Journal of Entrepreneurship & Organization Management

Fiedler, J Entrepren Organiz Manag 2019, 8:1
DOI: 10.4172/2169-026X.1000256

Review Article Open Access

Comparing the Strategic Financial Management of Three Electronic Multis Siemens, Philips and GE

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Abstract

Publicly traded companies finance their business activities through a combination of debt and equity with each requiring a different rate of return. While the providers of debt receive their return in form of interest payments, providers of equity capital receive a return based on the company's risk in excess of the market rate of return in form of dividend payments or increases in stock price. No matter the source of the company's capital, whether stemming from leverage, equity or retained earnings from operations, it is commonly used for funding current operations or growth opportunities to expand existing business or tap into new markets.

Keywords: Business; Market; Structure; Software

Introduction

Companies often differ in their growth ambitions and their way of financing. This paper aims to evaluate the capital structure and investment activities of Siemens, Philips and GE in this order. Initially, the growth strategies, whether organically or focused on growth will be discussed followed by a brief evaluation the company's capital structure. Thereafter, the value of the common stock of each company will be calculated using the dividend discount model. The following calculation will be used for each evaluation:

$$P_0 = \frac{Div_1}{r-g}$$

Where

P_0=*Calculated current price of share*

$$Div_1 = annual\ dividend * \frac{Expected\ EPS}{Current\ EPS}$$

R=Cost of Equity

G=Dividend Growth Rate

The sources corresponding to the values used for the calculation can be found as comments in the attached excel file. The values used for the calculation have been marked in yellow for identification.

Siemens

Growth strategy

"If you want to set the course, you can't be guided by what others have done. You've got to anticipate changes and seize the opportunities they provide" [1]. This statement by Siemens CEO Joe Kaeser underlines the company's focus on growth through innovation.

Growth through mergers and acquisitions: As part of its strategic plan labeled Vision 2020, Siemens clearly formulates its long-term plan to tap into new fields by seizing further growth opportunities. According to Siemens, this growth is not only to be achieved organically through R&D investments, management efforts, a focus on business excellence and effective and efficient resource allocation but also through strategic mergers and acquisitions, divestments, equity investments and strategic partnerships. Examples of recent acquisitions include the US software company CD-adapco or the Rolls Royce Energy aero-derivative gas turbine and compressor business of Rolls-Royce plc, UK with the later contributing 12% points to order and revenue growth in fiscal 2016. Similarly, the next 47 initiative aims at accelerating the development of new and disruptive technologies through the cooperation with selected start-ups [2].

To further continue its growth through mergers or acquisitions, Siemens intents to merge with the company Gamesa in 2017 to strengthen its core activities with an ownership division of 59% Siemens and 41% Gamesa [3]. Even though this merger is expected to add value to the company by providing additional core competencies, market access and skills, mergers are often accompanied by the challenges of combining, integrating and aligning two different sets of corporate cultures, IT systems and processes [4]. Failing to align the operations of the merged companies appropriately can lead to the inability of reaping the benefits of the merger, performance decreases and financial losses. Moreover, is a competitor is acquired or merged with; the possibility of cannibalization of sales should be taken into account when evaluating the expected benefits of this strategic step.

Similar to the challenges present when completing a merger, an acquisition poses similar challenges. In 2016, Siemens has announced the acquisition of Mentor Graphics with an Enterprise Value of US$4.5 bn [3]. Mentor Graphics is an established and leading automation and industrial software provider whose capabilities complement Siemens portfolio and helps strengthening its advancement in the digital industrial software domain [5]. The acquisition represents a joint decision of both companies thus the acquisition can be expected to be completed smoothly. However, it should be noted that the acquisition is done through the acquisition of Mentor Graphics shares for cash with Siemens paying a premium of 21% over the company's closing price on the day of the announcement [5]. This surely shows that Siemens is confident in exploiting the financial benefits through increased operational and financial performance through the acquisition.

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Recieved July 19, 2018; **Accepted** December 31, 2018; **Published** January 10, 2019

Citation: Fiedler FFHJ (2019) Comparing the Strategic Financial Management of Three Electronic Multis Siemens, Philips and GE. J Entrepren Organiz Manag 8: 256. doi: 10.4172/2169-026X.1000256

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However, this size of a premium paid during an acquisition can hint at some level of resistance within the target company. A higher premium can help the acquirer convince the target to agree to the deal. Similarly, however, a higher premium pressures the management of the acquirer to implement the synergetic benefits of the acquisition and present favorable financial results [6]. If this is not managed appropriately, the acquisition can lead to financial losses rather than gains.

Organic growth: To ensure that the company's growth ambitions are realized, Siemens has formulated the strategic objectives clearly in its strategic plan Vision 2020 including the development of the corresponding KPIs to track its performance along these dimensions. These include, for example, the strengthening of the business portfolio through the tapping of new growth fields with the KPI of achieving >8% margin in underperforming businesses. Similarly, the company's financial target system is developed in a way to grow the company value at higher rates than direct competitors with at least 15-20% ROCE. To improve the company's internal systems and processes, the Siemens aims to implement lean governance and continuous optimization practices to achieve cost savings of at least €1 bn [3].

Target capital structure

Siemens evaluates and monitors its capital structure through the use of industrial net debt to EBITDA ratio i.e., the amount of time it would take to cover industrial net debt through income excluding taxes, interest, depreciation and amortization. While this ratio was at 0.6 in fiscal year 2015, the company has reached its target of 1.0 in fiscal 2016. This achievement was mainly due to an increase in post-employment benefits compared to the previous year [2]. Thus, the company's current financial position does not suggest any major acquisitions. Nevertheless, Siemens remains on the lookout for further acquisition opportunities to grow its business and tap new markets which is reflected in the anticipated acquisition of Mentor Graphics in 2017.

Common stock

Evaluation of common stock (dividend discount model): To evaluate the common stock of Siemens, the dividend discount model was used. The calculation was conducted as follows:

$$P_0 = \frac{Div_1}{r-g} = \frac{3.92}{0.1006-0.053} = 82.40€$$

Model valuation versus trading value of equity: In contrast to the company's share valuation using the dividend discount model, Siemens shares currently trade at 126.28€. This is well above the present value of its expected future cash flows. However, a possible reason for this valuation is the fact that Siemens currently has an A1 credit rating by Moody's with a stable outlook [7]. Moreover, the company retains a major portion of its EPS for investment purposes. Thus, even though dividend payout´s remain rather low, the value of the company is expected to grow through this decision. The company retained 27.454bil€ of its earnings while distributing only 2.827bil€ in dividends and 0.4bil€ in share buybacks [2]. Due to its high retained earnings, the company is more likely to be an acquirer in a possible acquisition than a target. Moreover, to increase shareholder value, the company does not focus on dividends but rather share buybacks which increases the intrinsic value of existing shares [3].

Investment merits and key corporate finance issues

The financial success of Siemens is highly dependent on its innovative capabilities and growth potential. The company aims to implement this strategy by minimizing dividend payouts in favor of share buybacks and retaining the major portion of its earnings for investment, growth and acquisition purposes. This strategy appears reasonable in the highly competitive business environment. Acquisitions of appropriate target companies can further help the company to tap into new markets and spur growth. However, the challenges and difficulties associated with mergers and acquisitions such as the integration and alignment of newly acquired targets needs to be taken into account when evaluating potential targets. Failing to manage the process appropriately can lead to great financial and operational losses. Siemens, however, is well versed in managing M&As since ever since its foundation in 1847, growth through M&As has been a major part of its strategic plan.

Philips

Growth strategy

Growth through mergers and acquisitions: Generally, Philips aims to build a portfolio of businesses with growth potential through organic investments, partnerships and mergers and acquisitions. However, growth in the health care industry is a rather challenging endeavor. To deal with this problem, Philips' growth strategy is rather acquisition driven with multiple acquisitions in the previous year's totaling billions of Euros [8]. The challenges of acquisition driven growth strategies is well known to Steward McCrone, head of M&A at Philips. McCrone stresses the importance of valuing existing and future employees and a speedy completion to ensure the smooth integration and alignment of newly acquired companies [9]. The establishment of a department focusing solely on the identification of potential targets and the completion of mergers and acquisitions highlight the importance that Philips places on these strategic moves. McCrone, however, states that Philips often finances acquisitions through the divestment of business units and subsidiaries that perform below target or are not consistent with the company's core competencies. An example for this practice can be found referring to Lumileds, an originally US-based lighting company. Lumileds was acquired in 2005 to strengthen Philips lighting division. In 2014, the division was merged with the company's automobile lighting division to create an attractive target for potential acquirers [9]. The divestiture of the division in 2016 generated sufficient cash to finance the acquisition of Well incentive, a key player in the provision of health management software solutions even though the transaction took longer than initially anticipated [10]. Through the funding of acquisitions through divestment activities, Philips can avoid incurring high debt levels for financing. This minimizes the risks of financial distress. On the other hand, however, if the company relied solely on this tactic, growth could be inhibited through this risk adverse behavior since promising opportunities might be foregone due to low levels of cash on hand.

Organic growth: Similar to Siemens, Philips investment activities suggest that the company focuses on growth through innovation. Its capital allocation policy favors high ROIC growth opportunities with a 4%-6% organic growth target [11]. Generally, the foundation to Philips' ability to realize organic growth strategies lies in its restructuring activities in the early 2000s. The company started to shift its business portfolio towards leadership positions in growth businesses that deliver high margins throughout the fiscal year thus reducing the exposure to cyclical economic impacts. By focusing on those areas in which the company has a strong brand and competitive advantages, organic growth opportunities can be exhausted successfully. In 2011, the company introduced a strategic plan called "Accelerate!" which focuses on increasing the efficiency of existing businesses lading to cost savings and higher levels of capital for investment opportunities [12].

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Target capital structure

Regarding Philips' target capital structure, no information could be found in the public domain. However, historical trends and benchmarks to the industry will be used to evaluate the company's current capital structure. Currently, Philips features a debt to equity ratio of only 0.421 indicating that the majority of its business activities are financed by equity. However, the company's debt to equity ratio has been rather low historically not exceeding values of 0.5083 in the past 5 years [13]. Moreover, this is in line with the industry average of 0.5031 [14]. The company thus does not appear to face any solvency issues. On the other hand, however, any future plans concerning major acquisitions cannot be deduced from its current capital structure. Nevertheless, any cash reserves from its business activities and retained earnings have not been taken into consideration yet. Since Philips often uses capital generated through divestment activities to finance acquisitions, the current capital structure does not provide any specific insights.

Common stock

Evaluation of common stock (dividend discount model): Using the dividend discount model, the current share price of Philips was calculated as follows:

$$P_0 = \frac{Div_1}{r-g} = \frac{0.37}{0.0788-0.056} = 16.20€$$

Model valuation versus trading value of equity: Philips' shares are currently traded at 29.73€ which exceeds the value provided by the dividend discount model by 16.65€. Similar to Siemens, Philips shares appear to be highly overvalued. However, even though the company's dividend payouts are rather small, the company retains a major portion of its income for investment purposes to spur organic and inorganic growth. The company distributed approximately 342mil€ in dividends to shareholders while retaining 6.07bil€ of its earnings [15]. This practice is quite common in a business environment in which innovation is crucial for survival.

Investment merits and key corporate finance issues

Philips' investment strategy is very similar to that of Siemens in that the company retains the majority of its earnings and uses only a small portion for dividend payouts and share buybacks. The latter is aimed at preventing share value dilution caused by issuing shares to employees as part of their benefit plan. Retained earnings are subsequently used for investment purposes in R&D activities as well as acquisitions of appropriate targets. Moreover, the retention of earnings provides a safety cushion during the integration of newly acquired targets. Generally, the company does not face any financial distress. However, it should remain vigilant in identifying and selecting targets for acquisitions. The challenges associated with the integration and alignment of newly acquired entities can still present the company with unnecessary complications and financial costs.

GE

Growth strategy

GE places great importance on focusing on established businesses as well as on investments in new areas of business to capture future growth opportunities [16]. Effective capital allocation aims at fueling growth internally as well as through partnerships, acquisitions and mergers.

Growth through mergers and acquisitions: One of the most recent acquisitions includes the company Bio safe which added new key technologies to their portfolio. The acquisition-driven growth strategy is also reflected in the establishment of a venture group which was specifically set up to find and acquire new and promising targets.

One of such examples includes the merger of GE Oil and Gas and its competitor Baker Hughes Inc. creating one of the largest global petroleum companies. GE CEO Jeffrey Immelt states that this strategic move is taken to remain competitive against other major players such as Schlumberger Corp. GE was able to initiate this merger after a failed attempt by Halliburton Co. to acquire Baker Hughes Inc. This transaction was not approved by regulators since it would have put the newly created company in a monopoly position. However, the business offerings of GE and Baker Hughes Inc. are rather complementary thus the regulators' approval is expected. Part of the contract involves the contribution of $7.4 bn by GE to fund a dividend payout to Baker Hughes shareholders [17]. Similar to Siemens, this reflects the high confidence of GE management that synergetic effects, financial benefits and performance improvements are expected to result from this merger. However, this also puts pressure on the personnel responsible for the integration and alignment of businesses. Nevertheless, GE has standardized the way in which acquired companies are aligned with the existing business [18]. This formalization of processes helps to ensure a timely completion.

Organic growth: In fiscal year 2016, the company's organic growth increased by 1%, falling 1% short of the initial target of 2 % with a target of 3-5% for subsequent years. CEO Immelt points out that the key to company success and growth is organic growth complemented by mergers and acquisitions. To spur organic growth, the company has established a strategy encompassing the empowerment and training of people, a focus on customer value, high rates of innovation, leadership in technology, commercial excellence and the exploitation of its multinational capabilities and opportunities [18]. Moreover, when Immelt took reign in 2002, he upped the R&D budget to further increase the rate of innovation at GE to strengthen its position as leader in technology. The focus of exploiting the internal capabilities of the company to spur organic growth and strengthening its market position underline GE's commitment to organic growth.

Target capital structure

Neither the annual reports of GE nor the investment relations website of the company gave any indication of the company's target capital structure. However, to evaluate its current capital structure, industry benchmarks as well as historical ratios will be evaluated. At the end of fiscal year 2016, the company's debt to equity ratio was approximately 1.79. This is not only one of the lowest value the company has presented in the last 5 years but also represents a sharp decrease from the maximum debt to equity ratio of 3.22 which GE had featured in June 2012 [19]. High leverage values usually indicate heavy investments in growth opportunities through, for example, acquisitions. Thus, while the total expenses for acquisitions in 2012 were only 845 mil$, these expenses skyrocketed in 2013 to 5.33bil$ [20]. It is very likely that the reduction of GE's debt to equity ratio is due to the completion of a series of acquisitions aimed at implementing the company's growth strategy. Competing companies such as 3m Company or United Technologies Corp feature debt to equity ratios of 1.13 and 0.82, respectively [21]. Today, GE's ratio roughly approximates industry standards. Nevertheless, the higher ratio may indicate that the company has not yet completed possible mergers and acquisitions [22].

Additionally, executives of GE explain that the company is likely to add substantial amounts of new debt to support growth opportunities if the market allows exploiting opportunistic situations. This was the case in 2016 when the oil market plummeted. In order to exploit growth opportunities, GE was willing to incur over $20bn in new debt [17].

Common stock

Evaluation of common stock (dividend discount model): The dividend discount model calculates the current value of the company's stock as follows:

$$P_0 = \frac{Div_1}{r-g} = \frac{0.37}{0.0788 - 0.056} = 16.20€$$

Model valuation versus trading value of equity: Using the dividend discount model to evaluate GE's share value, the shares are currently traded at 13.36€ above its valuation, i.e., at 29.56€. However, similar to Siemens and Philips, in 2016, the company paid out only 8.5bil$ and 8.7bil€ in dividends and share buybacks respectively while retaining 139bil€ of its earnings [16]. These retained earnings can be used subsequently for internal investment purposes to spur organic growth or mergers and acquisitions. Immelt has underlined the importance of retaining earnings in order to finance organic growth opportunities (Appendix Table 1).

Investment merits and key corporate finance issues

GE's growth and financial success is highly dependent on acquisitions of appropriate targets worldwide. The retention of a major portion of its earnings enables the company to implement this growth strategy while simultaneously investing internally in R&D opportunities. The large amount of retained earnings and free cash flow totaling more than 32.6bil $ highlights the fact that the company is not only more likely to acquire possible targets than being acquired and is financially able to do so [16]. Moreover, the company is willing to incur substantial amounts of debt to exploit opportunistic growth and acquisition opportunities. The use and profitability of these practices is highly dependent on the qualifications, skills and capabilities of the responsible personnel. However, due to its long history as acquirer and the formalization of the acquisition and merging process, the company can be expected to succeed in its endeavor (Appendix Table 2).

Conclusion

Siemens, Philips and GE are major players in the power generation, electrification and automatization industry. These industries are highly characterized by fierce competition and growth opportunities. To remain competitive, continuous innovation is key. While all three companies invest heavily in their R&D capabilities, mergers and acquisitions are a vital part of their growth strategy. This enables the companies to enter new markets more rapidly and benefit from their targets core competencies, intangible assets and market knowledge. The importance of their acquisition-driven growth strategy is also reflected in their dividend and retained earnings policies. All three companies retain the majority of their earnings for investment purposes while distributing only a small fraction as dividends to their shareholder. While this enables GE, Siemens and Philips to implement their growth strategies, the actual cash flow to their shareholders remains limited. Still, the value of their shares may benefit after the successful implementation of R&D investment and acquisition strategies. However, mergers and acquisitions come with a series of challenges that need to be dealt with including the integration and alignment of different structures, processes and cultures. Moreover, the acquirer often needs to pay a premium for the target's shares. This does not only represent an additional financial burden but also puts pressure on management to realize synergetic benefits as quickly as possible.

The application of the dividend discount model to evaluate the value of the companies' shares may provide an incomplete picture in this situation. Even though the shares appear to be highly overvalued, the "true value" of the shares should incorporate the companies' future growth opportunities and reflect its focus on growth through innovation and mergers and acquisitions. Thus, the application of the dividend discount model may not be the most adequate tool to evaluate the value of the company.

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