

SILVER LAKE

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# *the Deal* *of the next century*

*The Silver Lake partners are wagering on a whole new way to invest in infotech—the biggest, baddest LBO fund ever to hit Silicon Valley. They've raised more than \$2 billion in a matter of months. Can they make it work?*

**M**ount Everest base camp, May 1999. In the frigid morning air, on a laptop charged up by a pair of car batteries, technology executive Charles Corfield furiously pecks out an e-mail to Silicon Valley:

"You can get packages to me in Nepal via DHL to the expedition agent in Katmandu.... It takes two to three weeks to get documents turned around (from U.S.A. to Everest base camp back to U.S.A.). Assuming, worst case, that the

**By Andy Serwer**

logistics prove too difficult to handle the paperwork, do you want to leave a placeholder for me in the offering so I can complete the paperwork and financial arrangements on my return (late May)?"

Hard to believe, eh? Here's a guy about to risk life and limb climbing Mount Everest, and he's getting all worked up over some "offering" on the other side of the planet. What's up with that?

As it turns out, Corfield isn't the only one making a mountain out of this particular transaction. You see, Corfield is trying to get in on one of the biggest, hottest deals ever to hit Silicon Valley, or Wall Street for that matter. It's called "Silver Lake," as in Silver Lake Partners, a humongous, new-economy LBO fund that is set to pour billions of dollars into buyouts of undervalued infotech companies.

It's a radical concept. LBO tech companies? The laws of financial nature say you can't do that, right? And yet so compelling is the logic behind Silver Lake (and so skillfully

has the fund been sold by its general partners!) that money has poured into it like a flash flood. You want to talk about buzz? Poke around a little bit and you'll find out that everybody who's anybody in Silicon Valley and Wall Street has invested in Silver Lake. Tech giants like Bill Gates and Michael Dell (through their money managers) and Larry Ellison have anted up. So have big players at all the major investment banks. And then there are the institutions: GM's pension fund, Calpers, Stanford, and the World Bank. All told, the fund's partners (who have never worked together before) have raised \$2.2 billion in only a few months. "I think it's a matter of an idea whose time has come, brought to market by the right people," says David Stockman (yes, *that* David Stockman), a partner at Blackstone and the firm's point man for its investment in the fund.

Why is everyone gushing over Silver Lake? The simple answer is that the fund offers a whole new way of investing in the growth engine of our economy—infotech. (Say no more, right?) The fund is managed by a team of top guns from Silicon Valley and Wall Street, each with an overflowing Rolodex and résumé. There's high-voltage, Silicon Valley superstar investor Roger McNamee, whose firm, Integral Capital Partners, is partly owned by the venture capital juggernaut Kleiner Perkins. Then there's former head Hambrecht & Quist banker Jim Davidson. Buyout maestro Glenn Hutchins from Blackstone. And Dave Roux, a one-time senior executive at Oracle and Lotus. Some have taken to calling the Silver Lake partners "the four amigos." "The strat-

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egy of the fund is very interesting,” says Silicon Valley godfather Jim Clark, another investor, “but what attracted me was the team.”

Before Silver Lake, investors who wanted to be in technology could basically either buy shares of public tech companies or buy into private companies through venture capital. Of course, both public and private sector tech investing have produced incredible returns over the past decade, which has attracted great piles of capital, which in turn has driven prices sky-high. So essentially, both traditional venues of technology investing are now saturated.

Buyouts as a means of investing in technology really haven't been on the map. For one thing, you generally don't LBO companies with super-rich valuations (Cisco), or companies with no earnings (the Internets), or companies with volatile profit streams (Compaq). For years, the mantra of the LBO fund manager was: “We don't do real estate. We don't do oil and gas. And we *don't* do tech.” But the Silver Lake partners believe they have discovered a huge anomaly that will allow them to do technology buyouts. They have no intention of going after highflying companies. Instead, they are setting their sights on a large group of slower-growth tech businesses, completely off Wall Street's radar screen.

“Until very recently, no way could you have done Silver Lake,” says John Phelan of MSD Capital (that's Michael Dell's private investment firm). There really weren't enough seasoned tech companies with stable cash flows that make for good LBO candidates. But that's all changed.

Here are some numbers the Silver Lake guys like to throw around to buttress their argument. (Or, as Hutchins is fond of saying, “In God we trust. All others bring data.”) As a percentage of GDP, the technology industry has nearly doubled during the past 20 years to 8.2%. And as a percentage of the S&P 500 market cap, tech has more than tripled over that period to 18.1%. The U.S. information technology industry now comprises about 1,000 public companies with about \$1 trillion in annual revenue and a combined market cap of \$3 trillion. In short, the tech industry has grown up. The perception that tech companies are a homogeneous group of high-growth, expensive, unstable toddlers and teenagers is simply not true anymore. Scores and scores of tech companies are slower growth, less pricey, and stabler.

The most stunning piece of Silver

Lake's data (what they call the “secret sauce” part of their research) shows that 50% of all publicly traded tech companies sell on average for one times annual sales or less. Amazing, huh? Of course, those companies aren't growing like a Dell, but many are still posting top- and bottom-line growth of 10% or more. For an old-economy company that would be just ducky, but for a tech company in the Internet Age, that just doesn't cut it.

So, the Silver Lake guys say, it turns out that within the tech universe there is a huge body of healthy companies that are growing well above GDP yet are completely unappreciated by the market. That's practically the definition of a company suitable for a traditional LBO. To take this point one step further, some of the most compelling opportunities the Silver Lake guys see are actually large, healthy subsidiaries of tech giants that are no longer perceived as core businesses. An example would be Lucent before it was spun off from AT&T. “These are perfectly good businesses that now happen to be in the wrong place,” says Hutchins. “And because buyout funds wouldn't do tech,

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these businesses often couldn't be sold.”

So you have this pool of mature tech companies, ripe for LBOs, and at the same time you have all those above-mentioned institutional investors scouring the capital markets for a less crowded and less expensive way to play technology. Perfect. New supply. New demand. A new market. And maybe the next great nexus of Wall Street and Silicon Valley. This was the great epiphany of the Silver Lake general partners. “To us it's one of the most incredible opportunities we have seen in years and years,” says McNamee, who is scaling back his venture capital activity to focus on Silver Lake.

Silver Lake seems to have come together in a flash, uniting some of the smartest money on both coasts. But it's also the story of four old friends who found themselves in the right place at the right time with the right idea and were bold enough to act on it.

Hutchins and Roux first became friendly nearly 25 years ago while undergraduates at Harvard (don't hold that against them).

In the early 1980s, McNamee, then at T. Rowe Price, was one of the first customers of Datext, a database publishing company of which Roux was the founder and CEO. McNamee's funds were also one of the biggest shareholders of Lotus when Roux was that company's senior VP of corporate development. Davidson's wife met McNamee on a Deer Valley, Utah, ski slope during a Hambrecht & Quist conference and insisted that the couples meet that night for dinner. McNamee and his wife later became godparents of Davidson's son. And so on. (By the way, “Silver Lake” is taken from the name of the main ski village at Deer Valley.)

The idea behind Silver Lake began to take shape years ago. “Glenn [Hutchins] and I first kicked around doing a tech LBO fund back in the summer of 1994,” says Dave Roux. “We called the project Delta Capital, and we even had some money committed, but we concluded at that point the wine needed more cellar time.” And so Hutchins, who had been at the White House as a special adviser, went to work at Blackstone to do buyouts. Roux took a job as executive vice presi-

dent of corporate development at Oracle, where he was in charge of Oracle's mergers and acquisitions activity, its venture capital portfolio, and its investments in other companies.

Skip ahead to the fall of 1997, when McNamee happened to mention to Roux that he was getting concerned about the rising valuations in venture capital and was taking a look at LBOs. In fact, McNamee said, he'd actually been doing some work to that end with Kleiner Perkins and Morgan Stanley; the latter was helping to underwrite Integral's research effort. “I told Roger, ‘Well, I've been doing some of that too,’ ” recalls Roux. “And we got together to compare notes. Roger pulled in his friend Jim [Davidson], who I also knew, and we began a three-way conversation.” During the winter of 1997-98, Roux and Davidson in particular continued to noodle over the idea, often at San Jose Sharks and Golden State Warriors games. But at that point there were prior commitments, of course—as in real jobs. Roux, for one, had told Larry Ellison that he would be

the CEO of an Oracle subsidiary called Network Computer, which was in need of a major turnaround.

By the summer of 1998, though, Roux's overhaul of that company seemed to be taking hold, and in October he asked Ellison for his leave. Okay, said Ellison, find a CEO for Network and you're free. (A side note: Network Computer, renamed Liberate Technologies, just pulled off a successful IPO in mid-July. Roux remains its chairman.) Meanwhile, Davidson, as head of technology investment banking at H&Q, was also becoming excited by the plan. Davidson had previously suggested to other senior H&Q partners, including CEO Dan Case, that the firm move further into the buyout business by expanding its merchant-banking effort to include taking controlling stakes in companies. But ultimately Case declined, foreseeing conflicts with investment-banking clients if H&Q were to begin buying out whole companies. So Davidson too decided to pull up stakes and join what was then not much more than a concept, now called NBT Capital (for Next Big Thing).

By that fall, other bankers like Frank Quattrone of CSFB were pitching in on NBT. Davidson, who had been working on the nuts and bolts of the project's business plan, made an all-important presentation with McNamee to the Kleiner Perkins partnership. The verdict? The Kleiner crew gave it the high sign. Another major step forward. Meanwhile, Hutchins was increasingly finding himself out in Silicon Valley, scouting companies for Blackstone. His old buddy Roux would introduce him around and also hit him up for counsel on their burgeoning plan.

The NBT team then began to call around on Wall Street to set up financing for the deal. A fund this size would need several layers of bankers, but none more important than a financial agent or an investment banker to help sell the deal. The two players in this particular business are DLJ and Merrill Lynch, and the Silver Lakers were wooed hard by both. DLJ's salesman was none other than John Chasty, the firm's Sean Connery-sound-alike former CEO. Merrill sent Herb Allison, then its COO and president, out to Silver Lake's Sand Hill Road offices to talk up the boys. Merrill won the business.

Meanwhile, Silver Lake was approached by several big-league buyout firms, each with offers to partner. The Silver Lake guys declined to comment on this, but one of those offers came from

TPG, Texas Pacific Group, the powerful LBO shop run out of Fort Worth by David Bonderman. TPG had already done a few technology buyouts (such as Zilog and Paradyne) as part of its general-interest funds. But the idea of a fund dedicated solely to tech was said to be as compelling to Bonderman as it was to the Silver Lake group. Bonderman could absorb Silver Lake into his firm and create a turnkey operation. "Bonderman told them they wouldn't have to worry—he would raise about \$700 million," says a Wall Street source. And Silver Lake was supposed to come up with a couple of hundred million bucks from its contacts in the Valley. Although talks went on for weeks, the Silver Lake group ultimately said thanks, but no thanks. The idea of giving up control was too much. Even for a nine-figure check!

While the idea of a billion-dollar first-time fund by a newly formed partnership in an area virtually devoid of LBO activity apparently didn't bother David Bonderman, it was received with some trepidation by Merrill Lynch at first. "When we heard the plan, we immediately thought it was special," says Kevin Albert, head of Merrill's LBO fundraising practice. "We also thought it was big." Recalls Davidson with a grin: "When we told Merrill we wanted to do a \$1 billion fund, they sort of rolled their eyes and said, 'How about \$500 million?'" The bankers' reti-

### *One guy in Florida heard about the partnership and sent Silver Lake a check for \$10 million—the fund's minimum—sight unseen.*

cence has so far been unwarranted, at least in terms of raising money. In fact, the Silver Lake partners say that they could have collected \$4 billion and that the biggest challenge so far has been cutting limited partners back. But to be fair to the bankers, when Silver Lake first approached Merrill, Hutchins, the only member of the team with any actual LBO experience, wasn't even on board!

"We knew we had to get someone with buyout expertise," says Roux. "We kept hoping it would be Glenn because we were working with him informally anyway and because he's the best." Finally, late last year Hutchins relented: "He told us he was going to Deer Valley with his family skiing over Christmas," says Davidson. "And the three of us said, 'Gee, we just happen to be going there with our families too.'"

Hutchins broke the news to Davidson on the slopes, and Davidson gave him a jubilant high-five. And so the team was set.

One of the most important steps the partners had to take next was to ensure that debt financing would be available. For all its Silicon Valley sequins, Silver Lake is every bit a traditional LBO fund (the same kind of thing that KKR has been offering for 20 years). The way these babies work is that the fund's general partners—the guys who run the thing—raise money from limited partners, or investors. That money is later coupled with a huge slug of bank loans and high-yield bonds (the leverage, or the L, of the LBO), which is a multiple of the cash raised. That blend of debt and cash is what's used to buy out companies. By using mostly debt with a slice of cash, instead of all cash, the fund's partners can maximize returns, much in the same way an investor in stocks can amplify his gains by buying shares on margin. But just like a stock bought on margin, an LBO is riskier than a plain-vanilla equity investment, since losses, too, are magnified. Generally, a slower-growing buyout prospect (say a food company) is leveraged at around four to one. Hutchins figures that the faster-growing companies that Silver Lake hopes to buy—and they are already looking at dozens—should be leveraged at more like two to one. That implies the partnership will be borrowing many billions of dollars

during the fund's six-year investment period. Some serious scratch.

To secure that much LBO debt, the No. 1 place to shop on Wall Street is Jimmy Lee's office at Chase Manhattan. Lee, a Chase vice chairman, is the king of this business. Fortunately for the four amigos, Hutchins had worked with Lee for years. Even more fortunately, Lee, too, was musing about tech LBOs. Says Lee: "When Glenn told me about Silver Lake, I said, 'Funny you should call. We've just been looking at this area. Come on in.'" Hutchins did just that in the first week of February, and Lee quickly agreed to work with the fund.

The next order of business was lining up limited partners—the not-so-small matter of getting the money. This was a process that resulted in some classic "Sili-

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con Valley meets Wall Street” moments. For instance, Silver Lake told the Merrill bankers that they wanted to raise some 20% of the fund, at that point \$200 million, from their well-heeled buddies back in the Valley. Smart, since they should be an easy source of capital—and presumably they would network for the general partners. Fine, said the Merrill bankers. But one question: Do those guys really have that kind of money? (*Duh!*)

Another moment occurred when Silver Lake was presenting to the Blackstone partnership. Picture the four amigos on

about the partnership and sent Silver Lake a check for \$10 million—the fund’s minimum—sight unseen. (It was returned.) Or the time Hutchins was kept waiting by an investment committee of a major university because it was holding a meeting to approve the school’s buying into the fund, before Hutchins made his pitch! All remarkable stuff in a business where general partners often really have to work the dog-and-pony to raise money.

Now the question is, Have these guys created the next Apollo moon mission or the next Hindenberg? There are detrac-

hubris and greed. Silver Lake, these critics say, is going big just for the sake of bigness. And take a look at what their management fee brings in! A mere 1.5% of assets annually for the general partners amounts to more than \$30 million in this fund. Of course, Silver Lake’s response is that scale is truly important for its model; and in the age of the Internet, being first and having scale convey all sorts of competitive advantages.

The bottom line, of course, is that nobody has any idea whether Silver Lake will hit or miss. Sure, the partners have been extraordinarily successful raising money, but that’s like winning the first round of the playoffs. You don’t see the Atlanta Braves celebrating that anymore. The only thing that really counts in the LBO business is successfully liquidating the fund and producing bigtime returns. Only then will the Silver Lake team truly be champs.

It’s a late July afternoon, and Dave Roux has taken the day off to fly-fish the Calaveras River in the foothills of the Sierras, about 100 miles east of San Francisco Bay. It’s an unusual outing because Roux, a serious fisherman, is having absolutely no luck at all. After yet another hapless go at a promising stretch of the river, Roux looks up and says, “That’s the great thing about fishing. It teaches patience and humility—something that’s in short supply in the technology business.” How true. So far it’s been easy for Roux and his amigos to land the big ones. For the guys from Silver Lake to succeed in the long run, though, they may need plenty of what the river teaches. **F**

REPORTER ASSOCIATE *Angela Key*

### *Naysayers point to the disastrous 1989 buyout of Prime Computer, which blew up on the Whitney Group—a watershed in tech LBOs.*

one side of the table and the Blackstone grandees, including Pete Peterson, Steve Schwarzman, and Stockman, on the other side. “It was all very Wall Street, and then there’s Roger [McNamee] being Roger,” says one participant. “He’s full bandwidth, multiplexed, talking 90 words a minute, while taking a call on his cell phone and simultaneously checking his pager. It was quite something.” (Blackstone subsequently made a commitment.)

And there are other stories, a few almost as striking as our Mr. Corfield up at Mount Everest base camp. (He did get into the fund, even though the papers got lost in Katmandu.) There was the call to the team while they were pitching in Europe, informing them that the Rothschilds wished to participate. (And they are.) Or the guy in Florida who heard

tors. On the one hand are those who cling to the idea that tech companies can’t be LBOed. This camp solemnly points to the disastrous 1989 buyout of Prime Computer by the Whitney Group. Prime, then with more than \$1 billion in annual sales, blew up in Whitney’s face, a watershed event in the history of tech LBOs. Of course, the Silver Lake guys can tell you chapter and verse why they won’t make the same mistakes that Whitney did.

On the other hand, there are those who say that Silver Lake is really nothing new. Funds like those run by Behrman Capital and Broadview, they say, have been LBOing tech companies for years, albeit on a much smaller scale. The Silver Lake partners say their fund is so much bigger that it isn’t even in the same league. Which brings up another set of objections: