

Siemens Doubles Down on its Software Business with the \$4.5bn Acquisition of Mentor Graphics

Siemens AG (ETR: SIE)—market cap as of 28/04/2017: €111.86bn

Introduction

On November 14, 2016, Siemens, Europe's largest manufacturing and electronics conglomerate, announced that it had entered into an agreement to acquire the electronic design automation company Mentor Graphics, in a transaction valued at c. \$4.5bn. The cash offer of \$37.25 per share represents a 21% premium to the closing price on the last trading day prior to the announcement. On March 30, 2017, Siemens completed the acquisition.

About Siemens AG

Siemens AG is a German global powerhouse operating in electrical engineering and electronics, headquartered in Berlin and Munich. The conglomerate, founded in 1847, is subdivided into the following divisions: Power and Gas, Wind Power, Power Generation Services, Energy Management, Building Technologies, Mobility, Digital Factory, Process Industries, Healthcare and Financial Services. As of 2016, Siemens employed 351,000 workers – of which approximately one third located in Germany – and operated 289 plants in approximately 200 countries.



Siemens is a very active player in the M&A market, counting 30 acquisitions and 26 divestments since 2004. Moreover, in recent years, the company has taken part in a variety of joint ventures. In 2014, Siemens and Accenture formed OMNETRIC Group, a smart grid solution provider. More recently, Siemens has formed a joint venture in high voltage powertrains with Valeo, hoping to create a global leader in high-voltage components and systems for electric vehicles.

Looking at the shareholder structure, we see that institutional investors hold 64% of the 850m registered shares, while the founding family (von Siemens) still controls c. 6% of the firm. The senior management is currently diverting Siemens' path through a strategic realignment, called the "Vision 2020". The plan calls for a focus on growth fields along the electrification, automation and digitalization, a flatter organizational structure and the launch of a €4bn share buyback program, among other things.

As of FY2016, the firm announced revenues of €79.6bn, which represent a 5.3% year-over-year improvement, and EBITDA of €11.2bn (5.7% YoY increase). Net income, on the other hand, shrunk by 25% to €5.5bn, due to discontinued operations, while income from continuing operations remained steady at €5.3bn and diluted EPS (from continuing operations) increased from €6.30 to €6.42.

About Mentor Graphics, Inc

Mentor Graphics, Inc was founded in 1981 and, as of today, employs 5,200 individuals across the globe. The firm is headquartered in Oregon and is a global leader in the electronic design automation (EDA) market, providing software and hardware design solutions that enable companies to develop better electronic products faster and more cost-effectively. Mentor Graphics not only holds a broad industry portfolio (ranging from automotive to aerospace and military solutions), but is the only EDA company with an embedded software solution.

A trend specific to the EDA market, is the acquisition by larger players of small firms that can provide very niche software or technology to be included in the parent's core operations. Thus, many of the market leaders are the result of mergers with many smaller companies. Mentor Graphics is no exception: since its establishment, the firm has made 47 acquisitions, including that of Logic Vision for \$13m in 2009 and of Valor Computerized Systems for \$50m in 2010.

As of FY2016, Mentor Graphics reported revenues of \$1.18bn, showing a year-over-year deterioration of 4.8%. The company's EPS decreased by approximately 12% from the 2015 record of \$1.77. Furthermore, operating income of \$136.7m and net income of \$96.3m highlight, respectively, a 27% and a 35% decreased compared to FY2015.

Industry overview

Electronic Design Automation (EDA) solutions enable hardware and software engineers to design, analyse, and simulate semiconductor chips and very-large-scale integrated (VLSI) circuits. The EDA market is segmented into five products: computer-aided engineering (CAE), which accounts for c. 33% of the market as of 2016; semiconductor intellectual property (SIP), commanding a c. 34% share; physical design and verification, which holds a 21% share; printed circuit board (PCB) and multi-chip module (MCM), possessing a further 8% market share; and finally, services, which detain a c. 4% share.

Despite the presence of many large and small firms, the 3 main players, Synopsys, Cadence and Siemens PLM Software (previously Mentor Graphics), account for 80% of the total market. The global EDA market is expected grow at a 5.5% CAGR over the next 5 years and demand for EDA solutions in the aerospace and defense industry is thought to be the primary drive of this growth. Moreover, large players will likely look to gain market share in face of a moderate market growth rate and this should lead to a surge in M&A activity in the following years. Acquisitions could indeed help companies improve their distribution channels and increase their market reach, allowing them to remain competitive and to keep their leadership role in the market.

Deal structure

Siemens paid \$4.5bn in cash, making this the largest purchase for the German company since their 2014 acquisition of Dresser-Rand Group for \$7.6bn.

The accepted offer is of \$37.25 per share, which represents a 21% premium with respect to Mentor Graphics' closing share price on the November 11, 2016. The purchase price implies an EV/EBITDA multiple of 14.5x and the transaction is expected to be accretive within 3 years from closing.

The activist hedge fund Elliott Management, which owned 8.1% of Mentor Graphics before the acquisition, had claimed that their shares were deeply undervalued and urged the management to act to improve shareholder value, possibly by selling the business. The EDA firm had already resisted two takeover attempts in the past, one from the rival Cadence Design Systems for \$1.49bn in 2008 and one, 3 years later, from Carl Icahn who, after having accumulated a 15% stake, wanted to sell or break up the company. This time, on the other hand, Mentor Graphics did not fight back because, as explained by the CEO Mr. Rhines, Siemens' approach is completely different, with

the German company wanting to use its design tools to complement Siemens' existing products and expand offerings to its customers.

Deal rationale

The deal will significantly bolster Siemens' software operations by entering the Integrated Circuit (IC) design and embedded software segments and will create the world's leading supplier of industrial software. Further, the expertise and infrastructure from Mentor Graphics is expected to enable Siemens to reach out to more customers.

The deal is just a step in the firm's strategic realignment, the "Vision 2020". Indeed, Joe Kaeser, Siemens' CEO, has set out to reshape the group to make it more profitable by selling off non-core businesses and investing in areas that will facilitate faster growth and higher margins. Siemens' management seeks to grow the digital business as part of a retreat from consumer-oriented products to focus instead on industrial applications.

This acquisition comes after a series of past software deals done by Siemens, including the acquisition of UGS, Camstar and Polarion. Siemens has proved very apt at adapting and accommodating for these companies inside their Digital Enterprise Suite operation. Moreover, in the case of Mentor Graphics, Siemens will acquire complementing intellectual property in Electrical & Wire Harness Design and Electronic Systems Design, in addition to Integrated Circuit Design, Verification, Test and Manufacturing, solutions already provided by Siemens which will gain leverage from Mentor's expertise.

In regards to the earnings boost hailing from the transaction, about half of it will come from revenue synergies and the other half from cost synergies which will be achieved also through some job cuts; the total EBIT impact is expected to be over €100 million within 4 years from closing the transaction. According to Elliott Management, as Mentor's shares were deeply undervalued, the acquisition is a great outcome for Mentor Graphics' shareholders who received a fair compensation thanks to the hefty 21% acquisition premium.

Market reaction

The transaction has so far indeed proven accretive with Siemens's 2016 EPS at €6.74 and the current trailing twelve months (TTM) EPS at €7.05. Furthermore, their stock has been growing steadily from the deal announcement level of €109.31 per share to €132 per share, as of today. This can, however, be partially attributed to the recently announced negotiations between Siemens and Bombardier regarding a merger of their train operations.

Advisors

JP Morgan and Deutsche Bank advised Siemens on the transaction, whereas Bank of America Merrill Lynch served as financial advisor to Mentor Graphics.