

<http://www.mercurynews.com/mld/mercurynews/15170234.htm>

Posted on Tue, Aug. 01, 2006

SanDisk buying firm hurt by options probe SECOND SUCH DEAL IN PAST WEEK CREATES A FORCE IN FLASH MEMORY

By Dean Takahashi
Mercury News

Creating a powerhouse in flash memory chips that store data on gadgets from cell phones to iPods, SanDisk has agreed to pay \$1.55 billion in stock to acquire Israel-based msystems.

The deal could help the Israeli company avoid ongoing headaches from its stock price, which dipped in the fallout from an investigation into whether msystems had backdated stock options.

The deal values msystems stock at about \$36 a share, a 26 percent premium over its average value from the month of trading that ended Friday. Each msystems shareholder will receive 0.76 shares in SanDisk if the deal closes as scheduled in the fourth quarter.

While both companies touted the technological and business reasons for the merger, it raised the question of whether acquirers are pursuing companies with deflated stock prices connected to investigations of backdating. The deal is the second big tech acquisition in a week where the target company being acquired is enmeshed in a stock-option backdating investigation.

“The investigations would seem to make many Silicon Valley companies more interesting to potential buyers who are looking for a lower price,” said Richard Whittington, an analyst at Caris & Co. “You are likely to see mergers pick up. But this deal is very strategic for SanDisk. It creates a powerhouse, and it might have happened anyway.”

Judy Bruner, chief financial officer for SanDisk in Milpitas, said the backdating investigation didn't serve as a catalyst for the deal. She noted that SanDisk had to assess the potential impact of the options practices at msystems, lengthening the process of sealing the deal.

“We think this is a very strategic, long-term deal,” she said.

SanDisk and msystems are complementary despite being competitors, with each doing well in different parts of the NAND flash memory chip market, Bruner said. SanDisk does well selling its own branded flash chips in universal serial bus packages in retail stores under the SanDisk brand name. By contrast, msystems sells chips to companies that put their own brand names on the USB packages.

Jim Handy, an analyst at Semico Research, estimated that both companies now hold about 30 percent of the USB flash market and compete with Samsung, Micron Technology and Toshiba. Micron recently stepped up the pressure on SanDisk by acquiring Fremont-based Lexar Media for \$850 million.

SanDisk is also adding a lot of new factory capacity. Bruner said converting msystems chips so they can be made in SanDisk's factories will save money and help fill the factories coming on line.

The combined company will have 850 employees from msystems and 1,350 from SanDisk. Bruner said the combined company will look for cost savings but said she expects SanDisk to retain most of the msystems workforce.

Started by entrepreneur and Chief Executive Dov Moran, msystems is a 17-year-old spin-off from the Israeli military. SanDisk, also started by another Israeli entrepreneur, Eli Harari, is a year older than msystems.

“It's like these companies were separated at birth,” Whittington said.

Earlier this month, msystems said the Securities and Exchange Commission was investigating whether the company backdated its stock option awards to days when its stock price was low in order to inflate executive compensation. The Israeli company had to postpone a planned stock offering and said it would restate four years of financial results.

Bruner said that SanDisk thought about the security risk of buying an Israeli company at a time when Israel is at war with its neighbors. But she noted that msystems is located in Kfar Saba, a short drive from Tel Aviv and well away from the Lebanon or Gaza borders.

Analysts say tech companies with backdating investigations may be more attractive acquisitions because their stock prices have fallen, but that isn't a major factor in determining an acquisition.

“I'm surprised that SanDisk got this company for such a low purchase price, but I'm also surprised this deal didn't happen much earlier,” said Satya Chillara, an analyst at American Technology Research.

Shares of msystems rose \$4.21, or 13.2 percent, to close Monday at \$36 on the Nasdaq. SanDisk shares fell 48 cents, or 1 percent, to \$46.66.