

NXTCOMM 2007: CONVERGENCE GIVETH, AND CONVERGENCE TAKETH AWAY

OEM Capital would like to provide our views on the strategic trends for equipment in the telecommunications industry.

I recently attended the NXTComm show in Chicago in June, where the theme was convergence (internet, TV, and phone services from one provider) and has been for several years. The final solutions, and who is going to pay for it, are still an issue, as the industry estimates that 9 million customers will have fiber to the home by the end of 2007, growing to 18 million by 2010. At the same time, cable internet, a proven and cheaper solution, continues to grow. As long as the direction of the market remains unclear, it will allow a large number of smaller, VC-backed companies to remain active. Once a single or a few main solutions become leaders, a large number of startup companies will drop out.

Another convergence theme is in the wireless market, as cell phones are adding more content rich features such as video. The Apple iPhone has made a splash on the markets, and other suppliers such as Motorola, Samsung, and Nokia are making headway with new services. These new technologies are opening doors for new suppliers to jump into the markets. The forthcoming FCC auction of 700MHz spectrum will increase opportunities for companies in the wireless sector.

On the equipment side, another aspect of “convergence” is the mega-merger trend, which has had mixed short-term results. Alcatel-Lucent is having post-merger issues and larger than anticipated integration costs. Nokia-Siemens Networks is also having post-

merger struggles, but many agree that the merger will help the company stay competitive and will help raise gross margins. At least one more mega-merger should be coming, with Tellabs-Nokia Siemens being rumored lately.

As these industry giants merge, initially it will cause their current suppliers to experience shipment delays. Indeed, Tellabs recently cited consolidation as a factor in their recent earnings announcement: “two of our top five customers from the second quarter of 2006 have merged, and that has slowed spending.” Longer term, as the merged companies consolidate their vendor base, certain suppliers will be forced to drop out.

Convergence vendors are trying out several different technologies to provide added services. Once a single or main technology become the industry standard, a few equipment suppliers will win, while the rest will be left in the cold. For example, while fiber-optic technologies have captured many of the headlines, in the end it just may be that Ethernet-over-copper or other cable technologies may win out, leaving a large number of technology start ups in the dust.

The time to sell is when the sizzle is the highest, as the chances of being one of the “last men standing” are tough, and these markets will be competitive.

The communications equipment sector has been very active, with over 70 deals being announced in the past 3 months. Some recent examples of M&A activity in the industry are:

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CSG Systems acquisition of Prairie Voice Systems at about 2X revenue, announced July 30. This deal represents an expansion of CSG's product line.

Avaya acquired by private equity groups Silver Lake Partners and TPG, announced June 4. We have seen private equity groups take an interest in every aspect of technology, as long as there is cash flow, and we believe this trend will continue.

Cobham's acquisition of Patriot Antenna Systems for \$45 million cash, announced May 30. This is an example of a UK firm taking advantage of a strong currency to expand their product line and make further inroads into the US market. This trend may continue for the foreseeable future.

Conclusion: Convergence of services in the communications and wireless markets are creating numerous opportunities for technology companies. At the same time, convergence through mergers will limit the number of suppliers that can survive, and once an industry standard is chosen, companies with competing technologies will be pushed to the side.

Opportunities are plentiful for medium-sized companies to merge, acquire, or to be acquired. Large public companies, if they are not overwhelmed by their own mergers, are quite acquisitive and are looking for new technology. Private equity groups are interested in companies with good cash flow, good management teams, and revenues that are not overly cyclical. Venture-backed companies, many of whom have survived the long, post-2000 hangover, are looking for exit strategies. The timing and realization of exit strategies for business owners is the key, as it is often better to sell when the sizzle is the strongest. As convergence leads to both opportunities and increased competition, owners will have to decide if the timing is right for them.

OEM Capital works closely with companies in high tech industries to help identify potential merger and acquisition candidates, and to assist companies with grooming and strategic marketing. Our industry expertise, coupled with our experience and International Network of M&A Partners (IMAP), are key ingredients in our program to realize premium valuations for our clients.

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Thomas G. Kastner has over ten years of experience in the electronics industry specializing in semiconductors, semiconductor equipment, wireless and electro-optics components. Mr. Kastner is fluent in Japanese. He spent eight years in Japan as a senior executive for Hakuto Co., Ltd., a publicly-traded (Tokyo Stock Exchange) distributor of semiconductors and associated equipment, reporting to the company's chairman and CEO. More recently, he managed Hakuto's investment program in the US as President of Hakuto America, Inc., where he identified new opportunities, negotiated investment terms and monitored investments in eleven companies. These included Newport Corporation, a supplier of optical components and manufacturing equipment; Emcore Corporation, a manufacturer of compound semiconductors; and Micronic Laser Systems, a manufacturer of laser pattern generators for photomasks. Mr. Kastner also served as a director of two private US semiconductor equipment manufacturers that were successfully sold to larger public corporations. He is co-founder of Strategic Switch and Audio, Inc. a distributor of electronic components and remains a member of its board of directors.

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