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

Strategic and Financial Rationale of eBay's Acquisition of Skype: Hubris or Strategic  
Mismanagement - JAN GRUENER - 59320

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**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

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### **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 11<sup>th</sup>, 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*

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*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

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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).

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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).

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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.

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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   |

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*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 - JAN GRUENER

### ***Strategic and Financial Rationale of eBay's Acquisition of Skype: Hubris or Strategic Mismanagement***

#### **a. Background**

In September 2005, eBay, which operates a number of online auction and trading services, acquired Skype, a two-year old VoIP developer, for roughly \$2.6 billion plus up to \$1.5 billion of further performance-related incentives. Taking advantage of the opportunity created by the market, Skype, started by Niklas Zennström and Janus Friis, already registered more than 50 million users (Belson 2005).

eBay's management, under the leadership of its chief executive officer Meg Whitman, thought that Skype's communication platform would complement the transaction experience on its website. Skype's VoIP technology was expected to help eBay users to conduct real time communication, thereby increasing the number of transactions and making negotiations of especially high-value products such as real-estate, cars, and collections easier and more trustworthy. Second, there was a strategic fit in the sense that eBay also appreciated another key capability offered by PayPal, which was to enable users to make offers to sellers, negotiate, and complete the transaction, all within eBay (The Wharton School of the University of Pennsylvania 2005).

Despite the fact that the popularity of Skype was increasing rapidly, Skype had just started to convert existing users into customers, and in 2004, Skype had made \$7 million of revenues with

expected revenues of about \$60 million in 2005 (Forbes 2005). Even though this growth seemed impressive, the acquisition price equaled a revenue multiple over 370x based on 2004 revenues and a 43x EV/revenue multiple when valuing it based on forecasted sales of 2005, a multiple far surpassing the norm at that time in the tech M&A market (Konsynski 2009; The Guardian, 2009).

#### **b. Strategic Vision and Synergies**

The acquisition aimed to capture both cost and revenue synergies. eBay believed that adding Skype's communication feature would differentiate its platform, improve user satisfaction, and drive higher-value transactions. Integrating Skype's VoIP technology was intended to reduce disputes by allowing real-time buyer-seller communication and to enhance transaction completion rates. eBay expected revenue synergies to result from improved user experience and expanded customer engagement.

This strategic vision, however, raised several questions regarding alignment between Skype's communication-focused business model and eBay's transaction-centric marketplace. Skype's core users were primarily attracted to the VoIP service for free communication, not necessarily to conducting transactions. Additionally, as Google and Microsoft began to expand into VoIP, the competitive landscape shifted, making it difficult for eBay to establish a unique value proposition with Skype (Bertolucci 2009).

#### **c. Financial Rationale and Acquisition Premium**

The high acquisition price of Skype reflected eBay's expectations of high revenue growth and synergies, which implied that eBay management predicted that Skype revenue would be \$200 million in 2006 from only \$7 million in 2004. This strong growth target posed certain conspicuous questions particularly in light of the fact that, even though Skype started

implementing paid services like paid-for PC-to-phone services, their existing business still mostly comprised of free services (Forbes, 2005; Konsynski 2009).

**d. Integration and Strategic Fit**

The problem eBay faced after the acquisition was how to integrate Skype into its needs. eBay's issue was that its core business was based on an auction-transaction model, which was in contrast to Skype's business model, essentially a communication platform. Hence, major synergies might not have taken place due to the clash of business models. The forecast of how many people would adopt the communication feature might also have been questionable. These and other possible synergies should be analyzed and set into context with existing theory to further understand if there was certain strategic misfit involved in this acquisition (The Wharton School of the University of Pennsylvania 2005).

**e. Opportunity or Hubris?**

The premium paid and the ambitious synergy projections indicate that managerial overconfidence, or hubris, may have influenced eBay's decision to acquire Skype. Managerial overconfidence in the potential for value creation might have led to overvaluation and flawed integration planning. In this case, eBay's CEO and leadership team appeared confident that Skype's communication technology would transform eBay's platform for the better. This overconfidence may have led eBay's management to overlook the integration challenges and ignore the possibility that users might not adopt the new communication feature as expected. In 2007, two years after the acquisition, eBay recorded a \$1.4 billion write-down on Skype, signaling that the deal had not met its financial and strategic goals (Johnson 2007). Based on a comparison between the two concepts previously mentioned as well as feasible valuation methods (Exhibits 13-16), management is now tasked to determine the main reason for why

this acquisition had failed in certain aspects and if the price for Skype was adequate at the time of the acquisition.

## Exhibits

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

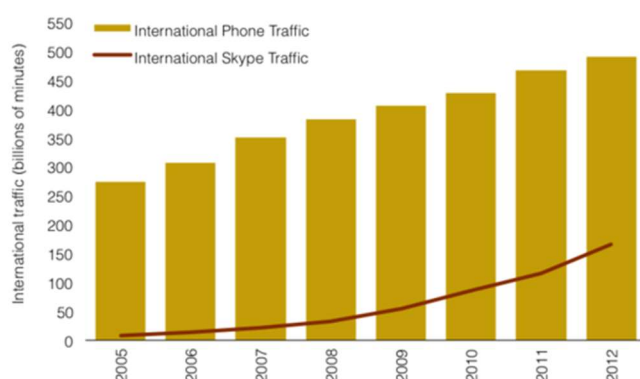


Exhibit 2: Development of Number of Users concurrently online on Skype during peak Activity between 2004-2013 in Millions (Richter 2013)

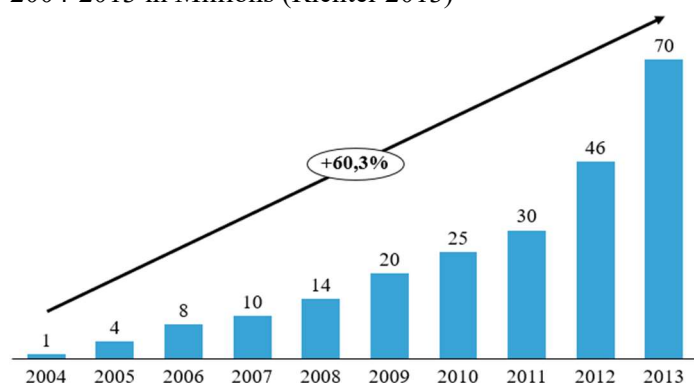


Exhibit 3: Skype's selected Balance Sheet Data (in \$000s)

	2006	2007	2008	2009	2010
<b>ASSETS</b>					
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
<b>Total assets</b>	<b>\$2 944 758</b>	<b>\$2 275 410</b>	<b>\$2 282 535</b>	<b>\$3 409 704</b>	<b>\$3 317 855</b>
<b>LIABILITIES AND EQUITY</b>					
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
<b>Net revenues</b>	<b>\$193 696</b>	<b>\$381 551</b>	<b>\$551 364</b>	<b>\$718 903</b>	<b>\$859 815</b>
<b>Cost of Revenues</b>	<b>\$140 107</b>	<b>\$229 496</b>	<b>\$293 201</b>	<b>\$343 981</b>	<b>\$415 702</b>
<b>Gross Profit</b>	<b>\$53 589</b>	<b>\$152 055</b>	<b>\$258 163</b>	<b>\$374 922</b>	<b>\$444 113</b>
<b>Operating Expenses</b>					
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
<b>Total operating expenses</b>	<b>\$196 708</b>	<b>\$1 586 036</b>	<b>\$235 301</b>	<b>\$739 541</b>	<b>\$423 464</b>
<b>Loss/Income from Operations</b>	<b>-\$143 119</b>	<b>-\$1 433 981</b>	<b>\$22 862</b>	<b>-\$364 619</b>	<b>\$20 649</b>
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
<b>Loss/Income before taxes</b>	<b>-\$141 090</b>	<b>-\$1 428 678</b>	<b>\$33 159</b>	<b>-\$372 063</b>	<b>-\$56 692</b>
Income tax (benefit)/expense	-\$22 044	-\$23 342	-\$8 447	-\$3 259	-\$49 787
<b>Net Income</b>	<b>-\$119 046</b>	<b>-\$1 405 336</b>	<b>\$41 606</b>	<b>-\$368 804</b>	<b>-\$6 905</b>
<b>Weighted number of shares, basic and diluted (Class A through J):</b>				<b>9 414 600</b>	<b>9 433 743</b>
<b>Fully Diluted Earnings Per Share before effect of charges</b>					

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
<b>Adjusted EBITDA</b>	<b>\$110 478</b>	<b>\$184 896</b>	<b>\$264 347</b>

Sources: Skype's IPO registration statement filing

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

	2006	2007	2008	2009	2010
<b>ASSETS</b>					
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
<b>Total current assets</b>	<b>\$49 010</b>	<b>\$40 168</b>	<b>\$43 242</b>	<b>\$49 280</b>	<b>\$55 676</b>
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
<b>Total assets</b>	<b>\$69 597</b>	<b>\$63 171</b>	<b>\$72 793</b>	<b>\$77 888</b>	<b>\$86 113</b>
<b>LIABILITIES AND EQUITY</b>					
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
<b>Total current liabilities</b>	<b>\$22 442</b>	<b>\$23 754</b>	<b>\$29 886</b>	<b>\$27 034</b>	<b>\$26 147</b>
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
<b>Total liabilities</b>	<b>\$29 493</b>	<b>\$32 074</b>	<b>\$36 507</b>	<b>\$38 330</b>	<b>\$39 938</b>
Total stockholders' equity	\$40 104	\$31 097	\$36 286	\$39 558	\$46 175
<b>Total Liabilities and Equity</b>	<b>\$69 597</b>	<b>\$63 171</b>	<b>\$72 793</b>	<b>\$77 888</b>	<b>\$86 113</b>

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

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

	2006	2007	2008	2009	2010
<b>Revenue</b>	<b>\$44 282</b>	<b>\$51 122</b>	<b>\$60 420</b>	<b>\$58 437</b>	<b>\$62 484</b>
<b>Operating Expenses</b>					
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
<b>Total operating expenses</b>	<b>\$27 810</b>	<b>\$32 598</b>	<b>\$38 149</b>	<b>\$38 074</b>	<b>\$38 386</b>
<b>Loss/Income from Operations</b>	<b>\$16 472</b>	<b>\$18 524</b>	<b>\$22 271</b>	<b>\$20 363</b>	<b>\$24 098</b>
Other income (expense)	\$1 790	\$1 577	\$1 543	-\$542	\$915
<b>Loss/Income before taxes</b>	<b>\$18 262</b>	<b>\$20 101</b>	<b>\$23 814</b>	<b>\$19 821</b>	<b>\$25 013</b>
Provision for income taxes	\$5 663	\$6 036	\$6 133	\$5 252	\$6 253
<b>Net Income</b>	<b>\$12 599</b>	<b>\$14 065</b>	<b>\$17 681</b>	<b>\$14 569</b>	<b>\$18 760</b>
<b>Weighted number of shares outstanding:</b>					
Basic	10438	9742	9328	8 945	8 813
Diluted	10531	9886	9470	8 996	8 927
<b>Earnings per share:</b>					
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
<b>Yields on U.S. Treasury Bills, Notes, and Bonds</b>	
3-month	0,04%
6-month	0,11%
1-year	0,22%
2-year	0,61%
5-year	1,97%
10-year	3,32%
30-year	4,40%
<b>Spreads on Long-term Corporate Bonds</b>	
Aaa	0,59%
Aa	1,01%
A	1,31%
BBB	1,85%
<b>Interest Rates</b>	
Federal Funds	0,09%
3-month Commercial Paper	0,13%
3-month Certificate of Deposit	0,23%
Prime Rate	3,25%
<b>Equity Betas</b>	
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
<b>Market Risk Premium</b>	
Market Risk Premium	14,73%
<b>Information out of the IPO Filing</b>	
WACC of Skype	17,00%
<b>Target D/V Ratio of Skype</b>	
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
<b>Display marketing services and other revenue</b>	376.500	3.900.000

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

Comparable Companies	Company Description
<b>8x8 Inc.</b>	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.
<b>BroadSoft Inc.</b>	A provider of software solutions enabling telecom service providers to offer VoIP and unified communication services.
<b>Akamai Technologies Inc.</b>	A global leader in content delivery networks (CDN) and cloud services
<b>Vonage Holdings Corp.</b>	A consumer and business-focused VoIP provider, with a subscription-based revenue model similar to Skype.
<b>VeriSign Inc.</b>	A provider of domain name registry services and internet security solutions
<b>ShoreTel Inc.</b>	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.
<b>Shareprice (in \$)</b>	3,11	45,48	92,90	5,16	180,77	10,45
<b>Shares outstanding</b>	62.436.804	26.166.000	150.226.986	223.490.000	96.100.000	46.146.000
<b>Market Cap</b>	194.178	1.190.030	13.956.090	1.153.208	17.372.000	482.226

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

Exhibit 13: Skype Comparable Companies, 2005 (Bloomberg)

<b>Comparable Companies</b>	<b>Company Description</b>
<b>8x8 Inc.</b>	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.
<b>Level 3 Communications Inc.</b>	Primarily provided network services, including VoIP solutions, internet connectivity, and content delivery.
<b>Verisign Inc.</b>	A provider of domain name registry services and internet security solutions
<b>IDT Corp.</b>	A telecommunications company with direct involvement in VoIP services, including its acquisition of Net2Phone.
<b>magicJack</b>	A consumer-focused VoIP provider offering low-cost internet-based telephony similar to Skype.
<b>Nortel Networks</b>	A telecommunications technology company with significant investments in VoIP infrastructure.
<b>RealNetworks Inc.</b>	An internet-based media pioneer leveraging platforms for user engagement including VoIP.
<b>Avaya Inc.</b>	A provider of unified communication systems, including VoIP solutions for businesses.

Exhibit 14: Skype Comparable Companies Financials, 2005 (in \$000s) (Bloomberg)

<b>Company</b>	<b>Market Cap</b>	<b>Interest bearing Debt</b>	<b>Cash and Cash Equivalents</b>	<b>Pfd Eqty &amp; Mrty Int</b>	<b>TTM Sales</b>
8x8 Inc.	190.734	0,00	22.721	0,00	9.534
Level 3 Communications Inc.	2.327.223	5.211.000	782.000	0,00	3.694.000
VeriSign Inc.	8.558.770	0,00	735.626	36.277	1.120.595
IDT Corp.	1.482.541	52.500	1.016.241	0,00	2.400.092
magicJack	21.415	0,00	6.578	0,00	5.452
RealNetworks	1.129.544	100.000	363.621	0,00	266.719
Nortel Networks	14.826.169	3.866.000	3.685.000	626.000	9.516.000
Avaya Inc.	8.246.541	368.000	911.000	0,00	4.246.000

Exhibit 15: Skype Comparable Transactions, 2000-2005 (Bloomberg)

<b>Target</b>	<b>Acquirer</b>	<b>Description</b>
ACT Networks Inc	Clarent Corp	ACT Networks focused on communication technology solutions, aligning closely with Skype's VoIP model, making it a valuable comparable for analyzing technological innovation in communication.
Le Groupe Videotron Ltee	Quebecor Inc.	This acquisition demonstrates the valuation of a large-scale communications platform with significant market influence and user base, similar to Skype's global reach and importance in digital communication.

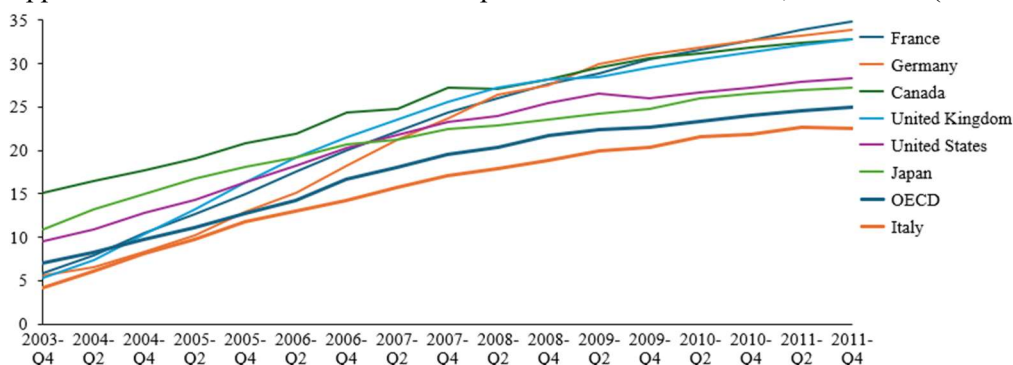
eShare Communications Inc.	Divine Inc.	eShare focused on collaboration and communication tools, offering valuable insights into valuing software-driven user engagement models that resonate with Skype's VoIP platform.
Netgraphe Inc.	Quebecor Inc.	Netgraphe was an internet-based platform monetizing digital services, comparable to Skype's strategy of leveraging internet infrastructure for user engagement and revenue generation.
Spectel Ltd	Avaya Inc.	Spectel specialized in conferencing technologies, directly overlapping with Skype's enterprise and business communication applications, particularly its role in fostering collaboration.
Shopping.com	eBay	Shopping.com provides a strong comparable as a platform-based business acquired by eBay to enhance user engagement and ecosystem synergies, directly mirroring eBay's strategy with Skype.

Exhibit 16: Skype Comparable Transactions Multiples, 2000-2005 (Bloomberg)

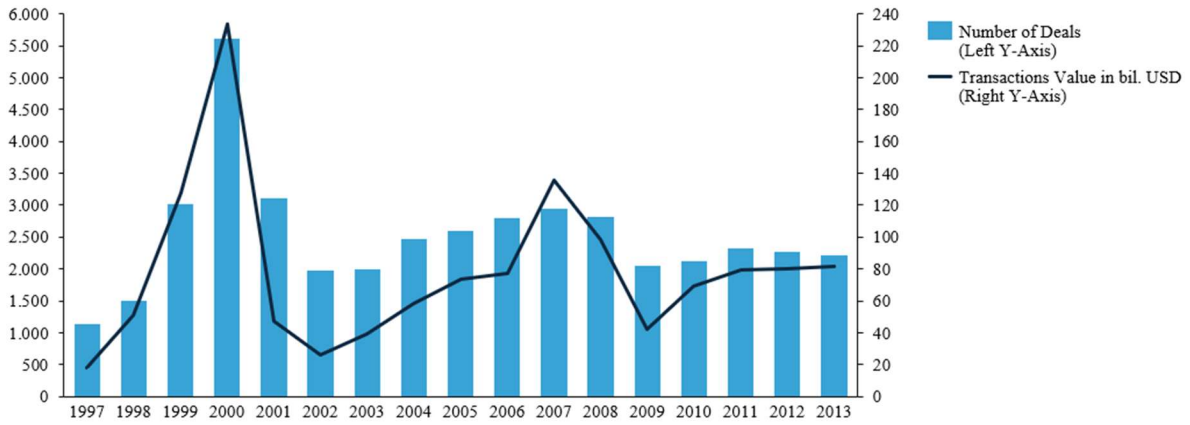
Target	Acquirer	Transaction Value	Revenue	EV / Sales
Le Groupe Videotron Ltee	Quebecor Inc.	3.515,00	674,66	5,2x
ACT Networks Inc	Clarent Corp	195,96	48	4,1x
Netgraphe Inc.	Quebecor Inc.	24,08	5	4,8x
Spectel Ltd	Avaya Inc.	86,05	47	1,8x
Shopping.com	eBay	500,19	128	3,9x
eShare Communications Inc.	Divine Inc.	106,13	80	1,3x

## Appendix

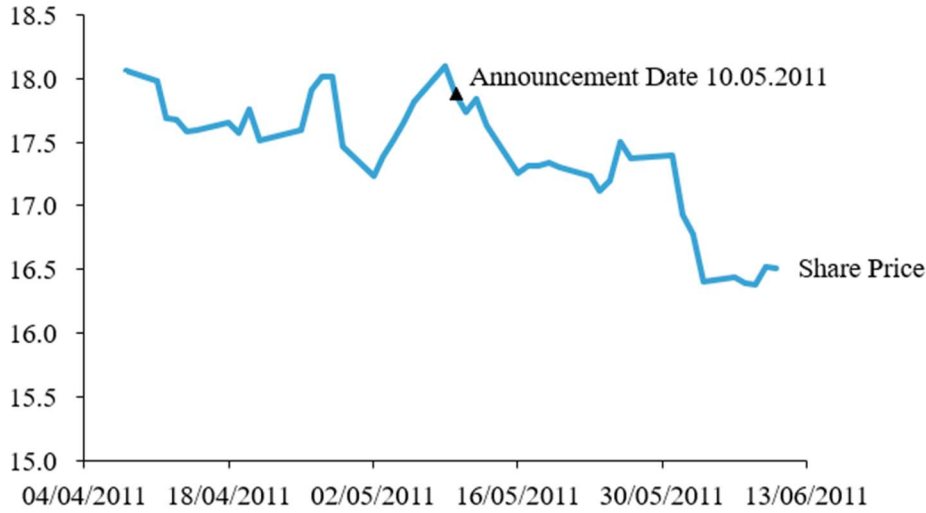
Appendix 1: Historical fixed broadband penetration rate of the G7, 2003-2012 (OECD 2003-2012)



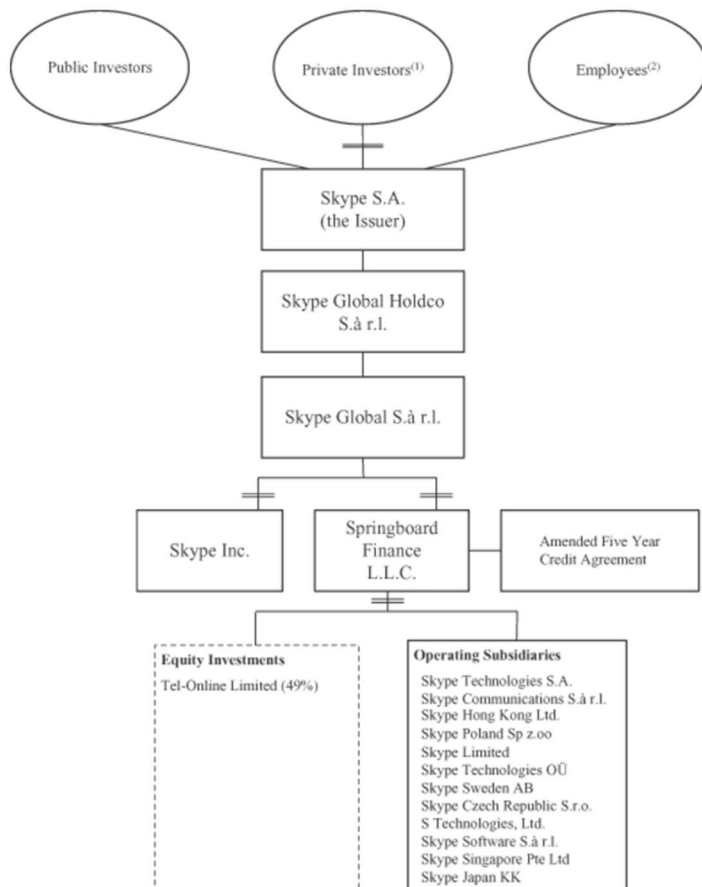
Appendix 2: Software & Internet Services M&A deal number and transaction volumes, 1997-2013 (Institute for Mergers, Acquisitions & Alliances 1997-2013)



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
<b>Definition</b>	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.
<b>Main Cause</b>	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.
<b>Focus</b>	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.
<b>Decision-Making Process</b>	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.
<b>Due Diligence</b>	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.
<b>Risk Awareness</b>	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.

<b>Acquisition Price</b>	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.
<b>Cultural Integration</b>	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.
<b>Key Outcome</b>	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.

## **Part B: Teaching Note**

### **SYNOPSIS**

On May 10, 2011, Microsoft announced the \$8.5 billion acquisition of Skype, making headlines as one of the largest technology deals of its time. This case study explores the key motivations behind the acquisition, the challenges Microsoft faced during the integration, the broader implications for the tech industry as well as the financial rationale behind this acquisition.

The case study begins by analyzing Skype's acquisition history, from its foundation in 2003 to its acquisitions by eBay in 2005 and Silver Lake Partners in 2009. In a further step, the focus is shifted to the VoIP and broader technology sector at the time of the Microsoft acquisition which is then followed by an account of possible merger motives of Microsoft. This all leads to answering the main question at hand, whether Microsoft overpaid for Skype.

In addition, the case study contains a separate components to complement the main part, which focuses on the strategic rationale as well as reasons for the failed acquisition of Skype by eBay.

### **POSITIONING**

This case study is designed for master's level university courses that focus on Mergers & Acquisitions or related topics in Corporate Finance. To get the most out of it, students should already have some basic knowledge of Corporate Finance, including common merger motives, caveats and synergies.

Although the valuations in this case study are simplified, it can also be used to introduce students to common valuation techniques like Discounted Cashflow Analysis (DCF), Comparable Transactions Analysis (CTA), Comparable Company Analysis (CCA) as well as an IPO valuation. If there is enough time, instructors can guide students through these methods.

## **LEARNING OBJECTIVES**

Throughout the preparation of the case study, students will:

- Understand the key milestones in Skype's acquisition history, from eBay's purchase in 2005 to its sale to Microsoft in 2011, and evaluate the strategic decisions and challenges that shaped its journey through different ownerships.
- Analyze the VoIP market and broader technology sector, focusing on the rapid advancements in communication technology, rising competition, and the strategic positioning of Skype as an acquisition target.
- Assess the strategic drivers behind Microsoft's decision to acquire Skype, including competitive pressures, anticipated synergies, and its vision for integrating Skype into its ecosystem to strengthen its product offering.
- Perform various valuation methods including a Discounted Cash Flow valuation and a comparable company analysis to explore if the anticipated growth potential, market conditions and synergy expectations reflect and justify Microsoft's acquisition price.
- Explore why eBay's acquisition of Skype failed, with a focus on strategic misalignment, overestimated synergies, and the challenges of integrating a communication-driven platform into a transaction-focused business model.

## **SUBSTANTIVE ANALYSIS AND TEACHING PROCESS**

### ***i. Introduction***

While parts of the case study can be omitted at the discretion of the instructor, a comprehensive solution and debriefing of the case will likely require at least three hours of class time and a significant additional asynchronous time commitment by the students. Two classes of one and a half hours might be favorable over one three-hour long class as it allows students to delve into

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the case and later still have an opportunity for clarifications regarding any doubts. The teaching note includes suggested board plans to help the instructor reiterate important concepts visually. In the case study students take the position of the Head of Business Development and M&A at Microsoft who faces the difficult decision of whether to advise the CEO to proceed with the acquisition of Skype or not, a decision which shall be supported by quantitative and qualitative analysis.

The instructor can start off the discussion by asking students about their general knowledge about Skype. With the information provided in the case study, they should be able to reflect on Skype's history of rapid growth in user numbers and the technical revolution and market conditions up until the decision point. At this stage, it is appropriate to shift the discussion to an overview of Skype's business model as well as give an account of its tumultuous past which should give the students an idea about why Skype might have been an interesting asset and highlight the potential caveats of a deal.

To aid the transition through the topics and spark discussions with the students, the following list of standard questions is proposed. The instructor is free to modify them as they please:

- Do / Did you use Skype? Why?
- What were some of the main contributors to Skype's rapid growth?
- What were the competitive advantages that put Skype ahead of its competitors?

Next, the instructor could focus on the acquirer by discussing Microsoft's market position and product portfolio and then discuss how Skype might fit into the realm of Microsoft in terms of potential synergies. At this point, the instructor can transition to a high-level discussion of the pros and cons of consummating the merger which are encouraged to be consolidated in a list on the board (Exhibit 1). This serves as a good basis to build upon and delve deeper into the subsequent sections making up the case.

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

- Have any of you heard about the Microsoft - Skype or eBay - Skype mergers?
- What is your opinion about Microsoft? Do you use their products / services?
- Do you believe Microsoft is a good suitor for Skype?

### *ii. M&A History of Skype*

To analyze the M&A history of Skype, students need a comprehensive understanding of the strategic decisions and outcomes of each acquisition. This part delves into the significant phases of Skype's ownership, exploring the motivations behind each deal, the challenges faced, and the ultimate outcomes. In this part the students will learn how to perform a functional analysis of the industry forces and how insights about the M&A history of a company will support the examination of whether a company is a suitable target or not. By examining eBay's acquisition in 2005, the sale to Silver Lake Partners in 2009, and Microsoft's acquisition in 2011, students will gain insights into the complexities of corporate acquisitions in the tech industry. This analysis will encourage critical thinking about merger motives, such as synergies and strategic fit, and prompt discussions on the successes and missteps of these transactions. By examining Skype's M&A history, students will be better equipped to analyze the acquisition of Skype by Microsoft, understanding the multifaceted considerations and strategic decisions that shape such high-stakes corporate transactions.

#### *1. Skype's Acquisition by eBay (2005)*

**Teaching Objective:** This section examines eBay's rationale for acquiring Skype and the key challenges that led to the acquisition's failure. Students will analyze the strategic fit and explore why the expected synergies did not materialize. Nevertheless, this topic will be dealt with in more detail in a later section.

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**Background:** In 2005, Skype had over 54 million users, positioning itself as a leader in VoIP technology. eBay acquired Skype for \$2.6 billion, hoping to integrate its communication services into the auction platform to improve user interaction and global reach (The Wharton School of the University of Pennsylvania 2005).

**Challenges and Outcome:** However, the anticipated synergies between eBay and Skype failed to take shape. By 2007, Skype's financial underperformance led to a \$1.4 billion write-down. Misalignment between the two businesses and operational issues compounded the integration challenges. As a result, eBay sold a majority stake in Skype in 2009 (Swarit Advisors 2021).

**Discussion Points:** What were the core strategic missteps in eBay's acquisition, and how could the integration have been handled differently?

### 2. Sale to Silver Lake Partners and Other Investors (2009)

**Strategic Reassessment and Decision to Divest:** By 2009, eBay decided to refocus on its core e-commerce business and recognized that Skype's growth potential might be better realized as an independent entity. Skype also faced legal challenges related to intellectual property (Alvarez & Marsal and Henley Business School 2015).

**The Deal:** In November 2009, eBay sold 65% of Skype to an investor group led by Silver Lake Partners for \$1.9 billion, valuing the company at \$2.75 billion. eBay retained a 35% stake (Swarit Advisors 2021).

**Intention Behind the Sale:** The new owners aimed to drive innovation, expand Skype's user base, and resolve legal disputes with Joltid, ensuring technical stability (Alvarez & Marsal and Henley Business School 2015). By 2011, Skype had grown substantially, setting the stage for its acquisition by Microsoft.

### 3. Acquisition by Microsoft (2011)

**Strategic Vision and Integration:** Microsoft viewed Skype as a key asset to strengthen its communication tools across its product ecosystem, including Windows, Office, and Xbox. The

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acquisition aimed to enhance Microsoft's enterprise communication offerings and integrate Skype's capabilities into its broader portfolio. Before Microsoft's acquisition, Skype engaged in negotiations with both Google and Facebook, underscoring its significance as a strategic asset within the tech industry. These discussions reflect the competitive landscape that likely motivated Microsoft to act decisively in securing the deal (Bright 2011).

***The Deal:*** In May 2011, Microsoft acquired Skype for \$8.5 billion in cash, making it one of Microsoft's largest deals. This move underscored the company's commitment to making Skype a central part of its communication strategy (Shan 2013).

### ***Intention Behind the Acquisition:***

- **Product Integration:** Embedding Skype into Windows, Office, and Xbox to boost collaboration and communication.
- **Strengthening Enterprise Tools:** Leveraging Skype's technology to enhance Microsoft's Lync, later rebranded as Skype for Business.
- **Competitive Positioning:** Acquiring Skype also helped Microsoft eliminate a strong competitor in the communication space (Microsoft Corp. 2011).

***Integration Strategy and Challenges:*** Microsoft integrated Skype as the default messaging service for Windows and Office but faced challenges aligning Skype's peer-to-peer infrastructure with its cloud-based architecture. Significant effort was required to transition Skype to a scalable, cloud-based system (Shan 2013).

- ***Continued Evolution:*** Skype continued to evolve under Microsoft, with improvements in features and integration across its product ecosystem. Despite rising competition from platforms like Zoom and Slack, Skype maintained a strong user base in both consumer and enterprise markets (Microsoft Corp. 2011).

### ***iii. Industry & Market Environment***

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In a next step, it is appropriate to provide students with more color surrounding the industry and market environment Skype faced in the years leading up to the merger which were characterized by rapid technological advancements in broadband and Voice over Internet Protocol (VoIP) technology, intensifying competition and a post-crisis rebound in M&A activity. Students are expected to recognize how an increase in bandwidth (Case Study Appendix 1) combined with a Peer to Peer (P2P) architecture was a crucial enabler for critical improvements in VoIP technology including reduced latency, better voice quality and the capacity to handle video calls (Wang 2005). Such improvements made VoIP services a viable alternative to traditional phone calls. Among Skype's technological advancements, the P2P infrastructure was most crucial to its excellent scalability which becomes apparent in Skype's peak user numbers shown in Exhibit 2 of the case study, which grew from 1 million people being online during peak activity in 2004 to 70 million in 2013, representing an impressive compound annual growth rate (CAGR) of 60% (Baset and Schulzrinne 2004).

When looking at Skype's history and competition, students are expected to make a judgment on the credibility of threats posed by competitors to Skype and Microsoft which did not operate a strong communication platform, (Windows Live Messenger and Lync) and whether such a threat could entice Microsoft to make a move on Skype. Despite their access to an established infrastructure, a large existing customer base and funding, offerings by traditional telecommunication firms such as AT&T and Comcast could not match Skype's global reach and user numbers were rather insignificant as becomes evident in their mentioned user numbers when compared to Skype's 663 million registered users by the end of 2010 (Appendix 1). On the other hand, students are expected to point out how big tech giants such as Google, Apple and Facebook were agile, tech savvy and boasted large user bases. Integration in existing hard- and software ecosystems reduced switching friction and provided them with synergy effects making them credible challengers for Skype. Showing students Exhibit 1 of the case study

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should highlight the extent of Skype's rise against the established telecommunications sector and how Microsoft might have felt pressure to participate in such a revolutionary development in communication services.

Lastly, the above-mentioned developments provide some evidence of technological shock being a driver of the rebound in merger activity after a low in 2009 shown in Appendix 2 of the case study, representing another pressure for Microsoft to keep up with the rapid technological evolution. As mentioned by Steve Ballmer in a press conference on the day after signing of the definitive merger agreement, Skype's established user base and proven technology made it an attractive asset to participate in this rapidly evolving field (Microsoft Corp. 2011a). Additionally, it gave Microsoft a head start by not having to spend considerable time and resources to build a platform from scratch while the technology keeps evolving. Moreover, beyond showing students this deal in the context of M&A activity in the same sector, Appendix 2 in the case study lends itself to discussing how increases in merger activity tend to coincide with rich equity valuations as was the case in the dot-com bubble and 2008 financial crisis (Gugler, Mueller, and Weichselbaumer 2012).

This section, relaying information about the industry and market environment around the time of the merger, is suitable for making students appreciate the disruptive nature of technological advancements and how Skype navigated these issues to become one of the most important online communication platforms of the 2000s. Additionally, the information provided on industry and market developments serves as an aid for students in their argumentation for or against Microsoft's acquisition of Skype and highlights the pressures that might have convinced Microsoft to strike a deal.

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

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- What were the short- and long-term pressures of Microsoft to acquire Skype?
- What group of competitors of Skype posed the most credible threat to its market position and why?
- What factors can contribute to the formation of a merger wave?

### *iv. Deal Structure and Form of Consideration*

The Skype deal was by far Microsoft's largest acquisition at that point in time and continued to be so until the LinkedIn acquisition in 2016 for \$26.2 billion. Microsoft's 10Q filing for Q3 2011 states that they acquired all outstanding shares of Skype Global S.á.r.l., which was the TopCo that owned all Skype entities at the time. Appendix 4 of the case study shows Skype's shareholder structure prior to takeover.

There are important lessons to be learned from the deal structure, most notably by analyzing the well-documented and publicized form of consideration. On the M&A announcement call, Microsoft's CFO Peter Klein confirmed the total consideration of \$8.5 billion in an all-cash transaction, adding that overseas cash will be used to make this transaction (Microsoft Corp. 2011a). This was a sensible decision, considering that Microsoft had \$50 billion of cash & cash equivalents as per their 2011Q1 filing, of which \$42 billion was outside of the US and subject to "material repatriation tax effects" (Microsoft Corp. 2010). Later on, in the Q&A section of the call, CEO Steve Ballmer explained that using overseas cash is appropriate given that Skype is a Luxembourg company, adding that there are additional benefits from a shareholder and balance sheet perspective. This – among others – allowed Microsoft to obtain an effective tax rate of 17.5% in 2011, substantially lower than the statutory 35% and 9.5% lower than in 2010 (Microsoft Corp. 2011b).

Analysts on Wall Street agree according to Forbes (Savitz 2011):

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- Kirk Materne, Evercore Partners, stated that using offshore cash is a “big plus over a comparable-sized domestic acquisition of the same size”.
- Kevin Buttigieg, Collins Stewart, said that the transaction “utilizes international cash balances which Microsoft otherwise couldn’t leverage without a large tax hit”.
- Ed Maguire, CLSA Asia-Pacific Markets added that “concerns over valuation need to be weighed against alternative uses of cash”.

This represents a text-book example of a common issue that international corporations face: how to make the best use of offshore cash. Besides making acquisitions such as in this case, companies also opt for investing offshore or hoping for a tax holiday on repatriated cash. Using the cash for dividends or stock repurchases would trigger a huge tax hit and is therefore unfavored (Savitz 2011).

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

- Do you think that Microsoft would have pursued the deal also if Skype was a US company?
  - Students should provide a qualitative answer along the lines of considering alternative uses for cash, e.g repatriating the cash, triggering a tax hit; investing in CapEx overseas; pursuing other (overseas) acquisitions
  - Conclusion: Microsoft probably wouldn’t have been willing to pay such a high price if it weren’t for the overseas cash
- Why is it common for private equity-owned firms to be registered in Luxembourg?
- In what other ways besides overseas acquisitions do corporations deploy offshore cash to avoid repatriation under high tax burden?

*v. Synergies*

To analyze the acquisition of Skype by Microsoft properly, students need to understand all the merger motives behind the deal. Therefore, a deep dive into the considerations of the shareholders of Skype and the management of Microsoft is needed. This part is anticipated to initiate an in-class discussion about the completion of the acquisition and what the key drivers behind the purchase could have been. Typically, students will consider the classic merger motives like synergies, diversification intentions and market undervaluation, but students are also expected to think critically about the decision to acquire Skype, the thought process of the two parties and the acquisition price. Therefore, listing and classifying them into different tables and charts on the whiteboard will prove useful to not lose track of the arguments (Exhibit 1). The participants of the course will most likely consider positive thoughts about the acquisition, without the in-depth consideration of bad motives to merge like Winner's Curse and Hubris as well as Agency Problems and Managerialism. Especially, Winner's Curse and Hubris will be an interesting point to discuss, since it was the most expensive acquisition Microsoft had carried out. The high goodwill amount which resulted out of the purchase may also raise doubt about the deal.

First, it is needed to break down the acquirer's motives. Microsoft, one of the leading tech firms in the world, offered a diverse array of software products, services, and solutions aimed at empowering individuals and businesses to achieve their full potential. Its flagship products, Microsoft Windows and Microsoft Office, were market leaders in the fields of personal computer operating systems and office suites. Therefore, from a strategic view, Skype could fit well to Microsoft's already established products. The following motives played a role for Microsoft acquiring Skype:

- 1. Achieving synergies through tax considerations and savings:** As detailed in the Deal Structure & Form of Consideration paragraph, the first motive has nothing to do with

the technology between the product range of Microsoft and Skype and will not be the go-to answer students will talk about, but it should be a point to discuss and to learn from. Microsoft, like most big tech companies, had billions of dollars in profits held offshore, which could not be brought back to the US without incurring taxes. Consequently, these funds could not be used to pay dividends, buy back shares, or hire employees in the US. Skype was based outside the US, allowing Microsoft to use these offshore funds for the acquisition. As Damodaran stated, when considering possible tax savings and the resulting synergies, a seemingly high purchase price becomes more understandable (Damodaran 2005).

- 2. Enhancing Microsoft's communication technology position by adopting a competing technology and preventing the acquisition by other competitors:** Skype was a popular platform providing internet-based voice and video calling services. By acquiring Skype, Microsoft aimed to solidify its standing in the communication technology market and better compete with tech giants like Google and Apple, which potentially could have also been interested in acquiring Skype (Halliday 2011). Moreover, Skype's technological growth by itself threatened Microsoft, so the motive for a strategic takeover to adopt competing technology was given. Furthermore, by preventing competitors from entering its focused product market space, Microsoft may preserve the firm's high growth phase for longer (Damodaran 2005).
- 3. Integrating Skype into Microsoft's already existing division structure and product and service lines (strategic alliances):** Microsoft identified an opportunity to incorporate Skype into its existing products and services, such as Microsoft Office and Xbox. It was not planned to hold Skype in a separate company, but rather to integrate it in its already existing division structure. Therefore, Skype became a distinct division within Microsoft, with Tony Bates, the former CEO of Skype, serving as the head of

this unit (Appendix 3). The integration was intended to improve user experience and add value for Microsoft's customers (Kolakowski 2011).

4. **Leveraging Skype's user base:** At the time of the acquisition, Skype boasted around 660 million users worldwide (Appendix 1). Acquiring Skype gave Microsoft access to this extensive user base, presenting opportunities for monetization through advertising, premium services, and other revenue streams.
5. **Strategic importance of voice and video communication:** With the increasing importance of voice and video communication in the tech industry, particularly due to the rise of smartphones and the popularity of video calling, Microsoft positioned itself to capitalize on this trend and broaden its communication offerings by acquiring Skype.

First, it is advised that the instructor directly asks the students which motives could have played a role for Microsoft's interest in acquiring Skype. As already stated, it is expected that most of the answers will relate to synergies and diversification aspects. These answers based on the above listed motives are correct, but students are expected to go more in-depth and analyze the product portfolio of Microsoft to understand which products and services of Microsoft could be enhanced (Exhibit 2) by the acquisition of Skype. Although, the case is a typical example of a strategic acquisition, students are expected to defend their arguments and give deeper insights to the synergies they came up with. Moreover, participants will undoubtedly analyze the price Microsoft paid and the high goodwill amount, which resulted out of the acquisition. Therefore, students may state that there could have been an overpayment and refer to Winner's Curse & Hubris, which is not a main motive in our case. It would be interesting for the instructor to ask which evidence students have for the Winner's Curse & Hubris motive and why they think Microsoft overpaid, since it is hard to measure Skypes real value. Furthermore, a discussion about integration problems should be held (Arthur 2013). An interesting point that could be introduced is the aspect of synergies through tax considerations and savings (Damodaran 2005).

## GENERAL PART

Since the expected focus of students will be the above-named motives, this could be a valuable learning experience. Subsequently, it could be interesting to give a hint to the high levels of cash Microsoft held as described in more detail in the Deal Structure & Form of Consideration section, which is a common phenomenon for the tech industry, and to ask what the students' opinion on the all-cash transaction is. Furthermore, at this stage it should be discussed that having a lot of cash on hand can cause agency problems, which may lead to value destroying actions, like overpayment in an acquisition deal (Jensen 1996).

The following list of standard questions is proposed. The instructor is free to modify them to better fit to the specific course and students:

- What were the main motives of Microsoft to acquire Skype?
- Which of Microsoft's services or products could be enhanced by the technology Skype offers?
- Why does the business model of Skype fit more to Microsoft compared to eBay?
- Was it only about synergies or were legal aspects also involved?
- Was Skype's user base important to Microsoft?
- Was it a move to prevent the acquisition by its competitors, or saw Microsoft other opportunities in Skype?
- What could be motives of an all-cash transaction?
- What were the potential risks and considerations Microsoft was facing?

After pointing out Microsoft's perspective, it is important to have a look on the other side of the table, the view of Skype's shareholders. Before the acquisition by Microsoft, Skype was held by an investor group led by Silver Lake Partners and eBay. The motives of the shareholders to sell Skype to Microsoft were the following:

## GENERAL PART

- 1. Profit Realization:** The sale presented an opportunity for Silver Lake Partners and other investors to secure a substantial return on their investment. Having acquired a majority stake in Skype from eBay in 2009, the \$8.5 billion deal with Microsoft represented a significant profit of more than \$5 billion (Reuters 2011).
- 2. Strategic Focus:** For eBay, divesting Skype allowed the company to concentrate more on its core e-commerce and payment businesses. Skype was not a natural fit with eBay's primary operations, and selling it helped streamline their business strategy.
- 3. Legacy considerations:** Some investors may have believed that Skype could achieve greater integration and value under Microsoft's ownership. Microsoft's extensive software and hardware ecosystem offered synergies that were less achievable while Skype was independent. Therefore, some shareholders may have searched for an adequate takeover to extend Skype's reach and preserving its relevance. There were no statements regarding that point when the acquisition took place, but it's still worth mentioning.
- 4. Market Conditions:** The timing of the sale was favorable. The technology market was strong, and Microsoft was keen to enhance its position in communication technology. This made Microsoft a motivated buyer willing to pay a premium.

The instructor and the group of students should speak about the position of the sellers and their motives, but the focus should be on the decision of Microsoft to acquire Skype. The following whiteboard activities are recommended to foster student interaction:

- Draw a table on the whiteboard with two columns: one labelled "Merger motives of Microsoft" and the other "Merger motives of Skype" (Exhibit 1).
- Invite students to suggest both obvious and hidden motives for each party, recording these ideas in the respective columns.

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- Facilitate a discussion on the various motives and their potential implications for each group.

After a hopefully exhausting, insightful, time-consuming, and valuable debate it is important to give students the opportunity to process what they have learned and recollect their thoughts. Therefore, the perfect timing for the instructor to give students a break has arrived.

### *vi. Valuation*

The goal of this valuation exercise is to understand whether Microsoft's payment for Skype was justified based on conventional intrinsic and extrinsic valuation methods. Having in mind Skype's extensive M&A history and previously published valuations in this context (Exhibit 3), the instructor can elect to spend more time on this chapter by performing more detailed calculations of key variables such as discount rates and cash flows. It is worth noting that a considerable part of Skype's valuation and balance sheet came in the form of intangible assets such as goodwill and intellectual property, which will be discussed in further detail in subsequent sections. This part focuses on a more high-level approach to valuing Skype from Microsoft's perspective with traditional valuation methods. This involves forecasting Skype's standalone business prospects, as well as accounting for possible synergies and new revenue streams such as advertising, that Skype had announced in its IPO filing. For the scope of this case study, students are expected to perform a high-level DCF and comparable company valuation (CCA), critically using the data in the student excel resource. The excel provided to the instructor contains a free cash flow forecast based on Skype's historical financial data and forward-looking statements disclosed in its April 2011 amended IPO filing as well as new advertising revenue from a 3<sup>rd</sup> party analyst research report (Winslow, Dennis, and Panigrahi 2011). With the information made available in the case study text and exhibits, students are expected to derive an appropriate method to forecast Skype's top-line growth, include new

## GENERAL PART

revenue streams/synergies, assume prudent margin levels and extrapolate historical line items to arrive at a sensible free cash flow. Notable differences to the model valuation could stem from (i) assumptions regarding top-line growth such as the development of paying users and revenue per user as well as other revenue growth, (ii) inclusion or exclusion of new advertising revenue streams, (iii) EBITDA margin forecast, (iv) D&A assumptions with regards to the amortization of acquired intangible assets resulting from purchase price accounting/ write-up of the private equity transaction, and (v) WACC and terminal value assumptions. Specifically, for the WACC students are to elect between the Skype WACC and the Microsoft WACC at the time, concluding that it is more accurate to apply the Skype WACC as cash flows with a certain risk profile (i.e. that of the company Skype) should be discounted at a rate reflecting the cost of such risk. While there is no right or wrong answer as intrinsic valuation is widely considered more art than science, the forecast at hand serves as a blueprint that a prudent investor from Microsoft's perspective would have likely considered.

In addition, a CCA based on public competitors as well as multiples disclosed in the IPO prospectus is made available to the instructor. With the data at hand, Students are expected to recognize which peers shall be considered to further analyze Skype's value based on multiples. They will be provided with a list of potential peers and their necessary financial data. Two unsuitable peers not active in the VoIP sector are provided and should be excluded from the valuation to arrive at an enterprise value of \$6.359 billion with Skype's 2010 financials and USD \$9.107 billion in 2011.

With exception of data in the IPO filing, market data was collected based on the valuation date of 30 April 2011, the day of the acquisition announcement. The resulting valuations are displayed in a football field chart (Exhibit 5) and range from \$3.122 billion to \$12.216 billion. Considering a weighing of 15% for EV / Sales and EV / EBIT multiple, 20% for EV / EBITDA

## GENERAL PART

and 50% for the DCF, representing a standard even split between market and intrinsic valuation in the absence of more detailed cash flow forecast and a more suitable peer group, the associated control premium is 10.4%.

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

- Which valuation methods would be suitable for Microsoft to apply?
- Does the purchase price represent a premium to Skype's intrinsic value and what factors might justify this premium?
- What are the potential synergies that Microsoft expected from this deal?

### ***vii. Decision Point***

At this point, decision makers are well aware of the tumultuous acquisition history of Skype and have studied in detail the context of the VoIP and broader technology sector sentiment at the time of the acquisition. In addition, the Head of Business Development and M&A thought extensively about merger motives from Microsoft's perspective, the contemplated deal structure, as well as applying a variety of valuation techniques to find a fair value for Skype. At this point, they are challenged with the decision of whether to proceed with the acquisition or not.

## INDIVIDUAL PART – JAN GRUENER

### ***viii. Strategic and Financial Rationale of eBay's Acquisition of Skype: Hubris or Strategic Misalignment:***

This section introduces students to the analysis of Mergers & Acquisitions in the tech sector and focuses on the importance of strategic alignment and managerial prudence. It thoroughly

examines the intentions behind the acquisition of Skype through eBay in 2005 and delves deeper into the reasons why this acquisition turned out to be a failure in terms of strategic goals. After evaluating the materials made available in this part of the case study, course participants should be able to understand strategic motivations and challenges behind mergers and acquisitions in the tech sector. Furthermore, they are expected to be able to distinguish between hubris/overconfidence and strategic misalignment/mismanagement, and to be aware of critical factors involved in such acquisitions or mergers, such as overestimated synergies and strategic fit issues.

#### **a. Introduction**

The purpose of this section is to introduce students to M&A in the tech sector through eBay's acquisition of Skype, focusing on how such deals in the tech sector provide access to markets, talent, and technology. Mergers & Acquisitions are a key strategy for tech firms seeking market access, capabilities, or diversification, often involving startups with limited funding and cash flows (Rossi, Yedidia Tarba, and Raviv 2013). However, firms in this sector are frequently valued on future potential rather than stable earnings, increasing risks of overestimated synergies and cultural mismatches (Ranft and Lord 2002). Aligning distinct corporate cultures is especially challenging, as startups' innovative and agile environments often contrast with larger, hierarchical firms, hindering synergies (Gerpott 1995). Careful planning and realistic valuation are crucial to success (Rossi, Yedidia Tarba, and Raviv 2013).

The \$2.6 billion eBay-Skype deal in 2005 highlights these issues. eBay aimed to enhance its auction platform with Skype's voice-over-internet technology, but the expected synergies failed to materialize. Instructors should encourage students to critically assess valuation challenges and cultural hurdles in tech M&A, emphasizing the importance of strategic planning and

accurate valuation to avoid complications. As mentioned above this part should serve as a brief introduction for students to the overall deal.

The following list of standard questions is proposed with regards to M&A in the tech sector.

The instructor is free to modify them as they please:

- Why do you think companies in the tech sector pursue mergers and acquisitions? What specific benefits might they aim to achieve?
- Why are tech companies often valued based on future potential rather than current performance, and what risks does this create and what challenges are involved when acquiring companies in the tech sector?
- Have you heard of eBay's acquisition of Skype? What do you know about it?

#### **b. Learning Objectives**

After working on this part of the case study, students are expected to develop the following competencies:

- Understanding the strategic motivations behind M&A in the tech sector, as well as the challenges of cultural integration and strategic fit in post-merger success.
- Analyzing the risks of overestimating synergies and revenue projections while evaluating M&A failures, including the roles of hubris and mismanagement.
- Applying theoretical frameworks (e.g., synergies, hubris hypothesis, and strategic fit/misfit) to critically evaluate real-world cases like the eBay/Skype acquisition.

At the end, students will address the central question: **Was the failure of eBay's acquisition of Skype due to hubris or strategic mismanagement/misfit?**

#### **c. Teaching Plan**

The following teaching plan is recommended for the instructor's use:

- Explaining the strategic motivations for M&A in the tech sector and challenges involved in successfully acquiring a company.
- Delve deep into the overall structure of the acquisition of Skype through eBay and the intention behind this deal.
- Teaching theoretical concepts of synergies, hubris, strategic (mis)fit and cultural integration.
- Preparing students to carry out a Comparable Company Analysis (CCA) and Comparable Transaction Analysis (CTA) and set this valuation in context with the previous qualitative analysis.

#### **d. The Acquisition of Skype through eBay**

After having introduced the students to the basic motivations and challenges of tech M&A deals, now the instructor can bring the students' attention to the strategic motivations and envisions behind eBay's acquisition of Skype. As previously described, eBay acquired Skype for \$2.6 billion, with the goal to expand its e-commerce business through the integration of communication technology. At that time, Skype was seen as one of the most prestigious startups in the Voice over Internet (VoIP) technology, with a userbase of over already over \$50 million and projected revenues of \$60 million in 2005 (Belson 2005).

However, in 2004, Skype's revenues were still only \$7 million, implying a revenue multiple of 370x based on 2004 and 43x based on projected revenues in 2005. Even though the growth expectations were impressive, this was extremely high for a company that had not yet demonstrated significant profits (Forbes 2005). Back then, the CEO of eBay, Meg Whitman, defended this move with the potential of enhancing user interaction during auctions. Particularly high-value sectors like automobiles and real estate, should be the main categories benefiting from real-time communication and build more trust (The Wharton School of the University of Pennsylvania 2005).

However, already from the beginning of the acquisition, the strategic fit between those two companies was not given for some experts, as some said that eBay's auction-based model did not naturally align with Skype's communication platform. These doubts proved to be true, as users did not adopt it as previously anticipated, thus many of the expected revenue synergies failed to materialize. Additionally, competition in the VoIP grew rapidly, with Google and Microsoft entering the market as well making it harder to increase market share of Skype.

The eBay-Skype case serves as an excellent illustration of the complexities involved in post-merger integrations in fast-paced environments. In class, students should discuss and critically analyze the underlying problems, why eBay's strategic goals failed and delve deeper into alternative approaches that would have proved more successful.

For this section the students should learn the following lessons:

- Understand the concept of strategic fit in M&A transactions and why the fit between eBay and Skype was problematic.
- Analyze the role of synergies in mergers and why they often fail to materialize, particularly in tech deals.
- Explore post-merger integration challenges and how cultural and operational differences can hinder success.

The instructor should present eBay-Skype as a real-life example of strategic motivation of mergers and integration complexities. The instructor should encourage students to discuss eBay's motivations for acquiring Skype, the multiple of revenues paid, and problems of integration. When evaluating why specific objectives were unmet at eBay, the instructor should talk with the students about the strategies eBay could have used to enhance integration and potential/cautionary measures that are associated with major tech acquisitions.

To foster engagement, instructors should encourage students to discuss how eBay could have handled the acquisition differently. Questions to prompt discussion include:

- What were the main strategic steps eBay made in the acquisition of Skype?
- Could eBay have structured the deal differently to ensure better integration?
- How might eBay have predicted the challenges associated with Skype's fast-growing but volatile market?

To extend the discussion, students should be encouraged to apply theoretical concepts that include the hubris hypothesis whereby overconfidence of managers in their abilities may lead to wrong acquisition decisions. Furthermore, talking about concepts like the strategic fit and misfit hypothesis should enable students to understand the reasons for the failure of some merge efforts because of the mismatch of business models. The mentioned theories will be described in the following section to set the stage for deeper analysis in this part of the teaching note.

#### **e. Theoretical Concepts**

##### *1. The Promise of Synergies*

One of the most fundamental motivations behind M&A deals in business practice are synergies. The instructor should discuss with the students the intentions behind synergies and in what form they can appear. They come in two primary forms: cost synergies and revenue synergies (Damodaran 2005). The concept envisions the belief that the whole is greater than the sum of its parts and that such improvements in efficiency and other enhancements can be unlocked through means of an acquisition or merger.

- *Cost synergies:* Such synergies can be achieved through the sharing of facilities, eliminating overlapping activities or achieving a scale that is more efficient. For instance, mergers can help two firms to rationalize their office services like human resources or information technology to remove redundancies and slashed expenses. Further, they might be able to bargain better with suppliers from the realization of a shift in the bargaining power in their favor.

- *Revenue synergies*: Synergies where the combined entity generates higher profits than two separate firms could have done on their own. It could occur due to synergies such as cross-sell, access to new customers or markets, or indeed the improvement of the customer journey. The concept is that the creation opens up new sources of growth which would not have been open to those establishments individually.

In the case of the eBay/Skype integration, the primary rationale was revenue synergy: according to eBay management, Skype VoIP was an excellent communication tool that could complement its auction marketplace, enabling theorization of buyers and sellers on its auction site. The rationale was that improving this communication would reduce the number of problems arising from the sales side of these contracts, leading to a higher volume of transactions to the satisfaction of the contracting parties (Belson 2005). In addition, eBay planned to integrate Skype with PayPal, eBay's payment processor, allowing users to complete the entire value chain, which would also stimulate growth for both companies.

However, as is the case with most M&A deals, the projected synergies are difficult to achieve. According to Kaplan and Weisbach (1992), the amounts that are expected as synergies are often only 30-50% of what is usually achieved in mergers and acquisitions, and this is usually caused by underestimating the amount of effort required to operationalize these synergies. In the case of eBay and Skype, the primary compatibility problem was that they were two companies whose business models were essentially incompatible. This form of communication did not complement Skype's original peer-to-peer platform with eBay's auction method. The two services operated in completely different ways, and it was virtually impossible to make them work well together.

Besides that, it is also worth mentioning that eBay mainly relied on revenue synergies as the foundation of the deal. Unlike cost synergies, which are more controllable, revenue synergies depend heavily on market conditions and external factors beyond management's control,

making them inherently less reliable. Given the uncertainty surrounding these synergies, it would have been prudent to apply a higher discount rate during the valuation process. This, in turn, should have resulted in a more conservative deal price unless Skype's standalone value was robust enough to justify the high acquisition cost.

In the end, the anticipated synergies between Skype's consumer base and PayPal were never realized. The vision of combining communication and payment services seemed more than logical, yet in real life, Skype had a very different audience than does PayPal. Therefore, there was no improvement of sales and an integration cost which the company could not bear, making the acquisition to turn out to be a great drain on eBay (Wray 2009).

## *2. Hubris Hypothesis*

The hubris hypothesis, which was originally developed by Richard Roll in 1986, provided a compelling explanation for problems arising from M&A failures. According to this theory, managers are prone to develop overconfidence in their ability to create value from M&A deals. They believe that they can almost always realize synergies, which others cannot, and therefore tend to overpay in acquisitions. Roll's hypothesis suggests that such hubris leads managers to overlook the risks and challenges associated with an acquisition, which in turn may lead to worse results than anticipated.

In the case of the eBay/Skype acquisition, hubris may have played a pivotal role, which can be shown through several indicators. Firstly, the acquisition price paid for Skype was exceptionally high compared to other technology acquisitions at a revenue multiple of 370x in 2004 and 43x in 2005 respectively (Forbes 2005).

Further evidence of overconfidence or hubris are eBay's revenue forecasts for Skype, which expected Skype's top line to grow from merely \$7 million in 2004 to \$200 million in 2006, representing an increase of nearly 3.000% in just two years (Forbes 2005). For a company that had not yet developed a fully sustainable business model, such rapid growth seemed rather

unusual from an objective point of view. It is particularly interesting to note that eBay's management believed that such a level of growth was feasible, implying that they may have overestimated their ability to drive performance post-acquisition.

### *3. Strategic Fit and Misfit Hypothesis*

Another theoretical concept, which is important when analyzing this case is the Strategic Fit and Misfit hypothesis. It suggests that whether an acquisition will be a success or failure largely depends on how well the target's operations and business model aligns with the acquiring company's strategic goals (Chatterjee 1986). If two companies strategically fit together well a successful integration is more likely than when strategic misalignments are present, since in this scenario the acquirer and target do not complement each other in value creating ways.

Taking our eBay and Skype case now as an example, objectively speaking there were indications of strategic misfits. eBay was a transaction-based platform concentrating its resources on facilitating online auctions, while Skype was a fundamentally different business model with its peer-to-peer communication platform. Neither did the two companies have complementary strengths (at least perceived by the customers) which could be leveraged to create value, nor was it possible to tie it to any other business units like PayPal (Wray 2009). Moreover, eBay's core strategic goals did not align with the integration of Skype. While the primary objective was to increase transaction volumes through an enhanced, more personal user experience, most of the auction page's users did not see value in this added opportunity with many of them still preferring anonymity in the auctioning process.

### *4. Cultural Clash and Integration Failures*

The post-merger integration (PMI) phase is arguably the most complex but also poses one of the biggest opportunities to add value during an acquisition. A KPMG study (2019) showed that more than 80% of mergers fail to capture the expected value. This is because it can be challenging to integrate two entities which have different cultures, strategy and operating ways.

Skype was operating on a proven business model and enjoyed strong operational efficiency with a rather traditional corporate culture. In contrast, Skype was a fast-growing startup with all the typical entrepreneurial chaos of the most similarly situated companies. There were substantial cultural differences which came to be seen as insurmountable in hindsight but probably saved both firms billions when they failed.

This cultural mismatch made the integration even harder with all the other arising issues already mentioned. Although eBay's top management envisioned Skype as a way to enhance online transactions for users, the reality showed that these companies operated in fundamentally different ways. The result was integration challenges due to the naturally misfitting cultures further contributing to the failure of this acquisition (Johnson 2007).

When delving deeper into the eBay/Skype case it is suggested that the instructor further discusses these key theoretical frameworks to provide a foundation for evaluating M&A outcomes. Additionally, the instructor should encourage the participants to apply them to the case and other real-world scenarios in order to foster a more profound understanding of non-financial aspects of M&A deals.

The instructor should present key theoretical frameworks, including synergies, hubris, and strategic fit/misfit, to provide a foundation for evaluating M&A outcomes. He or she should also encourage students to apply these theories to the eBay-Skype case and other real-world scenarios, fostering a deeper understanding of the non-financial aspects of M&A.

Students examining the eBay-Skype deal should focus on the critical concepts of synergy creation, the hubris hypothesis, and strategic fit/misfit. After identifying the relevant conceptual theories, students should be able to differentiate between hubris (overconfidence in managerial abilities) and strategic mismanagement (misalignment of business models), which are common in M&A failures. Appendix 5 of the case study summarizes the key differences between hubris

and strategic mismanagement and can be used as additional help to find suiting arguments for each in light of the Skype/eBay acquisition.

Exhibit 6 of the teaching note then shows a detailed but not exhaustive overview of the arguments in favor of hubris/overconfidence and those in favor of strategic misalignment/mismanagement. After the students have examined these distinctions between hubris and strategic mismanagement, they should come up with arguments listed in this exhibit and come to the conclusion that even though hubris definitely played a role in this deal, strategic mismanagement and misfit was the dominant reason for the failure of Skype's acquisition through eBay. Undoubtedly, eBay's chief executive Meg Whitman and the management showed overconfidence, which becomes evident through their inflated valuation and growth expectations. Nevertheless, the core issue was the strategic misfit and mismanagement that saw the deal eBay's transaction-driven marketplace and Skype's peer-to-peer communication platform fail. This misalignment hindered the realization of the envisioned synergies and enhancement of the customer experience during online auctions.

#### **f. Quantitative Analysis: Valuation of Skype at the Time of eBay's Acquisition**

As complementary exercise, course participants are expected to use adequate valuation methods to value the value of Skype at the time of its acquisition through eBay. As Skype was still a relatively young company at that time only existing for two years, certain valuation methods like DCF are not feasible due to their non-existing track records and negative free cash flows. Furthermore, multiple methods might only be possible for certain ratios or industry specific multiples need to be used.

Here, the instructor should discuss the possible methods with the students to let them develop a better understanding for company valuations and things to consider when doing such valuations.

The following list of standard questions is proposed with regards to the valuation methods that can be used. The instructor is free to modify them as they please:

- What valuation methods should be considered for a young company like Skype when there don't exist any track records?
- What circumstances might hinder someone doing a CCA from using multiples like EV/EBITDA, EV/EBIT, etc.?
- When looking at comparable companies and precedent transactions analysis for a company like Skype and the tech industry, are there special multiples which might make sense to consider (EV/users, EV/customers)?
- Even if there are such industry-specific multiples, what are difficulties when it comes to gathering sufficient and reliable information?

After teaching the course participants these concepts, they are expected to do a comparable company valuation (CCA) and a precedent transaction valuation (CTA). For the former one, students will be given a set of comparable companies (Exhibit 13, Case Study) of which to choose only suiting companies and exclude those which can't be considered peers (Exhibit 7, Teaching Note). Additionally, students receive the companies' market data to carry out the CCA (Exhibit 14, Case Study). In Exhibit 15 & 16 of the case study, course participants also will have a list of comparable precedent transactions and transaction data to perform the CTA. Due to the lack of more robust data favoring either method for a young, high-growth tech firm like Skype back then, students should apply a weight of 50% to each of the methods. With the results from these two multiples valuation methods, they should arrive at a standalone value for Skype of \$215 million.

When comparing this standalone multiples method valuation to the actual buying price of \$2.6 billion, it can be seen that the merger premium is close to 1,200% - much higher than any of the previous transactions in the VoIP sector, which further strengthens the underlying argument that even though Skype's revenue growth in the following years was extraordinary high, eBay has overvalued Skype. This is also consistent with the previous qualitative analysis of whether hubris or strategic mismatch played a greater role in the deal's failure. While revenues were ambitious but not far below management's expectations in the years following the acquisition (Skype S.à.r.l. 2010), the primary problem was the inability to integrate Skype's VoIP business model into eBay's transaction-driven marketplace.

#### **g. Epilogue**

eBay's 2005 acquisition of Skype, once seen as a bold move to enhance its platform, ultimately became one of the most notable failures in tech M&A. Indeed, by 2007 eBay had to write down \$1.4 billion of Skype's value, admitting the deal had fallen short of its anticipated goals. The misalignment between eBay's transaction-driven business and Skype's peer-to-peer communication model, combined with still overly ambitious revenue projections, doomed the partnership (Wray 2009).

In 2009, eBay sold 65% of Skype to a private equity group for \$1.9 billion, officially acknowledging the failed integration. However, Skype found new life under its new owners, and in 2011, it was sold to Microsoft for \$8.5 billion— even though through the 30% eBay still held, they eventually made a profit of that acquisition, this deal highlights the importance of strategic alignment in realizing a company's potential (Reuters 2011)

*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 1: Board Plan for the Merger Motives of both Parties

Merger motives of Microsoft	Merger motives of Skype
<ul style="list-style-type: none"> <li>Achieving synergies through tax considerations and savings</li> <li>Enhancing Microsoft's communication technology position by killing a competing technology and preventing the acquisition by other competitors</li> <li>Integrating Skype into Microsoft's already existing division structure and product and service lines (strategic alliances)</li> <li>Leveraging Skype's user base</li> <li>Strategic importance of voice and video communication</li> </ul>	<ul style="list-style-type: none"> <li>Profit Realization</li> <li>Strategic Focus</li> <li>Legacy Considerations</li> <li>Market Conditions</li> </ul>

Exhibit 2: Relationship between Skype and Microsoft's Products and Services (Shan 2013)



Exhibit 3: Skype Valuation History (own calculation)

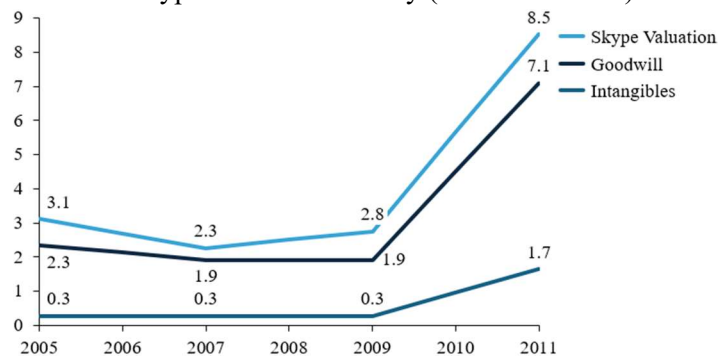


Exhibit 4: Skype Comparable Companies, 2010 (S&P Capital IQ)

Comparable Companies	Company Description	Exclusion Criteria
<b>8x8 Inc.</b>	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.	Included
<b>BroadSoft Inc.</b>	A provider of software solutions enabling telecom service providers to offer VoIP and unified communication services.	Included

<b>Akamai Technologies Inc.</b>	A global leader in content delivery networks (CDN) and cloud services	Size and Industry
<b>Vonage Holdings Corp.</b>	A consumer and business-focused VoIP provider, with a subscription-based revenue model similar to Skype.	Included
<b>VeriSign Inc.</b>	A provider of domain name registry services and internet security solutions	Size and Industry
<b>ShoreTel Inc.</b>	A company specializing in business-focused unified communication solutions	Included

Exhibit 5: Football Field Chart

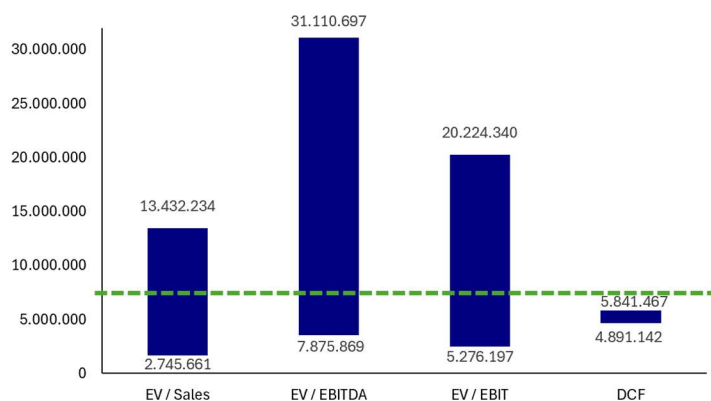


Exhibit 6: Arguments for Hubris and Strategic Misalignment

<b>Hubris/Overconfidence</b>	<b>Strategic Misalignment/Mismanagement</b>
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 7: Skype Comparable Companies, 2005 (Bloomberg)

<b>Comparable Companies</b>	<b>Company Description</b>	<b>Exclusion Criteria</b>
<b>8x8 Inc.</b>	A VoIP and cloud communications provider with a subscription-based model, directly comparable to Skype's core business.	Included

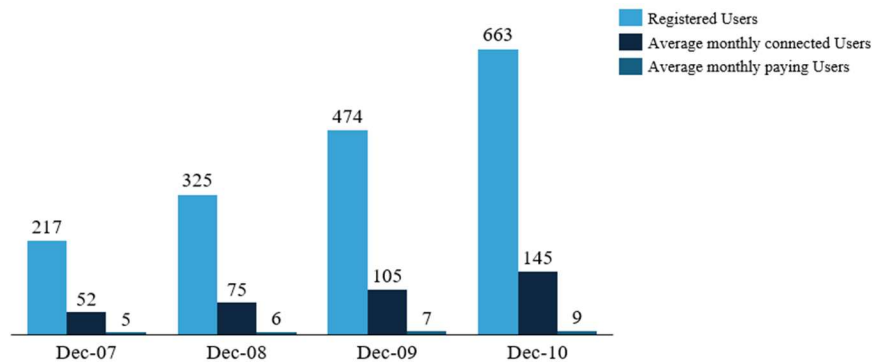
<b>Level 3 Communications Inc.</b>	Primarily provided network services, including VoIP solutions, internet connectivity, and content delivery.	Included
<b>Verisign Inc.</b>	A provider of domain name registry services and internet security solutions	Size and Industry
<b>IDT Corp.</b>	A telecommunications company with direct involvement in VoIP services, including its acquisition of Net2Phone.	Included
<b>magicJack</b>	A consumer-focused VoIP provider offering low-cost internet-based telephony similar to Skype.	Included
<b>Nortel Networks</b>	A telecommunications technology company with significant investments in VoIP infrastructure.	Size and Industry
<b>RealNetworks Inc.</b>	An internet-based media pioneer leveraging platforms for user engagement including VoIP.	Included
<b>Avaya Inc.</b>	A provider of unified communication systems, including VoIP solutions for businesses.	Included

Exhibit 8: Skype Comparable Companies Financials, 2005 (Bloomberg)

<b>Company</b>	<b>Current Market Cap</b>	<b>Net Debt</b>	<b>Enterprise Value</b>	<b>EV / Sales</b>
8x8 Inc.	190.734,21	-22.721	168.013	17,6x
Level 3 Communications Inc.	2.327.223,88	4.429.000	6.756.224	1,8x
IDT Corp.	1.482.541,37	-963.741	518.800	0,2x
magicJack	21.415,80	-6.578	14.838	2,7x
RealNetworks	1.129.544,10	-263.621	865.923	3,2x
Avaya Inc.	8.246.541,26	-543.000	7.703.541	1,8x

## Appendix

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



### Appendix 2: Merger Decision Pros & Cons List

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



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