

A Work Project, presented as part of the requirements for the Award of a Master's degree in Finance from the Nova School of Business and Economics.

SKYPE – LESSONS LEARNED FROM A HISTORY OF SUCCESS AND FAILURE IN
MERGERS AND ACQUISITIONS

Legal and Financial Aspects of Intellectual Property within the Skype Acquisition - TIMON
ABERHAM - 59209

Work project carried out under the supervision of:

Pranav Desai (Nova SBE)

17/12/2024

Abstract (100 words maximum)

The eventful acquisition history of Skype first gained attention in 2005 with eBay's \$2.6 billion takeover of the then-unprofitable VoIP technology company. After failed attempts to integrate the software into eBay's bidding platform and an associated \$1.4 billion write-down, legal disputes over the technology's source code with Skype's co-founders exposed the importance of intellectual property in the context of Mergers & Acquisitions. A subsequent majority stake sale to private equity investors at a \$2.75 billion valuation and two attempted public floats later, Microsoft announced the staggering \$8.5 billion acquisition that further illuminated challenges around intangible asset valuation and regulatory approval.

Keywords (minimum of four):

Mergers & Acquisitions (M&A), Corporate Finance, Synergies, Case Study, Company Analysis

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

Part A: Case Study

“This is a big day for Skype and this is a big day for Microsoft. We are adding a new division and a new promise to our customers, the promise of universal next-generation communications. Microsoft and Skype together will bring together hundreds of millions, or as Tony said, billions of consumers and empower them to communicate in new and interesting ways.”

Steve Ballmer, Microsoft CEO (Microsoft Corp. 2011a)

“We really appreciate the fact that, Steve, you have put your faith in us. We think there is a tremendous amount of opportunities as we look forward. We think this allows us to extend now from hundreds of millions to literally billions. We believe that this is a platform and a set of services that can reach everyone on the planet.”

Tony Bates, Skype CEO (Microsoft Corp. 2011a)

On May 11th, 2011, the top executives of Microsoft and Skype hosted a call to announce Microsoft’s \$8.5 billion acquisition of the rapidly expanding communications service company. The move came after its owners, a private equity consortium led by Silver Lake, published a preliminary IPO prospectus with plans to float Skype just one year earlier, as well as reported talks with both Facebook and Google about an acquisition in the week leading up to the announcement (Halliday 2011). While this made it apparent that Skype was a contended asset in a reviving tech market in the aftermath of the great financial crisis, big question marks kept surrounding the deal. Most importantly, was Skype worth \$8.5 billion, a staggering 10 times sales and 32 times EBITDA, considering its turbulent acquisition history and most recent valuation of \$2.75 billion just three years earlier? Would this acquisition – by far Microsoft’s largest at the time – aid the maturing company that was struggling to catch up with its fast-growing, dynamic peers such as Apple and Google?

Microsoft Corporation

Founded in 1975 by Bill Gates and Paul Allen, Microsoft quickly rose to prominence as a global technology leader, revolutionizing personal computing with its Windows operating system and Office productivity suite. Throughout the 1980s and 1990s, the company dominated the software market, establishing itself as a household name and one of the most valuable companies in the world.

In 2011, Microsoft was a dominant yet somewhat stagnant player in the technology industry. Despite being highly profitable, with strong revenue streams from its Windows operating system and Office suite, the company was increasingly viewed as a mature giant struggling to innovate in a rapidly evolving tech landscape. Microsoft's core business remained focused on enterprise solutions and PC software, but it faced significant challenges in emerging markets like mobile computing and cloud services, where competitors such as Apple, Google, and Amazon were gaining ground (Zachary, Hall, and Montevirgen 2024).

Investor sentiment reflected these concerns, with Microsoft's stock having remained relatively flat for much of the previous decade. Although the company had vast cash reserves, which allowed for strategic acquisitions like Skype, there was growing skepticism about its ability to remain competitive and innovative, particularly in the consumer tech space. In contrast, companies like Apple were thriving on the success of the iPhone and iPad, Google was rapidly expanding with Android and cloud services, and Amazon was making significant strides with AWS. In its 2010 Annual Report, Microsoft similarly tried to convince investors of its innovation capabilities in core focus areas such as communication and collaboration at work, foreshadowing the Skype deal:

“We continue to develop innovative software applications and solutions that we believe will enhance information worker productivity, improve communication and collaboration in work

GENERAL PART

groups, aid business intelligence, and streamline processes for small and mid-sized businesses.“ (Microsoft Corp 2010)

Skype Global S.á.r.l.

Founded in 2003 by Niklas Zennström and Janus Friis, Skype transformed the telecommunications landscape with its pioneering use of voice-over-internet protocol (VoIP) technology, allowing users to make voice and video calls over the internet. This innovation significantly altered global communication by enabling free or low-cost calls worldwide. Skype quickly grew into a major player in digital communication, attracting millions of users in a short period and establishing itself as a key platform for both personal and business use.

By 2011, Skype had more than 660 million registered users and had become a leader in online communication. However, it faced increasing competition from newer platforms such as Google Voice and Apple’s FaceTime. While Skype had successfully moved into mobile communication and video calling, concerns persisted about its business model, particularly its reliance on a small number of paying users while most accessed its services for free. The company’s peer-to-peer infrastructure, though innovative, also presented challenges in monetizing its vast user base. (Skype S.á.r.l. 2010)

Skype's history of mergers and acquisitions reflected its strategic importance in the tech industry. In 2005, eBay purchased Skype for \$2.6 billion, with the intention of integrating its communication features into eBay’s e-commerce operations. This vision, however, did not deliver the expected benefits, leading eBay to take a \$1.4 billion write-down two years later. In 2009, eBay sold a 65% stake in Skype to an investment group led by Silver Lake Partners for \$1.9 billion, retaining a 35% minority stake. The deal valued Skype at \$2.75 billion, allowing it to operate with more independence and focus on growth. Skype continued to expand under this new ownership, but with competition intensifying, it became the subject of acquisition

GENERAL PART

interest from major companies like Google and Facebook, ultimately paving the way for its acquisition by Microsoft in 2011. When the news broke on 30th April 2011 that Microsoft would pay a staggering \$8.5 billion for the communication company, those previous valuations numbers were still in people's minds. Wall Street's generally negative perception of the deal was quickly reflected in the stock price in the days after the announcement, losing 4.3% in the first week (Appendix 3). How the tech giant came up with a valuation that equaled 10 times sales and 32 times EBITDA, representing almost \$1,000 for each of the 8.8 million monthly paying users, was a much-discussed subject. (J. Shan 2013)

Industry Outlook

Skype's noteworthy rise in popularity took place against a backdrop of rapid technological advancements in broadband and Voice over Internet Protocol (VoIP) technology as well as intensifying competition and consolidation in the software & internet services industry.

Significant increases in in-home broadband internet adoption led to an average penetration rate of 24% in OECD countries by the end of 2010 (OECD 2003-2012) (Appendix 1). Elsewhere in tech, the smartphone was taking the world by storm while mobile broadband adoption rates nearly eclipsed 50% in OECD countries by mid-2011 laying the groundwork for Skype's launch on iOS and Android devices in 2010 and 2011 respectively (OECD 2003-2012).

In addition to increased broadband penetration rates Skype deployed an innovative Peer to Peer (P2P) infrastructure distributing the communication load between user's computers which increases call reliability and quality while cutting down on infrastructure costs such as servers (Baset and Schulzrinne 2004), (Wang 2005). Furthermore, video and voice compression algorithms allowed for high quality calls even with lower bandwidths (Anderson 2016).

GENERAL PART

As VoIP technology matured alongside broadband adoption, significant challengers to Skype's competitive position emerged in the form of other VoIP providers, big-tech and social media companies as well as traditional telecommunications firms.

While Skype, launched in 2003, was an early adopter of internet telephony software, it was never alone in the space which was pioneered by VocalTec, offering internet telephony, and Net2Phone, which bridged the gap from PCs to landlines, in 1995 and 1996 respectively. Another significant VoIP competitor Vonage, which also offers hardware solutions, was launched in 2001 and quickly became a household name in the space. What allowed Skype to stand out among its peers was its scalability (P2P) and freemium business model which offered user to user calls for free and user to landline calls at affordable rates. Further distinguishing factors helping Skype maintain its competitive position were the program's ease of use and user-friendly interface as well as innovations such as the adoption of group video calls.

Traditional telecommunication giants with a large customer bases and plentiful funding also created VoIP offerings such as AT&T's U-verse Voice and Comcast's Xfinity Voice which amassed 2.1 million and 8.6 million users respectively by 2011 and 2010 (AT&T 2011), (Comcast 2011). A new wave of challengers approached from the Silicon Valley shortly before Skype's acquisition by Microsoft. Google Voice (2009) and Google Hangout (2011) as well as Apple's Facetime (2010) and Facebook's Messenger application all offered voice and video call features. Shortly after this launch wave of new VoIP programs Skype itself was acquired by Microsoft and integrated into its ecosystem which already included the Windows Live Messenger (formerly MSN) communication platform.

In 2012 Skype reached 167 billion minutes of international telephone traffic, excluding PC to PC calls. At the time this represented 33% of international phone traffic disrupting the traditional telecommunication industry (Exhibit 1).

GENERAL PART

The merger was part of an uptick in M&A activity in terms of transaction volume following the 2008 financial crisis. After the total transaction value in the Software & Internet Services sector bottomed out at \$42 billion in 2009 it recovered to \$79 billion in 2011 (Institute for Mergers, Acquisitions & Alliances 1997-2013) (Appendix 2).

Deal Talks Begin

Based on the industry outlook and the services and products Microsoft and Skype offered, the deal talks begin. Steve Ballmer stated that the takeover of Skype will bring together the best world of both companies, since Microsoft offers a large variety of products like its office and home services, which are going to be enhanced through the communication technology of Skype. Therefore, Microsoft's dream about building experiences that aren't limited by distance or device could be achieved by bringing people together, whether it is on a single screen, a smartphone, a PC, a slate, or the simple TV through the achieved synergies by the acquisition of the established and well-known brand Skype. Moreover, Mr. Ballmer pointed out that Skype has more than 660 million registered users and a growth of 600,000 customers per year, which indicated the importance and the upside potential of modern communication technology. Furthermore, Microsoft was aware that its main competitors would also take steps towards the communication market or have already done so. Therefore, the company did not want to be in the position of being unable to compete (Microsoft Corp. 2011a). Tony Bates also made clear that Skype, which is headquartered in Luxembourg, is growing at rapid speed, fueled by several key opportunities. First, the core communications technology was highly synergetic with Microsoft's current products and services. Second, the large and engaged user base may be utilized as a key part of the company's new monetization strategy by adding a premium subscription packages layer, new advertising avenues and more. Furthermore, Skype's profitable sound business will add to Microsoft's bottom line and cash flow (Microsoft Corp.

GENERAL PART

2011a). The two companies had high hopes that an acquisition would bring advantages to both sides and that their strategies could be implemented more quickly by the knowledge the other offers. On top of that, the traded all-cash purchase price of \$8.5 billion seems attractive for Skype's current investors.

Now the question arises for Microsoft's management: are the parties deceived by only looking at positive aspects, or is the high purchase price justified for a company with a difficult acquisition and valuation history?

Timeline of Events (Intellectual Asset Management Magazine 2011)

- | | |
|-----------------------|---|
| <i>August 2003</i> | Skype is founded by Niklas Zennström and Janus Friis |
| <i>April 2005</i> | Skype user base grows rapidly, hitting the 100 million downloads mark |
| <i>September 2005</i> | eBay announces the acquisition of Skype for \$2.6 billion |
| <i>October 2007</i> | eBay takes a \$1.4 billion write-down on Skype, stating that “the company’s handling of the Skype buy-out had been a mistake” |
| <i>April 2009</i> | eBay announces the planned IPO of Skype, detailing that although it is a great standalone business ... Skype has limited synergies with eBay |
| <i>September 2009</i> | Skype IPO is called off after a series of legal disputes with co-founders relating to IP. Zennström and Friis allege that Skype is in breach of a licensing agreement with Joltid, a company owned by the co-founders that owns the IP for Skype’s peer-to-peer technology. |
| <i>November 2009</i> | eBay gives up a 14% stake in Skype to Joltid as part of a settlement and sells a majority stake to a private equity consortium for \$2.75 billion |

INDIVIDUAL PART – TIMON ABERHAM

August 2010 Skype announces plans to float in an IPO, publishing a preliminary prospectus that contains valuable information for potential buyers about the private company

May 2011 Microsoft announces the acquisition of Skype

INDIVIDUAL PART - TIMON ABERHAM

Legal and Financial Aspects of Intellectual Property within the Skype Acquisition

Considering this turbulent history of overvaluation and failed synergies, the \$8.5 billion price tag Microsoft was willing to pay for Skype came all the more as a surprise. One major component of this price tag was Skype's intellectual property ("IP"), which represented the core of its business value. An overview of the different types of IP can be found in Exhibit 17. Hence, it was paramount for Microsoft under the leadership of Chief IP Officer Horacio Gutierrez to conduct a rigorous IP due diligence process including a valuation to i) decide whether the upsides stemming from the acquisition were worth taking on the inherent risks, ii) mitigate the identified risks where possible and iii) support the valuation. This started with a thorough examination of Skype's IP history, which had been somewhat eventful to that point.

a. History

When Skype was set up in 2003 by co-founders Niklas Zennström and Janus Friis, they established a separate company Joltid Ltd., which owned the peer-to-peer technology called "global index" ("GI") lying at the heart of Skype's business protected by a copyright and patents. eBay had attempted to buy Joltid together with Skype in the 2005 transaction, but Zennström and Friis insisted to retain the IP rights in GI and instead established a license agreement with eBay that granted Skype the right to use an un-editable version of the code only, leaving it without access to the source code. When the co-founders – essentially the only

persons allowed to edit the GI code and therefore make the license agreement work – fell out with Skype in 2007 and left the company, they alleged that Skype and eBay were in breach of the licensing contract by continuing to alter the source code. They proceeded to file several copyright infringement lawsuits in 2009 shortly after it was announced that a group of investors led by private equity firm Silver Lake wanted to buy a majority stake in Skype. Amongst others, they claimed that the investor consortium was aware of this issue, and specifically mentioned Mike Volpi, who formerly headed another Zennström-Friis company and had held a board seat at Skype, and recently joined Index Ventures, part of the investor group proposing to buy 65% of Skype, as partner. Volpi was accused of using confidential information to inform the other investors and help Skype in developing the misappropriated code. All these violations were supposedly causing damages of “more than \$75 million daily” (Hughes Hubbard & Reed 2024). Soon after, Index Ventures dropped out of the transaction. Finally, the parties settled in November 2009, with Joltid Ltd. agreeing to transfer the GI copyright to Skype in exchange for a 14% ownership in the company. As a sweetener for the private equity consortium, Joltid committed to making further capital investments in Skype, which in the aftermath turned out to \$80 million (Skype S.à.r.l. 2010). The settlement entailed a downsizing of eBay's Skype stake by 5% from an envisioned 35%, and the other investors would now own 56% instead of 65%. This substantial concession from eBay finally ended a long legal battle between the company and Skype's founders and resulted in a substantial windfall for Zennström and Friis in the Microsoft acquisition just two years later. (Science X 2009)

b. Due Diligence Process

After ensuring that these prior disputes were completely resolved, Microsoft proceeded with the next step in its IP due diligence of Skype by compiling an account of Skype's IP assets (Exhibit 18) and confirming Luxembourg and EU IP law compliance as well as ownership

status. For IP that was not owned by Skype, the existence of a proper licensing framework and legal language with regards to change of control had to be evaluated. Once the groundwork was complete, the merger documentation phase starts. In this case, Microsoft chose a stock sale transaction as the most suitable tool to ensure that all IP identified in prior steps is properly transferred to the buyer. Additionally, an important risk-mitigation strategy involved negotiating a strong set of representations and warranties that Skype had to make under the acquisition agreement and for which it assumed liability for indemnification to Microsoft in case of misrepresentation. To conclude, Microsoft under Gutierrez evaluated tax implications, including the Luxembourg “IP box” regime, which grants an 80% tax decrease for income derived from IP assets.

c. Valuation

One main due diligence area for Microsoft revolved around the valuation of Skype’s IP with the aim of supporting deal negotiations, reassuring investors and getting comfortable with the eventual purchase price. This exercise received special attention in order to justify the high price tag for Skype, a company with a slim balance sheet and low turnover. Microsoft likely was able to gather all necessary data points to conduct an IP valuation with the income method, which estimates the future cash flows of Skype’s IP and discounts them to present value. Furthermore, Microsoft presumably derived an IP valuation with the relief from royalty method (“RRM”), which is based on the hypothetical royalty payments that are saved by owning the asset rather than licensing it. Another crucial IP valuation method that Microsoft applied is the market approach, which takes into consideration similar transactions in the market to determine a fair value for the target’s IP. Specifically, this involves calculating an average percentage amount of the value prescribed to intangible assets in precedent transactions and apply this

percentage to the deal at hand. A list of comparable transactions including the respective deal and intangible assets value can be found in Exhibit 19 and Exhibit 20.

d. The Deciding Point

Following a thorough examination of Skype's IP history, Horacio Gutierrez and his team embarked on a rigorous IP due diligence process to prevent such situations from arising in the Microsoft acquisition. A valuation of Skype's IP using several advanced techniques enabled them to compare the results to the overall price Microsoft was prepared to pay. With all this information at hand, the CIPO together with other Microsoft executives was faced with the decision of i) whether the IP risks inherent to this transaction could be mitigated to a satisfactory extent, and ii) if the valuation results supported a \$8.5 billion acquisition of Skype.

Exhibits

Exhibit 1: International Telephone & Skype Traffic between 2005-2012 in Billion Minutes (Crabtree 2013)

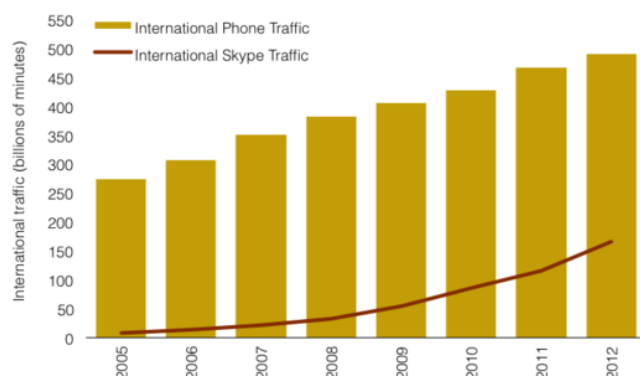


Exhibit 2: Development of Number of Users concurrently online on Skype during peak Activity between 2004-2013 in Millions (Richter 2013)

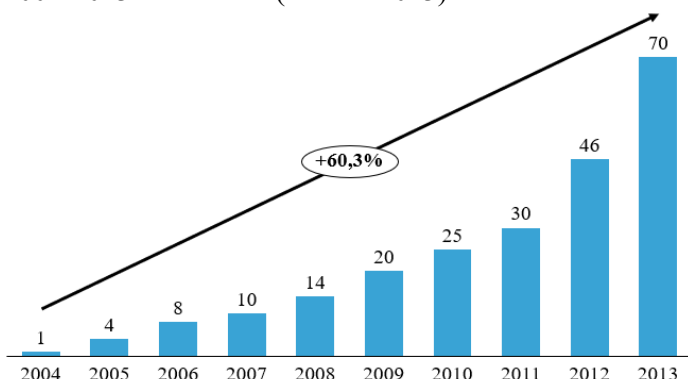


Exhibit 3: Skype's selected Balance Sheet Data (in \$000s)

	2006	2007	2008	2009	2010
ASSETS					
Cash and cash equivalents	\$92 837	\$115 884	\$260 187	\$114 077	\$142 465
Total current assets	\$121 953	\$154 234	\$319 804	\$202 445	\$243 387
Property and equipment	\$7 123	\$9 075	\$6 040	\$13 238	\$36 523
Goodwill	\$2 575 931	\$1 919 341	\$1 836 562	\$2 372 779	\$2 372 779
Intangible assets, net	\$235 711	\$188 204	\$112 934	\$788 118	\$637 688
Total assets	\$2 944 758	\$2 275 410	\$2 282 535	\$3 409 704	\$3 317 855
LIABILITIES AND EQUITY					
Accrued expenses and other current liabilities	\$39 658	\$46 359	\$65 159	\$90 952	\$121 100
Deferred revenue and user advances	\$56 219	\$89 419	\$108 012	\$142 600	\$176 681
Total current liabilities	\$111 740	\$170 463	\$219 893	\$302 246	\$353 726
Long-term debt	\$0	\$0	\$0	\$772 220	\$686 348
Total liabilities	\$150 730	\$186 007	\$222 493	\$1 172 131	\$1 071 165
Total stockholders' equity	\$2 794 028	\$2 089 403	\$2 060 042	\$2 237 573	\$2 246 690
Total Liabilities and Equity	\$2 944 758	\$2 275 410	\$2 282 535	\$3 409 704	\$3 317 855

Sources: Skype's IPO registration statement filing

Exhibit 4: Skype's user matrix (Skype S.à.r.l. 2010)

Users matrix (in millions, besides the \$)	2008	2009	2010
Registered users	325	474	663
Average monthly connected users	75	105	145
Average monthly paying users	5,8	7,3	8,8
Average communications services revenue per paying user	\$102	\$98	\$97
Communications services billing minutes	6900	10700	12800

Sources: Skype's IPO registration statement filing

Exhibit 5: Skype's selected Statement of Operations (in \$000s) (Skype S.à.r.l. 2010)

	2006	2007	2008	2009	2010
Net revenues	\$193 696	\$381 551	\$551 364	\$718 903	\$859 815
Cost of Revenues	\$140 107	\$229 496	\$293 201	\$343 981	\$415 702
Gross Profit	\$53 589	\$152 055	\$258 163	\$374 922	\$444 113
Operating Expenses					
Sales and marketing	\$59 787	\$64 304	\$83 222	\$120 989	\$131 939
Product development	\$38 900	\$22 857	\$33 599	\$45 027	\$72 263
General and administrative	\$37 865	\$42 423	\$48 648	\$160 962	\$104 954
Amortization of acquired intangible assets	\$60 156	\$65 514	\$69 832	\$68 737	\$114 308
Litigation settlement	\$0	\$0	\$0	\$343 826	\$0
Impairment of goodwill	\$0	\$1 390 938	\$0	\$0	\$0
Total operating expenses	\$196 708	\$1 586 036	\$235 301	\$739 541	\$423 464
Loss/Income from Operations	-\$143 119	-\$1 433 981	\$22 862	-\$364 619	\$20 649
Realized loss on amended credit agreement	\$0	\$0	\$0	\$0	-\$13 513
Interest income and other (expense), net	\$2 029	\$5 303	\$10 297	\$2 943	\$4 817
Interest expense	\$0	\$0	\$0	-\$10 387	-\$68 645
Loss/Income before taxes	-\$141 090	-\$1 428 678	\$33 159	-\$372 063	-\$56 692
Income tax (benefit)/expense	-\$22 044	-\$23 342	-\$8 447	-\$3 259	-\$49 787
Net Income	-\$119 046	-\$1 405 336	\$41 606	-\$368 804	-\$6 905
Weighted number of shares, basic and diluted (Class A through J):				9 414 600	9 433 743
Fully Diluted Earnings Per Share before effect of charges					

Sources: Skype's IPO registration statement filing

Exhibit 6: Skype's adjusted EBITDA calculation (in \$000s) (Skype S.à.r.l. 2010)

	2008	2009	2010
Net (loss)/income	\$41 606	-\$368 804	-\$6 905
Income tax (benefit)/expenses	-\$8 447	-\$3 259	-\$49 787
Interest expenses	\$0	\$10 387	\$68 645
Interest (income) and other expense, net	-\$10 297	-\$2 943	-\$4 817
Depreciation and amortization	\$75 534	\$79 049	\$161 297
Stock-based compensation	\$12 826	\$14 746	\$15 950
Realized loss on credit agreement	\$0	\$0	\$13 513
Management Services Agreements with shareholders	\$0	\$1 685	\$14 835
Acquisition transaction fees	\$0	\$98 715	\$1 229
Skype Acquisition transaction bonuses	\$0	\$3 647	\$0
Transition Services Agreement	\$0	\$1 118	\$2 463
Excluded bonus and severance	\$0	\$1 755	\$15 315
Joltid litigation settlement	\$0	\$343 826	\$0
Other litigation settlements	-\$410	\$2 928	-\$784
Separation costs		\$2 054	\$11 312
Foreign exchange gains and losses prior to invoice receipt and related to hedging instruments	-\$334	-\$8	\$12 165
Dispute with payment service provider	\$0	\$0	\$9 247
Non-capitalizable expenses attributable to this offering of securities	\$0	\$0	\$669
Adjusted EBITDA	\$110 478	\$184 896	\$264 347

Sources: Skype's IPO registration statement filing

Exhibit 7: Microsoft's consolidated Balance Sheet (in \$ millions)

	2006	2007	2008	2009	2010
ASSETS					
Cash and cash equivalents	\$6 714	\$6 111	\$10 339	\$6 076	\$5 505
Short-term investments	\$27 447	\$17 300	\$13 323	\$25 371	\$31 283
Accounts receivable	\$9 316	\$11 338	\$13 589	\$11 192	\$13 014
Inventories	\$1 478	\$1 127	\$985	\$717	\$740
Deferred income taxes	\$1 940	\$1 899	\$2 017	\$2 213	\$2 184
Other current assets	\$2 115	\$2 393	\$2 989	\$3 711	\$2 950
Total current assets	\$49 010	\$40 168	\$43 242	\$49 280	\$55 676
Property and equipment	\$3 044	\$4 350	\$6 242	\$7 535	\$7 630
Equity and other investments	\$9 232	\$10 117	\$6 588	\$4 933	\$7 754
Goodwill	\$3 866	\$4 760	\$12 108	\$12 503	\$12 394
Intangible assets, net	\$539	\$878	\$1 973	\$1 759	\$1 158
Deferred income taxes	\$2 611	\$1 389	\$949	\$279	\$0
Other assets	\$1 295	\$1 509	\$1 691	\$1 599	\$1 501
Total assets	\$69 597	\$63 171	\$72 793	\$77 888	\$86 113
LIABILITIES AND EQUITY					
Accounts payable	\$2 909	\$3 247	\$4 034	\$3 324	\$4 025
Short-term debt	\$0	\$0	\$0	\$2 000	\$1 000
Accrued compensation	\$1 938	\$2 325	\$2 934	\$3 156	\$3 283
Income taxes	\$1 557	\$1 040	\$3 248	\$725	\$1 074
Short-term unearned revenue	\$9 138	\$10 779	\$13 397	\$13 003	\$13 652
Securities lending payable	\$3 117	\$2 741	\$2 614	\$1 684	\$182
Other	\$3 783	\$3 622	\$3 659	\$3 142	\$2 931
Total current liabilities	\$22 442	\$23 754	\$29 886	\$27 034	\$26 147
Long-term debt	\$0	\$0	\$0	\$3 746	\$4 939
Long-term unearned revenue	\$1 764	\$1 867	\$1 900	\$1 281	\$1 178
Deferred income taxes	\$0	\$0	\$0	\$0	\$229
Other long-term liabilities	\$5 287	\$6 453	\$4 721	\$6 269	\$7 445
Total liabilities	\$29 493	\$32 074	\$36 507	\$38 330	\$39 938
Total stockholders' equity	\$40 104	\$31 097	\$36 286	\$39 558	\$46 175
Total Liabilities and Equity	\$69 597	\$63 171	\$72 793	\$77 888	\$86 113

Sources: Microsoft's 2006, 2008 and 2010 *Annual Reports*

Exhibit 8: Microsoft's Income Statement (in \$ millions)

	2006	2007	2008	2009	2010
Revenue	\$44 282	\$51 122	\$60 420	\$58 437	\$62 484
Operating Expenses					
Cost of revenue	\$7 650	\$10 693	\$11 598	\$12 155	\$12 395
Research and development	\$6 584	\$7 121	\$8 164	\$9 010	\$8 714
Sales and marketing	\$9 818	\$11 455	\$13 260	\$12 879	\$13 214
General and administrative	\$3 758	\$3 329	\$5 127	\$3 700	\$4 004
Employee severance	\$0	\$0	\$0	\$330	\$59
Total operating expenses	\$27 810	\$32 598	\$38 149	\$38 074	\$38 386
Loss/Income from Operations	\$16 472	\$18 524	\$22 271	\$20 363	\$24 098
Other income (expense)	\$1 790	\$1 577	\$1 543	-\$542	\$915
Loss/Income before taxes	\$18 262	\$20 101	\$23 814	\$19 821	\$25 013
Provision for income taxes	\$5 663	\$6 036	\$6 133	\$5 252	\$6 253
Net Income	\$12 599	\$14 065	\$17 681	\$14 569	\$18 760
Weighted number of shares outstanding:					
Basic	10438	9742	9328	8 945	8 813
Diluted	10531	9886	9470	8 996	8 927
Earnings per share:					
Basic	\$1.21	\$1.44	\$1.90	\$1.63	\$2.13
Diluted	\$1.20	\$1.42	\$1.87	\$1.62	\$2.10
Cash dividends declared per common share	\$0.35	\$0.40	\$0.44	\$0.52	\$0.52

Sources: Microsoft's annual reports 2006, 2008 and 2010

Exhibit 9: Selected financial data

	Week Ending April 29, 2011
Yields on U.S. Treasury Bills, Notes, and Bonds	
3-month	0,04%
6-month	0,11%
1-year	0,22%
2-year	0,61%
3-year	1,97%
10-year	3,32%
30-year	4,40%
Spreads on Long-term Corporate Bonds	
Aaa	0,59%
Aa	1,01%
A	1,31%
BBB	1,85%
Interest Rates	
Federal Funds	0,09%
3-month Commercial Paper	0,13%
3-month Certificate of Deposit	0,23%
Prime Rate	3,25%
Equity Betas	
Microsoft	0,93
8x8	0,54
BroadSoft, Inc.	0,93
Akamai	1,22
Vonage Holdings Corp.	0,87
VeriSign	1,11
ShoreTel, Inc.	1,68
Market Risk Premium	
Market Risk Premium	14,73%
Information out of the IPO Filing	
WACC of Skype	17,00%
Target D/V Ratio of Skype	
Target D/V Ratio	29,33%

Sources: FRED, Federal Reserve Economic Data, Skype's IPO Filing

Exhibit 10: Revenue Synergies (in \$000s)

	Dec 2012E	Dec 2020E
Display marketing services and other revenue	376.500	3.900.000

Exhibit 11: Skype Comparable Companies, 2010 (S&P Capital IQ)

Comparable Companies	Company Description
8x8 Inc.	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.
BroadSoft Inc.	A provider of software solutions enabling telecom service providers to offer VoIP and unified communication services.
Akamai Technologies Inc.	A global leader in content delivery networks (CDN) and cloud services
Vonage Holdings Corp.	A consumer and business-focused VoIP provider, with a subscription-based revenue model similar to Skype.
VeriSign Inc.	A provider of domain name registry services and internet security solutions
ShoreTel Inc.	A company specializing in business-focused unified communication solutions

Exhibit 12: Skype Comparable Companies Financials, 2010 (in \$000s) (S&P Capital IQ)

Company	8x8, Inc.	BroadSoft, Inc.	Akamai Technologies, Inc.	Vonage Holdings Corp.	VeriSign, Inc.	ShoreTel, Inc.
Shareprice (in \$)	3,11	45,48	92,90	5,16	180,77	10,45
Shares outstanding	62.436.804	26.166.000	150.226.986	223.490.000	96.100.000	46.146.000
Market Cap	194.178	1.190.030	13.956.090	1.153.208	17.372.000	482.226

Interest bearing Debt	0	1.970	0	212.452	80.388	0
Cash and Cash Equivalents	18.056	47.254	1.243.985	78.934	1.559.628	68.426
Pfd Eqty & Mnrty Int	0	0	0	0	0	0
Sales	63.396	95.623	1.023.586	885.042	680.578	148.464
EBITDA	4.973	12.692	369.604	125.525	316.799	-10.240
EBIT	3.975	10.344	253.162	95.773	249.144	-13.044

Exhibit 17: Types of Intellectual Property (Bryer and Simensky 2002)

<i>Patents</i>	“Legal process whereby technology is turned into controllable property with defined rights associated with its ownership”. It is a negative right to exclude others from making, using or selling inventions and new processes.
<i>Copyrights</i>	“Protects the expression of an idea, not the idea itself, just as a patent does not protect an idea, rather its embodiment in a product or process”. They protect original artistic and literary works such as songs or books, but also include computer software.
<i>Proprietary Technology</i>	Encompasses trade secrets and know-how. In contrast to patents, they do not have to be tangible in order to be protected, and owners are relieved from registrations. Trade secrets can make for a sizeable portion of a company’s intangibles, often outpacing patents and copyrights.
<i>Trademarks</i>	As defined in the Trademark Act of 1946 “includes any word, name, symbol, or device, or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured by others.” Internet Domain Names are not trademarks in the legal sense but share important characteristics.
<i>Computer Software</i>	Is subject to either patent, copyright or trade secret protection. This can be further divided into Product Software, Operational Software, System Software and Applications Software.
<i>Mask Works</i>	Somewhere between computer hardware and software, for example semiconductor chips that contain circuitry and logic. Often eligible for Copyright.
<i>Right of Publicity</i>	“Addresses the right of a person to control and benefit from commercial exploitation of his or her identity.”

Exhibit 18: Skype Intellectual Property (“Co-Branding Agreement” 2005)

- Skype Brand Features: It is noted that as per the IPO prospectus, Skype faced ongoing oppositions regarding the Skype trademark in certain legislations from BSKyB’s SKY brand
- Skype Software, Toolbar and Code
- Databases and account information related to any member of the Skype Group and the Skype Software
- Text, pictures, sound, graphics, video
- All copyrights, patents, trademarks, service marks, right of publicity, authors’ rights, contract and licensing rights, goodwill

Exhibit 19: TelCo Transaction Comparable Companies Description (SEC Filing)

Target	Description
<i>MCI</i>	MCI was a global communications company, providing Internet, data and voice communication services to businesses and government entities throughout the world and consumers in the United States.
<i>AOL</i>	AOL is a leader in the digital content and advertising platform space. Verizon has been investing in emerging technology that taps into the market shift to digital content and advertising.
<i>Nextel</i>	Sprint Nextel is a global communications company and a leader in providing and integrating wireless, long distance and local communications services. Sprint Nextel offers a comprehensive range of wireless and wireline communications services to consumer, business and government customers.
<i>Alamosa</i>	A wireless communications provider that operated as a Sprint PCS affiliate, offering digital wireless services across several states in the United States.
<i>Ubiquitel</i>	A wireless telecommunications provider that operated as a Sprint PCS affiliate, offering wireless services primarily in the Western United States.
<i>Pixar</i>	An American computer animation studio, known for creating pioneering animated films
<i>CheckFree</i>	A leader in electronic commerce services and products, including electronic bill payment and Internet banking

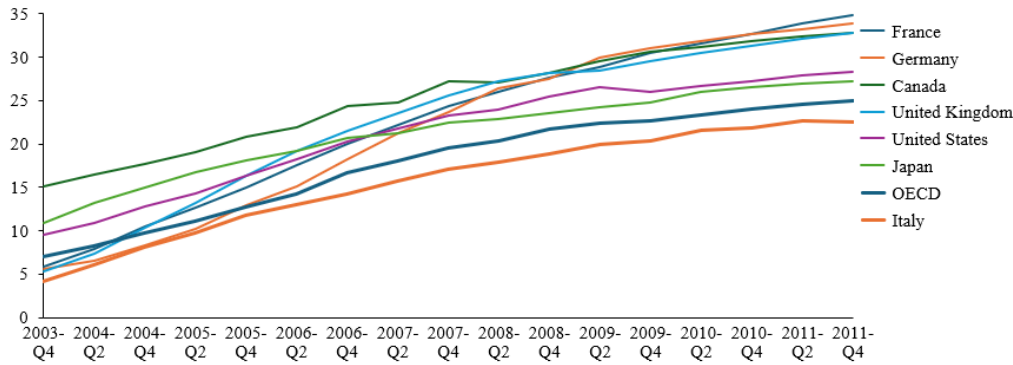
<i>Qwest</i>	A telecommunications company offering broadband, voice, and data services primarily in the Western United States.
<i>Centennial</i>	A telecommunications company providing wireless and wired communication services, primarily in the United States and Puerto Rico.
<i>Embarq</i>	A telecommunications provider offering local and long-distance voice, data, and high-speed Internet services.

Exhibit 20: TelCo Transaction Comparable Companies Data (in \$ million) (Ewens, Peters and Wang 2023)

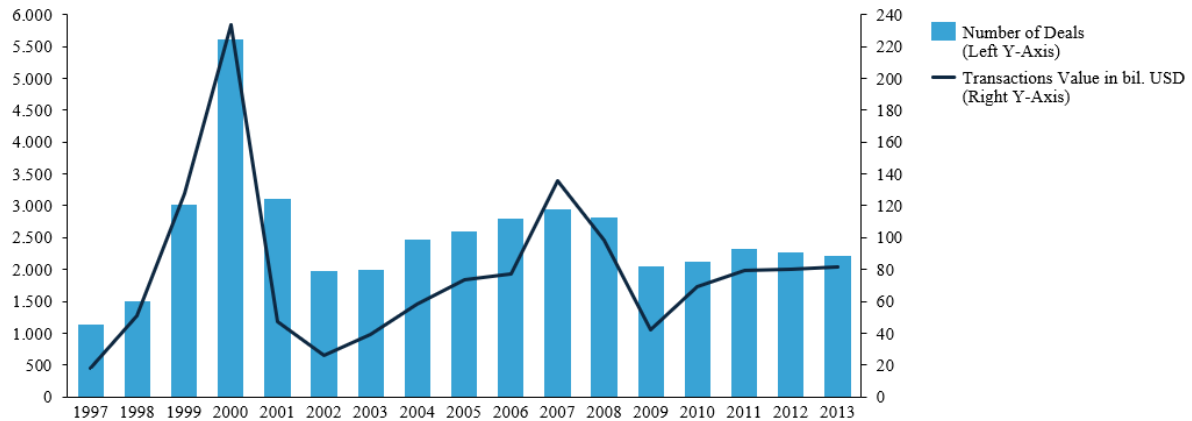
Acquiror	Target	Year	Deal Value	Intangible Assets
Verizon	MCI	2006	6.879	1.364
Sprint	Nextel	2005	37.800	25.088
Sprint	Alamosa	2006	3.400	1.277
Sprint	Ubiquitel	2006	985	368
Disney	Pixar	2006	7.495	233
Fiserv	CheckFree	2007	4.423	1.778
Century Link	Qwest	2011	12.273	9.693
AT&T	Centennial	2009	2.961	1.094
CenturyTel	Embarq	2009	6.070	1.393
Average			9.143	4.699

Appendix

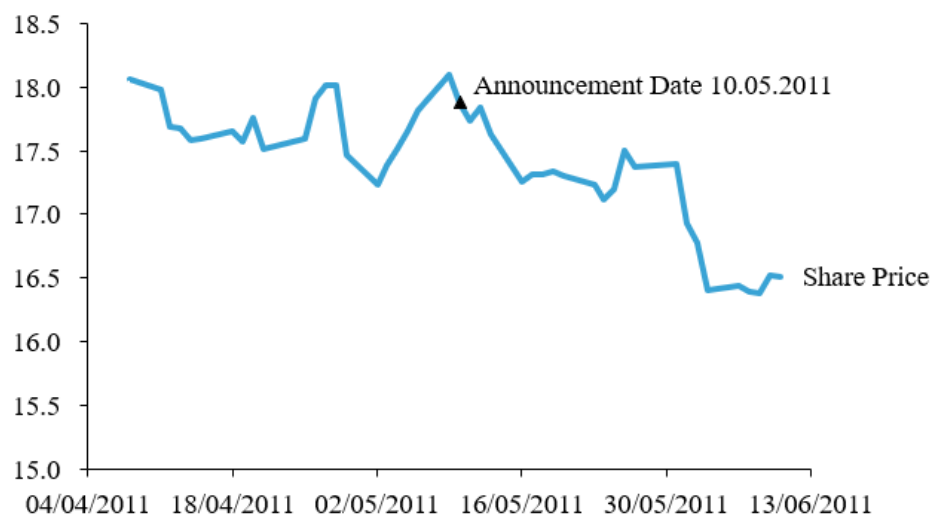
Appendix 1: Historical fixed broadband penetration rate of the G7, 2003-2012 (OECD 2003-2012)



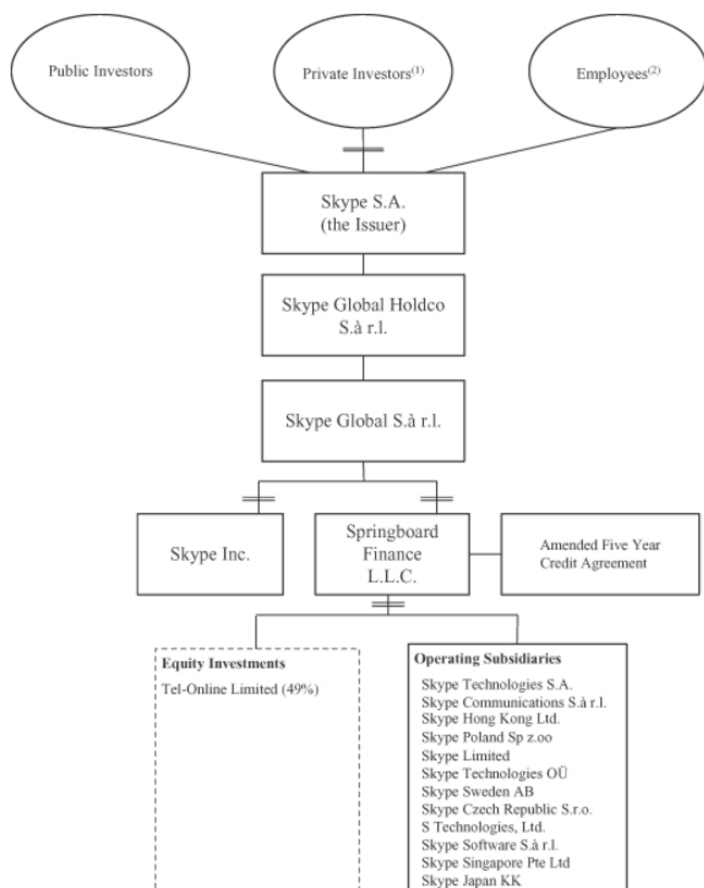
Appendix 2: Software & Internet Services M&A deal number and transaction volumes, 1997-2013 (Institute for Mergers, Acquisitions & Alliances 1997-2013)



Appendix 3: Microsoft Stock Price one Month prior and one Month post Announcement (S&P Capital IQ)



Appendix 4: Skype Shareholder Structure prior to the Microsoft Merger (Skype S.à.r.l. 2010)



(1) Includes Silver Lake, CPP Investment Board Private Holdings Inc., Andreessen Horowitz, eBay, Joltid, Charleston Investment Holdings Limited and certain of their affiliates. See "Principal and Selling Shareholders."

(2) Prior to this offering, employees, directors and consultants who invested in Skype Global or who acquired ordinary shares pursuant to the exercise of any stock option granted under the Skype Equity Incentive Plan held their equity interest in Skype Global through Skype Management, L.P. ("Skype Management"), an exempted limited partnership organized under the laws of the Cayman Islands, which is a shareholder in Skype Global, primarily to enable Skype Global to comply with the limitation on the number of record holders of its ordinary shares under applicable law. Skype Management received such acquired shares on behalf of the employees, directors and consultants and issued a corresponding number of partnership units to the employees, directors and consultants. In connection with this offering, the partnership will terminate and be wound up and Skype Management's ordinary shares in Skype Global will be distributed to the employees, directors and consultants according to their respective numbers of partnership units.

Appendix 5: Key Differences between Hubris and Strategic Mismanagement

Aspect	Hubris	Strategic Mismanagement
Definition	Overconfidence by managers in their ability to create value through an acquisition.	Poor alignment between the acquiring company's strategy and the target company's business model.
Main Cause	Managerial overestimation of potential synergies and value creation, driven by arrogance or ego.	Lack of thorough strategic analysis to ensure compatibility between the acquirer and the target.
Focus	Focus on immediate perceived gains and the managers' belief that they can outperform expectations.	Focus on acquiring assets or companies without fully understanding how they fit within the broader corporate strategy.
Decision-Making Process	Driven by gut feelings, overconfidence, and a disregard for risks or challenges in integration	Driven by incomplete or faulty strategic analysis, often missing key areas like market fit or operational integration.
Due Diligence	Often rushed or superficial due diligence, with key risks overlooked or dismissed.	More thorough, but the analysis may be flawed or incomplete, particularly in assessing strategic alignment.
Risk Awareness	Managers may acknowledge risks but believe they can overcome them through superior leadership.	Managers may not fully understand or anticipate the challenges that will arise due to the misfit between the two companies.

Acquisition Price	Companies often overpay for the target due to overconfidence in their ability to generate synergies	Companies may also overpay, but the issue is more related to a failure in valuing the strategic fit, not necessarily overconfidence.
Cultural Integration	Overconfident in their ability to merge different corporate cultures or believe culture is irrelevant.	Misjudgment of how the target's culture will integrate with the acquirer's, leading to friction and inefficiency.
Key Outcome	Failure to realize anticipated synergies, overvaluation of the target, and potential financial losses.	Failure to realize synergies due to the strategic misalignment of the two companies' business models.

Appendix 6: Underwriters of Skype's IPO

Underwriters

Goldman, Sachs & Co.
 J.P. Morgan Securities Inc.
 Morgan Stanley & co. Incorporated
 Merrill Lynch, Pierce, Fenner & Smith Incorporated
 Barclays Capital Inc.
 Citigroup Global Markets Inc.
 Credit Suisse Securities (USA) LLC
 Deutsche Bank Securities Inc.
 Lazard Capital Markets LLC
 RBC Capital Markets Corporation
 UBS Securities LLC
 Allen & Company LLC
 Evercore Group L.L.C.

Sources: Skype's IPO registration statement filing

INDIVIDUAL PART – TIMON ABERHAM

viii. Legal and Financial Aspects of Intellectual Property within the Skype Acquisition

This section introduces students to the complex world of Intellectual Property (IP) in the context of M&A, posing the main question whether Microsoft overpaid for Skype's IP. This in turn is crucial to answer the broader question that this teaching note presents, whether Microsoft is overpaying for Skype. Hence, this part examines the intangible assets purchased by Microsoft, which were themselves fraught with complications like several lawsuits. After evaluating the materials made available in the case study, students are expected to understand the high

relevance of IP in the Skype and Microsoft deal, considering both valuation and legal aspects. Students will dive into the perspective of Microsoft CIPO Horacio Gutierrez and, after having undertaken careful analysis of the below subject, give a recommendation on whether to proceed with the Skype acquisition.

a. Introduction

Main concerns around IP in any merger, and specifically when it comes to technology assets such as Skype, revolve around how to properly treat IP in the legal due diligence and documentation phase of an M&A deal to ensure a proper transition of the company's most valuable assets. Before delving deep into the subject, the instructor should be conscious of the fact that most students will not have studied IP in their previous classes and therefore will have limited knowledge of the matter. Therefore, it is recommended for the instructor to start with a clear definition. IP represents a unique part of intangible assets as it is protected by law from unauthorized use. Definitions most commonly include patents, copyrights, proprietary technology, trademarks, computer software, mask works and the right of publicity (Bryer and Simensky 2002). Exhibit 16 in the case study contains short descriptions of each type. The subsequent approach of this teaching note foresees the instructor conveying basic concepts around IP in M&A by explaining how Microsoft would have assessed the risks and value of Skype's IP. This then leads to an understanding of the risks – especially concerning litigation that originates from its history - and analyzing the valuation of Skype's IP.

a. Learning Objectives

After solving the case study, students are expected to develop knowledge on the following subjects:

- The relevance of IP in the context of M&A, showcased by eBay’s shortcoming in the 2005 acquisition and subsequent lawsuits as well as their costly resolution.
- Types of IP and key steps undertaken in a proper IP due diligence process for a merger in the technology sector, protections available to buyers and a proper transition of IP.
- Different techniques to value IP, required data points and calculations as well as rationale.

At the end, students will be challenged to answer the central question: **Is Skype’s IP overvalued in the Microsoft transaction?**

b. Teaching Plan

The following teaching plan is recommended as a guideline for the instructor’s use:

- Students should come to class prepared, knowing the different types of IP and their definitions with the help of Exhibit 16, as well as be informed about Skype’s IP history in the case text.
- The instructor will begin with a discussion on Skype’s IP history with a focus on the direct and indirect costs of eBay’s failures.
- With this context, the instructor and students collaborate on developing an outline for how Microsoft’s CIPO structured the Skype IP due diligence process.
- This leads to a discussion of IP within merger agreements and specifically the types of protections and mechanisms in place to ensure a proper transition of IP.
- Next, the instructor should conclude the legal aspects and transition onto the valuation of IP, by discussing the three basic approaches to value IP.
- With the case study and data at hand, students are challenged to conclude which method is the most appropriate for them to determine a fair value for Skype’s IP.

- The instructor could then round off the case study by concluding that Microsoft did not overpay for Skype considering the valuation at hand, and reiterate the importance of IP in M&A by circling back to the concessions eBay made to finally acquire the GI code as detailed in the epilogue.

c. Due Diligence Process

As not many details are available for the Skype transaction, it is proposed to structure this section in a more general way. This is achieved by outlining best practices and inferring that Microsoft, under the professional leadership of CIPO Gutierrez, had a similar approach. With the help of the instructor, students should be able to identify this process as follows:

1. ***Research about the target's IP History:*** Microsoft began by examining Skype's history in the context of IP, paying close attention to past litigation and IP disputes, crucially those between Skype's co-founders and eBay. Given the importance of this dispute exposing the essence of Skype's brand, the case study introduces students to the famed Joltid Ltd. copyright litigation and its resolutions, from which students are expected to derive specific learnings outlined in the teaching questions.
2. ***Identification and Verification of IP Assets:*** Microsoft then compiled a detailed list of Skype's IP assets, including patents, trademarks, copyrights, trade secrets, and proprietary technologies. This assessment was crucial for understanding the ownership status and ensuring there were no encumbrances or disputes related to these assets. A list of Skype's most important IP assets is found in Exhibit 18 of the case study.
3. ***Ownership Verification:*** Given Skype's complex IP history, particularly the dispute with Joltid over peer-to-peer technology, verifying ownership was paramount. The resolution of the Joltid dispute, which confirmed that Skype, as a Luxembourg entity, held clear title to this critical technology, played a significant role in Microsoft's due diligence. Certain

technology was also licensed from third parties, where the company had to ensure a smooth transition.

4. ***Compliance with Luxembourg and EU IP Laws:*** Ensuring that all IP assets were registered and protected under Luxembourg law, Microsoft engaged local legal counsel to navigate the intricacies of local regulations and ensure all documents met local standards. Compliance with EU directives and local procedures for IP registration and enforcement was verified.
5. ***Merger Documentation:*** Once the due diligence phase was concluded, an IP counsel was engaged to ensure proper drafting and negotiation of relevant documents, in particular the acquisition agreement, transfer documents as well as ancillary agreements. In the case of a stock sale as with the Microsoft and Skype merger, all IP owned by the selling corporation is automatically acquired by the buyer. (Bryer and Simensky 2002)
6. ***Representations and Warranties:*** Microsoft needed Skype to represent the truthfulness of information concerning IP, including the below list. This was transformed into a set of reps & warranties that Skype had to make under the acquisition agreement, being liable for indemnification in case of a misrepresentation. The topics that Microsoft likely sought protection for include (Bryer and Simensky 2002):
 - Ensure that the IP is either owned by the target/ seller and free of any liens, security interests and other encumbrances, or properly licensed and as such freely transferrable to Microsoft
 - If any IP is licensed to third parties, is there risk of IP infringement, and have infringement or dilution claims been made against the seller, or has the seller made infringement or dilution claims towards third parties?
 - Potentially ongoing litigation involving IP

- Pending applications for patents, trademarks, or copyrights or rejections/ refusal by the regulator thereof
7. ***Evaluation of IP Taxation and Strategic Planning:*** Microsoft evaluated the implications of Luxembourg's favorable tax regimes for IP, including the "IP box" regime, which grants companies an 80% tax exemption from taxation on net income derived from IP assets. Integrating Skype's IP into its global tax strategy, Microsoft aimed to optimize these benefits. However, further deep dive into these tax strategies are out of scope for the purpose of this case study.
8. ***Integration into Microsoft's Ecosystem:*** Throughout this process, Microsoft's approach to due diligence and the legal framework for IP transfer was thorough and strategic, mitigating risks and maximizing the strategic value of Skype's technology. This structured approach allowed the company to take full advantage of this acquisition and be in the driving seat from there onwards.

The following list of standard questions is proposed with regards to Skype's IP history. The instructor is free to modify them as they please:

- What leverage should eBay have used in its negotiations to ensure a proper transition of the peer-to-peer technology?
- What might have given eBay comfort to proceed with the acquisition, and what might they have missed?
 - Having Friis and Zennstrom on their payroll would mitigate these concerns, but eBay didn't consider what would transpire when they leave.
- How much did the failed IP protection impair the success of eBay's acquisition, and how much money did it cost the company directly (quantify) and indirectly (qualitative reasoning)?

- Indirect: Skype under eBay was always subject to restrictions and limitations that Joltid and the co-founders placed under the licensing agreement. eBay was at their mercy, no one else understood how the code functioned, and even if, was not allowed to alter it. Therefore, eBay could not integrate Skype in the way it wanted and even a sale (evidenced by the attempted IPO before the private equity transaction) was prone to fail.
- Direct monetary consequence for eBay was giving up a 14% stake in Skype to Joltid Ltd. in the PE transaction, which turned out to be worth apx. \$1.2 billion in the Microsoft transaction. As eBay's stake was downsized by 5%, it directly lost out on \$425 million. This adds to the 9% that eBay would have sold to the PE consortium but had to give to Joltid, missing out on apx. \$248 million considering the \$2.75 billion valuation of the deal (Exhibit 3). Hence, total direct monetary damage amounted to at least \$673 million, not considering legal fees.

Additionally, the following list of standard questions is proposed with regards to the wider IP in M&A context and Microsoft's due diligence process for the Skype acquisition. The instructor is free to modify them as they please:

- What are different kinds of IP rights and how are they protected?
- How does the IP due diligence process for a merger look like and how is this incorporated into the merger agreement?
- What lessons can be learned from the Skype / Microsoft deal?

d. Valuation Aspects - The Role of IP in Skype's Valuation

Coming back to the crucial aspect of whether Skype's IP was overvalued in the Microsoft deal, a theoretical foundation needs to be established before proceeding with the valuation. Generally

speaking, there are three basic approaches to value intellectual property that Microsoft could draw upon for the Skype acquisition (Bryer and Simensky 2002):

- **Cost Approach:** Estimating the value of developing Skype’s IP from scratch, including R&D, legal fees, and other associated costs.
- **Market Approach:** Comparing Skype’s IP with similar transactions in the market to determine a fair value.
- **Income Approach:** Estimating future cash flows generated by Skype’s IP and discounting them to present value. This involves projecting revenue from licensing agreements, subscriptions, and other monetization strategies.
- **Mix between Market and Income Approach:** Relief from Royalty Method (RRM) calculates value based on the hypothetical royalty payments that would be saved by owning the asset rather than licensing it. In practice, data on royalty rates is hard to find, but a toy example is included in the excursus below for illustrative purposes.
- Further resources for instructor:
 - “The Intangible Valuation Renaissance: Five Methods” 2019
 - Bryer and Simensky 2002, Chapter 4 and especially 4.9-4.13

Excursus: Relief from Royalty Method (RRM) – Valuation of Disney’s Marvel Character

Rights (toy example with estimated and rounded numbers): Disney acquired Marvel Entertainment in 2009 for approximately \$4 billion (The Walt Disney Company 2009). Prior to that, Marvel licensed its characters, such as Spider-Man, to companies like Sony for film and merchandise rights. Suppose Disney earns \$500 million annually in revenue directly related to Spider-Man films, merchandise, and other media. Such licensing deals typically include royalty payments of between 5% to 15% (“Factors Affecting Royalty Rates in Brand Licensing” 2021). For simplicity, assume an 8% royalty. Assuming perpetual IP rights and a 10% WACC for Disney, annual royalty savings amount to ($\$500 \text{ million} \times 8\% = \40 million). Applying the

perpetuity formula, the present value of an indefinite \$40 million annual cash flow is \$400 million before taxes and \$316 million after 21% taxes.

Skype's valuation history implied by the three precedent transactions detailed in other sections of this teaching note and the case study can be observed in Exhibit 3. When eBay took a goodwill charge of \$1.4 billion including a \$530 million earn-out settlement to Skype's co-founders, its 2007 Annual Report detailed that the \$900 million internal devaluation was derived using the income approach described above. While this is a common practice for companies, outsiders lack the necessary data points and therefore mostly rely on the market approach. For this, a clear set of criteria to identify comparable companies was formulated:

- Deal value of at least \$1 billion
- Active in the Information Technology and/ or Telecommunications sector
- Product offering connected to communications
- Global operations/ wide geographic reach

Following these indicators, a list of precedent transactions (Exhibit 9) has been created and curated accordingly with data from Ewens, Peters and Wang 2023, made available to the students in the case study. On this basis, they are expected to exclude some deals based on their comparability and subsequently derive an expected value of Skype's intellectual property. The average size of intangibles included in the total deal value of the curated list stands at 36.5%. On the basis of a total transaction value of \$8.53 billion consisting in \$7.1 billion goodwill, \$1.6 billion identifiable intangible assets and \$222 million unearned revenue (Microsoft Corp 2013), the maximum value attributable to intellectual property consequently is \$3.11 billion. Students are encouraged to apply this percentage to the valuation of Skype they derived in the DCF exercise and compare this to the actual value.

The following list of standard questions is proposed. The instructor is free to modify them as they please:

- What are common methods to value IP? How were these applied in the context of the Microsoft / Skype merger?
- Did Microsoft overpay for Skype's IP?
 - No: benchmarking the Skype deal to comparable transactions precedent, Microsoft did not overpay considering the actual recognized intangible assets of \$1.6 billion (Microsoft Corp 2013, p. 66)

e. Epilogue

As briefly mentioned in the case study text, the legal challenges posed by Skype's co-founders finally resolved in an IP rights transfer of the sought-after GI code amid several concessions from eBay. To further highlight the importance of dedicating sufficient attention to IP aspects in an M&A process, the details of the settlement reveal the negotiation power that Friis and Zennström had over Skype due to the GI code (Skype S.à.r.l. 2010):

- Next to the 10% ownership in Skype, Joltid received a cash payment of \$85 million that it used partly to invest \$80 million for an additional 3.4% stake, as well as a warrant package equivalent to another 1% equity.
- Skype acquired the GI IP rights from Joltid subject to the perpetual, royalty-free license-back to Joltid of certain patents regarding the peer-to-peer architecture and limited rights to license the IP to third parties.
- On top of all that, Skype agreed to invest in a social music service founded by Friis and Zennström and exclusively broadcast their service, promote a new video service under development by another Friis-Zennström start-up, and invest in a newly founded venture capital fund, also owned by Friis and Zennström.

This settlement was a crucial building block of the subsequent private equity buyout and following acquisition of Microsoft. Analyst's commentaries on the Microsoft transaction confirmed the notion that Microsoft would not make the same mistake and pay special attention to a smooth transition of IP aspects: *"You can bet your bottom dollar that Horacio Gutierrez [Chief Intellectual Property Officer for Microsoft] and his team have been heavily involved in the due diligence that must already have taken place, and will also be in the thick of what comes next. They will check every patent, copyright, trade secret and other right to make sure that Microsoft is getting exactly what it is paying for."* (Randy 2011)

As such, the due diligence process reconstructed in this teaching note is an accurate estimator for Microsoft's actions, and resulted in the successful transition of Skype's IP to Microsoft which it valued at \$1.6 billion as recognized in the company's 2012 annual report.

ix. Epilogue

After Microsoft acquired Skype in 2011 for \$8.5 billion, the platform initially thrived. Skype saw rapid integration into Microsoft's services, replacing Windows Live Messenger by 2013 and becoming a key feature in Office 365, Xbox, and Windows devices. It remained a leading communication tool for personal and business use during its early years under Microsoft. However, competition soon emerged, notably from Zoom and Slack- Furthermore, Microsoft Teams, launched in 2017, began to overshadow Skype. Teams' success, especially during the COVID-19 pandemic, relegated Skype to a less central role (Novet 2023). While Skype remains available, its market share and relevance have significantly declined as Microsoft shifted its focus to Teams for enterprise and collaborative communication (French 2020).

Whether Microsoft's acquisition of Skype was worth it at all and if so, whether the astronomical price tag was justified, remains debated. Initially, the deal appeared successful, as Skype integrated into windows and replaced Messenger, gaining millions of users. Microsoft likely derived some strategic value, particularly through Teams' success, which incorporated lessons from Skype. Despite that, the acquisition is often viewed as overvalued given the high price not justified by common valuation methods as well as Skype's fading prominence (French 2020).

Exhibits

Exhibit 3: Skype Valuation History (own calculation)

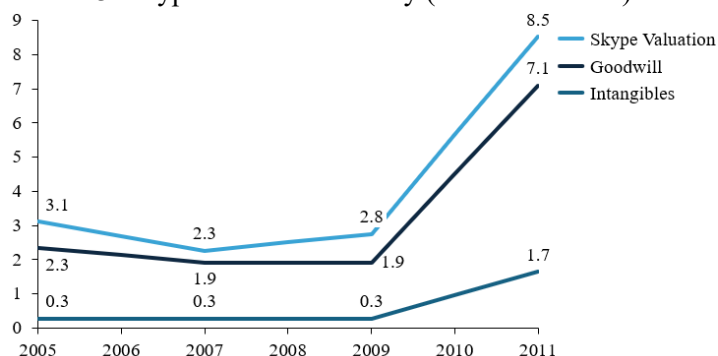


Exhibit 4: Skype Comparable Companies, 2010 (S&P Capital IQ)

Comparable Companies	Company Description	Exclusion Criteria
8x8 Inc.	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.	Included
BroadSoft Inc.	A provider of software solutions enabling telecom service providers to offer VoIP and unified communication services.	Included
Akamai Technologies Inc.	A global leader in content delivery networks (CDN) and cloud services	Size and Industry
Vonage Holdings Corp.	A consumer and business-focused VoIP provider, with a subscription-based revenue model similar to Skype.	Included
VeriSign Inc.	A provider of domain name registry services and internet security solutions	Size and Industry
ShoreTel Inc.	A company specializing in business-focused unified communication solutions	Included

Exhibit 5: Football Field Chart

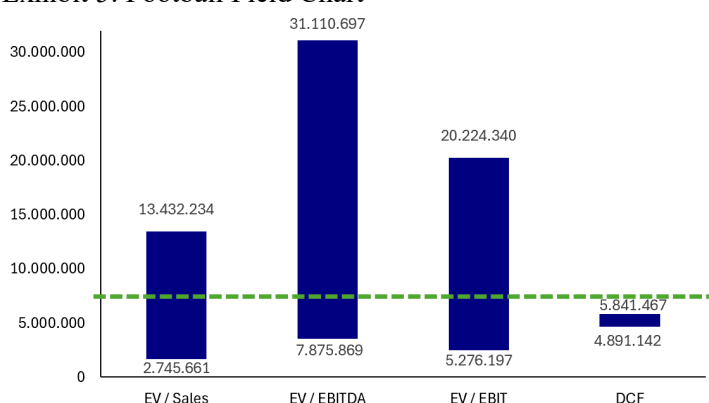


Exhibit 6: Arguments for Hubris and Strategic Misalignment

Hubris/Overconfidence	Strategic Misalignment/Mismanagement
Unrealistic revenue growth projections: Expected \$7M in 2004 to grow to \$200M by 2006 (3,000% increase).	Mismatch of business models: eBay's transaction-driven platform vs. Skype's peer-to-peer communication.
Overestimated synergies: Assumed VoIP would seamlessly improve user trust and auction efficiency.	Unrealistic synergy expectations: Belief that Skype would increase auction transaction volumes.

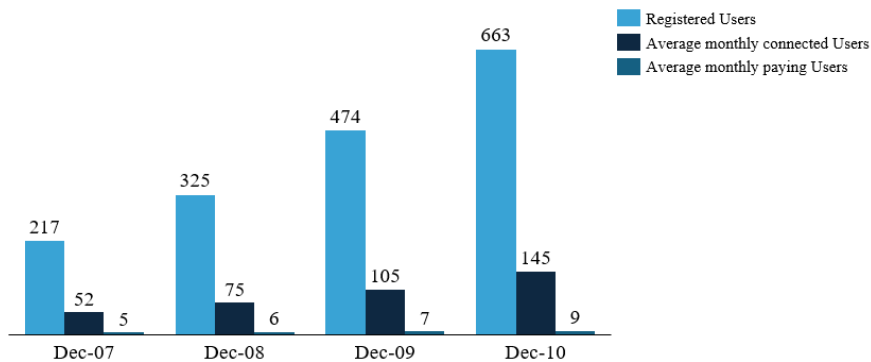
Neglected competitive landscape: Ignored competition from Google and Microsoft in VoIP.	Cultural clashes: Skype's agile startup culture clashed with eBay's structured corporate culture.
Ego-driven decision-making: Believed eBay's leadership could uniquely leverage Skype's potential.	Poor integration planning: Operational and strategic integration challenges were underestimated.
Assumed VoIP would revolutionize auctions without user demand validation.	Market misjudgment: Misunderstood user demand for VoIP in auctions, where anonymity was preferred.
Relied too heavily on projections and assumptions rather than tangible data.	Failure to adapt post-acquisition: Continued pursuing synergies despite clear signs of failure.
Failure to acknowledge integration complexity in cross-industry mergers.	Limited practical application of Skype's technology to eBay's core user experience and transaction flow.
Overconfidence in ability to handle post-merger cultural and operational integration.	Lack of complementary strengths: No clear value-add or overlap between Skype and eBay services.
	Ignored customer behavior: Auction users prioritized anonymity, conflicting with Skype's functionality.
	Misjudged scalability: Assumed that Skype's technology could scale seamlessly within eBay's platform.
	No contingency planning: Lacked alternative strategies in case synergies failed to materialize.

Exhibit 9: TelCo Transaction Comparable Companies Data (in \$ million) (Ewens, Peters and Wang 2023)

Acquiror	Target	Year	Deal Value	Intangible Assets	% Intangibles	Exclusion Reason
Verizon	MCI	2006	6.879	1.364	19,8%	
Sprint	Nextel	2005	37.800	25.088	66,4%	
Sprint	Alamosa	2006	3.400	1.277	37,6%	<i>Geography</i>
Sprint	Ubiquitel	2006	985	368	37,4%	<i>Size</i>
Disney	Pixar	2006	7.495	233	3,1%	<i>Industry</i>
Fiserv	CheckFree	2007	4.423	1.778	40,2%	<i>Products</i>
Century Link	Qwest	2011	12.273	9.693	79,0%	<i>Geography</i>
AT&T	Centennial	2009	2.961	1.094	36,9%	
CenturyTel	Embarq	2009	6.070	1.393	22,9%	
Average	(excl. "bad" comparables)		13.428	7.235	36,5%	

Appendix

Appendix 1: Skype User Metrics in Millions (Shan 2013)



Appendix 2: Merger Decision Pros & Cons List

Pros	Cons
Large User Base: Skype had over 660 million users, giving Microsoft access to a massive, global audience.	Integration Challenges: Skype's peer-to-peer architecture might clash with Microsoft's centralized cloud infrastructure.
Synergies with Existing Microsoft Products: Skype could be integrated into Office, Windows, and Xbox, improving collaboration and productivity.	Competition in VoIP Market: Despite the acquisition, Microsoft faces competition from Google Voice, FaceTime, and Zoom.
Strengthening Presence in VoIP Market: The acquisition allows Microsoft to enter the growing VoIP market, competing with Google and Apple.	Risk of Overpayment (Hubris): Suffering from the "winner's curse" there is always a risk of overpayment
Defensive Move Against Competitors: Microsoft blocks Google and Facebook from acquiring Skype, protecting its position in communications.	Revenue Model Limitations: Skype struggled to monetize its largely free user base in the past.
Enterprise Communication Enhancement: Skype technology has the ability to boost Microsoft's enterprise communication platform, rebranded as Skype for Business.	Shifting Market Dynamics: Skype lost market leadership to competitors like WhatsApp, FaceTime, and Zoom.
Global Brand Recognition: Skype's strong global brand adds credibility to Microsoft's product portfolio.	Missed Mobile Opportunities: Skype's mobile apps were slow to develop compared to WhatsApp and FaceTime
Boost for Cloud and Mobile: Skype can help Microsoft expand its cloud services and support mobile platforms.	Cultural and Organizational Fit Issues: Skype's integration into Microsoft's corporate structure faces challenges, eventually hindering innovation.
Tax Efficiency: Microsoft can use offshore cash reserves to make the acquisition, minimizing tax costs.	
Increased Use in Remote Work and Education: Skype is a key tool for remote communication during the rise of remote work.	
Monetization Potential: Skype was seen as a platform with strong monetization potential through ads and premium subscriptions	

Appendix 3: Post-Acquisition Structure of Microsoft (Mc Guinness 2011)



References

- Alvarez & Marsal, and Henley Business School. 2015. "Boards in Challenging Times: Extraordinary Disruptions - Case Study: Skype Technologies: Reviving the Disruptor." Alvares & Marsal and Henley Business School. https://www.alvarezandmarsal.com/sites/default/files/am_boards_in_challenging_times_research_0.pdf.
- Anderson, Kelsie. 2016. "VoIP Codecs Explained - How to Improve Call Audio Quality." Telnyx. August 4, 2016. <https://telnyx.com/resources/codecs-affect-voip-sound-quality>.
- Arthur, Charles. 2013. "Skype: Has Microsoft's \$8.5bn Spending Paid off yet – and Can It?" The Guardian. August 30, 2013. <https://www.theguardian.com/technology/2013/aug/30/skype-microsoft-acquisition-analysis>.
- AT&T. 2011. "U-Verse Update 3Q11." Att.com. 2011. https://www.att.com/Common/about_us/files/pdf/3q_uverse_update_fact_sheet.pdf.
- Baset, Salman A., and Henning Schulzrinne. 2004. "An Analysis of the Skype Peer-To-Peer Internet Telephony Protocol." *ArXiv:cs/0412017* 1 (CUCS-039-04). <https://arxiv.org/abs/cs/0412017>.
- Bright, Peter. 2011. "Microsoft Buys Skype for \$8.5 Billion. Why, Exactly?" Wired. May 10, 2011. https://www.wired.com/2011/05/microsoft-buys-skype-2/?utm_source=chatgpt.com.
- Bryer, Lanning G, and Melvin Simensky. 2002. *Intellectual Property Assets in Mergers and Acquisitions*. New York: Wiley.
- Comcast. 2011. "2010 Financial Highlights." Comcast.com. April 8, 2011. <https://corporate.comcast.com/investors/reports/2010-financial-highlights>.
- Crabtree, Emma. 2013. "The Bell Tolls for Telcos?" TBK Consult. February 26, 2013. <https://tbkconsult.com/the-bell-tolls-for-telcos/>.
- Damodaran, Aswath. 2005. "The Value of Synergy." *SSRN Electronic Journal* 1 (1). <https://doi.org/10.2139/ssrn.841486>.
- . 2011a. "The Value of Control: Implications for Control Premiums, Minority Discounts and Voting Share Differentials." *NYU Journal of Law & Business* 8 (487): 487.

- <https://heinonline.org/HOL/LandingPage?handle=hein.journals/nyujolbu8&div=16&id=&page=>
- . 2011b. “Musings on Markets: Is Skype Worth \$8.5 Billion? An Exercise in Valuing Young, Growth Companies.” *Musings on Markets*. May 18, 2011. <https://aswathdamodaran.blogspot.com/2011/05/is-skype-worth-85-billion-exercise-in.html>.
- . 2015. “The Dark Side of Valuation Valuing Difficult-To-Value Companies.” NYU Stern. <https://pages.stern.nyu.edu/~adamodar/pdfiles/country/darkside.pdf>.
- Ewens, Peters and Wang. 2023. “Measuring Intangible Capital with Market Prices.” GitHub. 2023. <https://github.com/michaelewens/Purchased-intangibles>.
- Flowhaven. 2021. “Factors Affecting Royalty Rates in Brand Licensing.” Flowhaven. 2021. <https://flowhaven.com/resources/factors-affecting-royalty-rates-part-one>.
- French, Darcy. 2020. “Microsoft Skype Review.” TechRadar. April 16, 2020. <https://www.techradar.com/reviews/skype>.
- Gugler, Klaus, Dennis C. Mueller, and Michael Weichselbaumer. 2012. “The Determinants of Merger Waves: An International Perspective.” *International Journal of Industrial Organization* 30 (1): 1–15. <https://doi.org/10.1016/j.ijindorg.2011.04.006>.
- Halliday, Josh. 2011. “Skype ‘in Facebook and Google Talks.’” *The Guardian*. The Guardian. May 5, 2011. <https://www.theguardian.com/media/pda/2011/may/05/skype-facebook-google-talks>.
- Hughes Hubbard & Reed . 2024. “The Best Laid M&a Plans? How a Dispute over Ownership of Critical IP May Threaten EBay’s Sale of Skype.” Hughes Hubbard & Reed. 2024. <https://www.hugheshubbard.com/news/the-best-laid-m-a-plans-how-a-dispute-over-ownership-of-critical-ip-may-threaten-ebays-sale-of-skype>.
- Institute for Mergers, Acquisitions & Alliances. 1997-2013. “M&a Statistics by Industries.” Imaa-Institute. 2024. <https://imaa-institute.org/mergers-and-acquisitions-statistics/ma-statistics-by-industries/>.
- Intellectual Asset Management Magazine. 2011. “The Valuable IP Lessons to Be Learned from Eight Years of Skype.” *Intellectual Asset Management Magazine*, July 2011.
- Kolakowski, Nicholas. 2011. “Microsoft Completes Skype Acquisition.” *EWEEK*. October 14, 2011.

<https://www.eweek.com/mobile/microsoft-completes-skype-acquisition/>.

lawinsider. 2005. “Co-Branding Agreement.” Law Insider. August 22, 2005.
<https://www.lawinsider.com/contracts/1GcKwqxVBRx#recitals>.

Microsoft Corp. 2010. “Form 10-K.” Wwww.sec.gov. 2010.
https://www.sec.gov/Archives/edgar/data/789019/000119312510171791/d10k.htm#tx28259_9.

———. 2013. “Form 10-K.” Wwww.sec.gov. 2013.
<https://www.sec.gov/Archives/edgar/data/789019/000119312512316848/d347676d10k.htm>.

Microsoft Corp. 2010. “Form 10-Q.” U.S. Securities and Exchange Commission. October 28, 2010.
<https://www.sec.gov/Archives/edgar/data/789019/000119312510239825/d10q.htm>.

———. 2011a. “Skype Press Conference: Steve Ballmer and Tony Bates.” Microsoft. May 10, 2011.
<https://news.microsoft.com/2011/05/10/skype-press-conference-steve-ballmer-and-tony-bates/>.

———. 2011b. “Annual Report.” Microsoft. September 2, 2011.
<https://www.microsoft.com/investor/reports/ar11/index.html>.

Novet, Jordan. 2023. “The Rise and Fall of Skype.” CNBC. July 2, 2023.
<https://www.cnbc.com/2023/07/02/the-rise-and-fall-of-skype.html>.

OECD. 2003-2012. “Broadband Statistics.” OECD. 2024. <https://www.oecd.org/en/topics/sub-issues/broadband-statistics.html>.

Puca, Antonella. 2019. “The Intangible Valuation Renaissance: Five Methods.” CFA Institute. January 11, 2019. <https://blogs.cfainstitute.org/investor/2019/01/11/a-renaissance-in-intangible-valuation-five-methods/>.

Randy. 2011. “Microsoft to Buy Skype, and We Can’t Wait to See the Business Combination Accounting | Business Valuation Resources.” Bvresources.com. May 11, 2011.
<https://www.bvresources.com/blogs/intellectual-property-news/2011/05/12/microsoft-to-buy-skype-and-we-cant-wait-to-see-the-business-combination-accounting>.

Reuters 2011. “Skype’s Owners Set to Make \$5 Billion: Source.” *Reuters*, May 11, 2011.
<https://www.reuters.com/article/business/media-telecom/skypes-owners-set-to-make-5-billion->

source-idUSTRE7494J6/.

Richter, Felix. 2013. "Infographic: Skype Connects up to 70 Million People at the Same Time." Statista. August 13, 2013. <https://www.statista.com/chart/1417/skype-usage/>.

Savitz, Eric. 2011. "Microsoft: With Skype, a Good Use for the Giant Overseas Cash Pile." *Forbes*, May 10, 2011. <https://www.forbes.com/sites/ericsavitz/2011/05/10/microsoft-with-skype-a-good-use-for-the-giant-overseas-cash-pile/>.

Science X. 2009. "EBay Settles Lawsuit Filed by Skype Founders." Phys.org. November 6, 2009. <https://phys.org/news/2009-11-ebay-lawsuit-skype-founders.html>.

Shan, Jialu. 2013. "Microsoft'S Acquisition of Skype." IMD.

Shaw, Frank, Steve Ballmer, Peter Klein, Tony Bates, and Brian Lawler. 2011. "Microsoft Corp to Acquire Skype Company Participants Other Participants."

Skype S.à.r.l. 2010. "Form S-1 Registration Statement." *U.S. Securities and Exchange Commission*. United States Securities and Exchange Commission. <https://www.sec.gov/Archives/edgar/data/1498209/000119312510182561/ds1.htm>.

Swarit Advisors. 2021. "A Comprehensive Analysis on EBay Acquisition of Skype Deal." Swarit Advisors. August 10, 2021. <https://swaritadvisors.com/blog/a-comprehensive-analysis-on-ebay-acquisition-of-skype-deal/>.

The Walt Disney Company. 2009. "Disney to Acquire Marvel Entertainment." The Walt Disney Company. August 31, 2009. <https://thewaltdisneycompany.com/disney-to-acquire-marvel-entertainment/>.

The Wharton School of the University of Pennsylvania. 2005. "EBay Calling Skype: Is It a Good Connection?" Knowledge at Wharton. November 21, 2005. <https://knowledge.wharton.upenn.edu/article/ebay-calling-skype-is-it-a-good-connection/>.

United States Securities and Exchange Commission. 2007. "Form 10-K Annual Report EBay Inc." United States Securities and Exchange Commission. https://www.annualreports.com/HostedData/AnnualReportArchive/e/NASDAQ_EBAY_2006.pdf.

Wang, Hao. 2005. "Skype VoIP Service-Architecture and Comparison." *INFOTECH Seminar*

Advanced

Communication

Services.

ACS.

https://kirils.org/skype/stuff/pdf/2005/acs5_top1_paper.pdf.

Winslow, Philip , Simson Dennis, and Sitikantha Panigrahi. 2011. *Skype's Overlooked Display Ad Potential*. Credit Suisse.

Zachary, Gregg Pascal, Mark Hall, and Karl Montevirgen. 2024. "Microsoft Corporation."

www.britannica.com.

Encyclopedia

Brittanica.

December

2024.

<https://www.britannica.com/money/Microsoft-Corporation/>.