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I N T E R O F F I C E   M E M O R A N D U M

Doc. No: 074851
Date: 01-Aug-1994 03:45pm EDT
From: Larry Abruzzese @MSO
ABRUZZESE.LARRY AT A1 at IAMOK
Dept: Corporate Internal Audit
Tel No:

TO: Russ Gullotti @MKO

CC: Bill Foley @MSO

Subject: Last Draft - Corporate Divestment Mgmnt Letter

Russ,

Attached is the latest draft of an Audit Management Letter outlining Corporate Divestment Activity. The Fieldwork was conducted ending Q3 FY94.

I direct your attention to sections 6.0 through 7.2. These issues related to the former Worldwide Manufacturing & Logistics Operations formerlymanaged by Ed McDonough. I am asking that you review these sections in your new role in Computer Systems Mfg. I had formerly worked the wording and agreed upons with Ed and Marian O'Leary. Please review and respond by noon Thursday August 4. I will publish and assume all is well if I have not heard from you by then. As always, thank you for your cooperation.

Larry

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Resend
Larry abruzzese
cc Bill Foley
Marian oleary

I'm OK with sections
6.0 through 7.2

a- before you send have
Jay Connor look through
6.0 - 7.2. Should be ok
but have him look.

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# INTERNAL AUDIT MANAGEMENT LETTER

February 21 - March 25, 1994
Field Work Dates

Bill Foley
Group Audit Manager

Audit: Divestment
94-026

Issue Date: August 1, 1994

Audit Team: Larry Abruzzese (223-7056), Ade Balogun, Jack Cohen, Diane Hayes

## CONCLUSION

Divestment of once purchased investments no longer considered strategically important in furthering Corporate goals was expected to alleviate recent cash pressures. However, unresolved issues during the investment's acquisition and management phases have limited sale as a means of divestment:

- o Lack of documented and updated strategy statements adversely impact our ability to identify divestment candidates in a timely manner.

- o General plans outlining potential disposition alternatives which consider customers and other investors are not formulated when the investment is purchased.

- o Numerous management changes and reorganizations have caused ownership to be muddled and have weakened accountability for investments.

- o Very few of Digital's investments are highly liquid. Sale is consequently very time consuming and complex. Further, since investments are also in computer technology companies, their cycles are similar to Digital's; this could lead to suboptimal returns.

- o There are no formally published divestment guidelines.

Property divestiture has been the major source of divestment funds to date. Worldwide Mfg&Log has instituted a continuous improvement process that has resulted in tighter process controls; however, the following issues were noted:

- o Ambitious site evacuation milestones require stricter guidelines to ensure timely execution of critical steps.

- o Corporate EH&S was not actively involved in the Corporate space divestment efforts, and was not engaged in monitoring on-site EH&S activities until recently.

## RECOMMENDATION

The keys to profitable divestment of external investments begin during the investment planning phase and continue with effective management and monitoring throughout as demonstrated by the following:

- o Responsible managers must develop and document detailed strategy statements for all external investments, and keep them current.
- o Responsible managers should review existing investments and circumstances in order to identify and resolve outstanding issues impacting divestment.
- o The responsible manager must remain accountable for the investment's performance unless/until reassigned by the Investment Committee. The responsible manager will ensure active and adequate management attention is provided the investment with divestment always an active alternative/consideration.
- o The Investment Committee must develop and widely communicate formal guidelines for the divestment process.

For facility closings and spin-offs:

- o Corporate EH&S must become an integrated partner in Corporate space divestment efforts, and must be actively engaged in monitoring on-site EH&S activities.
- o WW Mfg&Log should continue to monitor and improve divestment guidelines and make use of them in future site/plant closures and spin-offs.

## AUDIT OBJECTIVES AND SCOPE

The objectives of this management review were to assess and evaluate the adequacy and effectiveness of the complete divestment process from identifying candidates to their eventual disposition, and the protection of shareholder value throughout. Specifically, this review focused on the sale of Digital facilities and assets, the sale of external investments as directed by the Investment Committee in September 1993, and the corrective actions for those external investments that may represent future divestment opportunities.

The scope of this review encompassed:

- o Review and assessment of the divestiture evaluation process.
- o Achievement of established goals and objectives.
- o Reliability and integrity of information.
- o The efficient and effective use of resources and the

safeguarding of assets.

- o Compliance with significant programs, policies, procedures, laws and regulations.

BACKGROUND

Digital's once strong cash position of over $2 billion has eroded to $1.1 billion (Q4 FY94) as a result of recent unprofitable operations performance and unfavorable cash flow. In FY94, the Corporation borrowed through debt financing and preferred stock.

Divestment can be accomplished in any of five ways:

- o True divestment of the external investments.
- o Spin-offs of businesses such as printed wire boards manufacturing in Greenville and manufacturing operations in Cupertino, Springfield and Westfield.
- o Real Estate Sales/Closures, such as, Hong Kong, Phoenix, Tempe manufacturing sites.
- o Sales of Vertical Digital Businesses.
- o Sale of rights to specific products.

A series of special Investment Committee reviews were conducted during September 1993 at the request of the Senior Leadership Team. The primary objectives of these reviews were to identify candidate programs for divestiture; to ensure that FY94 plans were in place to maximize the value of each investment; and extract new learnings. The reviews covered 47 of the 57 external investment programs. As a result of these meetings, 10 programs were identified for divestment. Corrective action plans were implemented for 16 programs. Eleven investments had been so integrated with Digital that they were no longer to be tracked independently. Ten programs were considered to be on course.

The bulk of the divestment activity to date, and the primary means of generating cash, has been the closing and sale of facilities. Worldwide sale of facilities and manufacturing plants (See Appendix I) has accounted for much cash and reduction of carrying costs. In some cases, Digital has sold existing businesses to employees, while other businesses were sold to component manufacturers with minimum Digital purchase quantities providing base volumes to improve the spin-off's viability.

COMPARISON TO PRIOR AUDIT

Divestment had not been audited previously; however, the Investment Process was the topic of an Audit Management Letter (92-102) dated January 1992, and a Post-Investment Review of Kienzle and Philips (93-518) was published November 1993. The closing and sale of facilities had been addressed in three restructuring Audits. FY91 Restructuring (92-100) dated November 1991, FY92 Restructuring (93-006) dated November 1992, and FY93 Restructuring (93-042) dated October 1993.

| Management Contacts | Position |
|---|---|
| Ilene Jacobs | V.P. Corporate Treasury |
| Ed McDonough | Former V.P. Mfg. & Logistics |
| Marian O'Leary | Mfg. & Logistics Finance |
| John Doherty | U.S. Alliances & Acquisition Mgr. |
| Rajan Nanda | APA Alliances & Acquisition Mgr. |
| Christian Serres | Europe Alliances & Acquisition Mgr. |
| Doug Hammond | Corporate Real Estate |
| Lois Haskins | Corporate Finance |

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## 1.0 ACQUISITION

### 1.1 Investment Strategy

Venture capitalists and some conglomerates acquire other companies specifically as investments with the goal of realizing profits upon divestment. These investments are managed for growth and performance ratios that make them more attractive for resale. Unlike these companies, divestment has not been Digital's primary investment goal. Digital acquisitions have been made chiefly to enhance existing core business and to augment product strategies. These investments are thus managed and goaled as a portion of a total business rather than as separate units; their goals have become segments of a much larger Business Unit total. Sponsors advocating acquisition often do not formally document strategy upon purchase; and customarily do not update strategy documents. A July 1993 audit of the BASYS investment (93-536) noted the Communications Education & Media (CEM) Business Unit did not have a defined business strategy for BASYS that supported Digital's strategic objectives.

Since both the business environment and Corporate strategies change over time, the strategic vision for these investments must also be updated periodically. An up-to-date articulated strategy statement is even more critical during periods marked by many reorganizations and personnel changes.

Recommendation

Responsible managers must develop and document detailed strategy statements for all external investments, and keep them current.

The Investment Committee (IC) should regularly review existing strategies and should require them for all future external investments when acquired.

### 1.2 PLANNING

Small business investments are, by nature, very risky. Merger and acquisition experts note that less than half of all acquisitions succeed. Given the low probability for business success, the keys to a profitable divestment process must begin during the investment planning phase and must continue with effective management and monitoring throughout the investment period.

Prior to acquisition, submitted investment justification must include, at a minimum: 1. a realistic financial forecast 2. divestment criteria in the event of both failure and success (that is, if profitable but no longer strategically compatible to core Digital business), 3. a general contingency plan listing disposition alternatives with consideration for all stakeholders, i.e., Digital customers, other shareholders.

Documented learnings sponsored by IC reviews and others have found proposed financial, market, and business objectives to be overly optimistic. This optimism was witnessed consistently in the January 1992 Internal Audit review of the Investment Process (92-102; January, 1992). Incompatibilities and disadvantages have routinely been underestimated.

Business managers should use sensitivity analysis to view upside, as well as downside, potential of an investment and set downside thresholds/triggers when divestment should be considered. Divestment alternatives should be included when the investment is proposed and not as an afterthought when the business is in trouble.

Very few investments have been sold after perceived successful performance. DECPress, an internally established organization, may represent such a case. Technical external investments have rarely been sold for more than the original investment. A high initial purchase price, managerial inattention, and incongruencies with new or changing Digital strategies may be partially responsible.

1.3 EXECUTION

Internal Audit noted during fieldwork that outstanding issues left unresolved at acquisition time have impeded our ability to manage investments and to initiate divestment proceedings. At the September 1993 Investment Committee Reviews a decision was made to divest our interests in Engineering Applications (EA) Systems. However the first issues that had to be addressed were concerns raised by Asea Brown Boveri (ABB), another EA stakeholder. Another consideration was the impact of our decision on significant EA and Digital customers. Both these considerations were important factors severely limiting our disposal options, delaying the sale and determining the prospective buyers list. ABB felt comfortable with Digital as the co-owner and wanted to ensure any prospective buyer was at least as cooperative. Major EA customers were also important to Digital itself therefore Digital risked customer satisfaction issues if the prospective buyer chose not to honor previous EA commitments to customers. Digital's reputation and prestige, closely tied with the investment while it is owned, remains linked even upon divestment.

Recommendation

Responsible Managers, with Corporate Treasury and Law Department advice, should study existing investments and circumstances in order to identify and either resolve (or develop strategies to address) outstanding investment issues.

Corporate Treasury and Law Departments should continue to advise managers and the Investment Committee, based on learnings, about

risks that unresolved acquisition issues could pose in restricting divestment activities.

The IC should ensure all current and future investment proposals include provisions/ criteria for determining an exit strategy and ensure these are reviewed regularly. This strategy need not be detailed, but should contain basic information that would be useful in finding buyers and noting important considerations and options.

## 2.0 PRESERVATION OF STOCKHOLDER VALUE

### 2.1 MANAGEMENT

Investment performance has been typically managed at the business unit/function level. The IC did not conduct formal investment reviews until FY92. The FY92 and FY93 reviews cycled through the investment portfolio once every two/three years. Beginning FY94, the review cycle was more formal and accelerated to be, at least, once through the portfolio annually. Also, in addition to formal review, quarterly management reporting was required over the last five quarters for investments above a minimum dollar threshold. These typically were four pages per investment.

Although some isolated sales of internally grown organizations were made, such as, DECLease and DECPress, the Corporation and the Investment Committee had not seriously considered nor encouraged divestment of external investments as a viable option until Spring 1993. A March 3, 1993 IC memo requested review of all external investments to identify potential candidates as a source of cash. Interestingly, sale was the only form of divestment that was to be explored. There was no mention of either closing/dismantling operations or of spin-offs. During the FY94 budget process, Business Unit Managers were asked to review their entire span of control - both internal assets as well as external - to identify divestment prospects. However, those interviewed told Audit this request went largely unanswered.

Also impeding the identification of divestment opportunities were numerous management changes and reorganizations. The manager who sponsored an acquisition typically managed the external investment; however, Digital's culture did not strongly establish that the original sponsor retain accountability. Therefore, ownership was found to be muddled when the IC performed a January 1993 study to identify the current owners/responsible managers for each external investment. Investment management was found to be either different than assigned or investments were not owned/managed by any SLT member. In these instances, the IC assigned managers to each investment and also instituted a formal process to re-affix responsibility upon transfer or reorganization. The IC is now responsible for maintaining the

list of SLT members responsible for managing investments. Although this would seem to be easily accomplished, the IC has admitted reorganizations and personnel transfers have made this difficult. In fact, during fieldwork, Internal Audit noted an instance where a responsible manager did not acknowledge ownership for an assigned investment.

The March, 1993 request resulted in September, 1993 IC Reviews where assigned managers presented a review and status of their investments to identify potential divestment candidates. At these IC meetings (Note that the 3 largest in size and cost - Philips, Kienzle, and Olivetti had not been reviewed as yet.), 47 investments were reviewed; 10 (21%) were slated for divestment; 16 (34%) needed corrective actions in preparation for sale; and 10 (21%) were deemed on course, still strategic, and were to be held.

At the September 1993 reviews, 11 investments (24%) were found to be absorbed into mainstream Digital activities to such a degree that they no longer existed. The decision to either consolidate into Digital operations or discontinue funding (liquidate) was made locally and was unknown to the Corporation until these reviews. Such independent and isolated decision making risks sub-optimal solutions, distorted financials and unknown legal or tax issues.

Besides legitimizing the sale of investments as a Corporate goal and a well planned objective, the March 1993 memo and the resulting September 1993 reviews revealed that some technology investments had been folded into current internal products and operations such that they no longer existed as a separate identity.

A Preliminary Report written by the Investment Committee, noting learnings from the September reviews, observed most external investments were relatively unimportant or immaterial (low cost) to the manager's total span of control. Thus, they garnered very little management time. Also, the specific management attention required for success was woefully underestimated when first proposed. An independent appraiser was said to have remarked when asked to assess the worth of one investment: "It (the investment) was bought high, received little management attention and added resources. Why the surprise that it is worth less (than the purchase price)?"

Recommendations

The responsible manager will remain accountable for the investment's performance unless/until reassigned by the IC. The responsible manager will ensure active and adequate management attention is provided the investment with divestment always an active alternative/consideration.

IC will continue to maintain the list of responsible managers and

ensure there is an assigned Manager for each investment at all times. Managers must receive permission from the IC prior to absorbing an identifiable investment into Digital mainstream operations.

3.0 DISPOSITION

Very few of Digital's investments are highly liquid with recognized value in public trading markets. STRATACOM, MIPS and GIGABYTE were rare exceptions that consisted of stock traded on an organized exchange. However, most investments are privately held and not publicly marketed. This lack of liquidity makes most investments very difficult to value and disposition. If the investment is to be sold, long extended periods of negotiation and much management attention and effort will be required.

Also, the overall number of qualified and interested buyers may be further limited and sale may be very time consuming and complex because most Digital investments have distinct characteristics such as small niche market presence or highly specific customer focus. The sale of DECPress took 6 months from the point where negotiations began to the day formal documents were signed. SYNERGY provides another example, where Digital Treasury has conducted protracted discussions with prospective buyers for over a year, yet, despite all this work, no available market for the stock has been identified to date. Successful divestment efforts require much business management time at the executive level, yet management has shown great reluctance in the recent past to actively work with Corporate Treasury and Law. Managers are measured by performance in their business unit and receive little credit for work performed on a divestment team. Corporate culture does not typically reward this activity.

When investments are characterized as: specialized; with few prospective buyers; suffering from poor business performance; with no independent data; indeterminate value, divestment via sale becomes very difficult. Abandonment or shut down becomes the more practical alternative. Few interviewed advocated abandonment or spin-off over sale, yet both these must be considered as equally viable options.

As noted earlier, Digital first explored divestment to increase cash flow. Since Digital's investments are also computer technology companies, their cycles are similar to Digital's. Performance and price are down when Digital would be most likely to sell to raise needed cash, and their performance would improve when Digital's performance should be best. Divestment, therefore, as a means of relieving cash pressures could very well lead Digital to sell when investments are worth the least and retain when values are at peak. Divestment is not recommended as the remedy to relieve cash pressures other than as an emergency measure.

Recommendation

Managers must understand sale is a protracted process which requires an inordinate amount of executive time. It should be recognized that abandonment and spin-offs can sometimes be more cost effective and preferable to sale. As a general rule, divestment to relieve cashflow pressures may not be cost effective in the long term.

## 4.0 PROCESS

Although there is a formal policy for External Investments (CARM 310-05) which was recently updated January 1994, divestment requirements are not addressed. There are no formally published divestment guidelines. As discovered at the September IC Reviews, business managers simply absorbed some investments into existing operations, while, in other cases, the process consisted of informal reviews by many of the same persons who were involved with the acquisition. A draft process summary format has been prepared and is awaiting approval by Vin Mullarkey, Chief Financial Officer.

A good divestment process should include data requirements that would facilitate the due diligence process for a prospective buyer. Some examples may include typical year end performance packages, similar to what is found in an annual report or prospectus. If justified, even audited financial information could be beneficial.

Also, each business should be required to specify a senior manager from within the business to represent the business in divestment efforts, supported by an experienced team from Corporate Treasury, Finance and the Law Departments.

Recommendation

Audit recommends the IC develop and widely communicate formal guidelines for the divestment process. Since the protocols are similar, Audit recommends using CARM Policy 301-05 (or some equivalent) as the basis for these guidelines.

In the interim, the draft process summary format currently under review should be approved and published.

## 5.0 RECENT ACTIVITIES

In January 1994, the Customer Business Units were organized into the Systems Business Unit. With this organizational change, the Industry Marketing V.P. has assumed responsibility for monitoring the programs (investments) within the old CBU structure. Mike Bilbao, Investments Finance, has instituted a formal review

process focusing attention to the SBU investments and producing a monthly status report to senior management. Mike meets with investment project managers ensuring IC decisions are being carried out, reviewing plans, and advising on performance. Engineering has recently installed Dennis Liptak to fulfill a similar role for Engineering investments. Both Mike and Dennis are from the Finance function, and, although Audit endorses the recent focus on monitoring and consulting activity, success in enhancing stockholder value requires total involvement of operational managers.

Recommendation

Audit supports management's recent efforts in reviewing investment performance, and recommends operational managers commit to publicly formulate and meet specific investment performance objectives.

## 6.0 PROPERTY DIVESTITURE

Background

The WW Mfg&Log Organization (recently reorganized into Computer Systems Division Manufacturing) has made steady progress in enhancing controls to support facility/plant closure planning. Guidelines have been established and updated after each closure to incorporate learnings. In addition, the WW Mfg&Log Divestment/Investment Finance Operations Group was formed to support local closure teams and conduct interval compliance tests to policies and procedures.

### 6.1 PLAN EXECUTION

Although the WW Mfg&Log Organization provided extensive management attention to the Hong Kong Plant (HKO) closure planning process, current guidelines for divestment do not ensure sufficient attention is paid to the faultless execution to plan. HKO plan timetables were aggressive and did not allow for slippage.

An October 1993 WW Mfg&Log status review revealed facility closure plans were not then in place. As of December 3, twenty-eight days before the committed vacancy, closure plans were still not complete for all areas, as noted in a WW Mfg&Log Compliance Report of that date:

o Final disposition for 77% of capital and expense items were not determined.

o The strategy for asset disposition was not clear.

- No documented closure plan for security existed.

- The record retention plan was not completed.

A post-closure report, resulting from an early February, 1994 review, indicated significant control procedures were not followed. Consequently, $1.8M of equipment at installed cost ($314K at Net Book Value) was allegedly left on-site after December 31. Local management sold equipment to former suppliers and ex-Digital employees, yet no invoices were issued. Proper asset control and accounting could not be verified. APA Security conducted an investigation as to the disposition of the equipment.

Recommendation

Audit recommends that Russ Gullotti, V.P. Computer Systems Division Manufacturing, review the timely achievement of key execution milestones by local teams to enhance control. This review should be conducted by persons independent from the local team. Further, when possible, future closure plans should allow ample time to recover should events slip from the original plan. Tight planning milestones increase pressures and jeopardize the implementation and monitoring controls.

6.2 ENVIRONMENTAL HEALTH & SAFETY

Corporate Property has been engaged in a process to understand and reduce Digital's total worldwide square footage, as a means to reduce cost outlays. Corporate Property has established square feet per person goals against which to measure and report progress.

As Digital continues to sell facilities, it is important to understand the major attributes which impact each specific property's value. This information is necessary to ensure effective sale negotiations. In the U.S., and increasingly throughout the world, environmental issues have a significant impact on real property values.

Until very recently (6-9 months), Corporate EH&S was not actively engaged in monitoring on-site EH&S activities nor involved in the Corporation's space divestment efforts. Tactical EH&S functional work was performed on-site. The Corporation had limited visibility to on-site EH&S issues. Property divestment efforts have been negatively impacted at one site:

- Westminster had not performed a full and complete assessment of environmental issues. Just prior to signing the purchase and sale agreement, the buyer conducted an environmental evaluation of the property (Sept/Oct 1993). As of April 1, 1994, the transfer date, initially scheduled for December 31, had been delayed a number of times because of environmental

issues.

Although significant environmental issues exist at the Springfield Facility, they have not impacted negotiations to date.

Recommendation

Doug Hammond (Corporate Admin. Manager), Kay Breeden (Corporate EH&S Manager), and Tom Siekman (V.P. and General Counsel) should continue working formally together to ensure an integrated effort in identifying and managing Digital's EH&S exposure.

Consistent with Kay Breeden's current detailed plans to enhance the effectiveness of the EH&S function. A central file for each Digital site will be established, identifying the property's environmental status. Also, given associated costs, EH&S will continue to prioritize site testing based on risk assessment and emphasis on sites targeted for sale.

7.0 PLANT SPIN-OFFS

To support Digital's cost reduction efforts, the WW Mfg&Log Organization has undertaken a number of plant spin-offs over the last 3 years. A plant spin-off usually consists of sale and/or transfer of Digital's assets (equipment & technology) and a contractual business commitment with the newly formed entity. Plant spin-offs enable Mfg&Log to reduce operating losses, provide potential returns to Digital, and retain access to the transferred technology.

Internal Audit examined the management activities for two Mfg&Log spin-offs; Springboard Technology (SBTC) in Springfield, Massachusetts and MicroModule Systems (MMS) in Cupertino, California. The audit focused on the planning, roles and responsibilities, execution strategy, and review processes used for these spin-offs.

The MMS spin-off took effect April, 1992. Because this was one of Digital's first spin-offs, no guidelines or support resources were in place. However, the SBTC spin-off (June 1993) was conducted under rules outlined in the WW Mfg&Log Closure Guidelines document. Audit noted the control process supporting plant spin-offs was significantly improved from the MMS to SBTC spin-offs.

7.1 NEGOTIATION STRATEGY

As evidenced in the SBTC spin-off, clear negotiation plans with identified goals afford the negotiator better positioning to effectively represent Corporate interests. Internal Audit found no documented evidence that a negotiation plan was used when developing the Digital/MMS spin-off agreement. Financial

exposure resulting from the SBTC transaction, was minimal as compared to the MMS spin-off exposure.

MMS

- o Digital guaranteed a revolving line of credit amounting to $10.6m.
- o Digital exchanged fixed assets ($35M book value) and Multi-chip technology for 1.9 million shares (19.9%) of MMS preferred stock. The equity holding has subsequently been diluted to 17% due to other MMS offerings.
- o Digital was initially responsible for an estimated $3M or more to de-fit the Cupertino facility currently sub-leased to MMS. However, to compensate for the dilution of Digital's equity interests, MMS agreed to pay half.
- o Digital management has also reported that MMS will have difficulty securing a lease in the Cupertino facility beyond August 1997. It will cost MMS an estimated $10M to move, and this will increase Digital's risk in recovering moneys lent to MMS.
- o Digital no longer needs MMS developed technology.

In contrast, the SBTC spin-off has a much better risk-reward profile for Digital:

- o SBTC secured its own $3M, revolving line of credit. Digital did not guarantee this loan.
- o Digital provided SBTC with $400K in working capital for start-up expenses and $500K for leasehold improvements.
- o SBTC agreed to pay $2.3M over 10 years for the equipment and the rights to the business.
- o The agreement to purchase SBTC product is contingent on SBTC's ability to offer competitive terms for price, quality and delivery.

Recommendation

Russ Gullotti should continue to ensure that properly approved negotiation plans are in place prior to negotiating future Mfg/Log Spin-off agreements. These plans should clearly identify Digital's position in terms of investment dollars, guarantees for loans, future purchase commitments, equipment transfers, and facility leases.

7.2 DIVESTMENT GUIDELINES

Evidence of the processes followed to ensure adequate planning and defined roles and responsibilities was not available for the MMS plant spin-off. There was no documented evidence of a project plan, implementation plan or post project review. Consequently, Audit could not verify:

- o All appropriate functions were represented throughout the process
- o There was adequate segregation of duties
- o Interests of the parties were not in conflict
- o Learnings were identified and effectively communicated

As evidenced in Springfield, planning lends to a more effective and efficient closure or spin-off. The Springfield plant spin-off benefited from the divestiture controls put in place by the WW Mfg&Log Organization. Project plans were established, responsible individuals were identified and a post project review was conducted. The Springfield spin-off was considered successful, by a majority of managers interviewed throughout audit fieldwork.

Recommendation

Russ Gullotti should continue to ensure divestment guidelines are used for site/plant closures and spin-offs. These guidelines should be periodically updated to reflect the learnings from each closure.

## APPENDIX I

## STATUS OF OWNED BUILDINGS

| | Site | User | Bldg. Vacant | Lease Exprtn | GSF |
|---|---|---|---|---|---|
| OWNED & SOLD | | | | | |
| BPO1 | Marlboro, MA | HQ | 30-Oct-90 | OWNED | 46,600 |
| PNO | Phoenix, AZ | MFG | 31-Mar-91 | OWNED | 524,460 |
| CXF | Colorado Spring | MFG | 31-Dec-91 | OWNED | 45,666 |
| MVO | Mountain View, | MFG | 28-Feb-90 | OWNED | 25,798 |
| GSO1,2 | Greenville, SC | MFG | 30-Jun-92 | OWNED | 321,560 |
| ENO | Enfield, CT | MFG | 30-Jun-91 | OWNED | 77,000 |
| HKO | Hong Kong | MFG | 30-Sep-93 | OWNED | 238,800 |
| TFO2 | Tempe, AZ | MFG | 01-Jul-92 | OWNED | 175,767 |
| HUO1 | Hudson, MA | HQ | 30-Sep-90 | OWNED | 25,725 |
| 9 Total | | | | | 1,481,376 |
| OWNED & LEASED | | | | | |
| CXN1 | Colorado Spring | MFG | 31-Mar-93 | OWNED | 105,149 |
| OWNED & VACANT | | | | | |
| APO | Andover, MA | MFG | 31-Dec-91 | OWNED | 329,599 |
| CXN2 | Colorado Spring | MFG | 31-Mar-92 | OWNED | 119,350 |
| BYO1,2 | Boylston, MA | HQ | 30-Jun-92 | OWNED | 60,381 |
| MOO | Marlboro, MA | HQ | 21-Aug-92 | OWNED | 62,080 |
| ETR1 | Madrid CLO | EURO2 | 31-Jan-93 | OWNED | 65,098 |
| HRO | Boylston, MA | HQ | 19-Mar-93 | OWNED | 6,287 |
| FXO | Franklin, MA | MFG | 31-Mar-93 | OWNED | 246,200 |
| SPO | Springfield, MA | MFG | 30-Apr-93 | OWNED | 417,339 |
| BTO | Burlington, VT | MFG | 01-May-93 | OWNED | 274,152 |
| ACO | Acton, MA | HQ | 31-May-93 | OWNED | 114,427 |
| TFO1 | Tempe, AZ | MFG | 30-Jun-93 | OWNED | 167,086 |
| DMO1 | Horsholm | EURO5 | 31-Jul-93 | OWNED | 26,986 |
| LCT | Lancaster, MA | LANDBANK | 31-Jul-93 | OWNED | 5,600 |
| ACI | Elk Grove Villa | FIELD-C | 31-Dec-93 | OWNED | 40,000 |
| ALF | Alpharetta, GA | FIELD-S | 31-Dec-93 | OWNED | 170,000 |
| CXO1,2 | Colorado Spring | MFG | 31-Dec-93 | OWNED | 190,000 |
| WMO | Westminster, MA | MFG | 31-Dec-93 | OWNED | 676,855 |
| 17 Total | | | | | 2,971,440 |
| OWNED & NOT YET VACANT | | | | | |
| GAO | Galway, Ireland | MFG | 24-Feb-94 | OWNED | 288,400 |
| KBO | Kaufbeuren, Ger | MFG | 30-Jun-94 | OWNED | 270,000 |
| MLO | Maynard, MA | HQ | 31-Jan-95 | OWNED | 1,097,858 |
| WFO | Westfield, MA | MFG | | OWNED | 542,314 |
| 4 Total | | | | | 2,198,572 |

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## DISTRIBUTION

Full Report

Charlie Christ
John Doherty
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Dept: Corporate Internal Audit
Tel No: DTN 223 7007

TO: See Below

Subject: DIVESTMENT MANAGEMENT LETTER

Attached is the final Internal Audit Management Letter for Divestment, #94-026.

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# INTERNAL AUDIT MANAGEMENT LETTER

February 21 - March 25, 1994
Field Work Dates

Bill Foley
Group Audit Manager

Audit: Divestment
94-026

Issue Date: August 1, 1994

Audit Team: Larry Abruzzese (223-7056), Ade Balogun, Jack Cohen, Diane Hayes

CONCLUSION

Divestment of once purchased investments no longer considered strategically important in furthering Corporate goals was expected to alleviate recent cash pressures. However, unresolved issues during the investment's acquisition and management phases have limited sale as a means of divestment:

- o Lack of documented and updated strategy statements adversely impact our ability to identify divestment candidates in a timely manner.

- o General plans outlining potential disposition alternatives which consider customers and other investors are not formulated when the investment is purchased.

- o Numerous management changes and reorganizations have caused ownership to be muddled and have weakened accountability for investments.

- o Very few of Digital's investments are highly liquid. Sale is consequently very time consuming and complex. Further, since investments are also in computer technology companies, their cycles are similar to Digital's; this could lead to suboptimal returns.

- o There are no formally published divestment guidelines.

Property divestiture has been the major source of divestment funds to date. Worldwide Mfg&Log (recently reorganized into Computer Systems Division Manufacturing) has instituted a continuous improvement process that has resulted in tighter process controls; however, the following issues were noted:

- o Ambitious site evacuation milestones require stricter guidelines to ensure timely execution of critical steps.

- o Corporate EH&S was not actively involved in the Corporate space divestment efforts, and was not engaged in monitoring on-site EH&S activities until recently.

RECOMMENDATION

The keys to profitable divestment of external investments begin during the investment planning phase and continue with effective management and monitoring throughout as demonstrated by the following:

- o Responsible managers must develop and document detailed strategy statements for all external investments, and keep them current.
- o Responsible managers should review existing investments and circumstances in order to identify and resolve outstanding issues impacting divestment.
- o The responsible manager must remain accountable for the investment's performance unless/until reassigned by the Investment Committee. The responsible manager will ensure active and adequate management attention is provided the investment with divestment always an active alternative/consideration.
- o The Investment Committee must develop and widely communicate formal guidelines for the divestment process.

For facility closings and spin-offs:

- o Corporate EH&S must become an integrated partner in Corporate space divestment efforts, and must be actively engaged in monitoring on-site EH&S activities.
- o WW Mfg&Log should continue to monitor and improve divestment guidelines and make use of them in future site/plant closures and spin-offs.

AUDIT OBJECTIVES AND SCOPE

The objectives of this management review were to assess and evaluate the adequacy and effectiveness of the complete divestment process from identifying candidates to their eventual disposition, and the protection of shareholder value throughout. Specifically, this review focused on the sale of Digital facilities and assets, the sale of external investments as directed by the Investment Committee in September 1993, and the corrective actions for those external investments that may represent future divestment opportunities.

The scope of this review encompassed:

- o Review and assessment of the divestiture evaluation process.
- o Achievement of established goals and objectives.
- o Reliability and integrity of information.
- o The efficient and effective use of resources and the safeguarding of assets.
- o Compliance with significant programs, policies, procedures,

laws and regulations.

BACKGROUND

Digital's once strong cash position of over $2 billion has eroded to $1.1 billion (Q4 FY94) as a result of recent unprofitable operations performance and unfavorable cash flow. In FY94, the Corporation borrowed through debt financing and preferred stock.

Divestment can be accomplished in any of five ways:

- o True divestment of the external investments.
- o Spin-offs of businesses such as printed wire boards manufacturing in Greenville and manufacturing operations in Cupertino, Springfield and Westfield.
- o Real Estate Sales/Closures, such as, Hong Kong, Phoenix, Tempe manufacturing sites.
- o Sales of Vertical Digital Businesses.
- o Sale of rights to specific products.

A series of special Investment Committee reviews were conducted during September 1993 at the request of the Senior Leadership Team. The primary objectives of these reviews were to identify candidate programs for divestiture; to ensure that FY94 plans were in place to maximize the value of each investment; and extract new learnings. The reviews covered 47 of the 57 external investment programs. As a result of these meetings, 10 programs were identified for divestment. Corrective action plans were implemented for 16 programs. Eleven investments had been so integrated with Digital that they were no longer to be tracked independently. Ten programs were considered to be on course.

The bulk of the divestment activity to date, and the primary means of generating cash, has been the closing and sale of facilities. Worldwide sale of facilities and manufacturing plants (See Appendix I) has accounted for much cash and reduction of carrying costs. In some cases, Digital has sold existing businesses to employees, while other businesses were sold to component manufacturers with minimum Digital purchase quantities providing base volumes to improve the spin-off's viability.

COMPARISON TO PRIOR AUDIT

Divestment had not been audited previously; however, the Investment Process was the topic of an Audit Management Letter (92-102) dated January 1992, and a Post-Investment Review of Kienzle and Philips (93-518) was published November 1993. The closing and sale of facilities had been addressed in three restructuring Audits. FY91 Restructuring (92-100) dated November 1991, FY92 Restructuring (93-006) dated November 1992, and FY93 Restructuring (93-042) dated October 1993.

| Management Contacts | Position |
| --- | --- |
| Ilene Jacobs | V.P. Corporate Treasury |
| Ed McDonough | Former V.P. Mfg. & Logistics |
| Marian O'Leary | Mfg. & Logistics Finance |
| | |
| John Doherty | U.S. Alliances & Acquisition Mgr. |
| Rajan Nanda | APA Alliances & Acquisition Mgr. |
| Christian Serres | Europe Alliances & Acquisition Mgr. |
| Doug Hammond | Corporate Real Estate |
| Lois Haskins | Corporate Finance |

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## 1.0 ACQUISITION

### 1.1 Investment Strategy

Venture capitalists and some conglomerates acquire other companies specifically as investments with the goal of realizing profits upon divestment. These investments are managed for growth and performance ratios that make them more attractive for resale. Unlike these companies, divestment has not been Digital's primary investment goal. Digital acquisitions have been made chiefly to enhance existing core business and to augment product strategies. These investments are thus managed and goaled as a portion of a total business rather than as separate units; their goals have become segments of a much larger Business Unit total. Sponsors advocating acquisition often do not formally document strategy upon purchase; and customarily do not update strategy documents. A July 1993 audit of the BASYS investment (93-536) noted the Communications Education & Media (CEM) Business Unit did not have a defined business strategy for BASYS that supported Digital's strategic objectives.

Since both the business environment and Corporate strategies change over time, the strategic vision for these investments must also be updated periodically. An up-to-date articulated strategy statement is even more critical during periods marked by many reorganizations and personnel changes.

Recommendation

Responsible managers must develop and document detailed strategy statements for all external investments, and keep them current.

The Investment Committee (IC) should regularly review existing strategies and should require them for all future external investments when acquired.

### 1.2 PLANNING

Small business investments are, by nature, very risky. Merger and acquisition experts note that less than half of all acquisitions succeed. Given the low probability for business success, the keys to a profitable divestment process must begin during the investment planning phase and must continue with effective management and monitoring throughout the investment period.

Prior to acquisition, submitted investment justification must include, at a minimum: 1. a realistic financial forecast 2. divestment criteria in the event of both failure and success (that is, if profitable but no longer strategically compatible to core Digital business), 3. a general contingency plan listing disposition alternatives with consideration for all stakeholders, i.e., Digital customers, other shareholders.

Documented learnings sponsored by IC reviews and others have found proposed financial, market, and business objectives to be

overly optimistic. This optimism was witnessed consistently in the January 1992 Internal Audit review of the Investment Process (92-102; January, 1992). Incompatibilities and disadvantages have routinely been underestimated.

Business managers should use sensitivity analysis to view upside, as well as downside, potential of an investment and set downside thresholds/triggers when divestment should be considered. Divestment alternatives should be included when the investment is proposed and not as an afterthought when the business is in trouble.

Very few investments have been sold after perceived successful performance. DECPress, an internally established organization, may represent such a case. Technical external investments have rarely been sold for more than the original investment. A high initial purchase price, managerial inattention, and incongruencies with new or changing Digital strategies may be partially responsible.

1.3 EXECUTION

Internal Audit noted during fieldwork that outstanding issues left unresolved at acquisition time have impeded our ability to manage investments and to initiate divestment proceedings. At the September 1993 Investment Committee Reviews a decision was made to divest our interests in Engineering Applications (EA) Systems. However the first issues that had to be addressed were concerns raised by Asea Brown Boveri (ABB), another EA stakeholder. Another consideration was the impact of our decision on significant EA and Digital customers. Both these considerations were important factors severely limiting our disposal options, delaying the sale and determining the prospective buyers list. ABB felt comfortable with Digital as the co-owner and wanted to ensure any prospective buyer was at least as cooperative. Major EA customers were also important to Digital itself therefore Digital risked customer satisfaction issues if the prospective buyer chose not to honor previous EA commitments to customers. Digital's reputation and prestige, closely tied with the investment while it is owned, remains linked even upon divestment.

Recommendation

Responsible Managers, with Corporate Treasury and Law Department advice, should study existing investments and circumstances in order to identify and either resolve (or develop strategies to address) outstanding investment issues.

Corporate Treasury and Law Departments should continue to advise managers and the Investment Committee, based on learnings, about risks that unresolved acquisition issues could pose in restricting divestment activities.

The IC should ensure all current and future investment proposals include provisions/ criteria for determining an exit strategy and ensure these are reviewed regularly. This strategy need not be

detailed, but should contain basic information that would be useful in finding buyers and noting important considerations and options.

## 2.0 PRESERVATION OF STOCKHOLDER VALUE

### 2.1 MANAGEMENT

Investment performance has been typically managed at the business unit/function level. The IC did not conduct formal investment reviews until FY92. The FY92 and FY93 reviews cycled through the investment portfolio once every two/three years. Beginning FY94, the review cycle was more formal and accelerated to be, at least, once through the portfolio annually. Also, in addition to formal review, quarterly management reporting was required over the last five quarters for investments above a minimum dollar threshold. These typically were four pages per investment.

Although some isolated sales of internally grown organizations were made, such as, DECLease and DECPress, the Corporation and the Investment Committee had not seriously considered nor encouraged divestment of external investments as a viable option until Spring 1993. A March 3, 1993 IC memo requested review of all external investments to identify potential candidates as a source of cash. Interestingly, sale was the only form of divestment that was to be explored. There was no mention of either closing/dismantling operations or of spin-offs. During the FY94 budget process, Business Unit Managers were asked to review their entire span of control - both internal assets as well as external - to identify divestment prospects. However, those interviewed told Audit this request went largely unanswered.

Also impeding the identification of divestment opportunities were numerous management changes and reorganizations. The manager who sponsored an acquisition typically managed the external investment; however, Digital's culture did not strongly establish that the original sponsor retain accountability. Therefore, ownership was found to be muddled when the IC performed a January 1993 study to identify the current owners/responsible managers for each external investment. Investment management was found to be either different than assigned or investments were not owned/managed by any SLT member. In these instances, the IC assigned managers to each investment and also instituted a formal process to re-affix responsibility upon transfer or reorganization. The IC is now responsible for maintaining the list of SLT members responsible for managing investments. Although this would seem to be easily accomplished, the IC has admitted reorganizations and personnel transfers have made this difficult. In fact, during fieldwork, Internal Audit noted an instance where a responsible manager did not acknowledge ownership for an assigned investment.

The March, 1993 request resulted in September, 1993 IC Reviews where assigned managers presented a review and status of their

investments to identify potential divestment candidates. At these IC meetings (Note that the 3 largest in size and cost - Philips, Kienzle, and Olivetti had not been reviewed as yet.), 47 investments were reviewed; 10 (21%) were slated for divestment; 16 (34%) needed corrective actions in preparation for sale; and 10 (21%) were deemed on course, still strategic, and were to be held.

At the September 1993 reviews, 11 investments (24%) were found to be absorbed into mainstream Digital activities to such a degree that they no longer existed. The decision to either consolidate into Digital operations or discontinue funding (liquidate) was made locally and was unknown to the Corporation until these reviews. Such independent and isolated decision making risks sub-optimal solutions, distorted financials and unknown legal or tax issues.

Besides legitimizing the sale of investments as a Corporate goal and a well planned objective, the March 1993 memo and the resulting September 1993 reviews revealed that some technology investments had been folded into current internal products and operations such that they no longer existed as a separate identity.

A Preliminary Report written by the Investment Committee, noting learnings from the September reviews, observed most external investments were relatively unimportant or immaterial (low cost) to the manager's total span of control. Thus, they garnered very little management time. Also, the specific management attention required for success was woefully underestimated when first proposed. An independent appraiser was said to have remarked when asked to assess the worth of one investment: "It (the investment) was bought high, received little management attention and added resources. Why the surprise that it is worth less (than the purchase price)?"

Recommendations

The responsible manager will remain accountable for the investment's performance unless/until reassigned by the IC. The responsible manager will ensure active and adequate management attention is provided the investment with divestment always an active alternative/consideration.

IC will continue to maintain the list of responsible managers and ensure there is an assigned Manager for each investment at all times. Managers must receive permission from the IC prior to absorbing an identifiable investment into Digital mainstream operations.

## 3.0 DISPOSITION

Very few of Digital's investments are highly liquid with recognized value in public trading markets. STRATACOM, MIPS and GIGABYTE were rare exceptions that consisted of stock traded on an organized exchange. However, most investments are privately

held and not publicly marketed. This lack of liquidity makes most investments very difficult to value and disposition. If the investment is to be sold, long extended periods of negotiation and much management attention and effort will be required.

Also, the overall number of qualified and interested buyers may be further limited and sale may be very time consuming and complex because most Digital investments have distinct characteristics such as small niche market presence or highly specific customer focus. The sale of DECPress took 6 months from the point where negotiations began to the day formal documents were signed. SYNERGY provides another example, where Digital Treasury has conducted protracted discussions with prospective buyers for over a year, yet, despite all this work, no available market for the stock has been identified to date. Successful divestment efforts require much business management time at the executive level, yet management has shown great reluctance in the recent past to actively work with Corporate Treasury and Law. Managers are measured by performance in their business unit and receive little credit for work performed on a divestment team. Corporate culture does not typically reward this activity.

When investments are characterized as: specialized; with few prospective buyers; suffering from poor business performance; with no independent data; indeterminate value, divestment via sale becomes very difficult. Abandonment or shut down becomes the more practical alternative. Few interviewed advocated abandonment or spin-off over sale, yet both these must be considered as equally viable options.

As noted earlier, Digital first explored divestment to increase cash flow. Since Digital's investments are also computer technology companies, their cycles are similar to Digital's. Performance and price are down when Digital would be most likely to sell to raise needed cash, and their performance would improve when Digital's performance should be best. Divestment, therefore, as a means of relieving cash pressures could very well lead Digital to sell when investments are worth the least and retain when values are at peak. Divestment is not recommended as the remedy to relieve cash pressures other than as an emergency measure.

Recommendation

Managers must understand sale is a protracted process which requires an inordinate amount of executive time. It should be recognized that abandonment and spin-offs can sometimes be more cost effective and preferable to sale. As a general rule, divestment to relieve cashflow pressures may not be cost effective in the long term.

## 4.0 PROCESS

Although there is a formal policy for External Investments (CARM 310-05) which was recently updated January 1994, divestment

requirements are not addressed. There are no formally published divestment guidelines. As discovered at the September IC Reviews, business managers simply absorbed some investments into existing operations, while, in other cases, the process consisted of informal reviews by many of the same persons who were involved with the acquisition. A draft process summary format has been prepared and is awaiting approval by Vin Mullarkey, Chief Financial Officer.

A good divestment process should include data requirements that would facilitate the due diligence process for a prospective buyer. Some examples may include typical year end performance packages, similar to what is found in an annual report or prospectus. If justified, even audited financial information could be beneficial.

Also, each business should be required to specify a senior manager from within the business to represent the business in divestment efforts, supported by an experienced team from Corporate Treasury, Finance and the Law Departments.

Recommendation

Audit recommends the IC develop and widely communicate formal guidelines for the divestment process. Since the protocols are similar, Audit recommends using CARM Policy 301-05 (or some equivalent) as the basis for these guidelines.

In the interim, the draft process summary format currently under review should be approved and published.

## 5.0 RECENT ACTIVITIES

In January 1994, the Customer Business Units were organized into the Systems Business Unit. With this organizational change, the Industry Marketing V.P. has assumed responsibility for monitoring the programs (investments) within the old CBU structure. Mike Bilbao, Investments Finance, has instituted a formal review process focusing attention to the SBU investments and producing a monthly status report to senior management. Mike meets with investment project managers ensuring IC decisions are being carried out, reviewing plans, and advising on performance. Engineering has recently installed Dennis Liptak to fulfill a similar role for Engineering investments. Both Mike and Dennis are from the Finance function, and, although Audit endorses the recent focus on monitoring and consulting activity, success in enhancing stockholder value requires total involvement of operational managers.

Recommendation

Audit supports management's recent efforts in reviewing investment performance, and recommends operational managers commit to publicly formulate and meet specific investment performance objectives.

## 6.0 PROPERTY DIVESTITURE

Background

The WW Mfg&Log Organization (recently reorganized into Computer Systems Division Manufacturing) has made steady progress in enhancing controls to support facility/plant closure planning. Guidelines have been established and updated after each closure to incorporate learnings. In addition, the WW Mfg&Log Divestment/Investment Finance Operations Group was formed to support local closure teams and conduct interval compliance tests to policies and procedures.

### 6.1 PLAN EXECUTION

Although the WW Mfg&Log Organization provided extensive management attention to the Hong Kong Plant (HKO) closure planning process, current guidelines for divestment do not ensure sufficient attention is paid to the faultless execution to plan. HKO plan timetables were aggressive and did not allow for slippage.

An October 1993 WW Mfg&Log status review revealed facility closure plans were not then in place. As of December 3, twenty-eight days before the committed vacancy, closure plans were still not complete for all areas, as noted in a WW Mfg&Log Compliance Report of that date:

- Final disposition for 77% of capital and expense items were not determined.
- The strategy for asset disposition was not clear.
- No documented closure plan for security existed.
- The record retention plan was not completed.

A post-closure report, resulting from an early February, 1994 review, indicated significant control procedures were not followed. Consequently, $1.8M of equipment at installed cost ($314K at Net Book Value) was allegedly left on-site after December 31. Local management sold equipment to former suppliers and ex-Digital employees, yet no invoices were issued. Proper asset control and accounting could not be verified. APA Security conducted an investigation as to the disposition of the equipment.

Recommendation

Audit recommends that Russ Gullotti, V.P. Computer Systems Division Manufacturing, review the timely achievement of key execution milestones by local teams to enhance control. This review should be conducted by persons independent from the local

team. Further, when possible, future closure plans should allow ample time to recover should events slip from the original plan. Tight planning milestones increase pressures and jeopardize the implementation and monitoring controls.

## 6.2 ENVIRONMENTAL HEALTH & SAFETY

Corporate Property has been engaged in a process to understand and reduce Digital's total worldwide square footage, as a means to reduce cost outlays. Corporate Property has established square feet per person goals against which to measure and report progress.

As Digital continues to sell facilities, it is important to understand the major attributes which impact each specific property's value. This information is necessary to ensure effective sale negotiations. In the U.S., and increasingly throughout the world, environmental issues have a significant impact on real property values.

Until very recently (6-9 months), Corporate EH&S was not actively engaged in monitoring on-site EH&S activities nor involved in the Corporation's space divestment efforts. Tactical EH&S functional work was performed on-site. The Corporation had limited visibility to on-site EH&S issues. Property divestment efforts have been negatively impacted at one site:

- Westminster had not performed a full and complete assessment of environmental issues. Just prior to signing the purchase and sale agreement, the buyer conducted an environmental evaluation of the property (Sept/Oct 1993). As of April 1, 1994, the transfer date, initially scheduled for December 31, had been delayed a number of times because of environmental issues.

Although significant environmental issues exist at the Springfield Facility, they have not impacted negotiations to date.

Recommendation

Doug Hammond (Corporate Admin. Manager), Kay Breeden (Corporate EH&S Manager), and Tom Siekman (V.P. and General Counsel) should continue working formally together to ensure an integrated effort in identifying and managing Digital's EH&S exposure.

Consistent with Kay Breeden's current detailed plans to enhance the effectiveness of the EH&S function. A central file for each Digital site will be established, identifying the property's environmental status. Also, given associated costs, EH&S will continue to prioritize site testing based on risk assessment and emphasis on sites targeted for sale.

## 7.0 PLANT SPIN-OFFS

To support Digital's cost reduction efforts, the WW Mfg&Log Organization has undertaken a number of plant spin-offs over the

last 3 years. A plant spin-off usually consists of sale and/or transfer of Digital's assets (equipment & technology) and a contractual business commitment with the newly formed entity. Plant spin-offs enable Mfg&Log to reduce operating losses, provide potential returns to Digital, and retain access to the transferred technology.

Internal Audit examined the management activities for two Mfg&Log spin-offs; Springboard Technology (SBTC) in Springfield, Massachusetts and MicroModule Systems (MMS) in Cupertino, California. The audit focused on the planning, roles and responsibilities, execution strategy, and review processes used for these spin-offs.

The MMS spin-off took effect April, 1992. Because this was one of Digital's first spin-offs, no guidelines or support resources were in place. However, the SBTC spin-off (June 1993) was conducted under rules outlined in the WW Mfg&Log Closure Guidelines document. Audit noted the control process supporting plant spin-offs was significantly improved from the MMS to SBTC spin-offs.

## 7.1 NEGOTIATION STRATEGY

As evidenced in the SBTC spin-off, clear negotiation plans with identified goals afford the negotiator better positioning to effectively represent Corporate interests. Internal Audit found no documented evidence that a negotiation plan was used when developing the Digital/MMS spin-off agreement. Financial exposure resulting from the SBTC transaction, was minimal as compared to the MMS spin-off exposure.

MMS

- o Digital guaranteed a revolving line of credit amounting to $10.6m.

- o Digital exchanged fixed assets ($35M book value) and Multi-chip technology for 1.9 million shares (19.9%) of MMS preferred stock. The equity holding has subsequently been diluted to 17% due to other MMS offerings.

- o Digital was initially responsible for an estimated $3M or more to de-fit the Cupertino facility currently sub-leased to MMS. However, to compensate for the dilution of Digital's equity interests, MMS agreed to pay half.

- o Digital management has also reported that MMS will have difficulty securing a lease in the Cupertino facility beyond August 1997. It will cost MMS an estimated $10M to move, and this will increase Digital's risk in recovering moneys lent to MMS.

- o Digital no longer needs MMS developed technology.

In contrast, the SBTC spin-off has a much better risk-reward

profile for Digital:

- o SBTC secured its own $3M, revolving line of credit. Digital did not guarantee this loan.
- o Digital provided SBTC with $400K in working capital for start-up expenses and $500K for leasehold improvements.
- o SBTC agreed to pay $2.3M over 10 years for the equipment and the rights to the business.
- o The agreement to purchase SBTC product is contingent on SBTC's ability to offer competitive terms for price, quality and delivery.

Recommendation

Russ Gullotti should continue to ensure that properly approved negotiation plans are in place prior to negotiating future Mfg/Log Spin-off agreements. These plans should clearly identify Digital's position in terms of investment dollars, guarantees for loans, future purchase commitments, equipment transfers, and facility leases.

7.2 DIVESTMENT GUIDELINES

Evidence of the processes followed to ensure adequate planning and defined roles and responsibilities was not available for the MMS plant spin-off. There was no documented evidence of a project plan, implementation plan or post project review. Consequently, Audit could not verify:

- o All appropriate functions were represented throughout the process
- o There was adequate segregation of duties
- o Interests of the parties were not in conflict
- o Learnings were identified and effectively communicated

As evidenced in Springfield, planning lends to a more effective and efficient closure or spin-off. The Springfield plant spin-off benefited from the divestiture controls put in place by the WW Mfg&Log Organization. Project plans were established, responsible individuals were identified and a post project review was conducted. The Springfield spin-off was considered successful, by a majority of managers interviewed throughout audit fieldwork.

Recommendation

Russ Gullotti should continue to ensure divestment guidelines are used for site/plant closures and spin-offs. These guidelines should be periodically updated to reflect the learnings from each closure.

## APPENDIX I

## STATUS OF OWNED BUILDINGS

| Site | | User | Bldg. Vacant | Lease Exprtn | GSF |
|---|---|---|---|---|---|
| OWNED & SOLD | | | | | |
| BPO1 | Marlboro, MA | HQ | 30-Oct-90 | OWNED | 46,600 |
| PNO | Phoenix, AZ | MFG | 31-Mar-91 | OWNED | 524,460 |
| CXF | Colorado Spring | MFG | 31-Dec-91 | OWNED | 45,666 |
| MVO | Mountain View, | MFG | 28-Feb-90 | OWNED | 25,798 |
| GSO1,2 | Greenville, SC | MFG | 30-Jun-92 | OWNED | 321,560 |
| ENO | Enfield, CT | MFG | 30-Jun-91 | OWNED | 77,000 |
| HKO | Hong Kong | MFG | 30-Sep-93 | OWNED | 238,800 |
| TFO2 | Tempe, AZ | MFG | 01-Jul-92 | OWNED | 175,767 |
| HUO1 | Hudson, MA | HQ | 30-Sep-90 | OWNED | 25,725 |
| 9 Total | | | | | 1,481,376 |
| OWNED & LEASED | | | | | |
| CXN1 | Colorado Spring | MFG | 31-Mar-93 | OWNED | 105,149 |
| OWNED & VACANT | | | | | |
| APO | Andover, MA | MFG | 31-Dec-91 | OWNED | 329,599 |
| CXN2 | Colorado Spring | MFG | 31-Mar-92 | OWNED | 119,350 |
| BYO1,2 | Boylston, MA | HQ | 30-Jun-92 | OWNED | 60,381 |
| MOO | Marlboro, MA | HQ | 21-Aug-92 | OWNED | 62,080 |
| ETR1 | Madrid CLO | EURO2 | 31-Jan-93 | OWNED | 65,098 |
| HRO | Boylston, MA | HQ | 19-Mar-93 | OWNED | 6,287 |
| FXO | Franklin, MA | MFG | 31-Mar-93 | OWNED | 246,200 |
| SPO | Springfield, MA | MFG | 30-Apr-93 | OWNED | 417,339 |
| BTO | Burlington, VT | MFG | 01-May-93 | OWNED | 274,152 |
| ACO | Acton, MA | HQ | 31-May-93 | OWNED | 114,427 |
| TFO1 | Tempe, AZ | MFG | 30-Jun-93 | OWNED | 167,086 |
| DMO1 | Horsholm | EURO5 | 31-Jul-93 | OWNED | 26,986 |
| LCT | Lancaster, MA | LANDBANK | 31-Jul-93 | OWNED | 5,600 |
| ACI | Elk Grove Villa | FIELD-C | 31-Dec-93 | OWNED | 40,000 |
| ALF | Alpharetta, GA | FIELD-S | 31-Dec-93 | OWNED | 170,000 |
| CXO1,2 | Colorado Spring | MFG | 31-Dec-93 | OWNED | 190,000 |
| WMO | Westminster, MA | MFG | 31-Dec-93 | OWNED | 676,855 |
| 17 Total | | | | | 2,971,440 |
| OWNED & NOT YET VACANT | | | | | |
| GAO | Galway, Ireland | MFG | 24-Feb-94 | OWNED | 288,400 |
| KBO | Kaufbeuren, Ger | MFG | 30-Jun-94 | OWNED | 270,000 |
| MLO | Maynard, MA | HQ | 31-Jan-95 | OWNED | 1,097,858 |
| WFO | Westfield, MA | MFG | | OWNED | 542,314 |
| 4 Total | | | | | 2,198,572 |

DISTRIBUTION

Full Report

Charlie Christ
John Doherty
Dick Fishburn
Russ Gullotti
Doug Hammond
Earl Kivett
Jim Mutrie
Rajan Nanda
Marian O'Leary
Lucia Quinn
John Rando
Christian Serres
Bill Strecker

DIRECTOR, CORPORATE SECURITY

Ray Humphrey

DIRECTOR WORDWIDE TRADE

Judy Maudlin

CORPORATE STANDARD

Internal Controls Committee

Dick Farrahar
Bob McNulty
Tom McEachin
Vin Mullarkey
Ron Maheu
Bob Palmer
Mick Prokopis
Tom Siekman

TREASURY

Ilene Jacobs

ASSISTANT CORPORATE CONTROLLER

Amit Nanavati

C&L

Stephen Soske

# April 14 Investment Committee

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# Investment Committee - April 14, 1992
## (Acton Conference Room; PKO3-1/Pole G7)

| | | |
|---|---|---|
| ***9:00 - 10:45*** | ***Role of Committee***<br>- Responsibilities<br>- Expectations<br>***Simple Plan of Record - What It Is*** | ***Win Hindle***<br><br><br>***Dick Fishburn*** |
| ***10:45 - 11:00*** | ***Break*** | |
| ***11:00 - 12:30*** | ***Statement of Strategic Intent - Channels of Distribution*** | ***Dick Fishburn*** |
| ***12:30 - 1:15*** | ***Lunch*** | |
| ***1:15 - 2:00*** | ***Prior Investment Review - Arthur Anderson Logistics*** | ***Eli Lipcon*** |
| ***2:00 - 3:00*** | ***Investment Proposals*** | |
| 2:00 - 2:15 | For Approval: PC Notebook Capital; U.S. Sales | TBD* |
| 2:15 - 2:30 | For Approval: Clearinghouse Proposal; Telecommunications IBU | Eric Sublet**<br>(Teleconference) |
| 2:30 - 3:00 | For Discussion: Telecommunication Acquisition; Telecommunications IBU | Matt Durnford**<br>Ernst Wellhoener<br>(Teleconference) |
| ***3:00 - 3:15*** | ***Break*** | |
| ***3:15 - 5:00*** | ***Statement of Strategic Intent - Alliance Strategy*** | ***Lucia Quinn/David Stone*** |

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* Sponsored by Bob Hughes

** Sponsored by Ernst Wellhoener, who hopes to join via teleconference at 2:30.

CFG:1/CRM/dc
4/14/92

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# INVESTMENT COMMITTEE
# (Sub-Committee of Corporate Strategy and Management Committee)

**Responsibilities**

- o Establish and maintain a simple ongoing plan of record to provide the context for investment decisions. Communicate as appropriate throughout the extended Corporation.

- o When necessary for clarity in the plan of record, resolve and align organizational interdependencies, with a focus on:

  - Multi-organizational.
  - Multi-year.
  - Non-technical strategy (technical strategy resolved at Product Committee)

- o Review and approve plans and performance to goals for non-product investments, including capital and external ventures. The Committee will also review generic categories of non-product investments for clarity of decision making.

**3/9/92**

# INVESTMENT COMMITTEE
# (Sub-Committee of Corporate Strategy and Management Committee) Cont'd

- o Maintain a process to validate business unit investment strategy with current performance.

- o Sponsors a corporate-wide investment planning process for business units, with an action orientation to decision making.

**Membership**

Win Hindle (CFO), Chair
Dick Fishburn, Executive Director
Martin Hoffmann
Charlie Christ
Bob Palmer
Bill Johnson
Dick Poulsen
Russ Gullotti

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Investment Committee

## EXPECTATIONS OF COLLECTIVE COMMITTEE

- The breadth and depth of the Committee membership provides the opportunity for significant positive change.

- The Committee is expected to be the primary corporate driving force for the Simple Plan of Record, with responsibility for the template for the overall Company Plan. Strategy definition and approval continues to reside with individual and collective operating management.

- The Investment Committee has responsibility to review and approve non-product investments that exceed the authority of an individual operating manager. The Product Committee has a similar responsibility for product investments.

- Alignment of organizational interdependencies will require integration of operational plans. Accordingly, the Committee should encourage collegial management within the Company. As such, it should exhibit the highest standards of this behavior in its own work.

- Statements of Strategic Intent represent Committee consensus. Minority opinions are expected and accepted and to the extent possible will be acknowledged in the Statements. Operational action plans will be compared with the Committee consensus.

- Future Committee membership is expected to rotate among other members of the Corporate Strategy and Management Committee. Current and future members are expected to exhibit commitment to Committee success. Committee minutes will be distributed to the full Corporate Strategy and Management Committee.

## Investment Committee
## EXPECTATIONS OF INDIVIDUAL MEMBERS

- The Committee members are expected to contribute based on their areas of expertise and significant Digital experience. Their role is not one of organizational representation.

- Continuity of individual attendance will be particularly important during the initiation phase in development of the Plan of Record (April 1992 - January 1993). Members are therefore requested to give priority to Committee meetings. In the infrequent instances when attendance is not possible, substitutes for the Operating Unit VP's are those who most closely represent similar area of expertise (e.g., Frank McCabe for Charlie Christ).

- Complete candor is expected for all Committee discussions. If there are differences of opinion among members, they should be addressed and worked to acceptable conclusion.

**Investment Committee**

## EXPECTATIONS OF COMMITTEE CHAIR

- Provide a focal point to communicate to other members of senior management key issues that arise from the Simple Plan of Record process (in both initiation and update phases).

- Ensure all points of view are understood as the basis for decision making at the Committee.

- Determine the appropriate involvement of the President and Senior Vice President, Operations in Committee matters.

- Interact with Operating and Support Group (Staff) managers to effect the efficient management of Committee matters.

Investment Committee

## EXPECTATIONS OF COMMITTEE EXECUTIVE DIRECTOR

- Coordinate the overall framework for the Simple Plan of Record.

- Create a rigorous value-added review process for decision making related to major investments within the corporation. Highlight areas where lack of alignment of organizational interdependencies places at risk committed returns for the investments.

- Frame for decision Statements of Strategic Direction for key work areas of the Company. Coordinate development of comparisons of operational action plans with desired outcomes; ensure appropriate review of opportunities.

- Provide continuity with other Corporate Committees and the BOD regarding investment matters.

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# SIMPLE PLAN OF RECORD - DESCRIPTION

The Simple Plan of Record is based on three fundamental design principals:

- A multi-year planning process to facilitate alignment of organizational interdependencies.

- Statements of Strategic Intent for 20 key work areas of the Company that provide the framework for integrated planning processes at the operational level.

- Tightly coupled interaction among planning and decision making processes so as to effectively communicate strategies, objectives, and goals throughout the Company.

The basic design of the planning process is included as Tab 4-2; a discussion of Statements of Strategic Intent, as Tabs 4-3 and 4-4; while the interaction of the processes is evident in the Investment Committee proposal format -- Tab 4-5.

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# A <u>SIMPLE</u> ONGOING PLAN OF RECORD

**Objective:** To establish a <u>simple</u> ongoing plan of record to provide the context for (investment) decisions within the Company.

**Design Assumptions:**

1. The primary goals of the plan are to ensure visibility of strategy as well as communication among the business units and functions. Where alignment of strategy is considered critical for success, a clear process of timely resolution will be established.

2. The first draft of the plan of record should be a compilation of existing business unit plans. It is recognized that significant tactical and strategic differences may exist at this stage.

3. The process must be viewed by operating management as adding value.

4. Constructive engagement must be possible among the various types of business units.

5. Based on the initial draft, the business unit strategies will be compared with statements of direction developed by senior management. It is anticipated that the development of the sense of direction and the development of an aligned investment strategy will be interactive.

6. The ongoing plan of record should build on existing processes within the corporation (e.g., rolling budgets, 8Q Volume Plan, etc.).

**Timing:** For maximum benefit, the plan of record should be updated quarterly. As mentioned earlier, creation of the update should be designed to minimize incremental work at the operating unit level. Suggested timing for the ongoing process is:

January - Major update: strategic lead-in to annual operating budget
April - Minor update
July/August - Medium update: tie first year to completed budget detail
October - Minor update

**Recommended Process:**

1. The operational submissions will emphasize statements of strategic intent across multiple dimensions, highlighting issues of competitiveness. The primary goal of the quantitative aspects of the plan are to permit inter-business unit communication.

2. The plan of record will be designed to include both a base plan of record (using Financial Planning Volumes) and opportunity volumes.

3. Financial Planning Volumes will be based on the projection of the Account Units.

4. For those business units that have opportunity plans in addition to their base plan of record, enabling resources and organizational interdependencies must be identified.

5. A timing gap in submissions may be necessary to ensure consistency within the plan of record.

6. Primary areas for communication are expected to be:

   - Industry plans -- Account Units and IBU
   - Channel plans -- Account Units, IBU, and PCU
   - Product plans -- Account Units and PCU
   - Service plans -- Account Units and SCU
   - SI plan -- SI Business Unit, Account Unit, and affected SCU

7. As corporate input, the minor updates (April and October) will include ONLY:

   - Revenue for total business unit (for example, for Account Units in Europe this would mean all European accounts)
   - Profit
   - Key asset areas, including capital expenditures
   - Staffing
   - Business factors comparison with prior plan of record. The effects of major changes in investments (e.g., acquisition, change in product plans) should be identified

8. The major update and the initiation submission will require an additional level of detail such that constructive engagement can begin and continue to exist among the business units.

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## STATEMENTS OF STRATEGIC INTENT

A design principle of the Simple Plan of Record is to describe in a concise manner for 20 areas of work the general direction or strategic intent that will lead to corporate success. Combined as a group, the 20 areas represent the framework with which investment proposals will be evaluated for corporate fit. These Statements of Strategic Intent can then be compared with operational plans to determine areas of opportunity.

Each area of work will include three sections. First, a one or two sentence summary of Strategic Intent will be developed. The next section describes **how** we intend to determine whether the Strategic Intent is achieved. Taken together, the series of outcomes for the 20 areas of work provide the structure for integrated operational planning. Finally, the operational plans pertaining to each area of work can be compared with the outcomes to determine whether current plans are likely to achieve the strategic intent.

The objective of the strategic intent process is not to set strategy. The objective is to create a framework that permits evaluation whether the individual operational strategies are aligned for collective success. If not, the process provides a means to determine whether alternative operational strategies are appropriate. The Statements of Strategic Intent will have a significant external and environmental emphasis, to ensure operational plans exhibit a continuous process of improvement relative to competitive and customer plans.

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## Statements of Strategic Intent

## INVESTMENT COMMITTEE REVIEW AND APPROVAL

| | Review | Approval |
|---|---|---|
| o Customer Perspective | | |
| - Account Management | Early Sept., Late Sept. | October |
| - Industry Focus | May, June | July |
| - Channels Strategy | April | May |
| - Horizontal Market Focus | November | January |
| o Internal Perspective | | |
| - Core Competencies | June, July | August |
| - Subsystems, Kernel Systems, and Servers | July | August |
| - Extended Infrastructure | August | Early Sept. |
| - Applications | Late Sept., October | November |
| - Information and Knowledge Services | Early Sept., Late Sept. | October |
| - Systems Integration | May, June | July |
| - Maintenance Services | November | January |
| - Pricing Strategy | August | Early Sept. |
| o Global Context | October | November |
| o Alliance Strategy | | |
| - Overall | April | May |
| - With Japanese Companies | April, May | June |
| o Organizational Excellence | | |
| - Customer Satisfaction/Quality | August | Early Sept. |
| - Benchmark | July | August |
| - Role of the Business Unit and Function | October, November | January |
| o People | Early Sept. | Late Sept. |
| o Knowledge and Learning Perspective | November | January |

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# XYZ Proposal

***Decision Requested:***

***Overview:*** A brief summary of the business rationale for the proposal

***Sponsor - BU Manager:***
***Coach:***

***Alternatives Considered:***

***Other Digital Business Units Impacted:***

***Business/Financial Summary*** (By Year by Highest Level of Business Unit)

Revenue - Before Proposal
Effect of Proposal
After Proposal

Profit Before Taxes - Before Proposal
Effect of Proposal
After Proposal

Memo: PBT Effect on Company*

Return on Assets
Cash Flow
IRR:
Payback Period:

*** If Different from Business Units**

***Issues for Discussion:***

***Recommendation of Impacted Business Units and Reviewing Staffs:***

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# Andersen Consulting (Logistics)

Eli Lipcon will bring his presentation to the Committee Meeting. The following background is from the April BOD Investment Summary (currently in progress) and has been provided by the responsible organization.

April BOD Investment Summary

Investment: Andersen Consulting (Logistics)
Responsible V.P.: Eli Lipcon
Originating V.P.: Eli Lipcon
Contact: Bob Foglietta

---

Investment Goals:
($Millions)
Original Investment requested from the Board: $8.0 Million
Current Forecast of spending: $7.6 Million

Operational Goals:

External Investment:

| PLAN | RESULTS |
|---|---|
| Meet all project and product milestones on time and on budget. | All milestones met and product release achieved in Sept. '91. Spending forecasted to be $400K less than planned. |
| Form long-term alliance with Andersen to develop large project business. | DSA agreement signed in Jan. '90. SIRA agreement signed in Jan. '92 for systems integration business. |

Financial Goals:
($Millions)

| FY'92 Commitment at the time of Board Approval: | | | Current FY'92 Forecast: | | |
|---|---|---|---|---|---|
| Revenue: | PBT: | Royalty: | Revenue: | PBT: | Royalty: |
| $89M (66 wins) | $19M | $4M | $4M (5 Wins) | ($1.4M) | $ .2M |

| Five Year Commitment at the time of Board Approval: | | | Current Five Year Forecast: | | |
|---|---|---|---|---|---|
| Revenue: | PBT: | Royalty: | Revenue: | PBT: | Royalty: |
| $437M (309 Wins) | $95M | $19M | $49M (35 Wins) | ($1.2M) | $3.9M |

Commentary:

Current projection is 5 closed sales by year-end. While start-up has been slow, Andersen's VAX pipeline is larger than their IBM product pipeline.

The internationalized version of DCS is to be released in September, 1992. It incorporates new modules, functional improvements, and multi-national features. It is actually ahead of contractual obligations.

Account sales forecasts have been revised downward for next 3 years

due to slower than anticipated roll-out, particularly in Europe, and a lower level of acceptance in the market than expected.

To generate leads and further the sales cycle, continued emphasis is being placed on joint marketing activities, including product seminars, co-operative advertising, direct mail campaigns, DECworld, Andersen's Logistics 2000 display, and Andersen's user group (ASSIST) both here and in Europe.

Advanced Micro Devices, Black & Decker and CPR (a French distributor of bank notes) are closed so far this year. Contract negotations are underway with American Airlines, Marriott Foods, and Ciba Geigy. Current pipeline consists of 34 targeted, active opportunities.

DCS was also chosen internally for Digital's Service Logistics project.

The projected mix of business now appears different than that orginally assumed. More sales are forecasted to be multi-site, favorably impacting both hardware and royalty revenue streams. Andersen's adoption of user-based pricing will favor easy implementation of additional sites.

Andersen is also planning to migrate DCS/Logistics to ALPHA. We will provide Andersen with a seed unit in Q2 FY93.

Digital and Andersen have recently been jointly awarded a $4 million contract by the Canadian goverment to do the work necessary for the final phase of a selection process aimed at implementing a new logistics system for the armed forces valued at $60 million. Two other competitors are also still in consideration. The final decision is expected in April 1993. At least four DCS modules will be used if the Digital/Andersen team wins.

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# US Sales PC Notebook Investment Proposal

Will the IRC recommend capital spending of $8.3M for the US Sales PC Notebook Investment which has a Net Present Value of $9.5M, (at 25%), and an Internal Rate of Return 92% by 1998?

## Overview:

This program will provide the US Sales force with a portable productivity tool which enables them to focus their efforts on the selling process, and therefore minimize the time devoted to administrative and less productive activities.

The PC Notebook will provide account teams with immediate access to infobases, communication, and automated tools, both to assist in the selling process and to ease administrative burdens.

**We support this proposal on the basis of increased efficiency.** That is not to say that we do not anticipate incremental revenues to result from this program, however, we have provided a conservative justification supported by the increase in sales rep productivity alone.

Because of the difficult economic environment, and the challenging competitive nature of the industry, the US Sales organization is especially supportive in those investments which will allow us to most effectively utilize our available resources.

Sponsoring Business Unit Manager: Bob Hughes
Coach: Don Zereski

## US Sales PC notebook Investment Proposal

Revenue:

Before Proposal:
Effect of Proposal: N/A
After Proposal:

Profit Before Taxes:

Before Proposal:
Effect of Proposal: $44M over seven years.
After Proposal:

Return on Operating Assets: 200%

| ($M) | FY92 | FY93 | FY94 | FY95 | FY96 | FY97 | FY98 |
|---|---|---|---|---|---|---|---|
| Cash Flow: (Cumulative) | ($2.7) | ($4.1) | $2.4 | $8.6 | $14.6 | $20.7 | $26.4 |

IRR: 92%

Payback Period: 2.6 Years

Alternative Considered:

We've reviewed smaller scale implementations of this project. It is our request, however, that the IRC approve the PC Notebook Program in full. Our implementation plan calls for a phased in process whereby the effectiveness would be monitored, and measurement against goals will be evaluated before future phases were implemented.

We do not believe that the status quo is an option. The current environment calls for innovative and highly productive modes of doing business. The PC Notebook Program is a piece of that strategy.

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## MACH PROPOSAL IN BRIEF

**Approval Requested**

Approval requested to invest K$ 1.874 in Multi Automated Clearing House (MACH) in the form of:

| | |
|---|---|
| 10% Shareholders equity (1992-1994) | K$ 374 |
| Convertible loan (4 years) | K$ 1.500 |

The IRR is 37% with a payback time of 5 years

**Business rationale**

1. Digital wants to become the market leader in the Mobile Communications Industry targeting more than 40% market share by 1995.

2. Through MACH Digital acquires a strategic position in the value chain over which it can leverage an additional 10% revenue of a M$ 100 plus market.

3. Digitals enters the lucrative market of Information Management and Information provision.

**Relation to business plan**

Addressing all aspects of the Mobile Communications market is a key element in the objectives/business plan of the Telecommunication Business Group (TBG) Europe. It allows Digital to become an active player in the Industry without becoming a competitor the the current customer base.

**Connection to Business Unit strategy**

Mobile is one of two focus areas. The Mobile Industry currently generates 20% of European Telecom business. The relative share is targeted to increase.

**Influence of economic/company conditions**

The total Mobile Coms market is positioned for a period of strong growth. The subscriber base in Europe by the year 2000 is expected to be between 10 and 20 million subscribers. (Currently 3 million)

Digitals European revenue growth in Telecom is forecasted to be over 18%. Revenue growth in Mobile is even bigger.

**Sponsor**

| | |
|---|---|
| Ernst Wellhoener | Vice President TBG-Worldwide |
| Jean-Claude Sainctavit | Director TBG-Europe |

**Financial Overview**

| K$000 | 1992 | 1997 |
|---|---|---|
| MACH Revenue | 16 | 12.642 |
| PBT | (1.036) | 7.728 |

(There will be leverage effects on other Digital business. Given the difficulty to measure these the business case is

not based on leverage effects)
IRR is 37% with payback time of 5 year.

**Alternatives Considered**
To enter Clearing House business completely on our own. Digital cannot however do this in time and would miss the window of opportunity.

INTEROFFICE MEMORANDUM

Date: 07-Apr-1992 03:53am EST
From: ERNST WELLHOENER @VBE
WELLHOENER.ERNST AT ALGOA1 at VALMTS at VBO
Dept: VB Telecom Business Group VP
Tel No: 828-6216 /ulysse::

TO: HERVE PETERSCHMITT @VBO

Subject: MACH

Gentlemen,

TBG from the beginning was focussed upon the Mobile Market because of the unique opportunity we have to become a true leader, but also because of its attractiveness in terms of growth and profitability. As one of the first steps to confirm our commitment we signed a development agreement with ERICSSON and a Marketing Agreement with RAM Data, the distributor of ERICSSONS Mobitex System to support Mobile Data applications.

With the current proposal TBG is taking another step to position Digital as a key player in the Mobile Market. The expected growth of the number of mobile subscribers within the next decade suggests that not only the number of Operators increases in the same time, thus expanding our customer base, but also the need for Mobile Services across these different Operators in various geographies. The window to establish ourselves in this Services market is there N O W! The risk of not doing it simply is to loose a perfect profit opportunity!

Therefore I ask you to support our strategy of not only be a provider of products and services to the Telecom Industry but a true participant by endorsing the proposal.

Thanks for your agreement in advance.

Ernst Wellhoener.
Vice-President
Worldwide Telecommunications Business Group

# CLEARING HOUSE PROPOSAL

INVESTMENT REVIEW COMMITTEE - APRIL 1992

**SPONSORS :**

**- ERNST WELLHOENER**

VICE PRESIDENT
TELECOM BUSINESS GROUP

**- JEAN-CLAUDE SAINCTAVIT**

DIRECTOR
TELECOM BUSINESS GROUP EUROPE

*Company Confidential*

# CLEARING HOUSE PROPOSAL

## AGENDA

1 - THE MOBILE COMMUNICATIONS ENVIRONMENT

2 - DIGITAL'S STRATEGY FOR MOBILE COMMUNICATIONS

3 - CLEARING HOUSE SERVICES - MACH

4 - INVESTMENT PROPOSAL

5 - FINANCIALS

6 - RISKS AND DEPENDENCIES

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# EUROPEAN MOBILE COMMUNICATIONS ENVIRONMENT

## YESTERDAY

- 3 MILLION SUBSCRIBERS
- ANALOG SYSTEMS
- EXPENSIVE
- BANDWIDTH SATURATION
- MONOPOLY OF NETWORK OPERATORS

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# EUROPEAN MOBILE COMMUNICATIONS ENVIRONMENT

## TOMORROW

- NEW DIGITAL TECHNOLOGY STANDARD : GSM
- 27 OPERATORS WILL START SERVICES IN CY 93
- ROAMING CAPABILITY
- NEW PRIVATE OPERATORS
- LOW COST HANDSETS
- 10 MILLIONS + SUBSCRIBERS BY END OF DECADE

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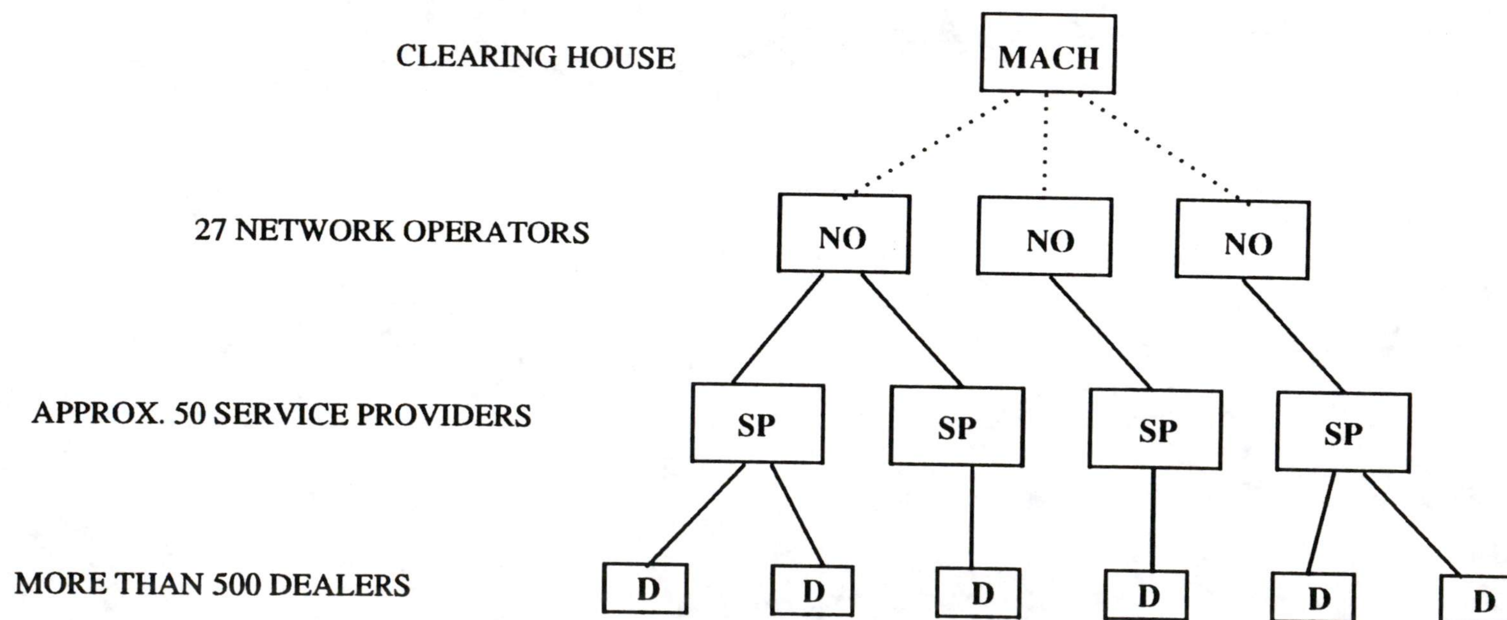
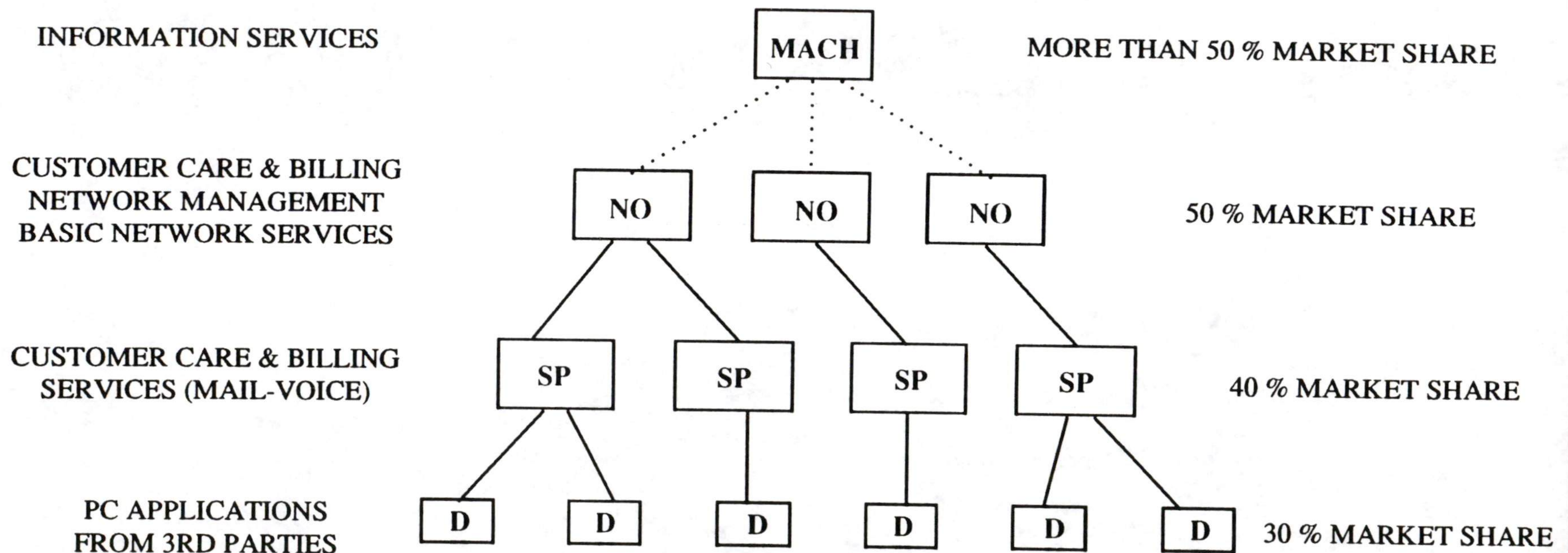
# EUROPEAN MOBILE COMMUNICATIONS ENVIRONMENT



# DIGITAL'S STRATEGY IN MOBILE COMMUNICATIONS




**RECOGNISED LEADER**
**WITH MORE THAN 40 %MARKET SHARE**
**AS SYSTEM INTEGRATOR**

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# CLEARING HOUSE SERVICES

**- ROAMING CREATES NEED FOR OPERATORS TO :**

* Collect detailed call information

* Validate and consolidate call information to enable financial bi-lateral settlement

**- MACH WILL :**

* Collect and validate all call information

* Deliver daily traffic reports to network operators

* Deliver bi-monthly reports allowing financial settlements

* Do settlement operations through bank Invik

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# CLEARING HOUSE SERVICES

## ALTERNATIVES

- **DIGITAL ALONE**
  - * Time to market problems (6 months)
  - * Little financial settlement expertise
- **DIGITAL WITH GROUP OF PTTs**
  - * Too long to organize
  - * Difficult to sell to private operators
- **DIGITAL WITH MACH**
  - * Market studies already done
  - * L.O.I. with few operators
  - * Prototype already working
  - * Service ready in 6 months

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# CLEARING HOUSE SERVICES

**MACH : Multinational Automated Clearing House**

**DAUGHTER COMPANY OF :**

**MILLICOM INTERNATIONAL Ltd :**

- Cellular telephony
- Satellite TV
- Paging

**KINNEVIK AB, STOCKHOLM WHICH OWNS :**

- 3C communications Luxembourg
- Bank Invik

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# RISKS AND DEPENDENCIES

1 - GSM LAUNCH IS POSTPONED

2 - OPERATORS CREATE A COMPETING CLEARING HOUSE

3 - ANOTHER CLEARING HOUSE IS CREATED BY A COMPETITOR

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# FUTURE ACTIVITIES

- Signature of the shareholders agreement

- Joint marketing and selling activities with a goal of winning 4 operators in CY92

- Jointly finalize the system specification and development plan

- Nominate 2 board members

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# CLEARING HOUSE PROPOSAL
# IMPACT ON DIGITAL

- BECOME "MEMBER OF THE CLUB"

  WHILE NOT COMPETITOR

- NEW REVENUES AND PROFITS

  10% LEVERAGE OF $100M+ ANNUAL BUSINESS

- ENTER INFORMATION PROVISION MARKET

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## *FINANCIAL ANALYSIS - Summary*

- *5 years NOR (1992-1997) : $15.4M*
- *5 years PAT (1992-1997) : $3.4M*
- *$1.65M Investment will yield 37% IRR*
- *Interest on Convertible Debenture will yield $640K*

# *INVESTMENT PLAN*

*K$*

| | 1992 | 1993 | 1994 | 1995 | 1996 | TOTAL |
|---|---|---|---|---|---|---|
| Equity Partners | 1113 | 1800 | 450 | - | - | 3362 |
| Equity Digital | 124 | 200 | 50 | 1282 | - | 1656 |
| Total Share Capital | 1237 | 2000 | 500 | 1282 | - | 5018 |
| Convertible Debenture (Digital) | 1500 | - | - | <1500> | - | - |

## *Shareholders Participation*

| | 1992 - 1994 | | 1995 | TOTAL | |
|---|---|---|---|---|---|
| | K$ | % | | K$ | % |
| Partners | 3362 | 90 % | - | 3362 | 67% |
| Digital | 374 | 10 % | 1282 | 1656 | 33% |
| | 3736 | | 1282 | 5018 | |

# *INVESTMENT PLAN*

- *Interest Payable Annually on Debenture : BIBOR +2%*
- *Free Option to Convert the Debenture or Redeem the Loan in 1995*
- *Conversion of Debenture at No Premium (par value)*
- *Investment Plan based on Worst Case Scenario*

# *RETURN ON INVESTMENT*

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|
| PAT Contribution | <112> | <108> | <59> | <149> | 867 | 1561 |
| Interest Income | 82 | 165 | 165 | 165 | 80 | - |
| PAT on Products | | 9 | 4 | 28 | 6 | 6 |
| Terminal Value | | | | | | 5000 |
| Total Return | <30> | 66 | 110 | 44 | 953 | 6567 |
| Investment | <1654> | <200> | <50> | 220 | - | - |
| Net Return | <1684> | <134> | 60 | 264 | 953 | 6567 |

Internal Rate of Return : 37 %

# BUSINESS PLAN

P&L

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| Revenue | | 16 | 220 | 712 | 1911 | 4273 | 8299 |
| PAT | <696> | <1118> | <1057> | <587> | <452> | <2627> | <4729> |

# CASH-FLOW

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| USE OF FUNDS | | | | | | | |
| From Operation | <624> | <1382> | <1236> | <637> | <842> | 2122 | 3865 |
| Cumulative | <624> | <2006> | <3242> | <3879> | <4721> | <2599> | 4266 |
| SOURCE OF FUNDS | | | | | | | |
| Equity | 37 | 1200 | 2000 | 500 | 1280 | - | - |
| Loan | 681 | 501 | - | - | <1182> | - | - |
| Surplus | 94 | 319 | 764 | <137> | <744> | 2122 | 3865 |
| Cumulative | 94 | 413 | 1177 | 1040 | 296 | 2418 | 6283 |

Cardinal®

**Telecommunications Business Group**

**Presentation to the IRB**

**of the**

**RABBIT**

**proposal**

**14th April 1992**

Index of slides for presentation of RABBIT proposal to IRB


Slide 1 - Title

Slide 2 - TBG projected revenues and profit without Hutchison Telecom

Slide 3 - Major trends

Slide 4 - Critical success factors for the IBU

Slide 5 - Profile of a partner

Slide 6 - Hutchison Telecom

Slide 7 - Return on investment

Slide 8 - Outsourcing revenue projection

Slide 9 - TBG projected revenues and profit with Hutchison Telecom

## Telecommunications Business Group

### Revenues and Profit

| Year | FY91 Act. | FY92 Fcst | FY93 Plan | FY94 Plan | FY95 Plan | FY96 Plan |
|---|---|---|---|---|---|---|
| NOR(M$) | 1206 | 1230 | 1434 | 1707 | 2034 | 2426 |
| Profit(M$) | 90 | 175 | 215 | 293 | 372 | 472 |
| Profit(% of NOR) | 7 | 14 | 15 | 17 | 18 | 19 |

## Telecommunications Business Group

### Major Trends

- revenue shift

Base hw/sw --> base services --> SI --> Market Partnership for End Users

- Telecomms of vital importance to all global industries

- Increasing demand for co-operation between operators and computer vendors to produce higher value services

Telecommunications Business Group

Critical success factors for IBU

- Access to upper levels of value chain
- Offer integrated solutions to End Users
- Become partner to industry to develop credibility and knowhow (leverage to develop profitable services business)
- Immediate entry into the 13 new operations that HT will create over next 8 years
- Keep competition out (principally HP)
- Develop relationship with other shareholders (Northern Telecom and Motorola)

Telecommunications Business Group

Profile of required partner

- Multiple geography
- Innovative but matching strategic vision and intent
- Free of risk (if equity by Digital) of being viewed as a competitor (carrier) by other key clients
- Service provision covers wireless. A space of critical value to other industries
- Leverage into new geographies and/or geographies where Digital and/or TBG is a minor player

Telecommunications Business Group

Hutchison Telecom

- Meet most of the above criteria
- Bypass of local loop at equivalent tariff level
- Gateway to India and China
- Testbed new competitive communications services
- Predicable revenue stream

**Telecommunications Business Group**

**Return on investment (see first attachement)**

**Telecommunications Business Group**

**Outsourcing revenue (see second attachment)**

## Telecommunications Business Group

### Revenues and Profit with Hutchison

| Year | FY91 Act. | FY92 Fcst | FY93 Plan | FY94 Plan | FY95 Plan | FY96 Plan |
|---|---|---|---|---|---|---|
| NOR(M$) | 1206 | 1230 | 1434 | 1707 | 2034 | 2426 |
| inc NOR(M$) (Outsourcing) | | 0 | 51 | 77 | 107 | 130 |
| Total | 1206 | 1230 | 1485 | 1784 | 2141 | 2556 |
| % increase | 0 | 0 | 3 | 4 | 5 | 5 |
| Profit(M$) | 90 | 175 | 215 | 293 | 372 | 472 |
| inc profit (M$) | | | | | | |
| Outsourcing | | 0 | 7 | 13 | 19 | 24 |
| Dividend | | 0 | 3 | 22 | 40 | 53 |
| Total | 90 | 175 | 225 | 328 | 431 | 549 |
| Profit(% of NOR) (without HT) | 7 | 14 | 15 | 17 | 18 | 19 |
| Profit(% of NOR) incremental | 7 | 14 | 15 | 18 | 20 | 21 |

RETURN ON INVESTMENT

US$ 150M FOR 10% STAKE IN HUTCHISON TELECOM (HT)

| | YR 1 (1992) | YR 2 | YR 3 | YR 4 | YR 5 | YR 6 | YR 7 | YR 8 | YR 9 | YR 1<br>0 | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| HT PROFIT PROJECTION (HK$M) | 50 | 360 | 950 | 2307 | 4151 | 5543 | 7143 | 7838 | 8190 | 9067 | 45599 |
| (US$M EQUIVALENT) | 6 | 46 | 122 | 296 | 532 | 711 | 916 | 1005 | 1050 | 1162 | 5846 |
| US$M | | | | | | | | | | | |
| DEC'S SHARE OF PROFIT (10%) | 1 | 5 | 12 | 30 | 53 | 71 | 92 | 100 | 105 | 116 | |
| EQUITY BALANCE | 150 | 151 | 154 | 162 | 175 | 193 | 216 | 241 | 267 | 296 | |
| ROE | 0% | 3% | 8% | 19% | 33% | 41% | 47% | 47% | 44% | 44% | |
| CASH FROM DIVIDEND (75% PROFIT) | 0 | 3 | 9 | 22 | 40 | 53 | 69 | 75 | 79 | 87 | |
| CASH OUTLAY UPFRONT | -150 | | | | | | | | | | |

IRR (without sale of equity) 16% (see note 1 below)

IRR (with sale of equity) 34% (see note 2 below)

PAYBACK 6.3 YR

Assumptions:

1. Investment of 150M for 10% stake in HT
2. Dividend is declared and paid at 75% of current year profit
3. Depreciation of PCN investment amortised for 10 years

Notes:

1. This IRR does not take into account any residual value of the equity stake.
2. Assuming P/E ratio of 15 (compared with British Telecom 8.9, Cable & Wireless 16 and Vodafone 17.1) then value of HT in year 10 would be US$ 17.4B
   If Digital's stake was sold for US$ 1.74B, then the IRR would be 34%.

Init[illegible] estimate of outsourcing revenue from Hutchison [illegible]ecom

Number of subscribers (000)

| YEAR | | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Hong Kong | | | | | | | | | | | | | |
| Cell | 68 | 90 | 110 | 121 | 173 | 212 | 252 | 292 | 324 | 356 | 390 | 425 | |
| Page | 285 | 316 | 350 | 383 | 418 | 456 | 497 | 536 | 578 | 622 | 670 | 721 | |
| CT2 | 0 | 19 | 65 | 137 | 200 | 268 | 300 | 323 | 346 | 369 | 392 | 416 | |
| Growth rates (%) | | | | | | | | | | | | | |
| Cell | | 32 | 22 | 10 | 43 | 23 | 19 | 16 | 11 | 10 | 10 | 9 | |
| Page | | 11 | 11 | 9 | 9 | 9 | 9 | 8 | 8 | 8 | 8 | 8 | |
| CT2 | | - | 242 | 111 | 46 | 34 | 12 | 8 | 7 | 7 | 6 | 6 | |
| United Kingdom | | | | | | | | | | | | | |
| Cell | 85 | 164 | 215 | 273 | 370 | 480 | 598 | 705 | 808 | 876 | 900 | 904 | |
| Page | 0 | 2 | 34 | 63 | 80 | 80 | 80 | 80 | 80 | 80 | 80 | 80 | |
| CT2 | 0 | 15 | 84 | 218 | 369 | 556 | 745 | 917 | 1072 | 1207 | 1346 | 1476 | |
| PCN | 0 | 0 | 30 | 280 | 600 | 1010 | 1340 | 1630 | 1880 | 2110 | 2310 | 2500 | |
| Growth rates (%) | | | | | | | | | | | | | |
| Cell | | 93 | 31 | 27 | 36 | 30 | 25 | 18 | 15 | 8 | 3 | 0 | |
| Page | | - | 1600 | 85 | 27 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | |
| CT2 | | - | 460 | 160 | 69 | 51 | 34 | 23 | 17 | 13 | 12 | 10 | |
| PCN | | - | - | 833 | 114 | 68 | 33 | 22 | 15 | 12 | 9 | 8 | |
| Total subscribers | 438 | 606 | 858 | 1475 | 2210 | 3062 | 3712 | 4483 | 5088 | 5620 | 6088 | 6522 | |

**Outsourcing revenue**

**Assuming US$35 per year per subscriber for IT costs, therefore outsourcing revenue is projected to be :**

| **Revenue (US$M)** | **15** | **21** | **30** | **51** | **77** | **107** | **130** | **156** | **178** | **196** | **213** | **228** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|

# Preliminary position paper

# for

# RABBIT

**Telecommunications Business Group**

**March 1992**

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3. Reason for choice Proposed partner - Hutchison Telecom ........ 4

4. Definition of business objectives through this deal ........ 5

5. "Passive" return ........ 5

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## 1. Introduction

"RABBIT" is the codename for this proposal which is to acquire a 10% equity stake in Hutchison Telecom (HT) pursuant to Telecommunications Business Group (TBG) strategy. HT is currently a wholly owned subsidiary of Hutchison Whampoa (see appendix 1 for more information).

## 2. TBG'S Strategy

**Goal:** To be, and to be perceived as, a major player in the World Telecommunications Market.

Rationale:

a) The World Telecommunication Market is the largest focus I.T Market in the world.

b) The services the World Telecommunications industry provides are critical to the success of every other industry/world wide (and therefore of direct concern to Digital).

c) As in b) this market is critical to Digital's global operations and success (strategic advantage accrues to us from depth of knowledge of this market.)

Strategic Intent: To be THE major IT player in the Telecommunications Market Worldwide.

Strategic Process: TBG is committed to moving up the value chain in the Telecommunications market to achieve massive incremental revenue gain and to increase the proportion of that revenue from an annuity base (both management fee and "annuity" certs)

Thus the percentage of revenue will shift from base hardware and software and 3rd party application to Systems Integration (e.g. DI in Germany) to Prime Contracting (e.g. Optus) to Market Partnership for end users.

Strategic Issues: Entry to the upper levels of the value chain has some constraints. Basic access is still via point applications and the Telecommunications Equipment Manufacturers (i.e. Ericsson, Siemens, ATT,etc). These partnerships are actively being worked.

Systems Integration is available in discrete areas and new operations particularly the wireless and video sectors.

Prime Contracting is generally only available (*at this time*) in new second carrier opportunities (such as Optus) or in the privatisation of state owned P.T.T.s or in the newer sectors, (again wireless) who need to get to market fast.

An alternative route to prime contracting/SI is via the development, (or provision) of year 2000 operations support systems - i.e. Optus phase 2 developments. This approach is also being worked in various areas i.e. Bell Canada.

Market Partnership is only beginning to be an opportunity.
Small activities with many accounts are beginning, based on the more traditional "sell through" basis. T.B.G.'s requirements for this area, to minimize downside risk are:

- Multiple Geography (single company operations).
- Innovative but matching strategic vision and intent.
- Free of the risk (if equity by Digital) of being viewed as a competitor (carrier) by other key clients.
- Service provision covers an entire space (given the above this can only currently be video or wireless) of critical value to all other industries.
- Leverage into new geographies/or geographies where Digital and/or TBG is a minor player.

## 3. Reason for choice

**Proposed partner - Hutchison Telecom**

Hutchison are an innovative and aggressive company with world-wide operations who are pursuing the establishment of wireless services in the Pacific Rim, China and Western Europe.

They are also one of only a few companies worldwide, currently, who meet most of the above criteria. (Second carriers/privatisations are restricted to a geography and composed of consortia). (Some of others are ATT via its SNDN, Unicom, Syncordia - all in the private networking space - thus also deficient for overall requirements, but also being worked.)

Hutchison's (and our) vision of the integrated Wireless business to provide the access for (and bypass of the local loop) the last mile would enable us, jointly, to offer a complete service for our end users (and enable them to move to new business and working practices).

It is T.B.G.'s view that the development of India and China (and some other areas), both of which are large potential Telecom markets, will require I.T. companies to enter via carriers as well as TEMs. (We plan to do both.) Hutchison is best placed in both these markets.

In addition an alliance with Hutchison would provide a predictable revenue stream from the account and its customers, and enable us to test bed new competitive communications services with shared risk and revenue.

## 4. Definition of business objectives through this deal

The equity stake suggested by this proposal provides Digital with the method of gaining predicable sources of long term revenue. Working with HT would also allow us to offer integrated solutions to our common end users. These solutions would not only include the usual mix of hardware, software and Systems Integration services but would also integrate telecommunication services. This level of equity in HT also places Digital in a good position to acquire a majority shareholding sometime in the future if this is deemed advantageous to Digital's long term direction.

In return for the equity Digital would receive a seat on the board of directors which would allow us to learn about the operation of the business. This knowledge could then be transferred into Digital, so enhancing our capability to work with other Telecommunications Service Providers (TSP) and giving us the ability to go after new and greenfield operations (e.g. India and China).

## 5. "Passive" return

The passive return on this investment will come from annual dividend payments and appreciation in value of our equity.

**(See Appendix 3 for review of financial returns)**

## 6. Return from Outsourcing

The potential revenue that Digital could earn by undertaking the management of Hutchison's information technology services (outsourcing) is given in Appendix 4. This is an approximate estimate based on the number of subscribers that Hutchison project they will have over the next ten years. Obviously in order to undertake outsourcing in HT's existing operations Digital would need to repurchase Hutchinson's IT operation. This investment has not been considered to date but will be taken into account when the full business plan for outsourcing is developed.

## 7. Risks

PCN in UK both from the point of view of the level of total investment (800 million pounds) and whether British Aerospace, who are contractually committed to finance 30% of this cost, will remain a shareholder of Hutchison Telecom (UK).

## 8. Alternative approaches

The main elements of this proposal are that Digital acquires a 10% equity stake in HT in return for a ten year contract to be the sole supplier of IT services to HT (Outsourcing). This would imply that Digital acquires HT's current IT operations including relevant people, hardware, software and contracts with other vendors and application software suppliers.

HT estimate themselves to be worth between US$ 1.2 to 1.5 Billion today. The process of due diligence will establish if this estimate is reasonable.

There are currently two potential ways of acquiring the 10% stake. The first way is to pay US$ 120 or 150 Million directly to Hutchison Whampoa, the parent company. The other approach proposed by HT is to expand the capital base of the company by selling 40% for US$ 1 Billion with the money staying inside Hutchison Telecom and Hutchison Whampoa would then have a reduced stake (60% as opposed to 100%) in the expanded Hutchison Telecom.

The amount could be paid for in either cash or deferred cash or Digital equity or by a more complex financial instrument or by supplying hardware, software and services in lieu of cash or a mixture of various forms of payment.

The two different methods are outlined below :

### Method 1 - Cash or combined with DEC stock

This would require the payment of between US$ 120 and 150 Million or US$ 250 Million either in cash or a combination of cash and Digital stock directly to Hutchison Whampoa in return for 10% equity stake in Hutchison Telecom (Hong Kong).

The benefits to HT of this approach is that it is quickly executed, clearly demonstrates Digital's commitment and in the case of the US$ 250 million investment they would have the cash available to develop their business.

The advantages to Digital are that there will be no need for management of the "credit" for services in lieu so saving management overhead and also any problems that may occur with metrics are minimised as business is booked in each country but under an umbrella agreement.

### Method 2 - Limited cash and Services

The proposal here is to pay a sum of US$ 50 or 75 million in cash and the balance in services in lieu of cash provided in the form as described above. These services in lieu would have to be provided at today's value i.e. any services provided after the first year would have to be discounted back to today's value.

The benefits of this method to both HT and Digital appear to be less significant that the first method due the the complexity involved in controlling and managing the provision of services in lieu on a worldwide basis.

## 9. Benefits to Hutchison Telecom and Digital

The benefits to Hutchison Telecom are as follows :

- Reduction of costs
- Release scarce management resources which could be better used to manage future expansion
- Priviledged access to IT technology
- Digital's global presence leading to faster set up of new operations
- Respectability of an alliance with Digital
- Access to Digital's customer base
- Digital's commitment demonstrated by acquisition of equity

The benefits to Digital are as follows :

- Lock out competition
- Reduced cost of sale
- Predicable sources of revenue from provision of services under long term contract and dividend payments
- Develop understanding of business in order to be able to develop next generation of applications which could be sold to other customers whilst respecting confidentiality
- Digital would have a Director on the board of HT who would have continuing operational involvement
- Digital will be well positioned to sell Systems Integration services to customers who wish to use HT's services.

## Appendix 1 - Hutchison Whampoa Limited

### Overview

Hutchison Whampoa Limited (HWL) is a Hong Kong based company with interests in property, container terminals, retail and other services, energy,finance and investment and telecommunications. HWL's 1990 revenue was 2048 million US$ which produced 560 million US$ profit including 109 million US$ of extraordinary profit. Approximately 80% of HWL's profits are generated in Hong Kong.

The chairman of HWL is Li Ka-shing who effectively controls the company via a 39.7% equity stake held by his company Cheung Kong in which he holds a 34.9% equity stake.

**HWL's revenue and profit for last five years**
(all figures in US$ millions)

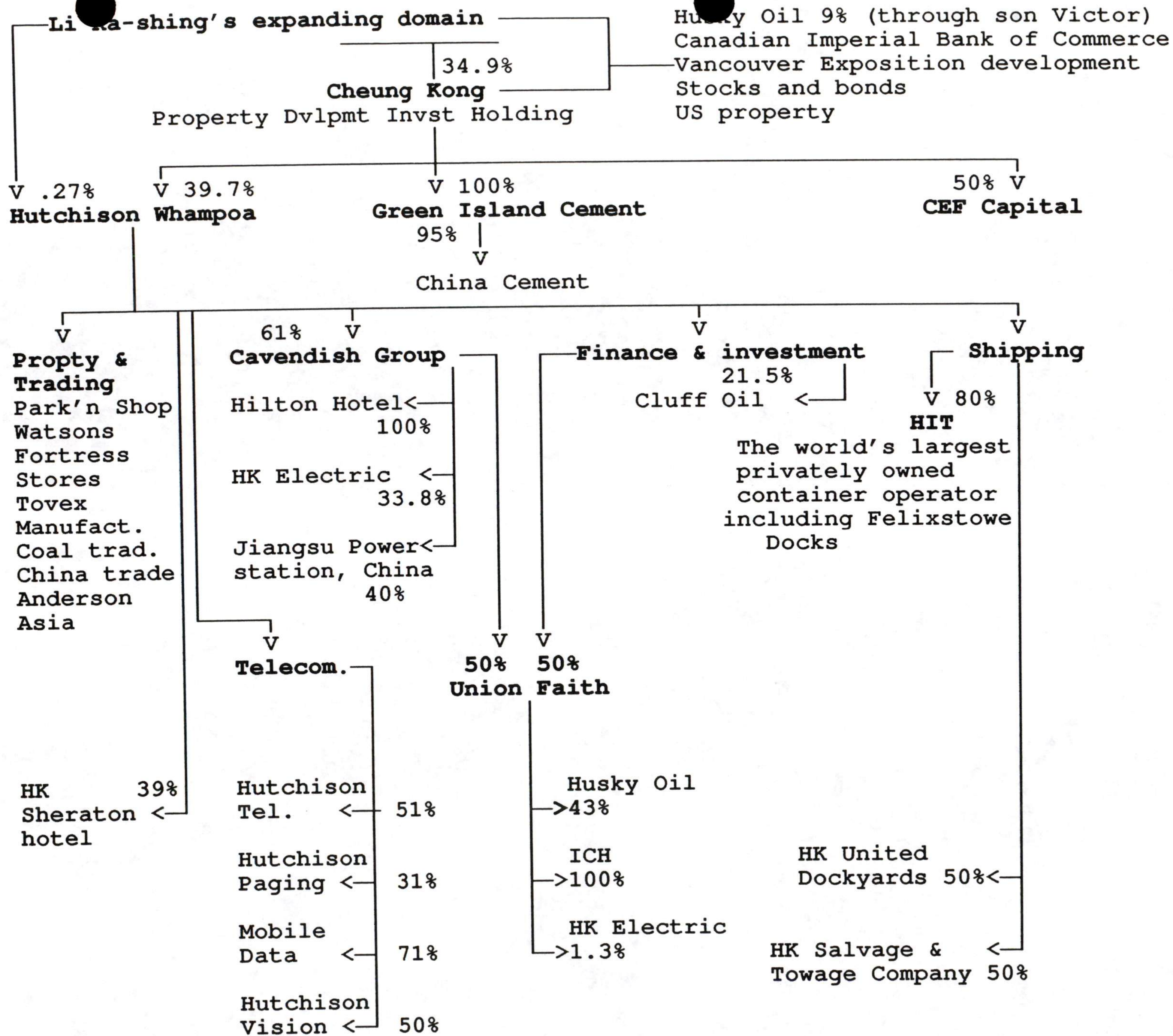
| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|
| Turnover | 700 | 965 | 1349 | 1650 | 2267 | 2048 |
| Profit after tax | 153 | 209 | 239 | 300 | 389 | 451 |
| Extraordinary items | 47 | 72 | 98 | 165 | 391 | 109 |
| Total profit | 200 | 281 | 337 | 465 | 780 | 560 |
| % profit/turnover | 28 | 29 | 25 | 28 | 34 | 27 |

**Profit from Divisions as reported in 1990**

| | 1990 profit after tax but before extraordinary items (all figures in US$ millions) |
|---|---|
| Property | 172 |
| Containers | 64 |
| Retail/other services. | 51 |
| Energy,Finance,Investment | 16 |
| Associated companies (estimation after tax) | 148 |

Note : Telecommunications is reported in with Retail and Other services.

(Source of information : Hutchison Whampoa Limited Annual Report 1990)




Note that all the companies above are moving towards greater automation thus opening up other potential markets for Digital outside of Telecommunications.

## Appendix 2 - Hutchison Telecommunications

Hutchison Telecom (HT) are the world's leading and most innovative wireless service provider. They are headquartered in Hong Kong but with world-wide markets. They started their operations in Hong Kong in 1985 with investment money from their parent company, Hutchison Whampoa, and they now have a 50% market share of the cellular telephone and paging markets in Hong Kong.

HT have expanded into Australia where they are operating a paging service. Due to their involvement with Kalori, the competitor to OPTUS, they are highly likely to receive a GSM license as they have already established their credentials during the bidding for the second telecommunications license in Australia. They plan to expand their operations into Asia (China, Taiwan) and the Indian sub-continent (India, Pakistan, Bangladesh) and into Western Europe and they are actively pursuing licenses in all these areas. They propose to deliver wireless-based services in these areas.

HT's largest operation outside of Hong Kong is UK where they have made a significant investment. In the last 18 months they have acquired a customer base of 170 thousand for cellular telephone service provision, licenses for paging, mobile data and personal communications networks. HT have recently acquired a company in Germany which will form the basis of their German subsidiary. They have won licenses in Portugal and Poland where they will commence operations in the near future and also have plans to open operations in other European countries with France and Greece imminent.

INVESTMENT FOR 10 YRS RETURN

US$ 150M FOR 10% STAKE IN HUTCHISON TELECOM (HT)

| | YR 1 (1992) | YR 2 | YR 3 | YR 4 | YR 5 | YR 6 | YR 7 | YR 8 | YR 9 | YR 10 | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| HT PROFIT PROJECTION (HK$M) | 50 | 360 | 950 | 2307 | 4151 | 5543 | 7143 | 7838 | 8190 | 9067 | 45599 |
| (US$M EQUIVALENT) | 6 | 46 | 122 | 296 | 532 | 711 | 916 | 1005 | 1050 | 1162 | 5846 |
| US$M | | | | | | | | | | | |
| DEC'S SHARE OF PROFIT (10%) | 1 | 5 | 12 | 30 | 53 | 71 | 92 | 100 | 105 | 116 | |
| EQUITY BALANCE | 150 | 151 | 154 | 162 | 175 | 193 | 216 | 241 | 267 | 296 | |
| ROE | 0% | 3% | 8% | 19% | 33% | 41% | 47% | 47% | 44% | 44% | |
| CASH FROM DIVIDEND (75% PROFIT) | 0 | 3 | 9 | 22 | 40 | 53 | 69 | 75 | 79 | 87 | |
| CASH OUTLAY UPFRONT | -150 | | | | | | | | | | |

IRR (without sale of equity) 16% (see note 1 below)

IRR (with sale of equity) 34% (see note 2 below

PAYBACK 6.3 YR

Assumptions:

1. Investment of 150M for 10% stake in HIL (Telecom group)
2. Dividend is declared and paid at 75% of current year profit
3. Depreciation of PCN investment amortised for 10 years

Notes:

1. This IRR does not take into account any residual value of the equity stake.
2. Assuming P/E ratio of 15 (3 compared with British Telecom 8.9, Cable & Wireless 16 and Vodofone 17.1) then value of HT in year 10 would be US$ 17.4B
   If Digital's stake was sold for US% 1.74B, then the IRR would be 34%.

Number of subscribers (000)

| YEAR | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Hong Kong** | | | | | | | | | | | | |
| Cell | 68 | 90 | 110 | 121 | 173 | 212 | 252 | 292 | 324 | 356 | 390 | 425 |
| Page | 285 | 316 | 350 | 383 | 418 | 456 | 497 | 536 | 578 | 622 | 670 | 721 |
| CT2 | 0 | 19 | 65 | 137 | 200 | 268 | 300 | 323 | 346 | 369 | 392 | 416 |
| Growth rates (%) | | | | | | | | | | | | |
| Cell | | 32 | 22 | 10 | 43 | 23 | 19 | 16 | 11 | 10 | 10 | 9 |
| Page | | 11 | 11 | 9 | 9 | 9 | 9 | 8 | 8 | 8 | 8 | 8 |
| CT2 | | - | 242 | 111 | 46 | 34 | 12 | 8 | 7 | 7 | 6 | 6 |
| **United Kingdom** | | | | | | | | | | | | |
| Cell | 85 | 164 | 215 | 273 | 370 | 480 | 598 | 705 | 808 | 876 | 900 | 904 |
| Page | 0 | 2 | 34 | 63 | 80 | 80 | 80 | 80 | 80 | 80 | 80 | 80 |
| CT2 | 0 | 15 | 84 | 218 | 369 | 556 | 745 | 917 | 1072 | 1207 | 1346 | 1476 |
| PCN | 0 | 0 | 30 | 280 | 600 | 1010 | 1340 | 1630 | 1880 | 2110 | 2310 | 2500 |
| Growth rates (%) | | | | | | | | | | | | |
| Cell | | 93 | 31 | 27 | 36 | 30 | 25 | 18 | 15 | 8 | 3 | 0 |
| Page | | - | 1600 | 85 | 27 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| CT2 | | - | 460 | 160 | 69 | 51 | 34 | 23 | 17 | 13 | 12 | 10 |
| PCN | | - | - | 833 | 114 | 68 | 33 | 22 | 15 | 12 | 9 | 8 |
| Total subscribers | 438 | 606 | 858 | 1475 | 2210 | 3062 | 3712 | 4483 | 5088 | 5620 | 6088 | 6522 |

Outsourcing revenue

Assuming US$35 per year per subscriber for IT costs, therefore outsourcing revenue is projected to be :

| Revenue (US$M) | 15 | 21 | 30 | 51 | 77 | 107 | 130 | 156 | 178 | 196 | 213 | 228 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|

7

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# Future Meeting Timing

| | |
|---|---|
| May | 6 |
| June | 1 |
| July | 13 |
| August | 3 |
| September | 8 |
| September | 28 |
| October | 26 |
| November | 23 |

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Based on Corporate Calendar Rev 2, 4/4/92

CFG:1/CRM/dc
4/14/92