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VECTOR VICTORIOUS

ALEXANDER SLUSKY HAS TAKEN HIS PRIVATE EQUITY FUND ON THE BUYOUT ROAD LESS TRAVELED: INVESTING IN MATURE, CYCLICAL AND VOLATILE TECHNOLOGY COMPANIES. SO FAR HE'S MAKING IT WORK.

BY VYVYAN TENORIO

IN DECEMBER 2002, Canadian software company **Corel Corp.** hosted a luncheon presentation for investors at the Mandarin Oriental hotel in San Francisco. In a room of tables set for 30, sat three people, including Amish Mehta, a partner at buyout boutique **Vector Capital**. Corel, maker of WordPerfect and CorelDRAW graphics products, was footing the bill, hoping to entice investors to hear chief executive Derek Burney make his pitch and bolster the company's flagging stock.

Halfway through Burney's presentation, before finishing up their salads, the two other investors stood up and left. Mehta and Burney stared at each other, then adjourned to the nearest bar, where Burney vented his frustrations over Corel's fortunes as a public company. Months later, Corel agreed to be taken private by Vector Capital for $120 million.

Being in a lonely spot doesn't faze the San Francisco private equity firm, which goes out of its way to take on mature, underperforming software businesses. Indeed, as Alexander Slusky, Vector's 39-year-old founder and managing partner says, the firm found its sweet spot in Corel, whose growth had been stymied by costly forays into new-product development. Under Vector, Corel drastically revamped its business around anchor products and went public again in less than three years. Its market value has effectively tripled what Vector paid, and the May 2 initial public offering yielded a tidy return, on top of nearly $140 million in profits via pre-IPO dividends.

In an era of private equity club deals and fiercely contested auctions, Vector Capital cuts a distinctive profile in the middle market. It spots undervalued or undermanaged technology companies that it shepherds through restructuring—deals that many buyout firms won't touch. In this respect, Vector Capital keeps company with a small but growing subset of tech buyout specialists, like **Silver Lake Partners**, **Golden Gate Capital**, **Gores Technology Group LLC** and **Platinum Equity LLC**.

"Vector Capital was one of the pioneers to go into technology buyouts, and it has a nice niche in the small end," says Clint Harris, managing partner at Wellesley, Mass., advisory firm **Grove Street Advisors**, a limited partner in Vector Capital's last two funds.

The hard-driving Slusky insists on hiring only professionals with financial savvy and requisite technology credentials to undertake situations such as Corel. Before joining Vector in 2002 and serving as Corel CEO, Mehta headed retailing software maker **Commercial-Ware Inc.** Prior to that, he was at private equity firm General Atlantic Partners, now **General Atlantic LLC**, of Stamford, Conn., where he invested in enterprise software and IT infrastructure companies.

"Generalist investors are not going to be ultimately successful in our business because you just need to live and breathe technology besides having financial sophistication," says Slusky. "There aren't many firms that can do both."

Now on its third pool of capital—a $350 million fund raised in 2005—Vector Capital can point to a recent run of liquidity events that showcase its investing style. In April, it sold security management systems provider Landesk Software Inc., a spinout from **Intel Corp.**, to **Avocent Corp.**, a deal valued at around $450 million. Close on its heels, announced in May and not yet closed, was a $400 million acquisition of another portfolio holding, **Savi Technology Inc.**, by defense contractor **Lockheed Martin Corp.** It

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also divested a corporate services division of domain name registrar **Register.com Inc.** to **Corp. Service Co.** of Wilmington, Del., for an undisclosed sum. All told, realizations and pre-IPO payouts generated nearly $750 million, including the value of its remaining 66% Corel stake.

For Vector, recent successes appear to have boosted its confidence to go for larger targets. The firm has allied with entrepreneur Steven Mihaylo for a possible take-private bid for Mihaylo's old company, Tempe, Ariz., telecom software and services provider **Inter-Tel Inc.** If Vector is successful, Inter-Tel—which could go for upwards of $600 million—will be its largest investment yet. Last month, it also formalized its bid to buy Seattle-based Internet security company **WatchGuard Technologies Inc.**, putting a $5.10 per share price tag on its offer.

Mehta: *"what was required was a dramatic turnaround"*

What's novel about Vector is that unlike many traditional buyout firms, it isn't afraid to bet on technology companies with cyclical revenue and volatile earnings. "Most buyout firms have tended to stay away from technology buyouts because the technology risks are too high and they can't leverage comfortably, although this is changing," says Harris. On the other hand, venture capitalists are not keen on buying those companies.

"There's definitely a place in the food chain for firms like Vector Capital," says Stephen O'Leary, senior managing director at technology advisory firm **Jefferies Broadview**.

Like the rest of his team, Slusky is a workaholic who is generous with his time, say portfolio company executives. Slusky was born in Ukraine, before coming to the U.S. at 12. Barely conversant in English then, Slusky now speaks at a rapid-fire clip. With engineers as parents, Slusky became interested in technology, spending summers at **Microsoft Corp.** headquarters outside Seattle where his family settled. Despite a brief stint as product manager at Microsoft, Slusky says he was never tempted to be a computer engineer. "I have tremendous respect for what engineers accomplish, but I've always loved analyzing a business in its totality, rather than as a specialist in one function."

He received a B.A. in economics at Harvard University and an M.B.A. at Harvard Business School, where he was a George F. Baker Scholar.

Slusky started his career in venture capital, working at Menlo Park, Calif., VC **New Enterprise Associates**, focusing on software, communications and digital media. Among his regrets: passing on search browser provider Netscape Communications Corp. "I tried to convince NEA to invest in Netscape, but they wouldn't support the high valuation [founder] Jim Clark was asking. NEA made me introduce the deal to John Doerr [of **Kleiner Perkins Caufield & Byers**], hoping he would talk some sense into Jim on valuation. Instead, John just did the deal himself at the price Jim asked," he recalls.

He soon realized that the most promising deals required a combination of venture capital's deep industry knowledge and private equity's hands-onapproach. The two NEA deals that Slusky flagged as his key contributions were both special situations. One was Platinum Software Corp., now **Epicor Software Corp.**, which he says he helped save from bankruptcy in 1994. The other was Internet access provider UUnet Technologies Inc., which he helped transform from a nonprofit organization serving mostly educational institutions to a for-profit business.

Wang: *max revenues and sell*

After NEA, Slusky joined Ziff Brothers Investments LLC in 1995 to manage the family's technology equity portfolios. That operation was spun out to form Vector Capital in 1997-'98, with ZBI as sole LP. Vector was co-founded by Val Vaden, who joined from early-stage VC **Benchmark Capital**.

That first fund made a bundle of money in NetGravity Inc., an online advertising services provider, a combination of Slusky's shrewd take on the company and an accurate reading of the market.

In the late '90s, Vector bought out VC investors who "didn't have faith" in NetGravity's future, as Slusky says. Vector took the unprofitable company public in 1998. A year later, Internet advertising company **DoubleClick Inc.** snapped it up in a $530 million stock deal. By the time Vector distributed shares to its limited partners, the stock had traded up, and the deal had doubled in value. "The key was exiting the DoubleClick stock in a timely manner, which we did," Slusky says.

To its credit, Vector has had a relatively low loss rate. Its single biggest blowup was Phase2Media Inc., an Internet advertising services company that it spun out from a small publishing company in 1999. The company filed to go public when the Internet bubble burst. "We lost $12 million, which wasn't catastrophic," says Slusky.

While investing its second fund in 1999, however, it became clear that there was a difference of opinion on Vector's bifurcated strategy, which toggled between VC deals and growth equity or buyout structures. Vaden departed, leaving Slusky to focus on structured buyouts.

"We want to play in markets where efficiencies are lower," says Slusky, which usually means steering clear of competitive auctions. With a team of eight professionals, the firm screens a universe of between 500 and 1,000 public and private companies and quietly strikes a bargain with its target.

Its best-known investment, Corel, is also the largest to date, with $58 million in equity. The company was a classic Business 101 case, Slusky says. Corel's plight was that Wall Street expected the company's products to continue to show double-digit growth, which required significant expenses. It masked a fundamental problem, however: The core WordPerfect and DRAW products were generating more than 80% of revenue, while the company spent almost 50% of operating costs on new initiatives that generated less than 10% of revenue.

"These were products that were going to serve markets Corel had never served before, tap channels that Corel didn't have and use technologies Corel was not a leader in," Slusky intones. "They were doomed to fail."

Vector proposed to return Corel to highly profitable core products and determine alternative strategies for growth. Microsoft owned a 20% block that it had bought in 2001 for $135 million, or $5.50 a share, as Corel teetered on the edge of default. Microsoft faced antitrust prosecution at the time and had a vested interest in keeping a rival alive. Vector bought out Microsoft, paying 56 cents a share, which was less than Corel's cash value at the time. Once it had 19.9%, it approached the board, in March 2003. By August, the buyout was completed.

Verma: *a nontraditional deal*

"What was required was a dramatic turnaround," says Mehta, who served as interim CEO. Mehta spent two years, not all of it by choice, flitting between San Francisco and Ottawa, until Corel landed a permanent CEO in former **IBM Corp.** corporate strategist David Dobson.

Corel stripped down its product portfolio, or some $10 million worth of revenue. Operations were made leaner, and expenses were halved to $57 million a year. "We renegotiated everything from phone lines and rates to the lease," recalls Mehta. Head count went from a peak of 1,000 in 2003 to about 450 before climbing back to 600 today. Over a six-month period, the company went from an annual 14% declining revenue rate and $96 million 2003 losses on $127 million of sales to single-digit revenue growth and 30% profit margins.

In 2004, Corel bought Jasc Software Inc. for $38.2 million, adding Paint Shop Pro, a popular digital photography and image-editing brand. Compression software maker WinZip International LLC was folded in during the IPO.

WinZip was yet another example of Vector's appetite for dicey spots. The WinZip sale, managed by Jefferies Broadview, was a difficult one to execute because owner and founder Niko Mak had specific requirements. With no competition, Vector snapped it up for about $30 million, or less than 3 times Ebitda, but it wasn't easy. Its financial books were nonexistent, and accounting was done ad hoc using Quicken. "The way we got comfortable with the business was to look at the order management system, connect that to the Quicken files and then connect that to the owner's tax returns," says Slusky. "We certainly believed that no one would pay the IRS more than they had to." In the end, he adds, the company's finances were "very clean."

Corel's revenue may have grown since the buyout, but the challenge now is future growth, says Eric Gebaide, managing director at investment banking boutique **Innovation Advisors Inc.** "Corel core products' competitors in word processing and graphics and digital imaging are very much bigger," he says.

Slusky believes the company can tap emerging markets for lower-cost software for low-end PCs, but he concedes that it can't compete effectively against Microsoft and **Adobe Systems Inc.** if they go for the same markets. Corel had also developed a Linux desktop version of its WordPerfect suite but stopped selling it because there was no demand. Corel's stock is now about 20% off its IPO price.

Still, Corel has already proven to be a lucrative investment, with a 6 times realized and unrealized return on its $58 million cost, based on the $12.75 a share closing price June 2. In some ways, "Corel is still a value play," says Slusky. "It is extremely well placed to be a consolidator of software companies."

Vector scored an even bigger home run with Landesk's acquisition by Avocent, priced at $416 million with earnouts of up to $60 million. Unlike Corel, which was a turnaround, Landesk was more typical of Vector's portfolio companies. "The way to improve equity value at Landesk was to maximize revenue growth," says Slusky. "You don't want to lose money, but the earning power comes later."

Landesk had been orphaned at Intel Corp. when it was spun out in 2002. That effort was spearheaded by CEO Joe Wang, who brought the deal to Vector and saw through months of negotiations with Intel, which retained a minority stake. The company beefed up product development and expanded its infrastructure management capabilities to include security management. Revenue grew from about $36 million when it was spun out to roughly $85 million in 2005. Ebitda, kept low initially, showed 600% growth last year as the company prepared to go public.

About 18 months ago, Landesk declined a bid from an undisclosed strategic buyer, according to a source. But, says Slusky, the offer had many conditions and "a great deal of complexity" that made the actual value lower than the Avocent deal.

Vector isn't looking back. It posted a stunning 10 times return multiple from the sale to Avocent, which hopes to combine its network connectivity gear with Landesk's desktop management offerings. Intel made more on its equity stake than on its original investment, says Slusky.

Weeks later, Savi was sold to Lockheed Martin for $400 million, the first major M&A in the radio frequency identification industry. Savi, a Sunnyvale, Calif., developer of logistics products used to track assets in aerospace, was spun out of **Raytheon Co.** in 1999.

At the time, the buyout involved an unusual demand from Raytheon that the management of the unit provide representations and warranties on Savi to mitigate risks, says Vic Verma, the longtime head of Savi. In return, Vector and management paid a mere pittance of around $10 million.

"You had to be flexible to do a nontraditional deal like this," says Verma. Vector sponsored the buyout and helped build the company, which subsequently raised about $150 million from customers and investors, notwithstanding the tech downturn. Revenue grew to $80 million last year, from $13 million in 1999.

The strategy for each company obviously differs. "Some companies are undervalued relative to growth prospects, others are undervalued relative to earnings prospects," Slusky says. "The key is in valuation and management. You have to pull different levers at different points in time."

Vector has increasingly entered contested situations, involving public companies that come under pressure from activist hedge fund shareholders. Typically, Vector takes minority stakes that it hopes can be a springboard for an acquisition.

"Should the company fix itself or a rival bidder is more aggressive than we are, the return is still a profitable way to lose," Slusky argues.

Its ploys don't always work. In November, it failed to gain a quorum with e-commerce software provider **BroadVision Inc.** after offering $45 million to take it private. Along with **Tennenbaum Capital Partners LLC**, Vector also made a spoiler bid to buy the main business of digital video production products maker Pinnacle Systems Inc. after Pinnacle had struck a merger agreement with **Avid Technology Inc.** That also was rejected.

In August, it did succeed in buying domain name registration provider Register.com for $202 million, although New York hedge fund **Barington Cos. Equity Partners LP** initially threatened a proxy contest for control of the board. Vector eventually won over Barington and persuaded it to invest in the buyout, along with **Ramius Capital Group LLC**.

Vector is your typical private equity firm in shying away from hostile takeover situations. "You have to be a constructive partner throughout a process—it never pays to alienate anyone," Slusky says.

The closest it has come is when it joined forces earlier this year with Inter-Tel CEO Mihaylo, who threatened a proxy fight to win seats on the board. Mihaylo and Vector recently struck an agreement for a potential acquisition of the telecom software maker, according to a May 18 filing, though a price has yet to surface. Mihaylo is Inter-Tel's largest stockholder, with a 19% stake. Inter-Tel's growth has slowed as it faces a technology shift from its switch-based systems to voice-over-Internet-protocol systems.

Late last month, Vector tabled a $108 million offer to buy security software provider WatchGuard, which had fallen prey to activist shareholders such as Los Angeles hedge fund **SACC Partners LP**. Vector, which owns a 9.4% stake, says it expects to put "modest leverage" into the deal. This is characteristic of Vector's style, Slusky says, although Inter-Tel, if it goes through, will be a sizable transaction with a "fair amount" of leverage.

Are there many sweet spots left to mine? The seemingly tireless Slusky thinks so. His firm is looking at half a dozen deals now, some of which are in competition with financial sponsors and strategic buyers. But Vector can now claim a reputation for good results and for treating employees well and retaining customers, he says.

Slusky acknowledges that recent deals have had very high Ebitda multiples.

"People forget that technology companies still have product cycles and that we're much closer to the top of the industry cycle than we are to the bottom," says Slusky. "So it's one thing to buy a company at higher multiples on depressed Ebitda numbers in 2002 and 2003, but I don't know how people justify paying high multiples on cyclically high numbers in 2006."

Then again, Slusky adds, "We're a value investor. A lot of the world looks expensive to us most of the time." ■

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