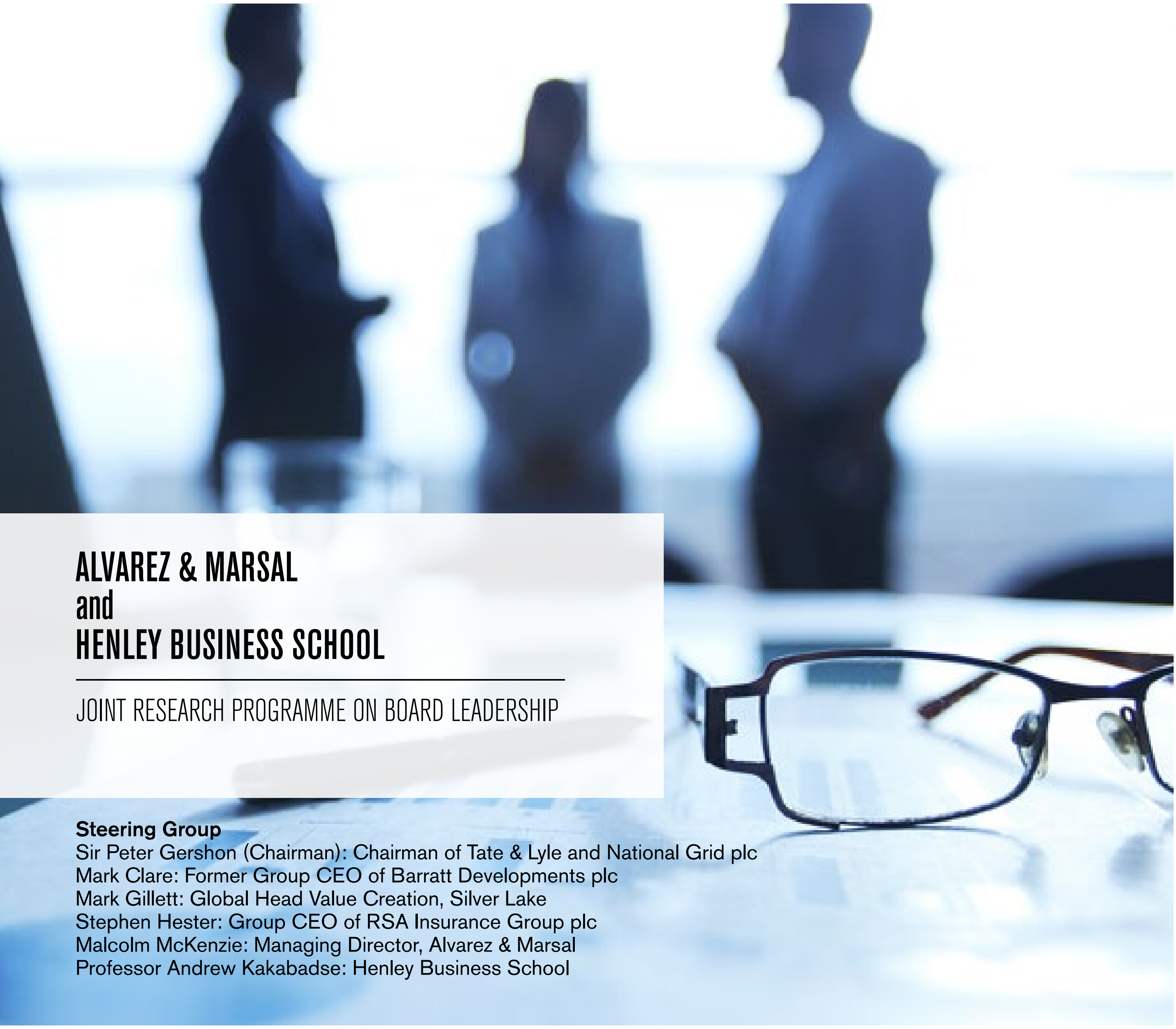
BOARDS IN CHALLENGING TIMES: EXTRAORDINARY DISRUPTIONS

Case Study: Skype Technologies: Reviving the Disruptor



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RESEARCH CASE STUDY

SKYPE TECHNOLOGIES: REVIVING THE DISRUPTOR

This case study is based on an analysis of interviews conducted during the first and second quarters of 2015, as well as an analysis of relevant documentation. The following participants took part in the study:

- **Miles Flint** | Former Chairman of the Board | Skype Technologies
- **Jim Davidson** | Founder | Silver Lake
- **Niklas Zennström** | Founder | Skype Technologies
- **Ben Horowitz** | Investor and Founder | Andreessen Horowitz
- **Mark Gillett** | Former Chief Operating Officer | Skype Technologies

INTRODUCTION

In October 2005, eBay acquired Skype for a total of $2.6 billion[1]. At the time, Skype had significantly disrupted the telecommunications and internet market. Between 2005 and 2007, the founding team ran the business from within eBay and managed to sustain performance. However, in the two years that followed, eBay changed management and struggled to integrate Skype with its existing services and realise the benefits of using Skype to enrich the experience of eBay consumers.

The impact of the global financial crisis, coupled with internal inertia, caused Skype's performance to suffer heavily with eBay taking a $1.4 billion write down in October 2007[2], ultimately resulting in eBay seeking to sell the business in September 2008. The business also faced litigation over Skype's intellectual property[3].

"Skype had become the Kurt Cobain of technology companies – wildly popular, deeply troubled." (Fortune Magazine)

Despite the challenges, Silver Lake Partners and other investors saw a great investment opportunity and on September 1, 2009, a consortium led by Silver Lake Partners acquired 65 percent of Skype's shares for all cash consideration of approximately $1.9 billion, valuing the business at $2.75 billion. Following a strategic realignment and rapid transformation, Skype continued its journey of 'Creative Disruption', reaching 170 million connected users in more than 190 countries, 25 percent of all international long distance (ILD) minutes and over 12 billion billing minutes by 2010.

What follows is insight from inside a disruptor from Skype's key Executives and Board Members on the journey from opportunity identification to transformation and value creation.

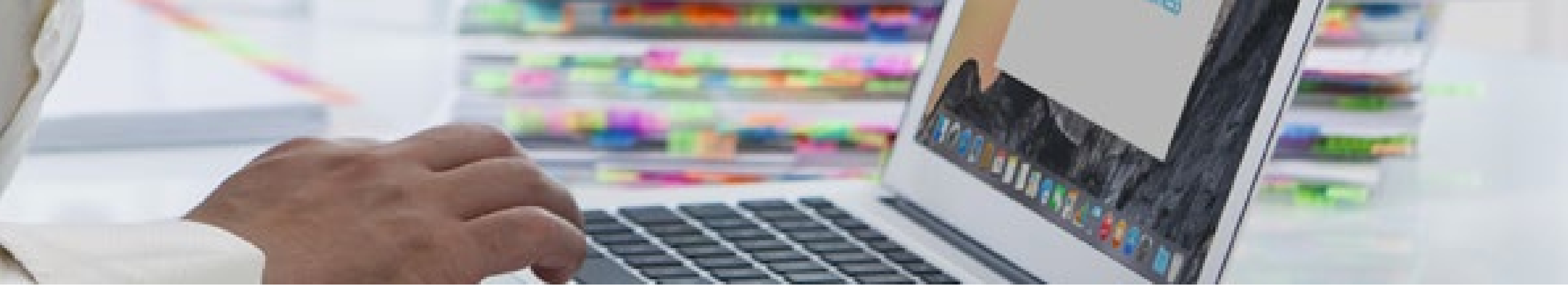
CALL OUT THE OPPORTUNITY

It was September 2008 when Lehman Brothers collapsed and the world economy contracted. Internet businesses suffered considerably with the downturn and Skype in particular was facing its own specific challenge to align the entrepreneurial culture established by the original founders with the more corporate culture of eBay.

"A series of management blunders turned a fast-growing startup into a cesspool of mediocrity and bureaucratic infighting. It was as if someone opened the fuel tank on a rocket heading to the moon." (GigaOm, Sept 2009)

"…as usually happens when the founders leave, so too do a lot of the original people, and there are new hires coming on board…so a little bit of that entrepreneurial spirit can be lost."

Disputes over intellectual property with the Skype founders and disagreements over the strategic direction of the business paralysed Skype at a time when it was facing potential



competition from some very large and well-established companies. AT&T, Google and Microsoft and Facebook were all trying to develop digital communications solutions. John Donahoe had succeeded Meg Whitman who had acquired Skype for eBay, and could dispassionately evaluate the situation.

Silver Lake identified Skype as a potential investment opportunity and initiated conversations to establish a consortium to acquire a substantial portion of equity from eBay. The consortium was purposefully diverse, including the Canadian Pension Fund Investment Board as institutional investor, eBay as previous owner, Silver Lake as private equity partner and newly minted technology venture capitalist Andreesen Horowitz whose founders had navigated the original internet growth boom. There was also at least one other potential rumoured bidding consortium separate from Silver Lake.

Whilst the Silver Lake consortium were agreeing to buy 65 percent of Skype from eBay, the founders of Skype used the investment vehicle Joltid to file a lawsuit against Skype seeking injunction and damage over intellectual property (IP), particularly with regard to a piece of technology known as "GI code." This threatened the whole deal and growth prospects of Skype and was one of the first challenges faced by the consortia.

"The price of Skype was objectively low enough that people were bidding but there was very good reason for this which was the IP litigation with the founders. I think everybody determined that from a legal standpoint the litigation threat was real in the sense that if the founders went to court and won they could shut down the service. And so that was why there weren´t very many bidders, it looked like a very dangerous deal on the surface."

Silver Lake put in place a risk mitigation strategy by identifying an exceptional team who they believed could rapidly rewrite the underlying code from scratch if the consortium was to lose the intellectual property litigation. This enabled them to maintain a clear investment thesis. With a global communications market worth $1.7 trillion, Skype, the leading global internet VoIP provider, was seen as a great opportunity. There was significant potential for value creation with various opportunities to improve operations and accelerate growth in core

"SILVER LAKE IS POTENTIALLY MAKING A MAKE OR BREAK DECISION FOR THE FIRM, ONE OF THE LARGEST INVESTMENTS UP TO THAT POINT FOR SILVER LAKE."

business. There were untapped growth opportunities in small and medium enterprises, mobile, advertising and new geographies. Moreover, Skype had highly attractive financial characteristics including a low tax rate and capital expenditures and an attractive working capital profile. Skype was a potentially highly strategic target for some large tech acquiring companies such as Apple, Google and Microsoft and had strong IPO potential. With this in mind, investors could see a favourable buy-in valuation relative to the growth outlook.

"Silver Lake is potentially making a make or break decision for the firm, one of the largest investments up to that point for Silver Lake."

The deal was signed on September 1, 2009 with the consortium led by Silver Lake Partners acquiring 65 percent of Skype's shares for all cash consideration of approximately $1.9 billion[4] valuing the business at $2.75bn.

DETERMINING THE RIGHT LEADERSHIP, OPERATIONAL AND STRATEGIC DIRECTION

By the end of October 2009, following an extensive dialogue with Joltid, the IP issues were resolved and Skype acquired the rights to the GI code. In exchange, Skype founders received an approximately 15 percent stake in the consortium and corresponding Board representation.

The investors were diverse, encompassing entrepreneurs, Silicon Valley venture capitalists, more traditional private equity, institutional investors and the previous strategic owners. Whilst Silver Lake had the largest stake, it was deliberately decided to appoint an independent chairman. Silver Lake did not have a majority, therefore this decision was itself a collaborative decision amongst the investors. Silver Lake looked for someone who had a good perspective on technology companies, was demonstrably independent and objective, able and willing to work with all Board Members and most importantly, someone the Board and management could trust. It was announced that Miles Flint, previously CEO of Sony Ericson who had successfully managed the complications of joint venture technology business, would become Chairman in January 2010.

"Miles was somebody who was very accomplished and trusted. He had two things, he had an understanding of technology and fabulous knowledge of the communications markets and how companies were addressing issues as they evolved. Things were changing rapidly."

Immediately upon taking control, the new Board wanted to obtain their own on-the-ground view and a subset of the Board spent an intensive period with the business, undertaking in-depth interviews with multiple levels of managers.

"We just said, look we've got some people who really get this, let's put them on a plane and send them to where more than 50% of the employees are and spend a week there. And we flew out and we met with CEO minus two, minus three, maybe even down to minus four in some cases."

This revealed that while many people were good, in developing its market focus the company had lost its focus on product, which is critical for a technology disruptor. For example, Skype was still a single platform application, did not yet have a mobile client and the whole product development process was slow and effectively broken. The Board decided to put Mark Gillett, an Operating Partner from Silver Lake (and the individual previously identified to lead the code rewrite if necessary), into the business as a partner to the CEO, and ultimately to serve as Chief Development and Operations Officer. His role was to fix these issues, and he successfully navigated this role transition. He stepped down from his PE role on the Board, formed a successful partnership with the CEO and management team and built new capability and pace in both product development and operations.

Determining strategic direction and implementing the correct leadership were two critical success factors for Skype. However, maintaining strategic direction and alignment was an ongoing challenge. What was Skype's purpose, its structure and the overall strategic direction?

The change in the business was broad reaching and operational. Many of the job roles in the company had been unclear and operations were fragmented internationally. The majority of employees participated in an assessment process and had to apply for roles which were defined in the new organisation. This helped determine who "wanted to be on the bus" for a very different journey.

The Board needed to agree whether Skype's competitive advantage lay in the internet or in the telecommunications industries, determine its market positioning (C2C versus B2B), address how it would sustain its disruptive growth and turn a strong cash flow, whether it would partner with potential competitors such as Google, Apple, Facebook and Microsoft or attempt to grow on a solitary basis, and what was the best structure and operating model to deliver profitable growth. Those amongst the consortium who saw Skype as an internet company advocated accelerating investment in research and development (R&D) whereas those who saw it as a telecommunications player pushed for cost controls and a focus on pricing and business development capability.

As the former Chairman explains:

"...[there was] an organisational structure logic which was unclear, and part of the reason that it was unclear was no one had really figured out whether Skype was a Telecoms asset or an Internet asset, and the truth is it's a bit of both. It seemed that people from North America tended to look at it as an Internet business and people from Europe tended to look at it more as a Telecoms business."

Articulating the purpose meant answering the questions of what business is Skype in and where was Skype going. These contrasting views from the Board were ultimately resolved through a common denominator in the investor Board: disruptive capacity.

"…they all understood disruption; they've all seen it or caused it. So you have eBay, Marc Andreesen and Ben Horowitz [from Netscape]… and the original Skype guys…I think ultimately that's why the telecom versus internet question was resolved that if you are a disrupter there are many more disruptive opportunities in the internet space than there are in the telecom space…"

The chairman role was equally important in creating alignment within the Board.

"The first leadership dimension you need is alignment from the boardroom ...and a coalition of the willing. As the Board progresses, I believe you need clear anointment of leadership."

"[Miles] is unflappably calm…and he holds his own counsel extremely well. He was able both to share his perspective and to enable others to share their perspective without carrying any bias. And he was both able to draw people in and to gently contain members of the Board which I think is a very important chairing skill when you've got a big roomful of people."

Management was able to quickly adapt to the changing strategic landscape. Google, Apple and Facebook had initially been viewed as potential partners, but as soon as it became clear that they would launch their own products and potentially risk the investment and Skype business, a strategic decision was required on the tenure of the investment. It was decided that it should be a long term hold, which meant it had to be improved operationally, with a focus on the product and leadership of the product. There was a need to transform the business.

The CEO, Josh Silverman, a former eBay Executive , was regarded as a great marketing and communications Executive . He provided the leadership to initiate the transformation and conduct much of the initial re-organisation. However, having decided to transform and improve the product and operations of the business, he and the Board determined that a new CEO with a strong background in technology and product development was required.

After extensive discussions, Skype announced Tony Bates as the new CEO in October 2010, to join Mark Gillett, Chief Development and Operations Officer and Jonathan Chadwick as Chief Financial Officer.

"…as we went through those discussions (i.e. what should be Skype's direction)…we came to the conclusion that we needed to change the leadership, the CEO. ...I think he [Tony Bates] was absolutely the right guy because he understood telecoms, he understood internet, he understood hardware… and he understood the technology, he moved very fast and he was prepared to make tough decisions quickly."

"… CONSTANT ALIGNMENT REQUIRES VIGOROUS DISCUSSIONS, SO THE PROCESS CAN BE QUITE CHALLENGING BUT IT'S NECESSARY TO DO THAT."

With the new CEO on-board, Skype was able to complete the transformation of the business which ultimately included replacing core systems and a comprehensive transformation of product, structure and people. During this disruptive period, it was important that roles were clearly defined and supported by exceptional communication and alignment.

"…it's very important in a complex disruption that the individual and collective roles of the Board are clear… I think we were probably talking daily during this time period.. [before close]"

"… constant alignment requires vigorous discussions, so the process can be quite challenging but it's necessary to do that."

During the peak of the transformational efforts, Board Members convened, often over Skype as much as weekly often with the CEO and CDOO. As the effort matured and the new CEO settled in, a new more structured and more typical rhythm of formal board meetings established.

APPLY THE RIGHT BUSINESS DISCIPLINES: SKYPE'S TRANSFORMATION AND GROWTH

Skype's successful transformation and disruptive growth draws particularly on five disciplines which were critically important in generating value:

I. Continually driving strategic alignment at the top.

II. Getting the right leadership team who understand the business, identify challenges and deliver fast results.

III. Articulating a purpose for the business, taking some calculated risks and importantly, doing this at pace.

IV. Having a constructive and supportive Chairman / CEO relationship throughout the process in order to reduce complexity and ensure that the investors are clear and supportive of management's strategy.

V. Being evidence-led and getting the facts to inform Board decisions.

1. REALISE STRATEGIC ALIGNMENT AND ENGAGEMENT

Ensuring continuous alignment at Board level was fundamental so that the management team could pursue the transformation and revival of Skype. The mix of investors with varying views on technology, investment horizons and organisation structure meant that difficult alignments needed to be managed, primarily by the Chairman of the Board. The Chief Executive could then drive the business around a common direction and understanding. The Chairman commented:

"Everyone wanted to make a success of it. The question then was how?"

Ultimately, the Board coalesced around the common objective of realising their investment, which was successfully achieved despite the difficult alignments throughout the process.

2. GET THE RIGHT PEOPLE IN PLACE

According to Skype's Chairman, appointing the wrong people could have easily derailed the whole venture.

There were long debates with the board about who should be the CEO and the management team needed to take up the challenge to quickly reform Skype and lead the eventual IPO. Mark Gillett, who had more than 16 years of experience at Silver Lake, Alvarez & Marsal and a number of software and electronics businesses, was appointed early on to the position of Chief Development and Operations Officer. Jonathan Chadwick, who had worked for more than 20 years with McAfee, Cisco and PWC, took charge as Chief Financial Officer. Ultimately, the Board decided to appoint Tony Bates as CEO, who had vast diversified experience in the tech industry with companies such as Cisco, Tokbox, Youtube and Lovefilm. Together this team was able to deliver an effective transformation of Skype.

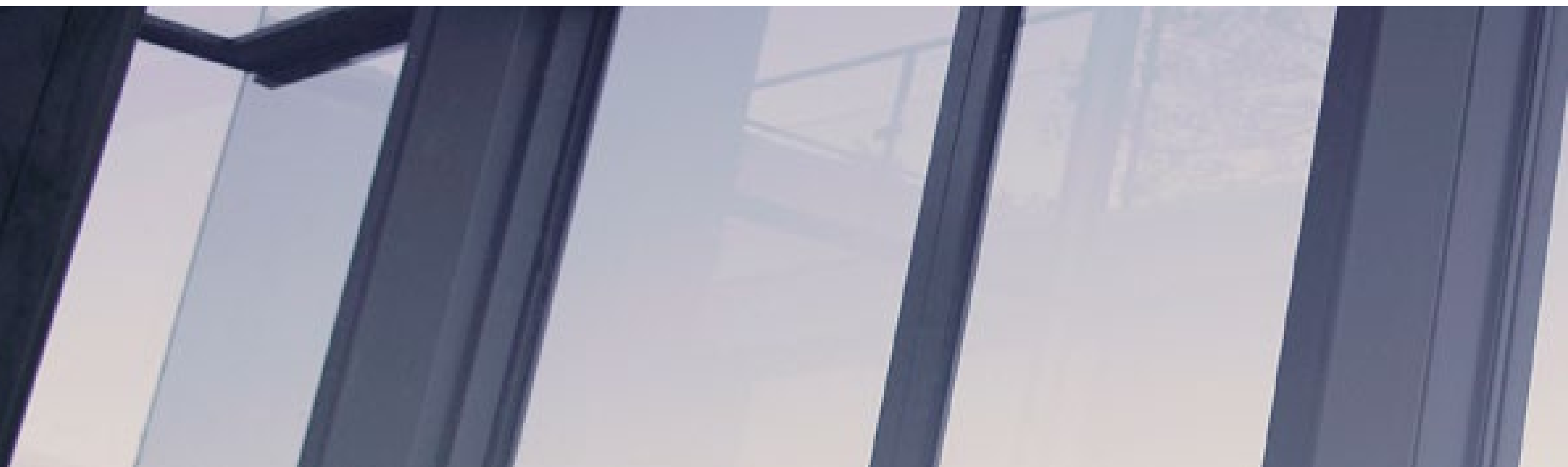
"…the one skill that the effective CEOs need to have, is they need to have great people doing their most important things..."

When recruiting the Executive team, it was just as vital to have people with the right experience:

"What we were looking for was people who had managed and experienced significant change, who were biased towards companies that knew how to deliver a product."

3. ARTICULATE THE PURPOSE, TAKE CALCULATED RISKS AND GET PACE

The transformation of Skype was achieved rapidly between January and December 2010. In parallel, a carve-out from eBay included core systems replacement, real estate separation and the creation of an independent legal and regulatory functions, while the transformation continued with a fundamental reorganisation of product, structure and people and process.



On the product side, products were broken down into both intern (shared) technology and externally facing 'release vehicles' and large, project oriented teams reorganised into smaller more nimble product teams. An agile development process was put in place which could deliver new releases to market 90-day or less increments, compared with the previous timescales of well over 12 months. On the people and structure side, new job families and career ladders were created and a product and process matrix was embedded in the organisation with a set of accountabilities and performance indicators.

In addition to the organisation-wide talent re-evaluation, significant time and millions of dollars was invested in a training and development program to align staff with a new operating philosophy and product development process. These actions reinvigorated Skype's ability to innovate and grow.

"The critical thing was really getting a grip on the software engineering and product development process."

4. ENSURE CONSTRUCTIVE CHAIRMAN / CEO RELATIONSHIP

Another key discipline critical to the success of Skype was a constructive Chairman / CEO relationship, which enabled trust to be built into the Board and ensured the necessary alignment and support for managerial action. The former Chairman explains:

"…to me the Chairman/CEO relationship is almost the beginning and the end of successful boards…it was much more a coaching, grown-up discussion between…kicking issues around and just sharing perspectives and experience of things we'd seen before that had worked and hadn´t worked. It was collegiate and collaborative."

"…part of the Chairman's role is coaching the CEO to develop his or her skills."

WHAT WE WERE LOOKING FOR WAS PEOPLE WHO HAD MANAGED AND EXPERIENCED SIGNIFICANT CHANGE, WHO WERE BIASED TOWARDS COMPANIES THAT KNEW HOW TO DELIVER A PRODUCT.

In addition it was critical that there was strong trust and working relationship between the CEO, CFO and the Chief Development and Operations Officer. This could have been complicated given that one had formerly been a deal partner in one of the investors. However, it seems that this triumvirate formed a trusting relationship, focused primarily on the success of the company. All three subsequently went with the eventual sale to become senior Microsoft Executives.

5. BE EVIDENCE LED

There was a great deal of information provided to the investors and Board, including internal strategy decks and internal planning. But the investors wanted to obtain a third viewpoint and, as previously discussed, they undertook in-depth site visits and staff interviews to ensure that they really understood the realities and had first-hand experience of the issues, and progress being made.

DECLARE SUCCESS: A WIN-WIN TO ALL THOSE INVOLVED

By the time Skype launched its IPO process it was already a member of the exclusive "100-100" club, with an online engagement of over 100 minutes per user per month and over 100 million active users per month. It had 170 million connected users in more than 190 countries, 25 percent of all international long distance (ILD) minutes and over 12 billion billing minutes in 2010.

The IPO process sparked the interest of major strategic acquirers and Skype was in fact not taken public but sold to Microsoft for $8.5 billion. This was more than a threefold increase in value within less than two years.

Skype's story has been recognised as a success for both sellers and buyers. For the equity sponsors, they received over three times return on equity. This meant eBay was able to recoup its initial investment (and a profit), CPP Investment Board ensured a good return for its pensioners and the Skype founders realised additional cash for a business they lost ownership of several years before. Andreesen Horowitz achieved a great return and started consolidating its reputation as a leading technology venture capitalist.

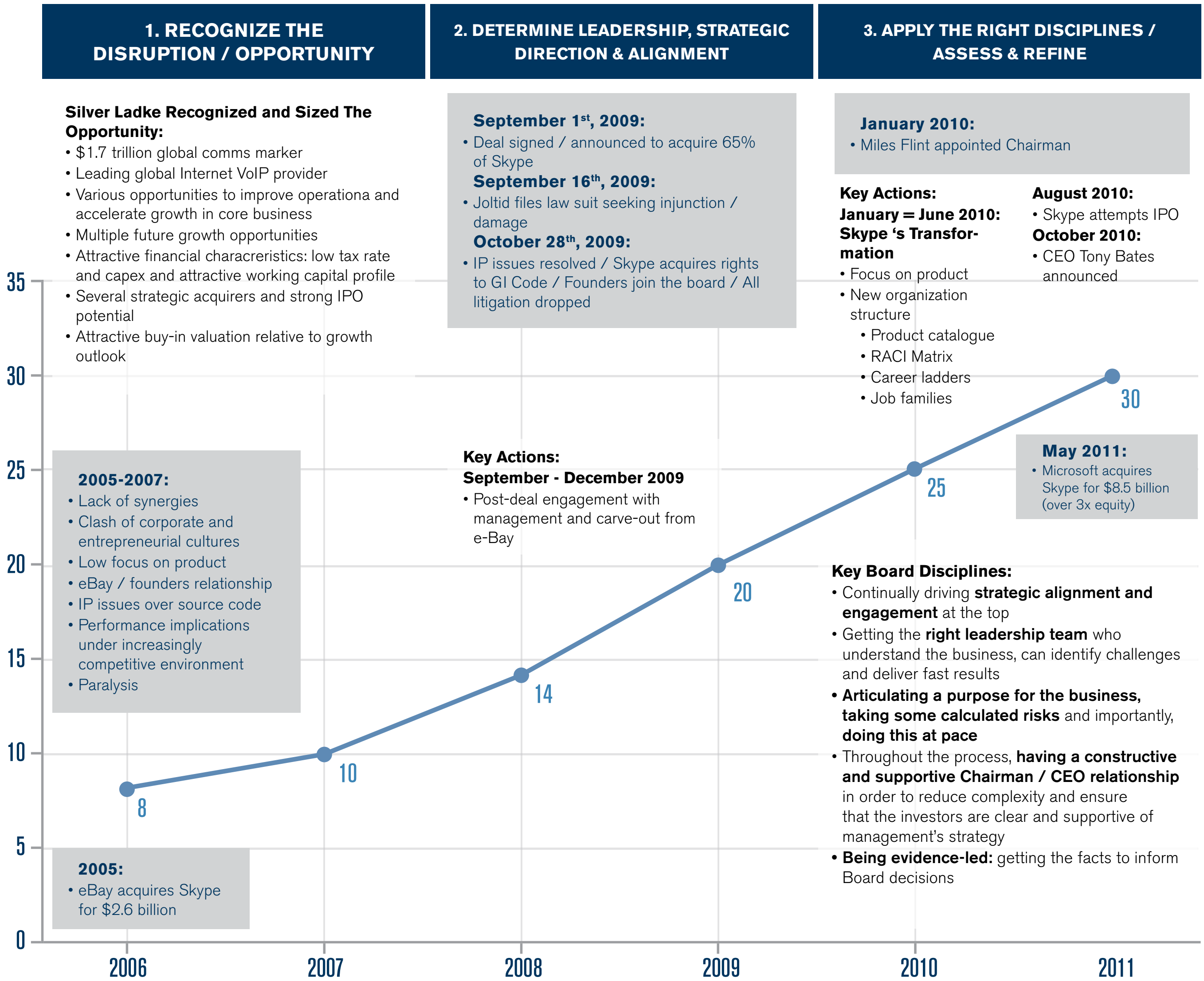
For Silver Lake, this strong result ensured good demand for their Fund Four, which was in fact oversubscribed[5] from a target of $10 billion. Not only was great value generated for the consortium members, but it appears as if the deal has been successful from Microsoft's perspective as well.

"I think it wasn't just a question of the investors getting a good return in a comparatively short period of time, at post disposal it continued to do very well."

"…two subsequent years, this wasn't flash in the pan it was sustainable change and transformation… it is momentum and people buy growth."

"…to fulfil my initial objective when we started the company,… if Skype would have a successful IPO and be a thriving, let's say independent company, that would be something I would be more pleased from a personal legacy point of view. But from a financial outcome I think this was a very good outcome."

APPENDIX A: SKYPE TIMELINE OF EVENTS



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