, it would face competition from other Linux players and established developers of mobile operating systems such as Symbian and Microsoft. Its problems were illustrated when Palm Inc announced its first device based on the Windows Mobile 5.0 operating system.

The share price reflected investors' fading hopes for the company. After briefly touching \$48 in October 2003, the share price had fallen to below \$8 by August this year. Behind the scenes however, events were moving fast. According to an SEC filing, between late May 2005 and July 2005 PalmSource was approached by mobile browser company Access Co Ltd, and by a communications technology company, which it only described as Company A, on an unsolicited basis, to discuss a potential strategic relationship.

To maximize shareholder value, the PalmSource board called in experts in the shape of Jefferies Broadview, a division of Jefferies & Company Inc, which describes itself as having one of the largest investment banking teams dedicated to the IT, communications, healthcare technology, and digital media industries. It conducted a wide range of calculations to assist PalmSource directors in working out what their company was actually worth. First it constructed a PalmSource Comparable Index, consisting of six embedded software companies with Trailing Twelve Month (TTM) Revenue between \$20m and \$500m. This consisted of Access Co Ltd, Intellisync Corp, Wind River Systems Inc, Openwave Systems Inc, Ceva Inc, and TTP Communications Plc.

It then calculated total enterprise value (TEV), which it defined as equity market capitalization plus total debt minus cash and cash equivalents. Then it divided this by selected operating metrics. Finally, it worked out the price to earnings ratio divided by long-term earnings per share growth rate that it referred to as PEG. This is what it found:

**Table 2: Value Calculations For Comparable Companies**

	Median multiple	Range of multiples
TEV / TTM Revenue	3.57 x	0.68 x - 23.61 x
TEV / Projected calendar year 2005 Revenue	3.42x	0.64 x - 17.40 x
TEV / Projected calendar year 2006 Revenue	2.95x	0.56 x - 13.15 x
TEV / Projected calendar year 2006 EBIT	22.13x	15.44 x - 37.59 x
Projected calendar year 2006 PEG	1.32x	0.78 x - 15.74 x

Source: Jefferies Broadview

What is apparent from the figures is the wide range of figures. Even though the median will exclude the extremes, the variation in the figures is extraordinary. So when it applied the calculations to PalmSource, a confusing picture emerged.

**Table 3: PalmSource Value Calculations**

	Median implied value	Range of implied values
TEV / TTM Revenue	\$19.12	\$7.25 – \$101.31
TEV / Projected calendar year 2005 Revenue	\$16.97	\$6.78 – \$68.12
TEV / Projected calendar year 2006 Revenue	\$16.46	\$6.75 – \$57.99
TEV / Projected calendar year 2006 EBIT	\$10.37	\$8.58 – \$14.50
Projected calendar year 2006 PEG	\$4.85	\$2.86 – \$57.62

Source: *Jefferies Broadview*

Jefferies Broadview then tried to narrow the issue down by considering the sum paid for companies in the mobile and embedded software market segment where the seller's revenue was between \$10m and \$500m. It looked at the price paid adjusted for cash and debt when appropriate in relation to sales.

Apart from two confidential transactions, it looked at Synchrologic Inc's purchase by Intellisync Corp, Extended Systems Inc's purchase by Sybase Inc, MDSI Mobile Data Solutions Inc's by Vista Equity Partners, and Digia Oyj's purchase by SysOpen Plc. This is what they found:

**Table 4: Value Calculations For Acquisitions**

	Median multiple	Range of multiples
Adjusted Price / TTM Revenue	2.05x	0.13x – 7.65x

Source: *Jefferies Broadview*

Again, the range is enormous. It includes one deal, presumably in the anonymous category, where the buyer paid 0.13 times past year's revenue. This is the weakness of the whole approach. All the companies might be in PalmSource's category, but a company worth 0.13 times revenue is lucky to find any kind of buyer. And no matter the problems facing PalmSource, it doesn't fall into this category.

So again, the board was faced with an enormous range of values when the multiples paid for companies in PalmSource's sector were applied to the company.

**Table 5: PalmSource Value Calculations**

	Median implied value	Range of implied values
Adjusted Price / TTM Revenue	\$12.85	\$4.97 – \$35.84

Source: *Jefferies Broadview*

A somewhat easier calculation of what a company might be worth is by seeing what premium, if any, over current market values, companies have been bought for. Jefferies Broadview looked at 38 transactions involving publicly held North American software vendors from July 1, 2003 to September 6, 2005 with equity consideration between \$50m and \$500m.

**Table 6: Premiums Paid for Acquisitions**

	Median Premium	Range of Premiums
Premium Paid to Seller's Equity Market Capitalization One Trading Day Prior to Announcement	27.80%	(0.5%) – 83.5%
Premium Paid to Seller's Equity Market Capitalization Twenty Trading Days Prior to Announcement	44.60%	(8.6%) – 108.4%

Source: *Jefferies Broadview*

So when these multiples are applied to the PalmSource share price, the following picture emerges.

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**Table 7: Premiums Applied to PalmSource**

	Median Premium	Range of Premiums
Premium Paid to Seller's Equity Market Capitalization One Trading Day Prior to Announcement	\$12.96	\$10.09 – \$18.61
Premium Paid to Seller's Equity Market Capitalization Twenty Trading Days Prior to Announcement	\$11.36	\$7.18 – \$16.38

Source: *Jefferies Broadview*

Finally, Jefferies Broadview used equity research analyst estimates for 2006 to calculate the present value of the projected share price using the median total enterprise value divided by the trailing 12-month revenue ratio for comparable public companies. This narrowed the figures down to this:

**Table 8: PalmSource's Share Valuation**

	Implied Median Value	Range of Implied Values
Projected calendar year 2006 Revenue	\$13.60	\$4.46 – \$19.50

Source: *Jefferies Broadview*

Jefferies Broadview stopped short of using discounted cash flow to value the company. PalmSource says this is most appropriate for companies that exhibit relatively steady or predictable streams of future cash flow. However, it was forced to admit that given its inability to develop reliable long-term forecasts and the uncertainty in forecasting the product mix, operating performance, future cash flows and sustainable long-term growth rate, Jefferies Broadview took the view that discounted cash flow analysis was "inappropriate" for valuing PalmSource.

One can only feel sorry for the directors as they struggled to see in Jefferies Broadview's report a precise indication of what the company was worth. They were clearly looking for a way to maximize the price paid for the company. But with three bidders battling for control, an auction was under way that would be certain to ensure they got the maximum possible price.

It was an auction where the price went up rapidly from \$11 a share, and Motorola thought it had a deal to buy the company with a \$17.25 offer until Access came up with its successful \$18.50 bid.

The bidders probably had a more accurate idea of what PalmSource was worth than the company itself. They could calculate what its software, and more importantly its 400,000-strong developer community, could add to their own offerings, and what additional revenue it could generate.

The problems faced by PalmSource's directors are typical of those of other boards in a rapidly consolidating industry. Increasingly, with much of the technology owned by vast corporations with wide-ranging interests, independent companies such as PalmSource are unusual. They are consequently difficult to value, and much of their attraction is rarity value that is hard to quantify.

PalmSource says the cash consideration was determined through arm's-length negotiations between PalmSource and Access, and Jefferies Broadview did not recommend any specific consideration, though it did consider the final offer was fair from a financial point of view.

It is inevitable that directors will try to seek the best possible advice to protect the interest of shareholders. The PalmSource takeover shows what an inexact science the valuation of a company amounts to. In the event, PalmSource was worth what Access was prepared to pay for it.