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Palm, Inc., Leveraged Recapitalizations and Business Value

Palm, Inc. (PALM) announced a "strategic relationship with the private-equity firm of Elevation Partners ("Elevation") and a recapitalization plan" designed to "position Palm to lead the next phase of the smartphone and mobile-computing markets" on June 4th, 2007. At the time of the announcement (immediately before), Palm's stock traded at $16.27 per share, the company had no debt, and more than a half billion dollars in cash. And Palm was seen by the markets as lagging, not leading in the development of its key markets.

Leading up to the announcement, Palm's board considered a number of "strategic alternatives," including the outright sale of the business. Rather than a sale, the board agreed to the announced leveraged recapitalization with Elevation. As part of the deal, Jon Rubenstein, former SVP of hardware engineering and head of the iPod division at Apple, Inc., will join Palm as executive chairman of the board. Two principles of Elevation will also join Palm's board, and there will be one resignation.

The leveraged recapitalization. Given Palm's debt-free, cash-rich balance sheet, the potential for a leveraged recapitalization and the creation of New Palm existed, and one will occur, with the following features:

1. Existing Palm shareholders will receive a dividend of some $9.00 per share (or about $940 million for the 102.6 million pre-transaction shares).
2. Elevation will invest $325 million in exchange for a convertible preferred series with a conversion price of $8.50 per share. This was represented as about a 16% premium to the "implied post-distribution price over the 10 trading days ended June 1, 2007, excluding the $9 per share distribution," or $7.33 per share. This investment will convert into 25% of the equity of New Palm (fully diluted to give effect to certain existing and new options).
3. The $940 million distribution will be financed with Elevation's $325 million investment, some $215 million of New Palm's cash, and about $400 million in new long-term debt.
4. In addition, New Palm will have a $40 million revolving credit facility, which can be used for working capital purposes.
5. New Palm has a pro forma current ratio of 1.46x and a long-term debt to equity ratio of 97%.

So what do the shareholders have? Palm's pre-announcement price was $16.27 per share. If we subtract the $9.00 expected distribution, shareholders would be left with implied value of $7.27 per share.

However, existing shareholders get the benefit of the 16% premium paid by Elevation, and the implied value is close to $7.50 per share when this is taken into account.

Palm shares were trading at $17.62 per share at the close of business June 5th, 2007. If we subtract the anticipated dividend of $9.00 per share from that price, we are left with an implied value of $8.62 per share. One day after the announcement, then, the market was saying that Palm shares were worth a slight premium to the implied Elevation price of $8.50 per share, plus the $9.00 per share expected distribution.

At the close of business on June 19th, Palm shares traded at $17.29 per share, implying a per share pro forma price of New Palm of $8.29 per share, or still fairly close to the Elevation price of $8.50 per share. The market's assessment of New Palm's business value is pretty close to that which business valuation principles would have suggested.

So what's the deal? Based on our review of the transaction, there are several positive factors that suggest that the recap transaction was favorable for Palm shareholders. These factors include:

1. Palm shareholders receive a return of $9.00 per share, or about 55% of the market value of their shares prior to the announcement.
2. The remaining company appears to be reasonably capitalized, i.e., not excessively leveraged.
3. Pro forma return on equity rises to 11.2% relative to a pre-transaction ROE of 6.6%.
4. The board avoided selling the entire company for what likely would have been a low premium in pricing.
5. The company gains a new, experienced executive chairman, who comes with an excellent reputation.
6. Management is incented to perform, positively, with options and ownership, and negatively, with debt.
7. Existing Palm shareholders will receive 73% of any future premium should the company later be sold.
8. Earnings per share, because of leverage, are poised for more rapid growth than before the transaction.

There are a couple of negatives to the transaction. First, there is more leverage. However, that is also a positive. The biggest negative is that in a severe downturn of the company's fortunes, Elevation's convertible preferred stock has superior rights to the remaining common stock. So the transaction is not without some expected risks. However, Palm is a publicly traded stock, and shareholders have the opportunity to liquidate their positions at the current market price if they are not happy with the outlook or desire full liquidity for any reason.

What does this mean for private companies? If Palm, Inc. can engage in a leveraged recapitalization to create liquidity and future opportunity for its shareholders, so can, perhaps, your company. A private company recapitalization could have all the bells and whistles of the Palm transaction or more (or less), depending on your objectives and your company's particular situation. Give us a call (901-685-2120) or email mercerc@mercercapital.com if you'd like to talk about the possibilities for a leveraged recapitalization for your company.

Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com

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To receive your free copy of the 40-page "Buy-Sell Audit Checklist" in a 8.5 x 11" format ready for your use (a $50 value), send us your favorite buy-sell agreement war story (please change all the names to protect the innocent and guilty!).

One of the reasons we wrote the book, Buy-Sell Agreements, was to help business owners and their advisors craft workable agreements. Examples of agreements gone wrong (and those that operated as planned) serve as a powerful reminder of what could happen to you.

Send your war story to Chris Mercer at mercerc@mercercapital.com and include your name. Once we receive it, we'll e-mail you your FREE copy of the 40-page "Buy-Sell Audit Checklist."

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September 17, 2007
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Partners Financial Private Business Group
Chicago, Illinois
Z. Christopher Mercer, ASA, CFA

September 18-19, 2007
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"
Dallas & Houston CFA Chapter Meetings
Dallas, Texas and Houston, Texas
Z. Christopher Mercer, ASA, CFA &
Travis W. Harms, CFA, CPA/ABV

September 25, 2007
Topic TBD
NACVA Illinois State Chapter Meeting
Chicago, Illinois
Brent A. McDade, CBA, BVAL

October 29-31, 2007
2007 ASA Annual Business Valuation Conference
San Diego, California
Matthew R. Crow, ASA, CFA
Timothy R. Lee, ASA
Travis W. Harms, CFA, CPA/ABV

November 20, 2007
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"
FEI Chapter Meeting
Memphis, Tennessee
Z. Christopher Mercer, ASA, CFA

December 2, 2007
"Discounts for Lack of Marketability Panel"
AICPA Business Valuation Annual Conference
New Orleans, Louisiana
Z. Christopher Mercer, ASA, CFA

December 3, 2007
"An Integrated Theory of Business Valuation"
AICPA Business Valuation Annual Conference
New Orleans, Louisiana
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Travis W. Harms, CFA, CPA/ABV

December 4, 2007
Baltimore Estate Planning Council
Baltimore, Maryland
Z. Christopher Mercer, ASA, CFA

December 4, 2007
ASA Maryland Chapter
Baltimore, Maryland
Z. Christopher Mercer, ASA, CFA

January 12, 2008
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"
ING International Forum
Miami, Florida
Z. Christopher Mercer, ASA, CFA

The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

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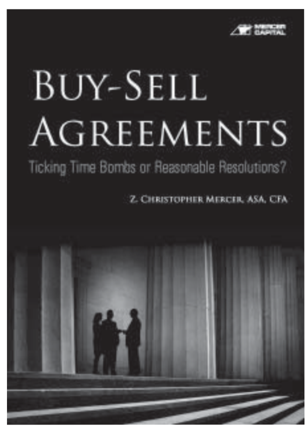
Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

Released in January 2007, *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"* has quickly become a valuable tool for attorneys, business advisors and business owners who recognize the importance of buy-sell agreements. Don't take our word for it. Below are just some of the published reviews of *"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?."*

To summarize *Buy-Sell Agreements* in one word, that word would be "methodical." Mercer focuses like a laser beam on virtually all of the possible permutations of the pricing and valuation provisions of buy-sell agreements, together with the advantages and disadvantages of each...*Buy-Sell Agreements* offers a comprehensive buy-sell audit checklist that alone makes it worthy of purchase, serious use and study...If you are looking for a book that has a comprehensive discussion of the pricing and valuation aspects of buy-sell agreements (which I've really not ever seen before), this is it...*Buy-Sell Agreements* is a no-brainer addition to the library of every one who works with or who drafts buy-sell agreements.

L. PAUL HOOD, ESQ.
Steve Leimberg's Business Entities Newsletter,
Issue 119, February 13, 2007.
Courtesy: Leimberg Information Services, Inc. (LISI)
at www.leimbergservices.com



In the teacher's manual to our *Business Associations* case book, my friend, colleague and coauthor Bill Klein posits that "any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice." Z. Christopher Mercer's new book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions* offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

STEPHEN BAINBRIDGE
William D. Warren Professor of Law, UCLA
Published on ProfessorBainbridge.com

In this eminently well-written, concise, and non-technical book, Chris lays out the fundamental parameters and processes that must be considered to minimize problems...Appraisers who read this book and apply its lessons will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.

RAND M. CURTISS, FIBA, MCBA, ASA, ASA
President, Loveman-Curtiss, Inc.
Chair of the American Business Appraisers National Network
Published on IBA Discussions Blog at www.go-iba.org/blog

Mr. Mercer has done a great job of addressing the reasons business owners might want to have a buy-sell agreement and the business factors these business owners should consider in the agreement... Overall, Mr. Mercer provides valuation practitioners, business consultants, and business owners with a very useful handbook for preparing, reviewing and interpreting buy-sell agreements.

DAVID A. ELLNER, CPA/ABV
The Financial Valuation Group
Published in the AICPA ABV e-Alert
Volume 9, Issue 2, February/March 2007

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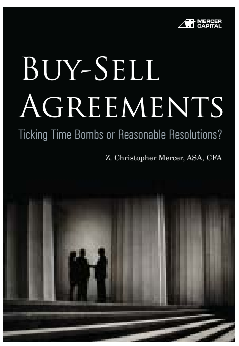
Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?



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Putnam C. Smith, J.D., LLM, Partner, Lipscomb, Johnson, Sleister, Dailey & Smith, LLP, Cumming, Georgia

Written for business owners, attorneys, CPAs, business appraisers, and other professional advisors to business, this book provides a roadmap for you (or your clients) to develop or improve your buy-sell agreement. The first book written from a valuation perspective which is important to note because business appraisers are usually consulted when there is a problem. Learn from our 25 years of experience working with well-constructed and terribly constructed buy-sell agreements (in almost every case no one realized there were problems until a trigger event occurred)!

HIGHLIGHT SECTIONS/CHAPTERS INCLUDE:

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- **The Six Defining Elements of Buy-Sell Agreements** - Agreements must have all six but most do not!
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