Frank Fischer

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SHARE
HOLDER
VALUE

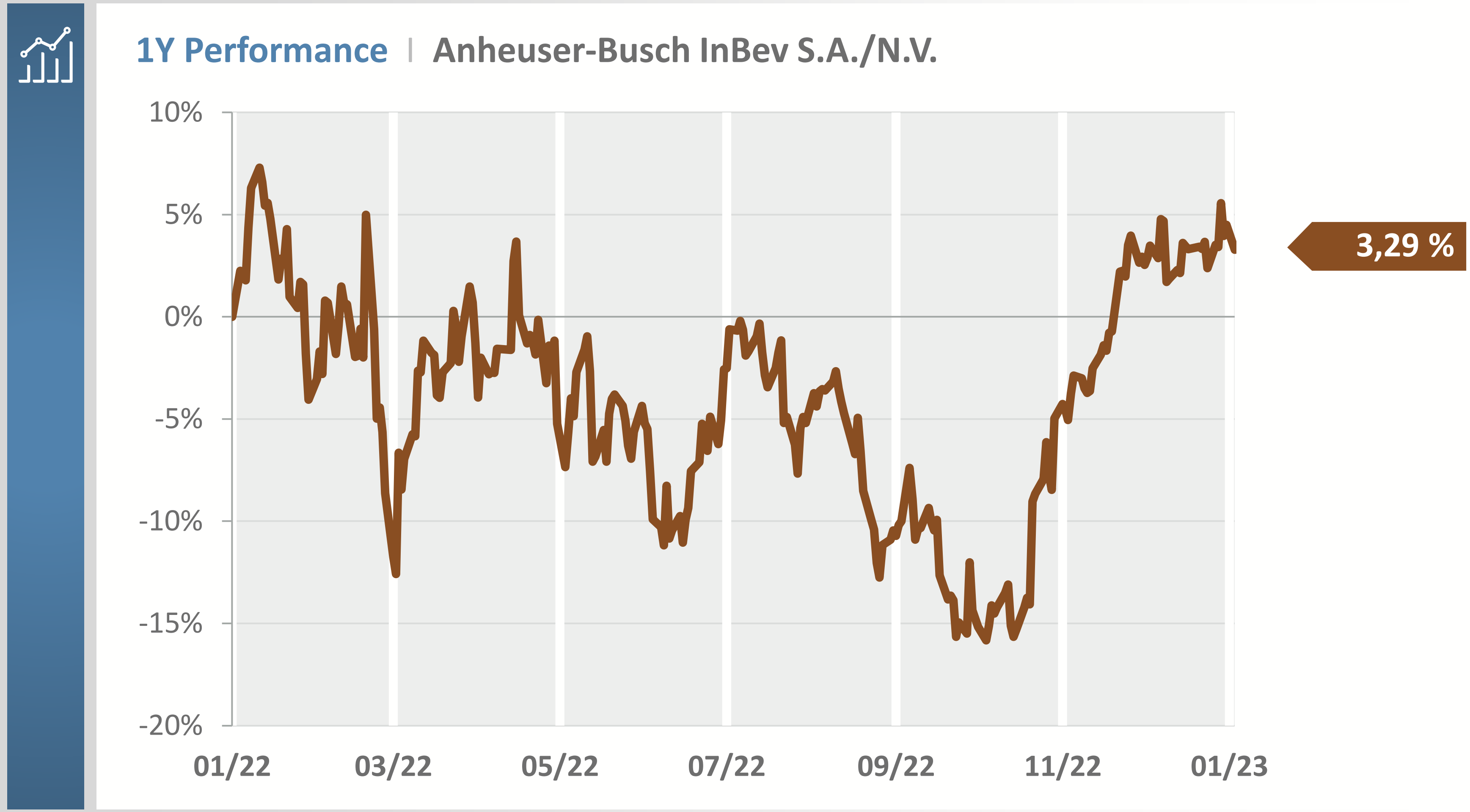
SAP – a SAAS story

Best Ideas 2023

Frank Fischer, CEO &CIO
Shareholder Value Management AG

Frankfurt, 12. January 2023 *Marketing Material not for Private Investors*

Last Year‘s Best Idea
Anheuser-Busch InBev S.A./N.V.



Source: Bloomberg **As of:** 09.01.2023 | **Past performance is not a reliable indicator of future performance**

Modern Value
Sustainable returns with wonderful companies!

It's far better to buy a **wonderful company at a fair price** than a fair company at a wonderful price.

Warren Buffett

Modern Value
Wonderful Companies…

- Grow faster than their respective industries
- Grow faster than the economy (sales growth > GDP growth)
- Obtain better returns on their assets than competitors
- Sell into growth markets
- Exploit opportunities when they arise
- Constantly try to innovate and improve
- Can withstand setbacks – a “capacity to suffer”
- Successfully allocate capital and reinvest earnings

Modern Value
Sustainable returns with wonderful companies!

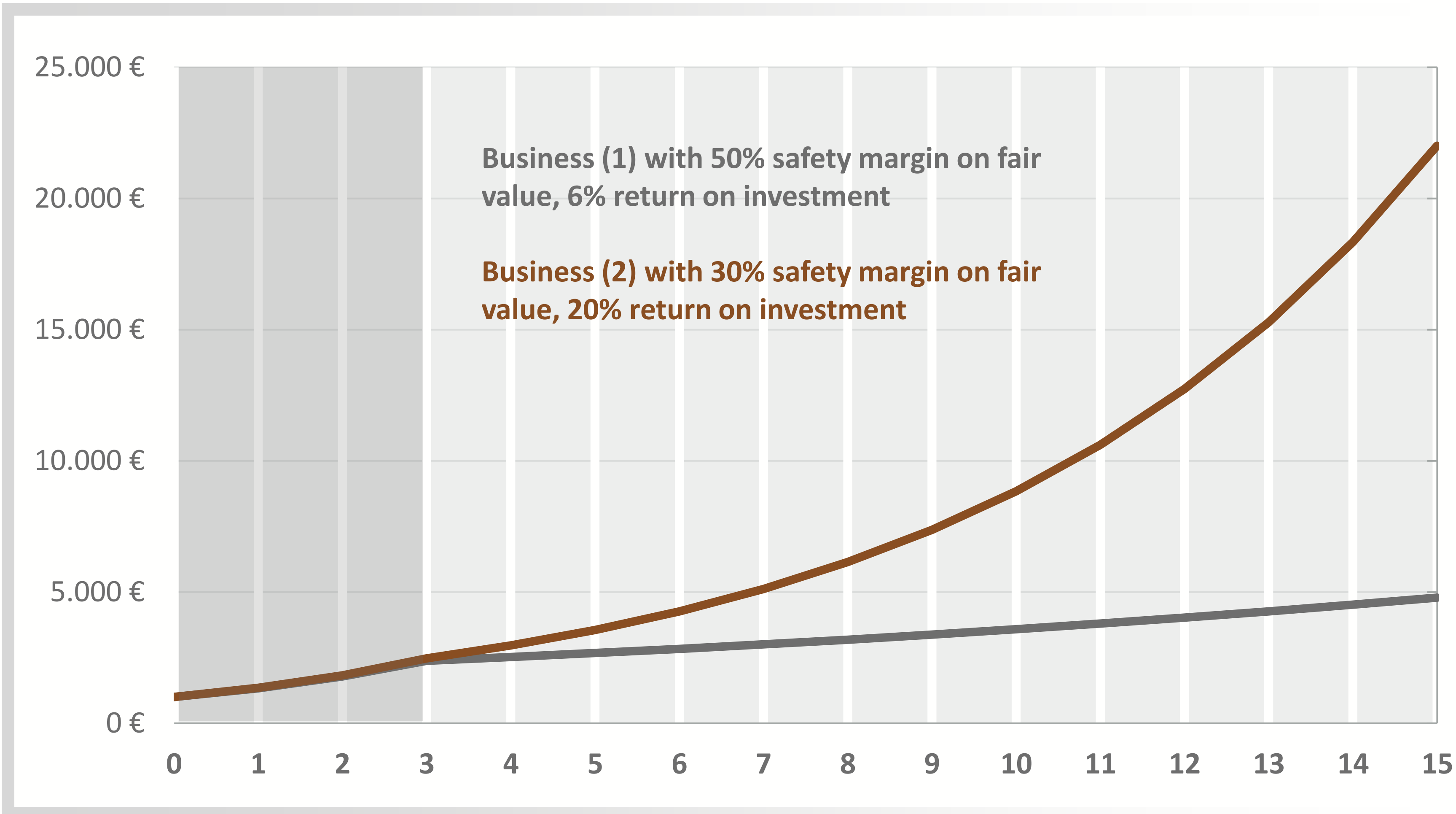
„If you have a business that's bringing in **5 or 6 percent on equity**, and you hold it for a long time, you're not going to do well in investing. Even if you buy it cheap at the beginning.

Time is the enemy of the bad company, and it's the friend of the good company.

I mean, if you have a company that's making **20 or 25 percent return on equity**, and you're doing it for a long time, time is your friend.“

Warren Buffett, Berkshire Hathaway Annual General Meeting 1998

Buffett Business (1) 50% MoS and (2) 30% MoS
-> Business (1) with 20% higher margin of safety!



Business (1)
6% ROE

Business (2)
20% ROE

Source: own calculation and presentation, calculation based on fictitious data, MoS (Margin of Safety)

Modern Value
What distinguishes quality companies?

- Goods & services with a positive **growth dynamic**
- Business model with above-average returns on capital > **20%**
- Internal investment requirements for many years and **incrementally better** results
- **Structural competitive advantages**, as protection against dilution of returns on capital for at least 10 years (**economic moat**)
- **Moderate debt levels** that are appropriate for the business model in question
- Reduced conflicts of interest between shareholders ("principle") and management ("agent") with the ideal of the **family- or owner-managed** company making economically sustainable decisions

Modern Value
What are the different types of moats?

1) **Network effect:** established networks that become more **useful** for all existing ones with each **additional** participant.
Example: Meta (Facebook) / Visa

2) **Intangible assets** as brand awareness, patents or (regulatory) licenses.
Example: LVMH / Roche / Verisign

3) **Switching costs:** switching to a competitor involves high costs. Example: SAP / Microsoft

4) **Cost advantages** due to location, processes, access to a unique facility or own size allow competitors to be undercut on price. Example: Heidelberger Cement / Admiral

SAP (XTRA:SAP)

- SAP is active in the B2B software space. They are one of the leaders in **ERP** software for corporates.
- Moat: very high switching costs.
  Generally, B2B software is a relatively predictable/ sticky space. ERP for large corporates is even more sticky than many other subsectors, as the switching costs are very high. We assume churn is around 5% or below p.a.
- Cash Flows are highly recurring due to license + maintenance model, increasing in SAAS
- Market cap of €122bn and EV of €123bn (as of 11/01/2023)

Thesis

The thesis here consists of a few key building blocks:

1. **The S4 HANA transition**
2. **Continued strong growth in acquired businesses**
3. **Some degree of margin expansion**

The predictability is high as particularly the S4 HANA transition is something where the growth path is very clear though limited as we estimate there is underlying churn in the mid single digits

S4 HANA Transition

S4 HANA is SAP's "new" ERP product generation. The S4 HANA transition began with the launch of S4 HANA in 2015. SAP's goal is to migrate all or virtually all of the current ECC 6.0 customer base to S4 HANA. Originally the idea was that support for ECC6.0 ends after 2025. The timeline was extended, now normal support ends after 2027, there is however an extended support offering with which the migration can be further delayed after 2027 – but at a higher price.

We assume of the 11,5bn maintenance and support revenues in 2019 ca. 80% was from ECC6.0. This stems from between ca. 25-30k customers.

S4 HANA Transition

The range of potential outcomes with regards to the level of uplift is wide: at the lower end, if customers simply choose to upgrade from ECC 6.0 to S4, on prem, in license + maintenance payment model, the uplift is 1,2x at the very lowest end, likely more like 1,3-1,4x. At the higher end, for subscription deployments in the public cloud, a 2,25x uplift has been indicated by SAP. The uplift might be even higher for private cloud solutions.

We are assuming a 1,8x uplift on average in our model. We think ca. 40% of clients might still choose traditional deployment and payment modes. I believe that by 2025, ca. 60% of current ECC 6.0 customers might switch.

Summary on ERP

In sum, being conservative, we think the ERP business will grow around ca. 2,5% CAGR (2020-2025) based on the assumptions given above. These are probably quite conservative, and there is likely not much downside to this – I do not believe pricing will be below 1% p.a.; churn will get higher; or that it is likely that the value uplift realized through the S4 HANA transition will be smaller. If anything, SAP might well surprise positively here.

Continued Strong Growth in Acquired Businesses

In the last 10 years, especially during Bill McDermott's tenure as CEO, SAP acquired a lot of SAAS / Cloud native businesses, including

- **Successfactors**
- **Qualtrics**
- **Ariba**
- **Concur**
- **Fieldglass**

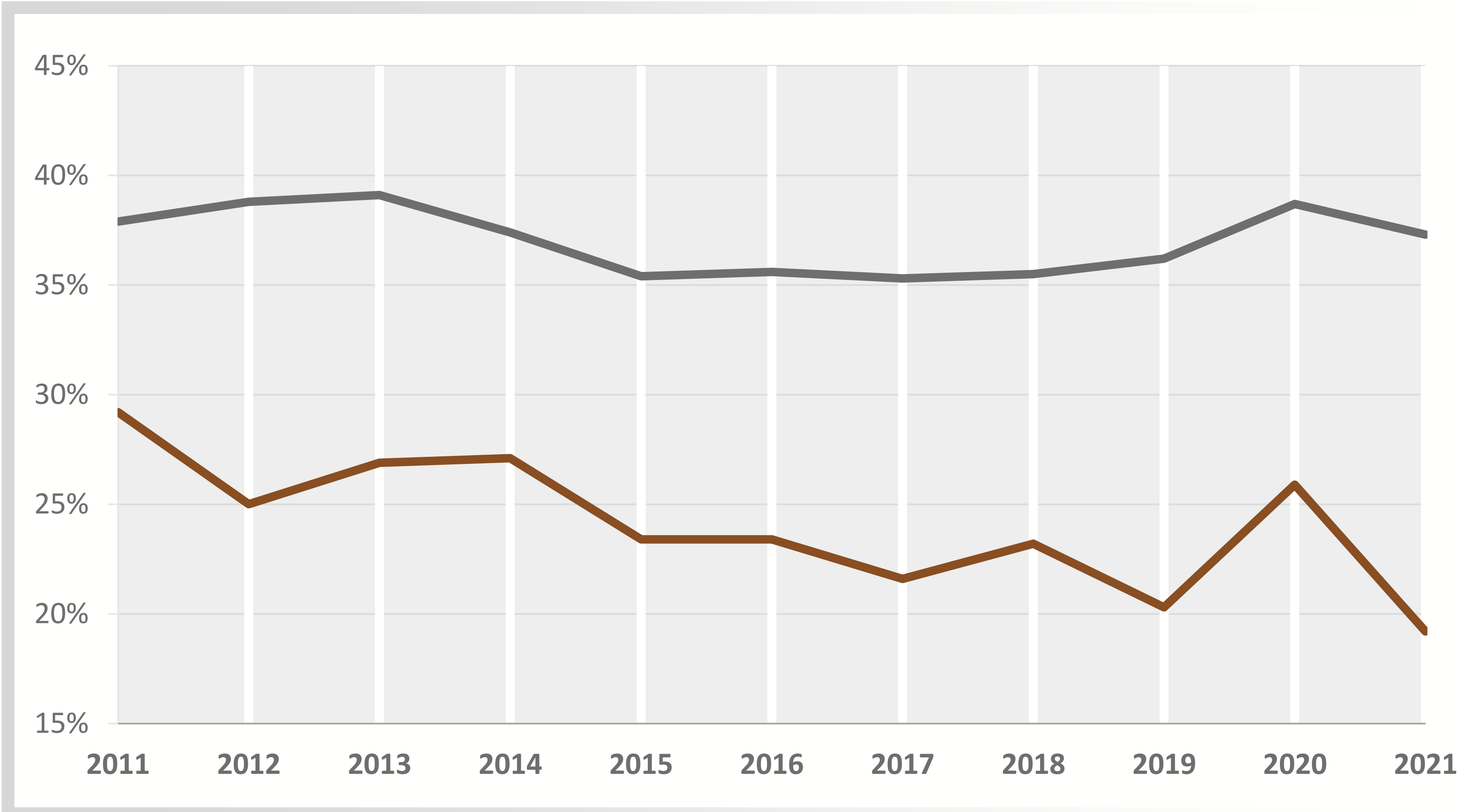
> For these businesses, I have assumed 11% growth p.a. It is worth noting that, pre-Covid, those businesses all grew above 20% p.a. - but they were also at a less mature stage

Margins

We have assumed a ca. **30bps p.a. operating margin expansion** over the time period (2020-2025, with an uneven distribution, before SBC). This is roughly in line with what SAP is aiming and guiding for and would naturally make sense given increased benefits of scale. We do think that there is tremendous margin potential at SAP over and above that level, as we only assume a 20% operating margin in 2025 for them.

However, SAP does not have an aggressive commercial culture/ more margin potential was always there and never really lifted. Thus, there is big potential upside, but we would not see that in the base case.

SAP vs. Oracle



Oracle
Operating Margin %

SAP
Operating Margin %

Source: Capital IQ **As of:** 31.12.2021

Outcome, Returns and Recommendation

With our modest current assumptions we should get to ca. 5%+ topline growth (core ERP at 2,5% CAGR) to ca. 35,5bn revenues and ca. 6%+ earnings growth per year.

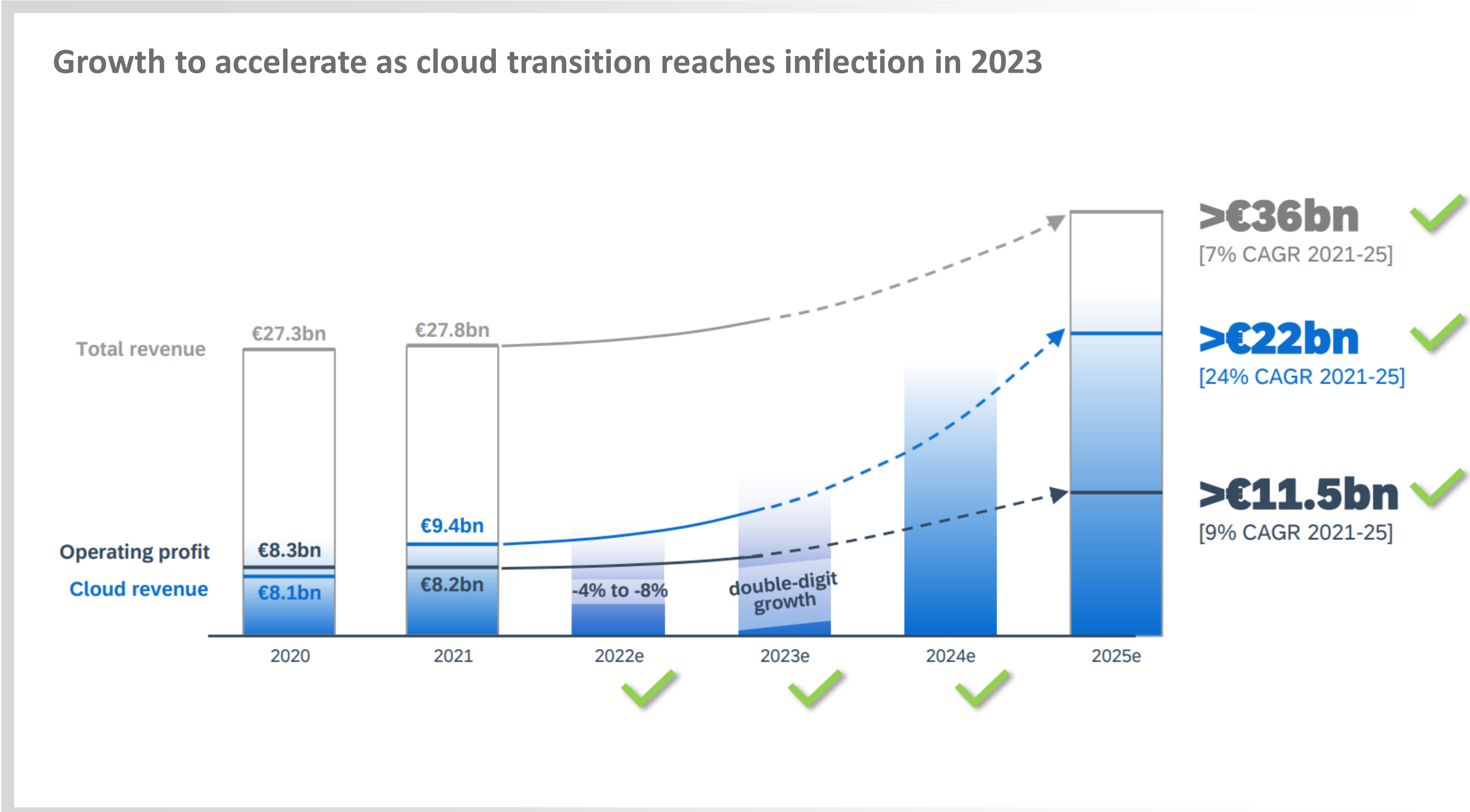
Slower growth in the early years, and then growth speeding up in the latter years, as the transition progresses. This is largely following SAP guidance for the near term.

Over time either customers will churn from SAP R3 or convert. So even after 2025 it is fair to assume roughly 6% top line growth.

Inflation, if structurally higher will add to nominal growth since it will be passed on through the pricing power

Main risk: execution of transition

Total revenue and operating profit



Source: SAP Third Quarter 2022 Results Presentation

SAP - The Opportunity

Valuation

- EV/EBIT incl. SBC at ca. 23x and 19x respectively for 2022/2023
- Company aims for 11,5bn operating profit in 2025. If they achieve this, we trade a touch above 13x 2025 (after-SBC).
- Balance sheet strong, with close to 1bn net debt only, ca. 0,1x net debt/EBITDA
- ROE was at ca. 15% in 2021, 17% in 2020
- **Expected 5Y TSR at €106 per share = around 10%**

The Business Owner

- Founders of SAP are still owners of the company and some of them are still actively engaged
- Dietmar Hopp Stiftung still owns around 6% of shares (Source: Capital IQ)
- Hasso Plattner owns close to 7%
- Hasso Plattner is a board member
- Governance is far from great though

Frankfurter Modern Value Index & ETF

Characteristics

WKN
FRA3TF

FRANKFURTER UCITS-ETF – MODERN VALUE

- 25 wonderful businesses chosen by SVM with the highest expected total shareholder return (TSR) over the next 5 years
- Quarterly re-composition and equal weighting of the top 25 stocks at 4% each
- 100% investment exposure (fully invested)
- Full transparency of all stocks
- Continuous price fixing
- Index and ETF are live:
    - Bloomberg: FRAX Index
    - Bloomberg: ETF LU2439874319

Frankfurter Modern Value Index & ETF

Index components

FRANKFURTER UCITS-ETF – MODERN VALUE

ADMIRAL GROUP plc
Adobe
airbnb
Alibaba
Alphabet
amazon
ABInBev
AUTODESK
BD
Booking.com
Charter COMMUNICATIONS
DiaSorin
Meta
Microsoft
NETFLIX
ORACLE
reckitt
RECORDATI
Roche
RYANAIR
SAP
Unilever
VERISIGN
VISA
zoetis

4,05% allocation currently

Source: Solactive **As of**: 12.2022

SHARE HOLDER VALUE

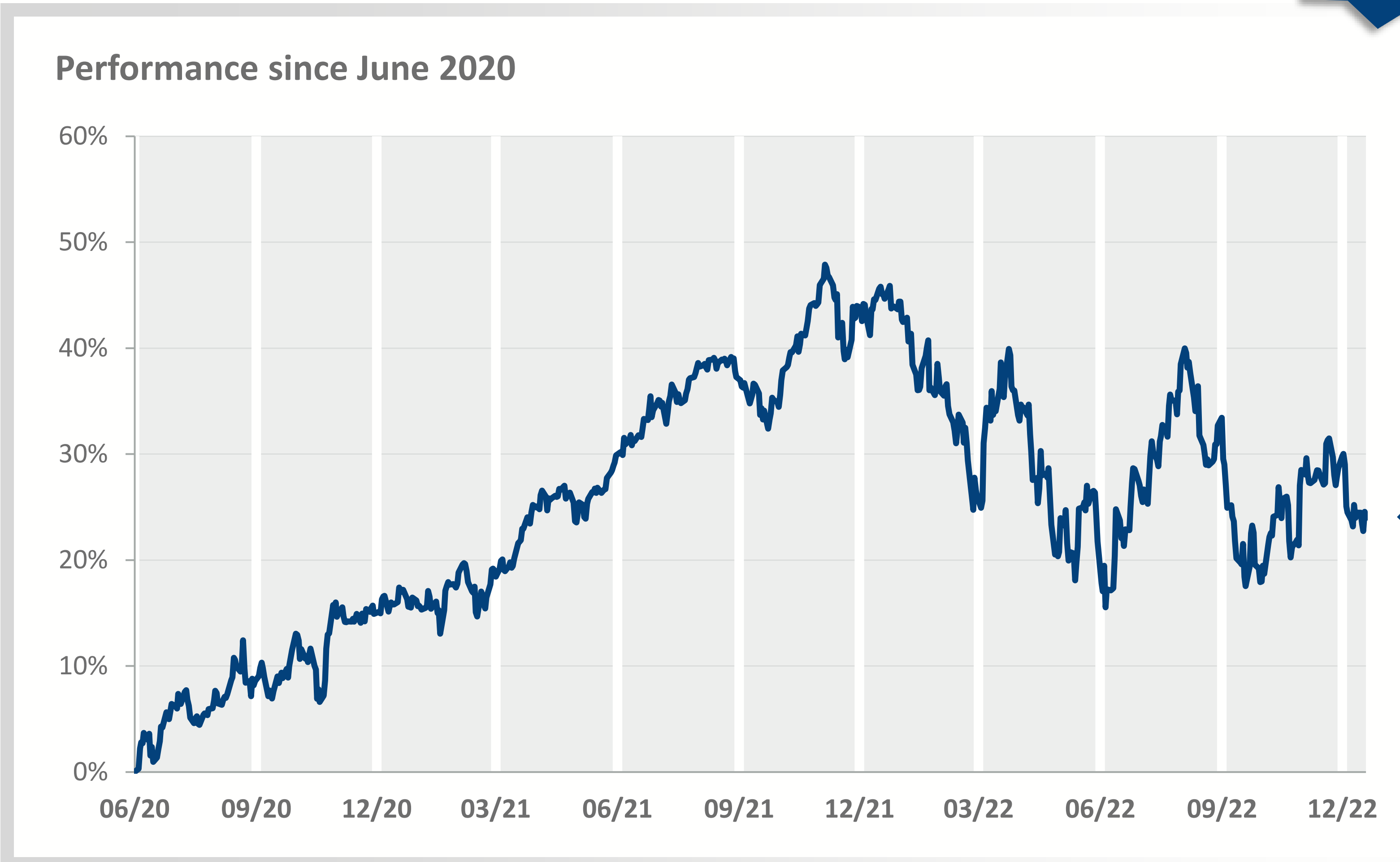
SAP – a SAAS story

Frankfurter UCITS-ETF – Modern Value

Performance since 12.06.2020

WKN **FRA3TF**

FRANKFURTER UCITS-ETF – MODERN VALUE



Frankfurter Modern Value Index

Source: Bloomberg, own depiction, *Frankfurter Modern Value Index (based on a backtest from 12.06.2020 to 16.06.2021) **As of:** 30.12.2022
Inception of the Fund: 29.07.2022 | **Past performance is not a reliable indicator of future performance**

The Frankfurter Funds Family
Small & Mid Caps | Balanced Funds | Equity Index

- Capital preservation and positive real returns via sustainable **Modern Value Equity or dynamic Balanced Funds** depending on risk appetite
- Primary goal is **long-term wealth creation with lower volatility** compared to the stock market
- Preference of **owner- or family-managed wonderful companies**
- **ESG sustainability research** with Sustainalytics based on exclusion criteria and complementary internal monitoring
- **Long-standing expertise** of fund management & **owner-managed** fund advisors

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FRANKFURTER INVESTMENT BLOG

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