



Deal Logic

Red Hat Inc./IBM Corp.

WHU Finance Society

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Abstract

Disrupt yourself to avoid getting disrupted: Large firms struggling with further growth, acquiring smaller innovation drivers with complementary assets isn't something new. But what is hard, in this context, is to justify the surging valuations and to identify the underlying synergies. When it comes to the High-Tech sector this can quickly become a philosophical question. The big question in the acquisition of Red Hat Inc. by IBM, analyzed in this Deal Logic, is the one concerning the future of cloud computing, especially when it comes to customer approval.

After a timid 2017 for US technology deals, we saw a strong turn in 2018 with a deal value increase of 38%, the consolidated value of transactions being USD 240.1bn, while the deal volume stayed approximately the same. This growth is rooted in two developments. Firstly, we can see a strong increase in acquisitions in the software sector, making it by the far the largest sector of M&A activity within the tech industry, others being IT Services, Internet, Semiconductors, and Hardware respectively. Secondly, the number of mega deals (deal value >USD 5bn) almost doubled. The most notable among those being IBM's acquisition announcement of Red Hat Inc., a major distributor of open-source software and technology, for USD 33.6bn in October. The acquisition is by far IBM's largest deal in its history and the third-biggest in the history of U.S. technology.

The payment method of cash and debt did not come as a surprise. Not only did the NASDAQ index experience a downward correction starting October 2018, but also IBM's stock, which decreased almost 20% between the 1st of October up until the announcement date. This decreased the probability of IBM's stock to be overvalued and, therefore, making a stock payment unattractive. The use of debt financing still remains relatively cheap, especially as IBM plans to return to its normal leverage ratio within the next two years. In order to reach that goal, dividends are not planned to be changed, but its share repurchase program will be suspended for 2020 and 2021.

So, will IBM succeed in disrupting itself before getting disrupted? The public cloud market is characterized by strong competition for market share with players such as Google and Amazon. After Microsoft's USD 7.5bn acquisition of GitHub to strengthen its open source engagement on Azure, Microsoft's cloud computing service, IBM has struggled to

keep up. The underperformance of the acquired firm SoftLayer and missed high hopes for the cloud foundry-based BlueMix with its strategic moves, namely Watson and blockchain, didn't bring the expected fast track acceleration. According to Synergy Research Group's latest public cloud report, IBM is far behind Amazon Web Services (AWS) and Azure. The market opinion is that the acquisition of Red Hat will not help IBM to become a cloud computing powerhouse. So how can the 63% premium be justified? Customer relationships are probably not the reason. Most of the blue-chip firms covered by Red Hat are mostly already covered by IBM, due to its wide range of products and services.

A key purchase aspect could be IBM's strategy towards hybrid IT. It comprises a flexible approach to enterprise computing in which a firm manages some IT resources in-house and others cloud-based. Red Hat's key asset is a successful middleware environment with OpenShift, called Kubernetes, which complements IBM's monolithic and mainframe enterprise customer support for cloud computing. Red Hat will become a unit of IBM's Hybrid Cloud division. The joint forces between IBM and Red Hat developers can act as an accelerator for the development of Hybrid Cloud solutions, a game-changing technology, which no one in the market has fully mastered. Statements by IBM, clarifying that this transaction aims for revenue growth rather than cost synergies, confirm that this is a growth rather than a profitability measure. A possible threat to the realization of synergies could be defections of former Red Hat employees, which IBM could address with adjustments in compensation and corporate culture.

All values in USDm, except Price, Initial (USD) & Price, Paid (USD)

Summary

Target	Red Hat Inc.
Acquirer	IBM Corp.
Date, Announ.	28.10.2018
Date, Effective	Pending
Deal Attitude	Friendly
Consideration	100% Cash
%Held/%Sou.	0.0 / 100.0
Deal Value	33,555
Price, Initial	190.00
Price, Paid	190.00
Total Fees	184.2
Premium*, 1d	62.8
Premium*, 1w	58.2
Premium*, 4w	39.4

* Pre-bid (%)

Sources: Thomson Reuters Eikon, CNBC, Forbes

Synopsis

- IBM offered USD 33.6bn to acquire Red Hat in October 2018
- Some 99.5% of shareholders voted to approve the deal, with about 80% of shares casting votes
- Red Hat shareholders will receive USD 190.00 in cash per share should the deal win shareholder and other regulatory approvals
- Prior to the acquisition, Red Hat's market capitalization stood at approximately USD 20.5bn.
- At signing, IBM had ample cash, credit and bridge lines to secure the transaction financing and intends to close the transaction through a combination of cash and debt.
- It's IBM's biggest deal ever, and the third-biggest in the history of U.S. tech

LTM Transaction Multiples

	Target	Acquirer	Industry†
EV/Sales	9.1x	1.9x	4.5x
EV/EBITDA	50.0x	8.7x	12.4x
EV/EBIT	61.0x	12.9x	16.1x
P/E	80.3x	10.0x	18.7x

† Of Target, Prepackaged Software, SIC: 7372

Rationale

- IBM has been struggling in a competitive cloud market, requiring action to not lose significant ground in the cloud computing race
- This acquisition blends hybrid cloud and open source synergies.
- Both companies target hybrid cloud from different angles; RedHat provides a compelling middleware environment with OpenShift, while IBM supports enterprise customers with monolithic and even mainframe support in their cloud offering.
- Both companies have a long track record of creating and contributing to OSS projects, with Red Hat in particular being the most successful Linux-driven company ever.
- Red Hat's Linux container software OpenShift is the key to the deal; it accelerates IBM's ability to help enterprises migrate workload to and between multiple cloud

Financial Advisors

Target	Fees	Acquirer	Fees
Guggenheim Partners	79.5	Goldman Sachs & Co	20.5
Morgan Stanley	43.3	JP Morgan	20.5
		Lazard	20.5

All values in USDbn, except EPS

Recent News*

- **2018/09** Red Hat shares plunged again after a mixed quarter and underwhelming guidance. At issue is the company's rate of deceleration: revenues grew at just 14% y/y this quarter versus 20% y/y in Q1
- **2018/06** Red Hat drives mission-critical stability with latest update to Red Hat Enterprise Linux 6
- **2018/05** At the Red Hat Summit, Red Hat Inc. has announced a handful of collaborations, partnerships and roadmaps, among them its plans to focus on the hybrid cloud sector by expanding the company's relationship with technology juggernaut IBM Corp.
- **2018/01** Red Hat has announced that it will buy container specialist CoreOS for USD 250m. The declared aim of the acquisition is to strengthen their segment of Kubernetes

* Prior To Deal

Sources: Thomson Reuters Eikon, Red Hat Investor Relations, Business Wire, Seeking Alpha

Company Description

- Red Hat Inc, located in Raleigh, North Carolina, provides open source software solutions, using a community-powered approach to develop and offer operating system, middleware, cloud, mobile, and storage technologies
- The company has become associated to a large extent with its enterprise operating system Red Hat Enterprise Linux and with the acquisition of open-source enterprise middleware vendor JBoss. Red Hat also offers Red Hat Virtualization (RHV), an enterprise virtualization product.
- Red Hat's consulting services include upgrade planning, platform migrations, and solution integration
- The company was founded in 1993

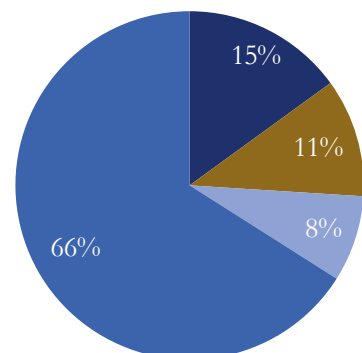
Key Management & Ownership Structure



James Whitehurst
CEO
Since 2008



Eric Shander
CFO
Since 2017



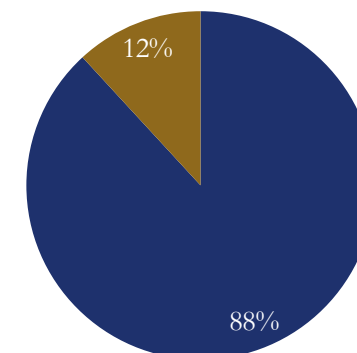
- T. Rowe Price Associates, Inc.
- The Vanguard Group, Inc.
- Fidelity Management & Research Comp.
- Freefloat

Key Financials

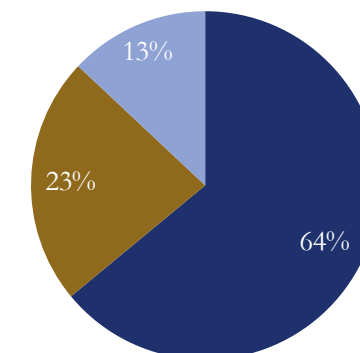
	2016A	2017A	2018E	2019F	2020F
Sales	2.1	2.4	2.9	3.4	3.9
% growth	14.7	17.5	21.1	15.3	15.1
EBITDA	0.5	0.6	0.8	0.9	1.0
% margin	14.8	20.1	19.0	15.7	16.7
Net Inc.	0.4	0.4	0.5	0.6	0.7
% margin	17.3	16.6	30.5	19.5	13.9
EPS	1.91	2.27	2.98	3.54	3.99

Sales Split

FY2018



- Software Subscriptions
- Training and services



- America
- EMEA
- Asia Pacific

All values in USDbn, except EPS

Recent News*

- **2019/01** IBM earnings beat Wall Street estimates on the top and bottom line for the company's fourth quarter. IBM stock rose in after-hours trading
- **2019/01** Red Hat investors approve USD 34bn merger agreement with IBM
- **2018/11** Post-acquisition, Red Hat promises things won't change – that they'll still support the same cloud platforms while giving extra emphasis to IBM Cloud
- **2018/10** IBM announced it would acquire Red Hat in an all cash deal for USD 34bn or USD 190.00 per share of Red Hat.
- **2018/03** IBM launches AI-powered 'Watson Assistant' for businesses

* Prior To Deal
Sources: Thomson Reuters Eikon, IBM Investor Relations, Economic Times

Company Description

- The International Business Machines Corporation (IBM) Corporation is an American multinational information technology company headquartered in Armonk, New York
- The company was incorporated in 1911 and currently has operations in over 170 countries
- IBM produces and sells computer hardware, middleware and software, and provides hosting and consultancy services in areas ranging from mainframe computers to nanotech
- The company has a large and diverse portfolio of products and services. These offerings fall into the categories of cloud computing, cognitive computing, commerce, data and analytics, Internet of Things (IoT), IT infrastructure, mobile and security

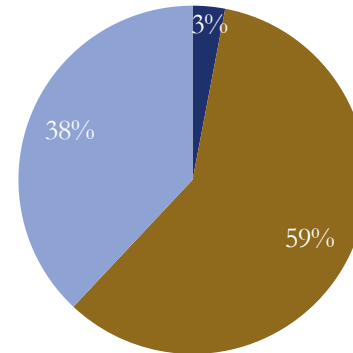
Key Management & Ownership Structure



Virginia Marie Rometty
CEO
Since 2012



James Kavanaugh
CFO
Since 2018



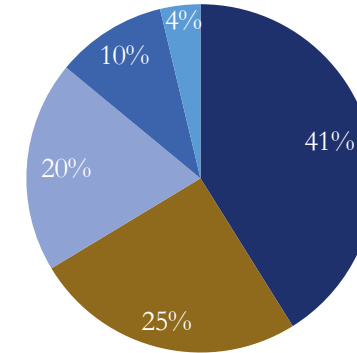
■ Brokers
■ Investment Managers
■ Freefloat

Key Financials

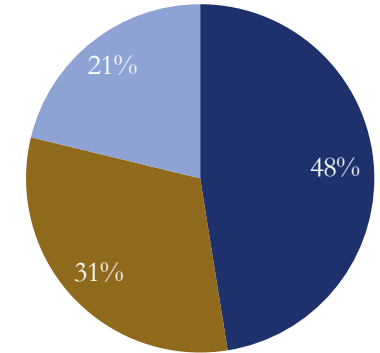
	2016A	2017A	2018E	2019F	2020F
Sales	79.9	79.1	79.6	78	78.6
% growth	(2.2)	(1.0)	0.6	(1.9)	0.7
EBITDA	17.4	18.7	18.51	18.5	18.9
% margin	21.8	23.7	23.2	23.7	24.1
Net Inc.	13.0	12.9	12.6	12.4	12.4
% margin	16.3	16.3	15.9	15.9	15.8
EPS	12.38	6.14	9.52	12.21	12.72

Sales Split

FY2018



■ Tech / Cloud ■ Cognitive solution
■ Business services ■ Systems
■ Financing



■ America ■ EMEA ■ Asia Pacific

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