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The cloud forecast:
How will IBM's entry impact the IoT landscape

"The acquisition of Red Hat for US$34 billion has highlighted the relevance of open source software and the importance of hybrid cloud solutions in the market. Not for the first time, IBM is undergoing a tremendous change and has repositioned itself in a growing and dynamic market environment."

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MARKET TRENDS

Being able to dynamically move data and resources securely between different cloud systems is one of the key advantages of hybrid or multi-cloud solutions and a fundamental cornerstone of the Internet of Things (IoT) sector. As IoT increasingly affects our professional and private lives and is expected to continue its growth path over the next years, the development of an optimal platform to manage workload and data streams is crucial. IBM seems to follow this logic with its most important acquisition of Red Hat, as well as the recent purchase of Instana.

In this Spot On, we woul like to share our experience with the recent market developments with you. We will discuss the rationale of the landmark transaction of Red Hat, its consequences and insights about the most recent acquisition of Instana, as well as further findings on value drivers within the industry. In the fast-evolving IoT market, M&A activity is an opportunity to accelerate knowledge building and growth to create a sustainable competitive edge.

Market trends

RECENT MARKET DEVELOPMENTS

There are countless studies about developments within the global IoT market. All forecast a tremendous growth within the next few years, predicting that market volume will reach up to US$1.1 trillion by 2023. The explosive increase in the actual number of "things" will lead to a penetration of IoT technologies in every aspect of our lives.

But IoT is not only "things" but also "Internet," and the most recent developments in 5G and cloud technology build the foundation of all potential IoT use cases. IoT is far more than just connecting devices. It allows us to manage, analyze and utilize generated data, as well as develop smart devices that use a hybrid approach known as edge computing, carried out somewhere between a cloud and on-premise environment. Despite the new opportunities, organizations face challenges in the process of implementing and utilizing cloud computing solutions. For instance, the results of a global survey on the challenges of cloud computing reveal that technological security, cloud spending and governance are the top three most important issues when it comes to the implementation of cloud solutions in daily business. Furthermore, participants reported that the opportunity of bring your own license (BYOL) is becoming increasingly important. Unsurprisingly, besides offering well-suited and secure solutions with reliable support systems at competitive prices, it is increasingly important for providers of cloud solutions to be a trustworthy partner for clients and their decision-makers.

The current market environment in particular provides multiple opportunities for strategically promising M&A activity. For instance, one of the most established and famous information technology (IT) companies worldwide, IBM Corporation, has been reborn in its attempt to catch up with the dominant players in the cloud computing market, namely Amazon and Microsoft.

As it seems impossible to close the gap to the frontrunners, IBM has acquired Red Hat and can now avoid the need to offer its own cloud services but offers the required solution to manage edge and cloud systems as well as IoT devices. There is no need for another cloud service provider, but everyone needs Red Hat. It is not only this acquisition that has a tremendous impact on the market, but it is also the splitting of IBM into two parts: one legacy and one new part, which marks a historical moment in the development of the IoT and cloud markets. In addition, IBM has taken the next step to deepen its commitment and expertise in the hybrid cloud sector. With the acquisition of Instana (deal value undisclosed), a US/German provider of cloud performance management software, the company adds artificial intelligence (AI)-based monitoring and controlling solutions to its product portfolio.

On the following pages, we will present the Red Hat case study and discuss the rationale from an IoT perspective. We continue with an overview of the most recent deals and valuations, as well as the outlook for the coming months.

Case study

THE RED HAT–IBM DEAL AND ITS CONSEQUENCES

About one year after the landmark deal in the cloud and IoT industry — the acquisition of Red Hat Inc. by IBM Corporation — company executives have announced the split of IBM into two public corporations by the end of 2021. What are the goals and the strategic rationale behind this defining decision, and how important was the Red Hat acquisition for IBM? How does the most recent purchase of Instana fit into this strategy? We will take a closer look at the deals, status quo and the implications for the future.

Cloud and IoT landmark deal: As stated in the press release of early July 2019, IBM purchased all issued outstanding shares of the open source software provider Red Hat for US$190 per share, in cash. With a total equity valuation of approximately US$34 billion, this was the largest acquisition in IBM's history. The goal behind this transaction is no less than developing the next generation of hybrid multi-cloud platform solutions. While combining competences to enforce open-source innovation, the two companies have kept their organizational independence — with an IBM headquarters in Armonk, New York, and Red Hat headquartered in Raleigh, North Carolina, about 540 miles apart.

Strategic rationale: Over recent years, IBM and Red Hat have already worked closely together. In consequence, this deal might not have been a surprise to insiders. However, the deal value of US$34 billion was unforeseeable. As a multinational technology company with expertise in the fields of enterprise IT infrastructure, application management and maintenance, but a lack of cloud solutions, the investment rationale for this deal is clear. With its position and customer base in the IT infrastructure market, IBM faces the challenges of shrinking margins and potential substitution of existing services by AI and automation solutions. On the other hand, the cloud market in particular shows significant growth rates and attractive margins. Established market players such as AWS, Microsoft, Google and Alibaba are competing for market share and have access to comprehensive knowledge and resources. To sell more of its own cloud solution and to close the gap to the established market players would require substantial effort with no guarantee for success. With the acquisition of Red Hat, on the other hand, IBM decided to reposition itself to another spot in the competitive landscape. With its open source platform, Red Hat is a well-established player when it comes to communication and exchange between different clouds. Whenever businesses need to shift data or connect applications between different public and private clouds, Red Hat has become a trustworthy partner for its clients. In consequence, with its marketplace, Red Hat does not directly compete with cloud computing giants but is benefiting from the increasing competition and growth rates on the market, offering its clients hybrid cloud solutions. Ginni Rometty — former president and CEO of IBM, now executive chairman of the company — put it in a nutshell: shaping the next generation of digital innovation and infrastructure, the company aims to become a trustworthy partner for dynamic technology solutions to enable its customers to utilize the advantages of hybrid multi-cloud environments.

Company split: Approximately one year after the merger, the company executives announced the next groundbreaking decision for the firm. After acquiring Red Hat, IBM will now split into two public companies before the end of 2021. With an expected investment of US$5 billion into the entity separation and organizational changes, the NewCo will become the provider of IT infrastructure services and technical support, with approximately US$19 billion in revenues. IBM, on the other hand, will focus on the growing cloud services business. With approximately US$59 billion in revenues, IBM's strategic scope will shift to cloud and cognitive software solutions for global businesses. Jumping on the bandwagon of digital transformation with large growth opportunities, IBM expects to significantly improve its margins. Even though it seems like the company is spinning off its low margin and shrinking business segment, which is increasingly being replaced by automation and cloud solutions, the company executives aim to maintain a strong strategic relationship between the two entities to utilize strategic benefits over the long run.

Complementing the product portfolio: On 18 November, IBM announced the acquisition of Instana, another company in the cloud/IoT sector. Headquartered in Chicago with a development division in Germany, Instana provides application performance monitoring (APM) solutions that enable organizations to manage applications in a hybrid cloud environment. Now, IBM can offer AI-based platform software that identifies IT performance issues and presents insights into how best to prevent and remedy these issues. Increasing the level of automation, organizations do not need to manually monitor and control the application infrastructure anymore. With this transaction, IBM has again highlighted its strategic scope and willingness to invest into the hybrid cloud market.

Valuation trends

To get a more detailed understanding of the value drivers in the IoT market, we cluster all firms into two groups according to their business model, with each group containing specific layers.

– **Cluster 1:** The cluster software as a service (SaaS) with the five layers: data ingestion, data analysis, data security, applications, and connectivity / edge computing.

– **Cluster 2:** The group perceptual things contains sensor-related businesses and a mix of hardware and software businesses. People & process is comprised of consulting businesses.

Development of revenue multiples across different layers

Legend:
- perceptual things
- connectivity / edge computing
- data ingestions
- data analysis
- global infrastructure
- applications
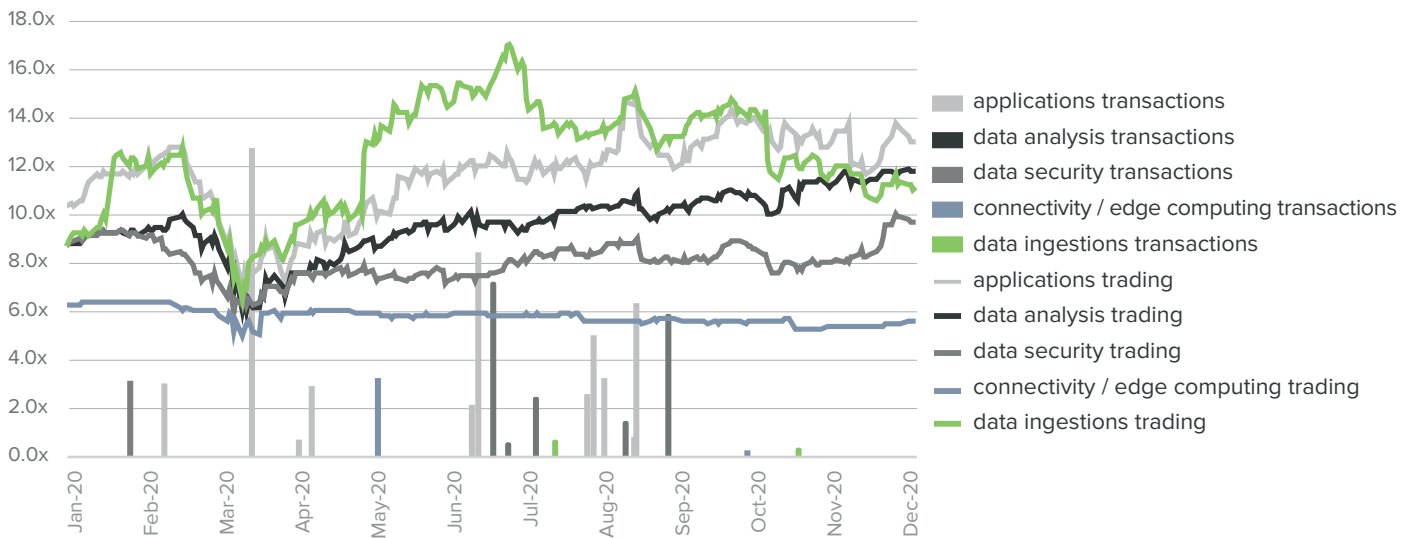- people & process
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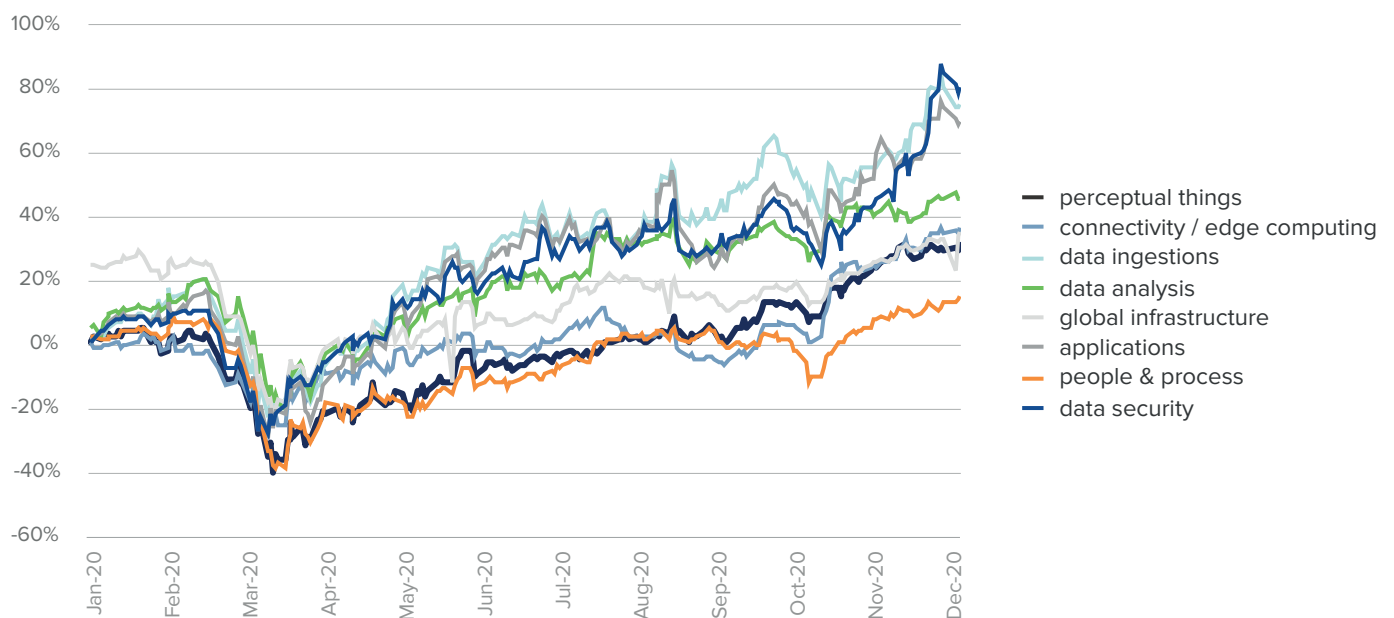
Source: S&P Capital IQ

It is notable that software business models, such as data analytics, ingestions or security, have not only recovered since their low point in March, but are currently outperforming last year's trading results by up to 60% when comparing their enterprise value with revenue multiples. In comparison, business models that are hardware or services related have recovered their losses but have not realized such gains.

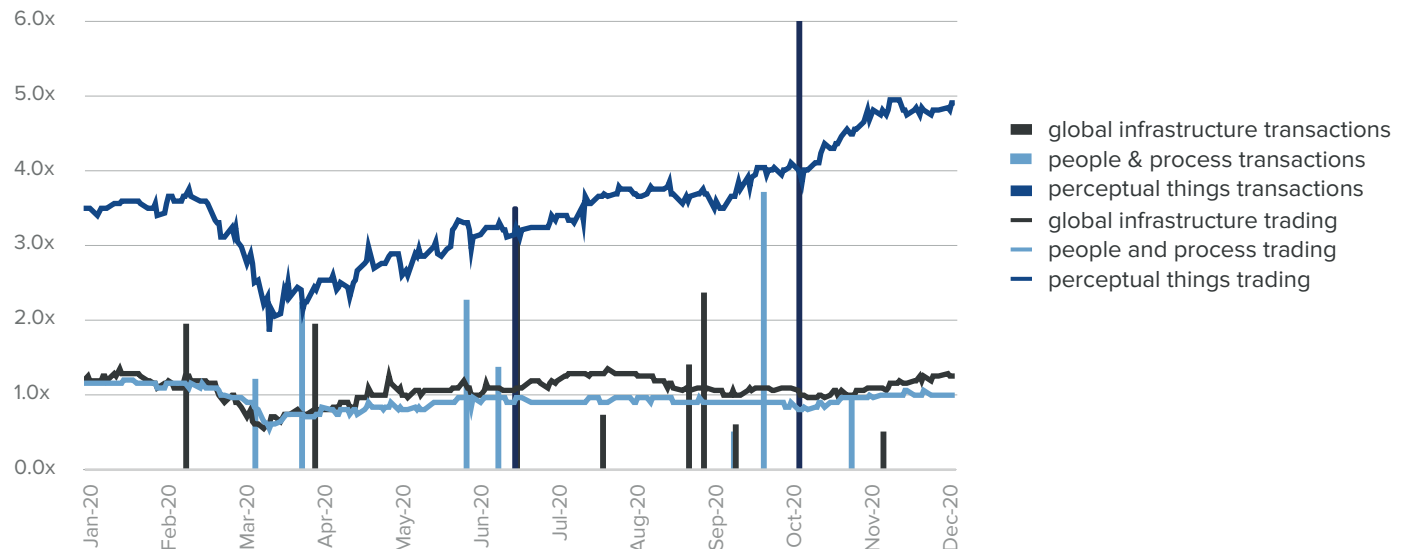**Cluster 1 — trading and transaction multiples**

Legend:
- applications transactions
- data analysis transactions
- data security transactions
- connectivity / edge computing transactions
- data ingestions transactions
- applications trading
- data analysis trading
- data security trading
- connectivity / edge computing trading
- data ingestions trading

Source: S&P Capital IQ

To put the trading results into perspective, we looked at the transactions in the sector during the same period. When comparing the trading multiples of the outperforming layers in comparison with transaction pricing, it is notable that the transactions have been priced much more conservatively.

In fact, the median EV/revenue multiple of the software transactions of the past 12 months was only 4.1x, compared with a median trading multiple of 9.3x.

Cluster 2 — trading and transaction multiples

Legend:
- global infrastructure transactions
- people & process transactions
- perceptual things transactions
- global infrastructure trading
- people and process trading
- perceptual things trading

Source: S&P Capital IQ

This picture is different for hardware- and service-related business models. Here, the median EV/revenue multiple of

the transactions is 2.3x, compared with the median trading multiple of 1.8x.

In summary, it is mostly software businesses that are highly sought after on the markets. They have proven to be crisis-resistant, with strong margins and growth. However, private markets are much more conservative with their valuations, despite a number of transactions that were completed during and after the first wave of COVID-19. Nevertheless, the number of transactions shows that IoT is still a market with a lot of investor demand and traction. In addition, the COVID-19 crisis might even have accelerated transformation in certain areas, which leads the markets to believe that software businesses in particular will thrive in the years to come. That being said, IBM's move to bet on cloud and software is logical and strategically beneficial.

Before the acquisitions of Red Hat and Instana — according to the 2019 annual report — IBM had a service- and hardware-focused business model, with Global Business Services and Global Technology Services making up close to 60% of the revenue, and Systems, IBM's hardware segment, another 11%. All three segments generated moderate growth and margins, with an average net profit margin of 8%. Both the Systems and the Technology Services segment even declined from FY2018 to FY2019. The only segment with net profit margins well above 10% is the Cloud & Cognitive Software segment. Going back to our segmentation of the market and the respective valuations of the segments, the software side of the business would likely be valued at the low end of the data analytics and ingestions peer group, due to its low growth momentum. The attractive margins still allow for a valuation that is significantly greater than the services and hardware businesses.

Considering the steep purchase price of Red Hat, which was close to 12x reported revenue and a 66% premium over the current market cap, simply consolidating Red Hat's revenue and growth would likely not have generated enough shareholder value, even when taking the synergies into consideration. From a valuation and shareholder value standpoint, the spin-off therefore makes sense. To separate the high-margin, high-growth segments, allows IBM's new business lines to focus on their cloud offering while following different key performance indicators (KPIs) and drivers than those followed by the service and hardware business segments. With the acquisition of Instana, IBM is complementing the new focus on hybrid cloud solutions.

Overall, these deals have significant implications for the IoT market landscape in various aspects. Firstly, the Red Hat deal — and particularly the transaction price — highlights the importance of solutions that help to manage hybrid or multi-cloud systems and thus enable edge systems that are independent from specific providers but follow an open source solution. Secondly, with the largest acquisition in history, IBM has shown that takeovers between companies with significant risks on both sides are also part of the dynamic market environment.

We remember Nokia, reinventing itself several times by starting as a pulp mill, then becoming a rubber company and finally the global leading mobile phone company — until the company lost something and went into decline. We doubt that it will be the same with IBM, but it is a bold move and thus has some risk. We look forward to seeing what will happen in the next few years and how it will impact the IoT market.
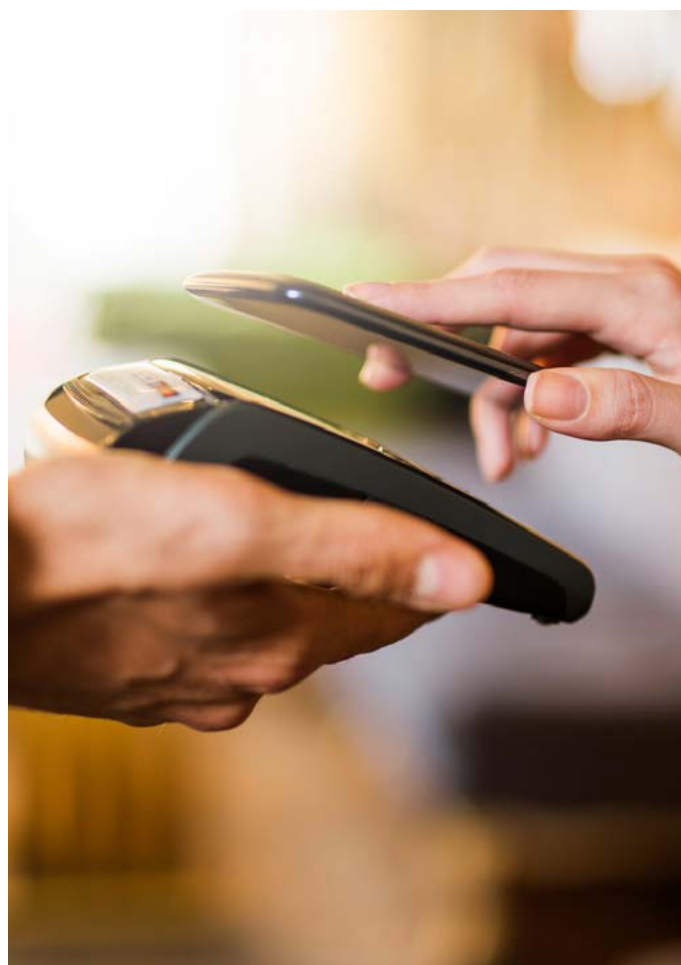
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– Growth equity and equity capital markets advisory

– Debt advisory

– Corporate finance services

IoT is one of our focus areas. Combining comprehensive sector knowledge with global execution has led Oaklins to become the most experienced M&A advisor in the IoT sector, with a large contact network of the most relevant market players worldwide. This results in the best possible merger, acquisition and divestment opportunities for IoT companies.

If mergers, acquisitions or divestitures of businesses or business units are part of your strategy, we would welcome the opportunity to exchange ideas with you.

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Jan leads Oaklins' IoT team. He is also a managing partner at Oaklins Germany. Jan has a strong network in this industry and is in regular contact with the key players. As part of his sector focus, he continuously follows developments, publishes newsletters and attends the major events. He has advised a number of clients either on M&A or on strategic development. He has a deep understanding of the market dynamics and value drivers regarding smart devices, connectivity, big data and intelligent solutions. Notable transactions Jan has completed include Garz & Fricke, vyzVoice and Höft & Wessel (now Almex).

Oaklins is the world's most experienced mid-market M&A advisor, with over 850 professionals globally and dedicated industry teams in more than 45 countries. We have closed 1,700 transactions in the past five years.

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