BEHIND THE NUMBERS
Quality of Earnings Analysis

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International Business Machines Corporation (IBM)
Earnings Quality Update- 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are cutting our earnings quality rating on IBM to a 2- (Weak)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

After steering investors to focus on revenue and cash flow instead of earnings, IBM promptly missed 4Q revenue targets with total sales down 6.5% with revenue down in every unit – not just global financing that is being wound down. They are also focusing investors on free cash flow as well where their adjusted figure was flat for 4Q at $6 billion and down $1 billion for the year at just under $11 billion. Working capital provided much of 4Q cash flow – primarily a nearly $1 billion increase in taxes payable that will be paid in 2021. We will likely need the 10-K to explore this quarter for more specifics on where $2 billion in charges was fully allocated. One item that jumped out was the spin-off/restructuring announced in October (4Q20) with the plan that it would cost $2.5 billion - $1.5 billion in cash (including taxes) and $1.0 billion non-cash. Now after 4Q20, the plan is already at $4.0 billion in cash costs expected with ~$3 billion in 2021. We also think the forecasts of restructuring to boost margins and grow revenues works out to produce about the same results as 2019 and even 2018 in terms of actual earnings.

What is strong?

- IBM is certainly not broke. Cash is about $14 billion and it continues to sell and wind-down financing receivables. Those declined by $4.9 billion in 2020 to $18 billion. It expects this cash on hand and further cash inflow from reducing those receivables to more than cover its $4 billion in restructuring/spin-off cash costs, its $6 billion dividend, and retire about $7 billion in debt. Plus, it will produce operating cash flow during the year. The issue arises longer term when the receivables no longer provide huge amounts of annual cash flow and IBM continues to service a growing $6 billion dividend, its appetite for more acquisitions, capital spending of $3-4 billion, shareholders who like share repurchases, and about $54 billion in debt as it invests cost savings from restructuring into the business. Even IBM is only calling free cash flow of $12 billion – the dividend alone will consume half of that.

- IBM did see more spending in R&D in 2020, up $344 million or 6%. Also, we noted in 2019 that capital spending declined and it was up to $3.5 billion in 2020 from $2.9 billion. That is still below the level of spending in both 2017 and 2018 when IBM was a smaller company.

What is weak?

- It was reported on the call that IBM used a considerable amount of the $2 billion charge already taken to restructure contracts. This is the type of restructuring we find clouds the picture the most. If the contract was unfavorable to IBM, they had to entice the client to make a change: give them the equipment rather than rent it, cut their payments or write a check to convince them to change, etc. Then IBM can ignore that upfront cost as it's part of the restructuring and claim the profitability is now much better if they compare apples-to-oranges. Here is the CFO on the call,

  *"We continue to take a disciplined approach to improving our margins and overall financial profile. As part of this, **a considerable portion of the $2 billion charge for structural actions was for GTS. We also have taken steps to restructure existing contracts and further reduce activity in lower value offerings**. These actions impacted our revenue performance this quarter but contributed to the gross margin expansion of 70 basis points. All of this positions NewCo for an improved margin, profit, and cash generation profile."*

  The CEO noted that customers have been promised more access to both companies in the future with their new contracts. We wonder if some of these future expenses for these enticements to change contacts were run through the $2

billion charge IBM took. We see that often when a company writes off fixed assets, but still uses them in the future and touts improved profitability. Right, there's no ongoing depreciation expense because it vanished in the restructuring charge. Here are the CEO's comments:

> "*we have by and large gotten very positive feedback over 98% of them are quite satisfied with our description of what'll happen both in terms of their contracts, the service they'll get from us and the assured guarantee of access to technical resources, both from the new company and from IBM over time."*

- The changing size of the restructuring plan is also worrisome. Normally companies get past a few weeks before they suddenly expand a major restructuring plan. On October 8, 2020, the spin-off plan was expected to cost $1.5 billion in cash and $1.0 billion in non-cash charges and investors were told to expect a charge of $2.3 billion in 4Q. Now on January 21, 2021, IBM makes the following claim in its presentation, *"Adjusted FCF (of $11-$12 billion in 2021 and $12-13 billion in 2022)* ***excludes cash impacts from structural actions*** *and transaction costs associated with the separation of managed infrastructure services business;* ***Company expects ~$4 billion over 18 months with ~$3 billion in 2021."*** It sounds to us that the cash costs just rose to $4 billion.

- Falling ROI was one of our big concerns in looking at IBM's history. We noted in the original report that ROI used to be about 20%-22% before it started to become an acquisition machine and inflated the debt on the balance sheet. IBM made over 170 acquisitions – where much of the purchase price is recorded as goodwill, not amortized, and thus inflates operating income compared to what it would be if they built assets in-house. Even with that built-in inflationary impact on operating income, operating income was basically flat in 2017-18 compared to 2005 and down in 2019 and 2020. ROI was about 14% in 2019 and even adding back the $2 billion charge for 2020, ROI is now about 10%.

- Free cash flow for 4Q is reported as flat y/y at $6 billion, which excludes the impact of financing receivables that IBM has been selling and letting others run-off in a wind-down situation. However, 4Q20 had almost $1 billion in cash flow from a rise in taxes payable. IBM is warning of a $1 billion tax headwind for 2021 as part of the spin-off so that source of cash flow that makes 4Q20 look flat, appears very temporary.

- Is IBM actually predicting much growth at all? Listening to the earnings call – it was said over and over "we're going to grow sales and expand margins." Despite that, revenue fell across the various divisions, signings are down, backlog is down for units reporting it.

- IBM is guiding to Free Cash Flow of $11-12 billion in 2021 (excluding the restructuring) and $12-13 billion in 2022. That will be with all the new margin enhancements and growth potential well in-place. But, working backwards, IBM normally spends about $4 billion on Capital Spending and Software. So, they are looking for Cash from operations of $15-17 billion. Here are the main components of Cash Flow without working capital:

	2022 est	2021 est	2020	2019	2018
Net Income	$8-$9	$7-$8	$5.9	$9.4	$8.7
Depreciation/Amt	$7.0	$7.0	$6.7	$6.1	$4.5
Stock Comp.	1.0	1.0	0.9	0.7	0.5
Basic Cash from Ops	$16-$17	$15-$16	$13.5	$16.2	$13.7
Less CapX and S.W	$4.0	$4.0	$3.5	$2.9	$4.0
Free Cash Flow	$12-$13	$11-$12	$10.0	$13.3	$9.7

Looking at this more closely, IBM was earning $9 billion in 2018 and 2019. In 2020, we adjusted for the $2.0 billion charge and the $939 million tax benefit from transferring intangible assets to a foreign entity and just used a 12% tax rate to reach net income of $5.9 billion. The company's non-GAAP earnings largely add back amortization of acquired intangibles – the cash flow statement does that too so we used GAAP net income. This is a simplistic view of things focusing more on the big picture. The company cannot talk enough about Red Hat, it didn't own that in 2018 and had it for part of 2019. Yet the company appears to be guiding to flat income for 2021 and 2022 compared to those years with multiple years of growth for Red Hat.

- There are two wild cards for the company's guidance. Paying down more debt could provide a tailwind to earnings and cash flow. Currently, interest expense is just under $1.3 billion. Debt reduction may also be hindered if IBM continues to make several acquisitions. Also, working capital could be a positive or negative on cash flow. Normally, when a company is a growth mode – working capital consumes cash. IBM excludes the receivable run-off from the global financing in all its discussions about free cash flow, so that tailwind may help reduce debt, but should not be seen as a free cash flow generator from operations.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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